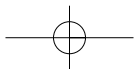
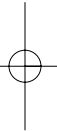
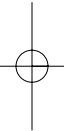
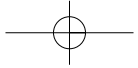


# Looking for Solutions to the Crisis

Proceedings from the international conference  
**The Financial Crisis, the US Economy,  
and International Security in the New Administration**

Organized by  
Economists for Peace and Security,  
Charles Leopold Mayer Foundation  
International Initiative for Rethinking the Economy  
Levy Economics Institute of Bard College

Schwartz Center for Economic Policy Analysis, New School for Social Research,  
New York, November 14, 2008





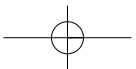
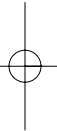
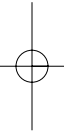
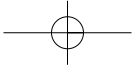
INTERNATIONAL INITIATIVE FOR RETHINKING THE ECONOMY

Launched and supported by the Charles Leopold Mayer Foundation, the International Initiative for Rethinking the Economy (IRE) promotes innovative solutions within the field of economic thought. Our mission is to identify and develop themes and proposals that call for innovation, have a potentially significant impact on society and lend themselves to practical applications.

Operating in a field where concrete social and environmental issues intersect with economic theory, we focus on five major themes: money and finance, institutional arrangements, regulation of goods and services, the role of territories and trade patterns. In all these domains, we encourage theoretical work and promote initiatives capable of leading to new proposals. We cherish ideological, disciplinary and cultural diversity and want to assist those who think, act and innovate in the economic field.

IRE has established an online documentary base in order to bring together and diffuse innovative proposals. It also organizes and supports seminars and publishes economic works.

**[www.i-r-e.org](http://www.i-r-e.org)**



## Foreword

The global financial crisis that has been unfolding before our eyes since Summer 2007 marks a turning point in the recent history of globalization. The wave of deregulations and the unprecedented expansion of the financial sector that took off in the early 1980s seems to have come to an end and the consequences are everywhere to see. Scholars, regulators and politicians across the world search for solutions, wondering how the system should be reformed. This debate has just begun but it seems clear that the difficulties will not be overcome by spontaneous market adjustments or minor regulatory interventions. What we need is a new financial architecture, built upon new policies and new regulations.

The International Initiative for Rethinking the Economy is part of this reflection. Since June 2008, we have hosted an international seminar on this issue, gathering together a group of prominent finance and financial regulation experts, both scholars and practitioners. The members of this group come mostly from North-America but other parts of the world, like Europe, China and Brazil, are also represented. This is not a coincidence. We believe that the United States still has a key role to play in the search for a new financial architecture. Nevertheless, the problems we are facing are global. Our efforts should be global as well.

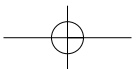
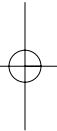
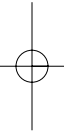
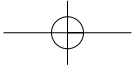
Our hope is to move gradually from diagnosis to policy proposals. One step in that direction was taken in November last year, when we organized an international conference in New York at the Bernard Schwartz Center for Economic Policy Analysis together with The Economists for Peace and Security, The Levy Economics Institute and the Charles Léopold Mayer Foundation.

The document you hold in your hands presents the proceedings of that conference. Our purpose was not to make a policy proposal but to identify key issues that we want to focus on in our future work. And we believe these issues have been clearly identified.

We would like to express our gratitude to people without whom this event would not have been possible, especially Pierre Calame, Director of the Charles Léopold Mayer Foundation, Professor James K. Galbraith, President of The Economists for Peace and Security, Thea Harvey, Director of The Economists for Peace and Security, and Gilles Raveaud, Assistant Professor at the Paris VIII University.

**Aurore Lalucq, Director**

**Wojtek Kalinowski, Head of editorial and publishing**





### **The Levy Economics Institute of Bard College**

Founded in 1986, The Levy Economics Institute of Bard College is an autonomous nonprofit public policy research organization. It is non-partisan, open to the examination of diverse points of view and dedicated to public service. The Institute believes in the potential for economic study to improve the human condition. Its purpose is to generate viable, effective public policy responses to important economic problems. It is concerned with issues that profoundly affect the quality of life in the United States, in other highly industrialized nations and in countries with developing economies. [www.levy.org](http://www.levy.org)

### **Economists for Peace and Security (EPS)**

EPS is an international network of thirteen affiliated organizations promoting economic analysis and appropriate action for peace, security and the world economy. It seeks a world whose people are secure, free from fear and want, where economies distribute goods and services efficiently and for the benefit of all. EPS works locally, regionally and internationally to reduce the military burden and to effect policy changes that can build a more just and peaceful future.

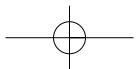
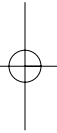
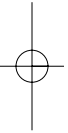
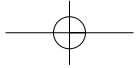
[www.epsusa.org](http://www.epsusa.org)

### **Schwartz Center for Economic Policy Analysis (SCEPA)**

The Schwartz Center for Economic Policy Analysis, made possible through a generous gift from Irene and Bernard L. Schwartz, is the economic policy research arm of the New School for Social Research Department of Economics. Our focus is on the U.S. economy, but always with an awareness of the global context of U.S. economic developments. Our research is focused on economic growth and development, equity and living standards, employment. Our activities include economic policy workshops, scholarly books and conferences, and annual lectures. [www.newschool.edu/cepa](http://www.newschool.edu/cepa)

### **Charles Léopold Mayer Foundation for Human Progress**

Founded in 1982, the Charles Léopold Mayer Foundation for Human Progress is an independent foundation under Swiss law. Its mission is to support the emergence of a world community and to contribute to three major changes that humankind must bring about in the 21st century: a revolution in governance in order to manage the new interdependence between human beings, between societies, and between humanity and the biosphere; the search for a universal ethic of responsibility; the creation of a sustainable society. [www.fph.ch](http://www.fph.ch)



## The participants

### **Marcellus Andrews**

Marcellus Andrews earned a BSBA from the Wharton School of the University of Pennsylvania as well as an MA, MPhil and PhD in economics from Yale University. Andrews is at present a professor of economics at Barnard College of Columbia University. His current book projects are *Economic Policy and the Road to Social Justice* (completed manuscript) and *Re-imagining American Freedom* (in progress).

