

The Johnson Legacy and the Obama Challenge

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This is my father's centennial year, as well as Lyndon Johnson's. They were friends, fellow New Dealers, and allies in the quest for the Great Society. My father felt that it was a debt of honor, for him to come to Austin, to this library, in the 1990s to pay tribute to President Johnson, to heal the rift over Vietnam, and to honor the immense achievements of the Johnson administration in the economic and social sphere.

I regret that the press of events this fall, including the financial crisis and the passing of my mother—who danced the Charleston with President Johnson on Bermuda in 1961—impeded the preparation of a full paper for this conference. But perhaps it is just as well. Last summer we were discussing, with hope but also some skepticism, projects like universal health insurance and universal pre-kindergarten, which would help fulfill the promise of the Great Society. Today we are on to a more ambitious agenda, the resurrection of the New Deal.

We have been thrown back to this by events in the financial sector, eerily prefigured by the follies of the 1920s, as detailed in my father's classic and current bestseller, *The Great Crash*. Amazingly, it took just nine years from the repeal of Glass-Steagall to reproduce the central pathology of that earlier time: the rampant peddling of toxic securities confected from worthless assets to an investing public that never quite gets the word. The deep springs of human folly flow ever into the wells of finance. But when the wells are poisoned—as they were then and are now—many years can pass before we drink from them again.

How were the wells polluted and by whom? Some blame Fannie Mae and Freddie Mac, the great quasi-public housing agencies, but their role in sub-prime securitization was relatively small. The trouble arose primarily in unsupervised mortgage originators like Countrywide Financial and IndyMac, those who underwrote the resulting securities, like Citigroup and Lehman Brothers, and those who rated them, like Moody's and Standard and Poor's. At the bottom of the pile were borrowers, some fraudulent but most just naive victims of the hard sell, who accepted loans based on incomes and credit histories they didn't have, on houses that were systematically over-appraised, on terms timed to explode within two years or three. At the top were the Credit Default Swap speculators, whose bets on the chance of non-payment metastasized risk through the system. Overlooking all was a complaisant state—a Predator State—that combined commercial and investment banking, relaxed the underwriting rules, legalized and deregulated the default swaps, desupervised the mortgage originators, and resolutely ignored warnings of massive fraud from the FBI and other sources.

The result is the first full-fledged financial collapse since 1929. I say this very carefully, because it is necessary to adjust ideas. Lyndon Johnson presided over years of stable postwar prosperity, of full employment with mild inflation and the dollar at the center of a world system. In 1970,

1974, 1980, and 1981-82 we had recessions; but they were shocks to a stable system: the oil shocks of 1973 and 1979, the Volcker interest-rate shock of 1981. These were events you could model, from impact to effect. The present slump has no similar external cause. It is the result of an internal system failure, at the heart of the mechanism that makes the capitalist economy run. We have no known way to calibrate the scale of consequences of this event, nor their duration. In particular, the method of averaging past postwar recessions, which is perfectly defensible in normal times, cannot apply. These are not normal times. We have in the past two months been overwhelmed by crisis, and repeatedly surprised by adverse events. There is no reason, now, to expect this to stop. And therefore there is no reason for any attitude except realistic pessimism and grim determination.

An astonishing feature of this crisis is the almost complete vacuum of formal economic ideas with which to analyze it. The relevant masters: Keynes, Galbraith, and Minsky, were shunted aside in academic economics decades back. Their place was taken by a generation whose ideas draw on Walras, Hayek, and Friedman, who held that the economic system is inherently stable, that unemployment tends to a natural rate, that control of inflation is the only legitimate goal of central banking, that otherwise government should do very little and that the pursuit of full employment in the Johnson administration was, as Professor Christina Romer put it in a paper delivered here in September 2007, a “mistaken revolution.” For Professor Romer, LBJ was the author of “inflation and instability”—though why Johnson rather than Nixon should be blamed for the inflation of the 1970s is not clear—and the hero of modern macroeconomics is Ronald Reagan, who had the courage to drive unemployment up to 11 percent in 1982 so as to end inflation once and for all. Thus, she wrote, “The costly wrong turn in ideas and macropolicy of the 1960s and 1970s has been set right, and the future of stabilization looks bright.”