### **Marshall Auerback**

Marshall Auerback has 25 years of experience in the investment management business, serving as a global portfolio strategist for RAB Capital Plc, a UK-based fund management group with \$4bn under management since 2003. He also serves as a consultant to PIMCO, the world's largest bond fund management group and a director of Pinetree Capital in Toronto, Ontario, Canada. From 1983-1987, he was an investment manager at GT Management (Asia) Limited in Hong Kong, where he focussed on the markets of Hong Kong, the ASEAN countries (Singapore, Malaysia, the Philippines, Indonesia, and Thailand), New Zealand and Australia. From 1988-91, Mr Auerback was based in Tokyo, where his Pacific Rim expertise was broadened to include the Japanese stock market. From 1992-95, he worked in New York for the Tiedemann Investment group, where he ran an emerging markets' hedge fund. From 1996-99, he worked as an international economics strategist for Veneroso Associates, which provided macroeconomic strategy to a number of leading institutional investors. From 1999-2002, he managed the Prudent Global Fixed Income Fund for David W. Tice & Associates, a USVI-based investment management firm, and assisted with the management of the Prudent Bear Fund. Mr Auerback graduated magna cum laude in English & Philosophy from Queen's University in 1981 and received a law degree from Corpus Christi College, Oxford University in 1983.

### **William K. Black**

Bill Black is an Associate Professor of Economics and Law at the University of Missouri-Kansas City. He is the Executive Director of

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the Institute for Fraud Prevention. He has taught previously at the LBJ School of Public Affairs at the University of Texas at Austin and at Santa Clara University. He has held positions as attorney with Squire, Sanders and Dempsey, litigation director of the Federal Home Loan Bank Board, deputy director of the Federal Savings and Loan Insurance Corporation, Senior Vice President and General Counsel of the Federal Home Loan Bank of San Francisco, and Senior Deputy Chief Counsel, Office of Thrift Supervision. He was deputy director of the National Commission on Financial Institution Reform, Recovery and Enforcement. He recently helped the World Bank develop an anti-corruption initiative.

**Jack A. Blum**

Jack Blum is counsel to the law firm of Baker and Hostetler and is based in Washington. His law practice includes compliance work for banks and brokers and well as consulting for the Internal Revenue Service on offshore tax evasion. He currently represents the man who turned Liechtenstein bank records over to thirteen governments. He was counsel to the Antitrust and Monopoly Subcommittee and the Senate Foreign Relations Committee for a total of fourteen years. During that time he investigated financial fraud and money laundering. The most notable investigations include an investigation of sub-prime lending (1969-1970), international banking (1974), Lockheed aircraft's bribery for foreign officials (1975-6), drug trafficking and related money laundering (1986-88) and the Bank of Credit and Commerce International (1988-89).

Mr. Blum was co-author of a UN report on offshore havens (1999) and he chaired a UN experts group on asset recovery (200-2002). He is currently Counsel to Americans for Democratic Action, and the National Consumers League, Board Chair of the Violence Policy Center, and a board member of the Fund for Constitutional Government and Global Financial Integrity. Most recently, working with the Norwegian government, he has been named to the advisory board of a World Bank study of illicit financial flows.

**Luiz Carlos Bresser-Pereira**

Luiz Carlos Bresser-Pereira is an economist and social scientist. He is emeritus professor at Getulio Vargas Foundation; edits the *Brazilian Journal of Political Economy* since 1981; offers regularly a one month course at the École de Hautes Études en Sciences Sociales; and writes every two weeks a column for *Folha de S. Paulo*. From 1963 to 1982, while keeping his academic activities, he was vice-president of the

large retailing company, Pão de Açúcar. In 1983, with the election of the first democratic governor to São Paulo, Franco Montoro, he became president of the state bank of São Paulo, and two years later, chief of staff of the governor. In April 1987, in the aftermath of the Cruzado Plan crisis, he became Finance Minister of Brazil: he was able to reestablish economic order, but, given the lack of political conditions for the required fiscal adjustment, he resigned from the ministry at the end of that year. His proposal for solving the debt crisis through securitization of the debt with a discount was 18 months later adopted by the Brady Plan.

In 1995 he was invited to become Minister of Federal Administration and Reform of the State, in the first Fernando Henrique Cardoso administration. In this capacity he introduced the 1995 Public Management Reform, which is today recognized internationally. In 1999 he was, for six months, Minister of Science and Technology.

He is member of the boards of several non-profit organizations. Since July 1999 he has been fully dedicated to the academic life at Getulio Vargas Foundation, where he teaches economics and political theory, and orients PhD candidates. He was visiting professor giving regular graduate courses on development economics at the University of Paris I (1978), and on political theory of modern democracy at USP's Department of Political Science (2002-2003). He was also visiting fellow at USP's Institute of Advanced Studies (1989) and at Oxford University's Nuffield College (1999) and St. Anthony's College (2001).

### **Pierre Calame**

Pierre Calame has for twenty years been Senior civil servant in various positions related to physical and urban planning, housing, international cooperation. In 1985 he was appointed General Secretary of Usinor, the industrial group in the iron and steel industry. Since 1988, he is the General Director of the Foundation Charles Léopold Mayer for the Progress of Humankind, a Swiss-based international foundation, devoted mainly to the mobilization of knowledge and experience to help face the next decade's major challenges.

Pierre Calame is the member of the Founders' Committee of the China Europa Forum. He is working on the development of a dialogue between Chinese and European societies, a prototype of what could be in the future the society-to-society dialogue between other parts of the world. Author of numerous books and publications, his most recent work is "Essai sur l'oeconomie" (ECLM 2009) in reference to the Greek word "Oikos", meaning "home".

**Ping Chen**

Ping Chen, co-director of Virtual Center for Complexity Science teaches economics at the China Center of Economics Research. As a young figure among Chinese reformers since 1978 he was one of the reform scientists who systematically criticized Mao's economic policy and global strategy. He served as an outside consultant to Shanghai City government on financial policies in 1997, with a proposed project of developing consumer credit system in Shanghai (1997-2001), which was soon adopted nationwide (2001). His policy analysis and commentary articles widely appeared in leading Chinese media. Ping' story as a reform-minded scientist was reported by Fox Butterfield, the New York Time reporter in China, in his best seller book "China: Alive in a Bitter Sea," *Sekai* (The World) in Japan, and The New Republic in USA. His discovery of empirical economic chaos was reported by the Associated Press and The Atlanta Journal and Constitution.

**Paul Davidson**

Paul Davidson is a macroeconomist who has taught economics at the University of Pennsylvania, Rutgers University, Bristol University (in the UK), Cambridge University (in the UK), and the University of Tennessee. He is a Visiting Scholar at the Schwartz Center For Economic Policy Analysis at the New School and is currently an Emeritus Holly Professor of Excellence at the University of Tennessee, Knoxville. He is especially known for promoting a Post Keynesian economics school of macroeconomics. He and Sidney Weintraub founded the *Journal of Post Keynesian Economics* in 1978. He is the Editor of the *Journal of Post Keynesian Economics* and author, co-author or editor of 22 books and over 210 articles. His research interests include: international monetary payments and global employment policies; monetary theory, income distribution, energy economics, demand and supply for outdoor recreation, Post Keynesian economics.

**Gary Dymski**

Gary Dymski has been founding Director of the University of California Center Sacramento (UCCS) since July 2003. He received his B.A. in urban studies from the University of Pennsylvania in 1975, graduating as a member of Phi Beta Kappa. He obtained a Masters in Public Administration from the Maxwell School at Syracuse University in 1977. He worked as economic analyst at Legal Services

Organization of Indiana from 1977 to 1979; from 1979 to 1981, he served as fiscal advisor and staff director for the Democratic Caucus in the Indiana State Senate. He began doctoral study in economics at the University of Massachusetts, Amherst in 1981, and received his Ph.D in 1987.

Gary spent 1985-86 as the Leo Model Fellow in Economic Studies at the Brookings Institution. He held a position as assistant professor of economics at the University of Southern California from 1986 to 1991; in 1991 he joined the economics faculty at the University of California – Riverside (UCR). He was promoted to professor of economics in 2001. In the 2001-02 academic year, Gary served as Associate Dean for Research and Graduate Studies in UCR's College of Humanities, Arts, and Social Sciences. In the 2002-03 academic year, Gary was founding director of the Edward J. Blakely Center for Sustainable Suburban Development at UCR.

### **Lord John Eatwell**

John Eatwell is Director of the Cambridge Endowment for Research in Finance, and Professor of Financial Policy at the Judge Business School, University of Cambridge. He has taught economics and finance at Cambridge since 1970. He became President of Queens' College, Cambridge in 1997. From 1980 to 1996 he was also a Professor in the Graduate Faculty of the New School for Social Research, New York. He has been a Visiting Professor at Columbia University, New York, the University of Massachusetts, Amherst, and the University of Amsterdam.

From 1985 to 1992, John Eatwell served as economic adviser to Neil Kinnock, the then leader of the Labour Party. In that post he was responsible for much of the work that led to a substantial re-alignment of the Labour Party's economic policies. In 1992 he entered the House of Lords, and from 1993 to 1997 was Principal Opposition Spokesman on Treasury and Economic Affairs. In 1988, together with Clive Hollick, he set up the Institute for Public Policy Research, which has now established itself as one of Britain's leading policy think tanks. He was Chairman from 1997 to 2000, and remains a Trustee.

In 1997 he joined the Board of the Securities and Futures Authority (SFA), Britain's securities markets regulator (up to the end of 2001), serving on the Enforcement Committee and the Capital Committee. When the SFA ceased to operate he became a member of the Regulatory Decisions Committee of the Financial Services Authority (until 2006).

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John Eatwell is a non-executive director of Cambridge Econometrics (an economic research firm), Rontech Ltd (a producer of management software for the financial services sector), and of SAV Credit Limited (a credit card company). He is an adviser to the private equity firms Warburg Pincus & Company International Ltd and Palamon Capital Partners. He was a non-executive director of Anglia Television Ltd. from 1994 to 2001. From 1997-2000 he chaired the British Screen group of companies (which included British Screen Finance, British Screen Rights, and the National Film Trustee Company). From 2000-04 he chaired the Commercial Radio Companies Association.

**James K. Galbraith**

James K. Galbraith teaches economics and a variety of other subjects at the LBJ School. He holds degrees from Harvard (B.A. magna cum laude, 1974) and Yale (Ph.D. in economics, 1981). He studied economics as a Marshall Scholar at King's College, Cambridge in 1974-1975, and then served in several positions on the staff of the U.S. Congress, including Executive Director of the Joint Economic Committee. He was a guest scholar at the Brookings Institution in 1985. He directed the LBJ School's Ph.D. Program in Public Policy from 1995 to 1997. He directs the University of Texas Inequality Project, an informal research group based at the LBJ School. Galbraith maintains several outside connections, including serving as a Senior Scholar of the Levy Economics Institute and as Chair of the Board of Economists for Peace and Security. He writes a column called "Econoclast" for *Mother Jones*, and occasional commentary in many other publications, including *The Texas Observer*, *The American Prospect*, and *The Nation*. He is an occasional commentator for Public Radio International's *Marketplace*.

**Teresa Ghilarducci**

Teresa Ghilarducci is the Irene and Bernard L. Schwartz Chair in Economic Policy Analysis at the New School for Social Research and the Director of SCEPA. She was most recently a professor of economics and director of the Higgins Labor Research Center at the University of Notre Dame. Her forthcoming book, *When I'm Sixty-Four: The Plot Against Pensions and the Plan to Save Them*, for Princeton University Press, investigates the effect of pension losses on older Americans. Her book *Labor's Capital: The Economics and Politics of Employer Pensions*, MIT Press, won an Association of American Publishers award in 1992. She co-authored *Portable*



*Pension Plans for Casual Labor Markets* in 1995. Ghilarducci publishes in referred journals and testifies frequently before the U.S. Congress. She holds a PhD in economics from the University of California, Berkeley.

### **Jeffrey Madrick**

Jeff Madrick is editor of *Challenge Magazine*, visiting professor of humanities at The Cooper Union, and director of policy research at the Schwartz Center for Economic Policy Analysis, The New School. He is a regular contributor to *The New York Review of Books*, and a former economics columnist for *The New York Times*. He is the author of several books, including *Taking America* (Bantam), and *The End of Affluence* (Random House), both of which were New York Times Notable Books of the Year. *Taking America* was also chosen by Business Week as one of the ten best books of the year. His most recent book is *Why Economies Grow* (Basic Books). He has served as a policy consultant for Senator Edward M. Kennedy and other U.S. legislators. He has written for many other publications, including *The Washington Post*, *The Los Angeles Times*, *Institutional Investor*, *The Nation*, *American Prospect*, *The Boston Globe*, *Newsday*, and the business, op-ed, and magazine sections of *The New York Times*. He has appeared on Charlie Rose, The Lehrer News Hour, Now With Bill Moyers, Frontline, CNN, CNBC, CBS, and NPR. He was formerly finance editor of *Business Week Magazine* and an NBC News reporter and commentator. His awards include an Emmy and a Page One Award. He was educated at New York University and Harvard University, and was a Shorenstein Fellow at Harvard. Princeton University Press has just released his latest book, *The Case for Big Government*.