This, let me stress, is not the conservative vision. It is the standard view of the entire economic establishment. It is a sign of the fact that there is, in the panoply of what is called mainstream economic knowledge in our day, practically no sign of an awareness of how badly wrong things can go. Until they do.

Roosevelt’s economists had a different view, as did their direct descendants who worked for Lyndon Johnson, and this I think justifies treating the New Deal and the Great Society as a single coherent whole. That generation was bred in the Depression and understood the instability of finance, the importance of regulation, and the role that government can play. There has been considerable controversy in recent days over what the New Deal did or did not do, with many repeating the oft-stated view that it took the war to end the Depression and some arguing that it did nothing important at all. In a new paper Marshall Auerback corrects this record, summarizing the actual accomplishments of those years:

The key to evaluating Roosevelt's performance in combating the Depression is the statistical treatment of many millions of unemployed engaged in his massive workfare programs. The government hired about [40] per cent of the unemployed in public works and conservation projects... It also built or renovated 2,500 hospitals, 45,000 schools, 13,000 parks and playgrounds, 7,800 bridges, 700,000 miles of roads, and a thousand

airfields. And it employed 50,000 teachers, rebuilt the country's entire rural school system, and hired 3,000 writers, musicians, sculptors and painters...

By calculations now widely accepted, the New Deal reduced unemployment by more than half, from well over 20 percent in 1933 to under 10 percent by 1936, and then, after a lapse in 1937, to 10 percent again by 1940. Let me add that under Lyndon Johnson the unemployment rate fell to under 4 percent for three years in a row, though with mild inflation that was already subsiding by the time he left office in 1969. It is impossible to know whether we would have had the inflation except for the economic influence of the Vietnam war; the test of whether peacetime full employment is possible without inflation was left to the late 1990s. But then, the Clinton boom reduced joblessness once again to under 4 percent for three years running, and proved that, in fact, full employment without inflation is entirely possible.

Further, we have the good fortune today to have come through the New Deal and Great Society and through the 40 years since then with most of the institutions then erected still intact. We still have deposit insurance and Social Security and Medicare and Medicaid. These institutions and the memory of others like the Home Owners Loan Corporation and the National Youth Administration and the Job Corps and the Office of Economic Opportunity and Manpower Development and Training give us something to work with going forward, if we can only bring the history to mind. So too does the Employment Act of 1946 as revised by the Humphrey-Hawkins Full Employment Act of 1976, a delayed legacy of the LBJ years. The Roosevelt-Johnson legacy makes our lives vastly easier now, because we can retrace what they did, and because we can build on the institutions they built.

What then is the agenda ahead? Let me lay things out in rough order of legislative rather than economic priority, that is by urgency of enactment and implementation rather than the scale or duration of effect.

We must first stabilize the financial system, quelling panic and stopping runs. The essential steps are already worked out by trial and (mostly) error, which could have been avoided if the advice I gave in the Washington Post on September 25 had been accepted straight away. But over two months we got there, abandoning an unworkable "market friendly" plan to buy back toxic assets to a more sensible plan involving (a) expanded deposit insurance, (b) support for commercial paper and money market funds, (c) nationalization of Fannie Mae, Freddie Mac, and AIG, and (d) partial nationalization and recapitalization of the banks. We then learned what we should have known: none of this will revive the economy. Even with fresh capital banks are unwilling to lend; even were they willing to lend they would have trouble finding families and businesses willing to borrow, and with incomes and collateral to support the loans.

The next steps must therefore target the real economy.

At the top of the list, we find revenue-sharing and an infrastructure fund. There is a lot of talk in the news about capital investment, which is very important; a few days ago the National Governors Association defined the need at \$136 billion over 18 months. It is no less important to backstop state and local public services and the people who provide them; if this is not done

there will be a major collapse in the public sector early next year. Increasing the Medicaid match is one easy and effective way to get money to the states to prevent this.

To deal with the industrial crisis, reinvent the Reconstruction Finance Corporation, created under Hoover but run under Roosevelt by a great Texan, Jesse Jones. The RFC lent to firms and kept them alive while they developed new production plans and technologies. Meanwhile, to get a large share of health care costs off the books of the major industrial employers, especially the auto companies, let's call an LBJ institution into action, and lower the age of eligibility for Medicare to 55.