### **Perry Mehrling**

Perry G. Mehrling is Professor of Economics at Barnard College, Columbia University where he has taught since 1987. His research interests lie in the monetary and financial dimensions of economics, a field he approaches from a variety of methodological angles. His most recent book is *Fischer Black and the Revolutionary Idea of Finance* (Wiley 2005). Dr. Mehrling's training in economics includes a MSc in Econometrics and Mathematical Economics from the London School of Economics (1983), and a PhD in Economics from Harvard University (1988). His webpage is <http://www.econ.barnard.columbia.edu/faculty/mehrling/mehrling.html>.

**Dimitri Papadimitriou**

Dimitri B. Papadimitriou's areas of research include financial structure reform, community development banking, fiscal and monetary policy, employment policy and distribution of income, wealth and well-being. He heads the Levy Institute's macro-modeling team studying and simulating the U.S. and world economies. In addition, he has authored and co-authored studies relating to Federal Reserve policy, fiscal policy, employment growth and social security reform. Papadimitriou is president of the Levy Institute and executive vice president and Jerome Levy Professor of Economics at Bard College. He has testified on a number of occasions in hearings of Senate and House of Representatives Committees of the U.S. Congress, was vice-chairman of the Trade Deficit Review Commission of the U.S. Congress (2000-2001) and a member of the Competitiveness Policy Council's Subcouncil on Capital Allocation. He was a Distinguished Scholar at the Shanghai Academy of Social Sciences (PRC) in fall 2002. Papadimitriou has edited and contributed to eight books published by Macmillan and Edward Elgar and is a member of the editorial board of *Challenge*. He is a graduate of Columbia University and received a Ph.D. in economics from New School for Social Research.

**George A. Papandreou**

George A. Papandreou holds a M.Sc. in Sociology and Development from LSE, and is a fellow at Harvard University's Center for International Affairs. An MP since 1981, he served in several government posts before becoming Foreign Minister from 1999-2004. An active supporter of the Information Society and the driving force behind the Greek EU Presidency's e-Vote, in 2003 he was placed among the "25 who are Changing the World of Internet Politics". He has received several honours for his commitment to promote peace and democracy, notably his successful campaign, as Foreign Minister, to engineer a rapprochement between Greece and Turkey. As President of PASOK (Panhellenic Socialist Movement) since January 2004, George A. Papandreou is leading radical reforms of the Greek party political system. He was unanimously elected as President of the Socialist International in January 2006.

**John Jr Barkley Rosser,**

J. Barkley Rosser, Jr., Ph.D 1976, University of Wisconsin-Madison in Economics, is Professor of Economics and Kirby L. Cramer, Jr. Professor

of Business Administration at James Madison University. He has been involved in providing advice both to several past presidential campaigns as well as a variety of government agencies at both the national as well as state and local levels. Author of over 100 publications, his better known books include *From Catastrophe to Chaos: A General Theory of Economic Discontinuities*; *Comparative Economics in a Transforming World Economy*; and *The Changing Face of Economics: Conversations with Cutting Edge Economists*. He has served as Editor of the Journal of Economic Behavior and Organization since 2001.

### **Bernard Schwartz**

Bernard L. Schwartz is chairman and CEO of BLS Investments, LLC, a private investment firm. He also manages the investments of the Bernard and Irene Schwartz Foundation, which mainly supports higher education, medical research and New York City-based cultural organizations. He promotes the development of US economic policy initiatives through investment in educational institutions, think tanks and advocacy organizations.

Prior to establishing BLS Investments in March 2006, Mr. Schwartz served for 34 years as chairman of the board and chief executive officer of Loral Space & Communications and its predecessor company, Loral Corporation. In recognition of his achievements and extensive experience in industry and global finance, Mr. Schwartz is often called upon to express his views or provide counsel on matters ranging from U.S. economic growth and competitiveness to technology and infrastructure investment. At a number of institutions, he has initiated programs (including the Schwartz Center for Economic Policy Analysis and a Chair in Economics and Policy, at the New School) that rigorously examine current US economic performance, in the process challenging current orthodoxy to arrive at innovative policy proposals that will further US economic and technological preeminence. The programs employ lectures, position papers, conferences and debates, and tap the expertise of leading economists, business people and policy makers. The policy proposals that emerge from these programs are broadly distributed to government officials, members of Congress, educators, researchers, the media and the general public. Mr. Schwartz graduated from City College of New York with a B.S. degree in finance and holds an honorary Doctorate of Science degree from the college. He and his wife live in New York City and have two daughters, three granddaughters and one grandson.

## Looking for Solutions to the Crisis

**Allen Sinai**

Allen Sinai is Chief Global Economist, Strategist and President of Decision Economics, Inc. (DE), a global economics, strategy, financial market information support and advisory firm. During his career Dr. Sinai has served a wide variety of organizations and decision-makers in the United States and abroad, as a forecaster, educator, and econometric model-builder. He has been consulted by various administrations from both political parties on key economic and policy issues, has often testified before Congress, and meets regularly with senior level policymakers from other countries. He is a recognized expert on the Federal Reserve and monetary policy, both as a scholar and in forecasting Federal Reserve policy, and has served as a consultant to the Federal Reserve.

Between 1983 and 1996, Dr. Sinai was Chief Global Economist and a Managing Director, and the Director of Lehman Brothers Global Economics of Lehman Brothers, Inc.. From 1988 to 1992, he served as Executive Vice President and Chief Economist of The Boston Company, an asset management and banking subsidiary of Shearson Lehman Brothers, where he also headed a small economic information company, The Boston Company Economic Advisors, Inc.. Before joining Lehman Brothers, he was at Data Resources, Inc., serving as Chief Financial Economist and a Senior Vice President at DRI from 1971 to 1983.

Allen Sinai holds a Bachelors Degree in Economics from the University of Michigan and a Doctorate in Economics from Northwestern University.

**Joseph Stiglitz**

Joseph E. Stiglitz received his PhD from MIT in 1967, became a full professor at Yale in 1970, and in 1979 was awarded the John Bates Clark Award, given biennially by the American Economic Association to the economist under 40 who has made the most significant contribution to the field. He has taught at Princeton, Stanford, MIT and was the Drummond Professor and a fellow of All Souls College, Oxford. He is now University Professor at Columbia University in New York and Chair of Columbia University's Committee on Global Thought. He is also the co-founder and Executive Director of the Initiative for Policy Dialogue at Columbia. In 2001, he was awarded the Nobel Prize in economics for his analyses of markets with asymmetric information, and he was a lead author of the 1995 Report of the Intergovernmental Panel on Climate Change, which shared the 2007 Nobel Peace Prize.

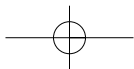
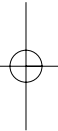
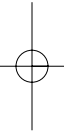
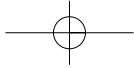
Stiglitz was a member of the Council of Economic Advisers from 1993-95, during the Clinton administration, and served as CEA chairman from 1995-97. He then became Chief Economist and Senior Vice-President of the World Bank from 1997-2000. In 2008, he was appointed by French President Nicolas Sarkozy to chair a Commission on the Measurement of Economic Performance and Economic Progress.

Stiglitz holds a part-time appointment at the University of Manchester as Chair of the Management Board and Director of Graduate Summer Programs at the Brooks World Poverty Institute. He serves on numerous other boards, including Economists for Peace and Security's Board of Trustees, and the Board of Governors of the Levy Economics Institute of Bard College.

His most recent book, *The Three Trillion Dollar War: The True Cost of the Iraq Conflict*, with Linda Bilmes of Harvard University, was published in March 2008 by WW Norton and Penguin/ Allen Lane.

#### **Lucy Law Webster**

Lucy Law Webster is a retired UN Political Affairs Officer who is Executive Director of the Center for War/Peace Studies, a Board member of Economists for Peace and Security and an officer of the international World Federalist Movement.



## Introduction

James K. Galbraith

Let me say first a very warm word of welcome to all of you, to this conference organized by Economists for Peace and Security, an organization which I have the honor to chair, by the Charles Leopold Mayer Foundation, and the International Initiative for Rethinking the Economy. I would particularly like to acknowledge and thank for the support, inspiration and moral contribution of Pierre Calame and Aurore Lalucq, and the Levy Economics Institute of Bard College. And I would like, as always, to thank Dimitri Papadimitriou, president of the Levy Institute, for his support and help in these matters.

We are here, I'm very happy to say, at the Schwartz Center for Economic Policy Analysis of The New School in New York, an invaluable institution for contributing to our public debate. And I am particularly pleased and honored to recognize the presence this morning with us of Bernard Schwartz. Thank you very much.

I would like to begin by giving you a brief account of the origins of the meeting that we're holding today. They lie in a correspondence that began in the early part of this year between myself and mainly Aurore Lalucq but working closely with Pierre Calame. It was our feeling at the time that the problems of the financial sector, which had begun to emerge with great clarity in August and September of 2007, were not yet at that time fully appreciated, nor were their implications for the U.S. economy and the world economy fully understood. And we thought it would be useful at that moment to bring together a group of people who could meet privately over a couple of days and review the situation amongst ourselves so as to develop, to the extent possible, a common viewpoint and to come to a fuller understanding amongst ourselves, principally, of the scope and dimensions of the problems that were likely to develop.

Given the support and the facilities of the Charles Leopold Mayer Foundation and the Initiative for Rethinking the Economy, a venue for meeting in the very pleasant burg of Paris was offered and accepted, and it proved, I have to say, remarkably easy to get a very interesting and distinguished group of people to agree to come and

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spend a couple of days on this. We duly convened in June 2008 and had, I think, two rather remarkable days of intense conversations.

The question arose of how to summarize those conversations for a larger audience, and I took that responsibility largely on myself, drawing on the records of the meeting. I drew up an extensive memorandum which initially circulated in certain political circles, but also was prepared for publication and is now in print in *Challenge Magazine*, another vital and far-sighted organ for public discourse in these matters, edited by Jeff Madrick, who is also here this morning. That article, that memorandum, made the case – at a time when the financial crisis was not yet the leading news story nor the leading political issue in the ongoing presidential campaign in the United States – that whatever happened between the summer and the election, this crisis was likely to be the leading item on the agenda of the incoming administration.

The reason we felt that way was that, in our view at the time, the financial system of the United States and of the Western world had come to a pass which we had not seen in our professional lifetimes, that it had developed a series of difficulties which would not be overcome by ordinary processes of market adjustment in a very short period of time, nor by minor regulatory fixes and interventions. And we felt that the macroeconomic implications of this problem would become essentially the dominant economic issue within a reasonably short period of time. I think it's fair to say that we did not fully anticipate that it would happen as quickly as it did. I certainly felt that my reputation as a prophet would be safe if I published in November and events happened after the election. As it happened, the pace of the crisis was accelerated, relative at least to our expectations, and serious unmanageable problems emerged by the middle of September.

We found ourselves facing a situation in which a sequence of financial events that had been building up for the better part of a decade, and in particular: the willful and conscious erosion of regulatory and supervisory standards in the housing finance industry; the emerging and rapidly spreading practice in the middle of this decade of the securitization of sub-prime and all A-mortgages<sup>1</sup> and their bundling into mortgage-backed securities; collateralized debt obligations<sup>2</sup>

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(1) AAA is the highest ranking accorded by rating agencies to any bond or security.

(2) Collateralized debt obligations are a type of asset-backed securities that are considered to greatly increase risk in the financial markets, since loan issuing institutions retain no risk for the loans they make. As shown by the credit crunch 2007/8, this leads to uncontrolled degradation of underwriting standards.



backed and insured by credit default swaps<sup>3</sup> – all of this was creating an environment that John Eatwell has described as “market gridlock”. The financial system had lost the capacity to price the assets that it was trading, lost confidence in the value of the portfolios of counterparty institutions, and lost the willingness to play the role of the spark and fuel of economic expansion.

What did we find at that moment? The collapse of the investment banks, either into mergers and acquisition, or, as in the case of Lehman Brothers, into bankruptcy. We found that the organs of government of the Bush administration, after having attempted to deal with this problem on a case-by-case basis, found that they were unable to do so and came to the Congress with what they called a systematic approach. That systematic approach took the form of a piece of legislation that was in fact about two-and-a-half pages long and asked for a grant, or an authorization, to repurchase the troubled securities to the tune of \$700 billion. And in the initial phases of the legislative process, the request was to do so without supervision or review.

Since that was the situation around the 18<sup>th</sup> or 19<sup>th</sup> of September 2008, the members of our group had some advantages of preparation. And we used those advantages in two public forums, one of which was a collaboration between myself and Bill Black in *The Nation*, which laid out a number of clauses and conditions that we felt ought to be in any legislation that Congress might seriously consider. That is to say, provisions relating to such elementary matters as conflict of interest or unjust enrichment. There was a series of about eight things that we thought, given that action was going to become politically inevitable, should at least be part of a process of effective governance of how that action was conducted. That was the first step, and it had, I believe, some influence. At least I heard from those who were engaged directly in the legislative drafting that our intervention and their thinking was running on very similar lines.