In housing, we need a foreclosure moratorium, mortgage renegotiation, and mass write-downs of the terms of adjustable rate mortgages, something now getting underway through Fannie Mae, Freddie Mac, and nationalized banks like IndyMac. This is a capital transfer to homeowners, permitting them a stable and sustainable housing payment so long as the rest of the economy is stabilized so that they do not lose their jobs. Achieving this is not a small job: it required 20,000 people at the HOLC to monitor and manage a million mortgages in the 1930s.

The American elderly, and those who plan to be elderly soon, have suffered a 40 percent loss in the value of equities in their 401(k)s over just the last year. This will translate, quite soon, into a major loss of purchasing power. Individual losses cannot be made good, but suffering can be averted and the economy as a whole protected by a simple device: raise the basic Social Security benefit, say by 30 percent, beyond the cost of living, for the first time in a generation.

The above measures could easily total \$450 billion per year of direct spending, plus an estimated \$80 billion of mortgage relief if all ARM's were written down to 4 percent and fixed at that rate.

Finally, if more is needed and it may be, there is the payroll tax. Let the government pay the contribution to the Social Security Trust Fund for a period of three to five years. Cutting the payroll tax would add about 8.3 percent to the after-tax incomes of working people, and a similar amount to the balance sheet of their employers, which could be used to create new jobs. The numbers can be made as large as needed, up to another \$900 billion per year. Overall, we've just identified over \$1.4 trillion in potential economic relief, or around 10 percent of GDP. That would place the range of expansionary fiscal policy between the levels of the New Deal and those of World War II. If results are favorable at smaller sums, the payroll tax tier can be scaled back, with the total coming in between 6 and 8 percent of GDP.

The third necessary step is financial sector reform. The world of sub-prime securitization, over-the-counter credit default swaps, tax havens and regulation-evading shell corporations is a world that fosters fraud, abuse, distrust and systemic risk. It is a world brought down by *systemic distrust*, by the fact that bankers no longer trust their counterparties. The *bona fides* of the credit system, and therefore the economic growth, and the tax revenue, for which we rely on this system, cannot be restored until this world ends. Going forward there can be no global finance without effective global financial regulation. Strict compensation limits on banks receiving public rescue funds should encourage an entire generation of top bankers to retire, the sooner the better. When this happens, new management can get control of the books, the personnel, and the practices of the banking system. And trust can begin to be restored.

As recovery takes hold, new tasks will come to the fore. An effective energy policy is necessarily integral to an economic recovery program, for four reasons. First, the survival of the planet depends on getting control of the emission of greenhouse gas. Second, the long-term economic viability of the country depends on developing the new, energy efficient technologies, in generation, in transportation and in the appliances of daily life, that can form the basis of our export trades. Third, the act of investing in these new technologies and enterprises will motivate the flow of capital to this country and support the position of the dollar. And fourth, and most immediately, failure to control the demand for oil in an economic recovery will simply hand the price weapon straight back to the Saudis, the Iranians, and others who do not have our best interests at heart.

Finally, in this country we underrate a central reason for the macroeconomic success of the Johnson years. That is, that they occurred under the umbrella of a stable, dollar-centered world economic system, created at Bretton Woods in 1944. We are today again (or still) in a dollar-centered system, but it is an unstable one. It is based on nothing more than the willingness of China, Japan, and other countries to hold U.S. Treasury bonds and bills. They do so in their own interest, to be sure, and are unlikely to stop without grave provocation. But many countries are left out of this system, and suffer much more than we do from the caprice and predation of unregulated finance. And our own position, however favored, is insecure. The economists of the Johnson era, notably my father and Walt Rostow, understood that the fortunes of the United States cannot be disentangled from the progress of India, Africa, Latin America, and the rest of the developing world. President Johnson understood this very well. In the years since, we have forgotten. But now, with the world in turmoil, we would be well advised to rediscover this deep truth, and to set ourselves the task of again designing a functional world economic system, dedicated effectively to stable economic development, to the reduction of poverty and to the protection of a fragile and endangered planet.

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