Then, in the course of this discussion, I also got an inspired message from John Eatwell, who is here today, who suggested that we really ought to propose an alternative line of attack, that would focus, given the disappearance of the investment banks, on the security and soundness of the banking system and the powers that the federal government already had to deal with this crisis. With the help of a small sub-working group, some of whom had been at the Paris mee-

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<sup>3</sup> A credit product where the buyer receives credit protection, whereas the seller guarantees the credit worthiness of the product. By doing this, the risk of default is transferred from the holder of the fixed income security to the seller of the swap.

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tings and some of whom had not been, and including some others who are here today – and I'll mention Marshall Auerbach in particular –, I was able to draft and publish an op-ed piece in *The Washington Post* on the 25<sup>th</sup> of September which laid out an alternative plan. It was published under the somewhat mischievous headline of "A Bail-Out We Do Not Need," when in fact the topic of the article was the direction of the action, rather than the necessity for it; but I found myself an inadvertent populist hero as a result of that headline, which I was not going to complain about. I did also find myself being invited up to discuss the particulars of these issues with the members of Congress who were going to have to vote on it on the 28<sup>th</sup> or 29<sup>th</sup> of September.

That alternative line of action, which again closely tracked the themes and principles of the conversations in Paris, suggested that what we should do, first and foremost, was deal with the panic that was overtaking the banking system, and that the appropriate way to do that was to extend deposit insurance and put a stop to the purely fear-based run of deposits from smaller banks to larger banks.

Secondly and closely parallel, we argued that something should be done to stabilize and secure the commercial paper market and the money market funds.

Thirdly, that rather than attempting to stabilize the price of the troubled assets – this sea of mortgage-backed securities – in a way that was bound to be both inefficient and futile, by buying them back in an open market, that the appropriate way to stabilize and secure the banking system was for the government to buy preferred equity in the banks directly.

It's very interesting to note, whether one can trace direct influence or not, and I very much doubt that one ever would be able to do that, that within a month reality had pressed the Bush government to largely adopt action along these lines; that is to say, to take the steps that we believed in advance would ultimately be the necessary steps: stabilizing the banking system and making a direct capital replenishment of the banks. Major arguments are now ensuing, and should properly ensue, as to whether those steps have been taken in a way which is fully effective, efficient, and protects the public interest. Those questions will continue to be pursued; but I think that there is very little doubt that a course of action is underway which is more effective than would have been the case had the initial program of attempted asset repurchases been pursued.

Still, in Paris in June, and in the discussions in Washington in September, those of us who had been involved in this were never in

any doubt that stabilizing and securing the *financial* side of the equation was a necessary but not a sufficient condition for an *economic* program going forward. There is, in discussions of this crisis, a tendency, in certain circles anyway, to treat it as a financial crisis; and an implication of that use of words is that if one deals with the financial issues, the larger economic problems will be resolved. In other words, something has happened to the machinery of the banking sector, a problem of confidence, a problem of liquidity, maybe a problem of solvency, something of that nature – if that something can be resolved and credits start flowing again, then the underlying problem or effects of the crisis on economic growth will be mitigated or dealt with.

We do not think this to be the case. In our view – and it's a very simple view really – there needs to be a borrower as well as a lender for a credit transaction to take place. And the borrower has to have a reason to want to borrow – that is to say, an expectation of profit – and an asset against which to borrow. And that asset in the American economy for many years has been housing equity, which, of course, is now gravely impaired.

So we have a situation that is going to require, as a first condition, financial stabilization, but as a second condition, a broad-based program for economic recovery. Already the outlines of that program were being discussed at the Paris meeting. They are basically common sense. They are put together out of the pieces of the problem that we actually face. A major piece of that problem is housing, the fact that there are millions of houses out there which are in foreclosure or threatened by foreclosure, and many more whose value in the open market is driven down to well below the debt that is owed on them; and therefore are both no longer a font of collateral for consumer household borrowing, and also pose the temptation for homeowners to walk on those houses rather than have to pay the bank if they choose to leave.

So, this is a crisis that can only be resolved at the level of the housing industry, the housing sector, and by a mechanism that was already proposed in January 2007, I believe, by Paul Davidson, who is here. And the mechanism is to reestablish something along the lines of the Homeowners Loan Corporation (HOLC)<sup>4</sup> of the 1930s, able to renegotiate and reset mortgages in ways that would make them largely sustainable for the population. This is not a small endeavor. The HOLC at its peak employed 20,000 people, and we are now in a much

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(4) Established in 1933 by the Homeowners Refinancing Act, in order to refinance homes to prevent foreclosure.

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larger economy with perhaps an even larger housing problem. But it is something which is increasingly recognized as necessary. And I can also report that the principle of such an operation was accepted in a colloquy between Congressman David Scott of Georgia and Chairman Barney Frank of the Financial Services Committee on the floor of the House in the debate just before the final adoption of the TARP [Troubled Asset Relief Program] bill on the second vote. A couple of the principles were actually in the legislation, and there was an agreement between those two leading members of Congress that the other principles should be put into place when the opportunity arises. This is the first major initiative whose necessity is increasingly accepted across the board.

Secondly, we live in a federal system where state and local governments fund themselves to a very large extent from taxes on local activity and particularly on the value of property. As property values decline, state and local revenues decline. We have every indication that there will be massive cuts in the budgets for public services, for schools, for police, for fire, for libraries, for parks, which can only make the problem worse in two ways: one, by diminishing the value of the property assets that everybody holds; and secondly, by layoffs of public personnel who will then have increasing difficulty in servicing their mortgages. So it becomes a fundamental part of the solution that the revenue base of the states and localities be back-stopped, be supported, by direct federal assistance. We need to dip into the tool bag of that great liberal innovator, President Richard Nixon, and reenact general revenue sharing so as to stabilize the state and local public sector.

I would say thirdly that, just as states and localities are forced by revenue cuts to cut their budgets, they are forced by the closing of the credit markets to cut their capital budgets; and this just at a moment when capital expenditure by state and local governments and by the federal government is absolutely essential in order to absorb the resources that are being released in the housing sector and elsewhere in the economy. In other words, this is a moment when, from every practical point of view, we ought to be doing all of the things that we neglected to do in the flush times of the private sector, through the technology boom and bubble of the late 1990s and through the housing boom and crash of the last decade. We have an enormous backlog of public work that should be done and an enormous prospect of things that will need to be done in order to give the private economy a focus and a direction that will help meet some of our major long-

term problems, in particular the problems of energy, security, and climate change. It is clear that this is the moment, if we are ever going to do this, to put such a program into place, to get it started. One institutional feature of this would be a national infrastructure fund, and another would be a mechanism at the federal level to lay the groundwork for a sustainable energy future.

Fourth: we need to worry about the effects of the collapse of asset values on the income positions of the elderly population and the population which includes, I think, a fair number of those in this room: people who would like eventually to be elderly. This is a situation where it is the private part of the retirement system which has fallen into crisis, a system which has built up over the last generation into defined contribution pension plans, many of which were invested in very volatile assets and whose value has now declined dramatically.

What should be done then? I have a very simple proposal, which is that we should consider, for the first time in a generation, an across-the-board increase in Social Security benefits. You cannot, of course, make everybody whole for the value of their own investment at any particular time. People made different choices, took different kinds of risks, and are going to have to bear the consequences of that. But, as a public policy matter, it is essential that the elderly population as a whole and individuals in it not be allowed to fall into poverty, and that the purchasing power of this segment of the population be maintained in order. As it is, we have a system in place that would permit us to do this in a relatively easy way. We don't have to reinvent the Social Security system; it exists.

**“The financial system of the Western world has come to a pass which we had not seen in our professional lifetimes.”**

We may be required, as time goes forward, to take even larger measures. We do not know the full extent and the implications of the problems that are emerging in the automobile industry – and no doubt throughout much of the industrial sector. We're only learning now, in the last few days, that General Motors could easily be out of business by the end of the year if action is not taken to provide it a lifeline. It's a complicated, difficult problem, there are many arguments on both sides; but the reality is the full extent of the industrial and economic decline that we may be facing. So we may need to be prepared to go beyond the stabilizing measures I've just described and take additional steps. I'm thinking about the equivalent of a holiday on the payroll tax, or the reinvention of the Reconstruction Finance Corporation, or the reenactment of the Comprehensive

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Employment and Training Act, the jobs program, something that would bring us back toward the major employment enterprises of the New Deal which had an enormously impressive effect, when you actually count the people who worked for those agencies as employed, in reducing the actual unemployment rate in the 1930s from 25 percent to down to 7 percent by the middle of the decade.

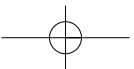
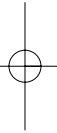
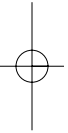
I think that there is really no need at this stage to present measures like those I've just been outlining as part of a unified ideological or philosophical framework. It's really up to people who will come later to decide whether it deserves that level of definition and identification. It's up to us, however, to advance the ideas that we think will work in a practical way, in a spirit of pragmatism, in a discussion which I hope to carry out and listen to over the course of today, a discussion that is open-minded, that is flexible, and that will at the end of the day advance the cause of an early, as opposed to a delayed, solution to the specific problems that we face.

The underlying premise is clear: that doing nothing is not an option. Doing little is not an acceptable option. Assuming that a problem which is rooted in a major meltdown of financial confidence and governance, and in a major crisis in the housing sector, will go away in a short period of time, that it would respond to regulatory measures alone, or to a stimulus package of a short-term character alone, seems to me something that we can safely set off the table as being beyond the realm of plausibility. Therefore, we are faced with the task of designing a sequence of economic policy measures that will be effective over the length of a presidential term or longer, and thinking through how to sequence those measures so that you can have some short-run successes that will lead toward a more stable and sustainable outcome over time. It's a complicated problem, but it is a problem at which we cannot afford to ignore.

In thinking about it we have two enormous advantages. Compared to the 1930s, or even the 1960s, we have the institutions that were created in those days, institutions which have been deeply deprecated in our political discourse for many decades, but which are in fact the foundation of the success and resilience of our economy, from deposit insurance, to Social Security, to Medicare, to the whole structure of the New Deal and the Great Society, which left us with a tradition of orderly governance. Even if that tradition has been under attack for a long time, it's still there.

The second advantage that we have, of course, is this extraordinary event that occurred on the 4<sup>th</sup> of November 2008, an event that

changed the terms of dialogue in the politics of this country, and perhaps in the politics of the world, moving it away from the rigid ideology opposed to public interest and the public purpose, away from the use of government institutions as masks for private and predatory purposes, and closer to – what? Nothing more than the practical, open-minded, open-handed, and responsible approach to the enormous challenges and problems we actually face. I don't think the population of the country was asking for more than that, and they certainly shouldn't get any less.





session 1 moderator **Lucy Law Webster**

# Understanding the financial crisis

**Joseph Stiglitz**

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First let me say that I agree with almost everything Jamie said. In particular, I agree that we're going to need not only a large stimulus but also a sustained effort. What I want to do in my remarks is to highlight a few of the issues going forward, the likely controversies, and what views I have on those. And I'll come back to the issue of the size of the stimulus in a few minutes.

The first issue is the general framework that the Bush administration has taken to try to revive the economy. It has been, you might say, too little, too late and very badly designed. They didn't want to believe that their economy policies had the disastrous effects that they did. As it is, I had argued that their tax cuts in 2001 and 2003 and the war in Iraq played an important role in leading to this crisis. Let me try to explain why.

The tax cut in 2001 and 2003 wasn't designed to stimulate the economy. It was something that was already on the agenda. It was an attempt to lower the taxes of upper-income Americans to exacerbate the inequalities that had been growing for a long time. That's not how they would put it; but still that was the effect. It didn't stimulate the economy very much and it put the burden of adjusting, of responding to the breaking of the tech bubble, on monetary policy. The war made things worse, because it led to an increase in the price of oil. We were spending hundreds of billions of dollars importing oil. Money that would have gone to keep the American economy going was being

sent abroad. So again, the American economy was weakened, and again the burden was placed on monetary policy.

They responded with reckless enthusiasm, low interest rates and lax regulation. Lowering interest rates was not enough; you had to basically lend to anybody who was not on a life-support system with liar loans, negative amortization loans, where at the end of the year you owed more than you did at the beginning of the year. They said, "Don't worry if you're getting more and more in debt because the house prices were going up", in a kind of pyramid scheme.

From an economic point of view, there were two obvious things that were wrong with this: First it was based on a notion that there was a free lunch. The more you borrowed, the richer you were going to be. Borrowing is not that difficult. It's repaying that's the problem. And it was really based on the notion that anybody who was "smart enough" to find a mortgage broker to give them money would be a rich person. There isn't that much money lying on the street; but that's what they believed.

The second thing, of course, was the notion that the prices of houses could keep going up while real incomes of most Americans were going down. Again, as I jokingly say, you don't need a Nobel Prize to figure out you can't spend much more than a hundred percent of your income on housing every year. It was just a matter of time before that particular set of ideas slammed into reality.

So the tax cuts and the war fed the housing bubble. The housing bubble fed a consumption boom. Savings fell to zero. We are now facing some of the consequences of that. But from a macro point of view, the profound question that we have to face is what will replace that as a stimulus to aggregate demand? There's not likely to be another IT bubble, nor another housing bubble, which means that there may be a problem of insufficient aggregate demand for an extended period of time.

We live in a global economy and we need a reform of the global reserve system, because given the volatility of the current system countries want to hold on to their reserves. Dollars are one of the forms in which they hold reserves. The result of that is that we're exporting Treasury bills, rather than automobiles or other products. It's fine to export Treasury bills, but Treasury bills don't create a lot of jobs.

Then there is this structural problem in our global economy, a problem which we faced before – Keynes talked about it. When you look at it from a global point of view, part of the global deficiency in aggregate demand is caused by the surplus economies, economies

that are taking income in and not spending it. Keynes had proposed – and in my book, *Making Globalization Work*, I revived that kind of idea – to penalize countries for having surpluses in order to dissuade them from accumulating them. The way we do that is to have an annual emission of a new global currency, and to decide that countries with surpluses won't get their share of that emission. It's a way of rebalancing the global economy. Since the structural problem we face will be very difficult to solve in the United States alone. It will require a global solution over the long run.

The rest of my remarks will focus on the shorter run, on the United States and on our failed response. As I said, in our failed response, in February, we had a tax cut, again – the all-purpose solution for the Bush administration to any economy problem. I and many other people thought it would not work. With the mountain of debt, the anxieties going forward, people would not spend much of their money. And that turned out to be the case. Different studies give different numbers – 20 percent, 50 percent – but still, it didn't stimulate the economy very much. That's why we need now a much larger stimulus.

What the US administration has been doing so far is another version of trickle-down economics. Throw enough money at Wall Street, and some of it will trickle down to the rest of the economy. It didn't work – and in a way, predictably so.

One of the reasons it didn't work is that, to use another analogy, it's like giving a massive blood transfusion to somebody suffering from internal hemorrhaging, internal hemorrhaging of foreclosures. We're not doing anything or very much about the foreclosures; in fact, the administration, in a perverse way, says: "we don't want to help ordinary Americans, we don't want to help foreclosures. We need to help the core of the American economy, the American bankers, investment banks particularly, who got us into the mess". It is not surprising that things have not been working very well, because who do we put in charge? The same people who got us in the mess.

As for the foreclosures: what should be done? We have to do something. If we don't, even if we give more money to the banks today, there's going to be more defaults, and their holes in the balance sheets are going to open up. It won't solve the problem.

I see three things we can do. The first is to help homeowners. For instance, right now we subsidy 50 percent of the housing cost of homeowners, who are upper-income homeowners, in New York State. We subsidy it through tax deductions on interest, mortgage interest and real estate taxes. We pay 50 percent for upper-income and

nothing for lower income people. It's not only inefficient, but also obviously inequitable. If we converted the tax deduction into a tax credit it would make housing more affordable. As a general principle, the housing subsidy has been questioned by economists as distorting the resource allocation in our society. That's a debatable question about whether you want to encourage home ownership; and that is the main misgiving I have about this kind of proposal. But if we do want to promote home ownership, we should be helping it at the bottom end, not at the top.

**“You don't need a Nobel Prize to figure out that you can't spend more than a hundred percent of your income on housing.”**

There is one thing the British government does that I think we ought to give serious consideration to: For people who are long-term unemployed, the government picks up paying for the mortgage as part of the unemployment program. They recognize that when people lose their jobs, it's not just about the flow of income, it is a real anxiety. So they try to make life more bearable. There's no moral hazard here. Nobody is going to say, “I want to be fired in order for you to pick up my mortgage”. It seems to me an interesting idea.

The second thing we can do is to reform our bankruptcy law. We changed the bankruptcy law a couple of years ago in a perverse way, and I think it actually may have had a part in the crisis. Because what it did was to make it more difficult for people to discharge their debt. And by making it more difficult, it encouraged the bankers to lend more, because they said, “we have them over a barrel”. A minimum-income person making about \$14,000 a year can have 25 percent of his wages garnished to pay a debt. That seems to me to at least raise very serious issues. It's more difficult for a homeowner to restructure his debt than it is for someone who owns a yacht. We deliberately made it more difficult. And I think we ought to do it just the opposite. I call for a homeowner's Chapter 11. Chapter 11 is designed to allow firms to restructure their debt in a quick way so they stay in business – avoiding loss of jobs and Organizational capital. You can think of the home as a similar kind of thing, and we should allow people whose homes are under water – that is to say, the value of the mortgage is greater than the value of the home – to go through an expedited process of Chapter 11 bankruptcy, right down with the amount of debt, convert in effect the debt to equity. The bank would then get a large share, perhaps all of the capital gains in the home. That would separate speculators from homeowners. The homeowners are not buying the home for the capital gains; they're buying it to stay in it.

A third proposal would be to use some of the funds that have been made available at low-cost by the government to help ordinary Americans to own their homes. In effect, what we are doing now is using the government's ability to borrow to help Wall Street, but not using it to help the rest of America. We already have the required legislative framework, we just have to expand it – and we could discuss the exact terms. It wouldn't cost the government anything. It wouldn't add to the deficit to lend and to restructure the mortgages, to make them more affordable for ordinary Americans.

That's one set of issues. The second set of issues concerns restructuring TARP. When Henry Paulson first came forward with his proposal, almost every economist said: "This is a stupid idea. It will never be able to be implemented quickly, and something has to be done quickly." This turned out to be right, and he finally gave in. The Congress refused initially to put in this provision of equity injection, which is what they're doing right now. But, as always, the devil is in the details, and if you want to mismanage something, you can even mismanage a good idea; and that's what Paulson managed to do.

You can see that by contrasting what the UK did and what the U.S. did. The UK designed its plan so to make sure that the money went to recapitalize the banks, to create more lending – and they were very careful with the way they did it. I don't have the time to go into it in detail, but basically they did things like the following: They said there has to be some accountability, so the CEO's had to go. They also said "we aren't going to pour money in while you're pouring money out; you can't pay dividends until you've repaid us". They didn't care about the usual argument used against cutting dividends, the one that claims that it would be a back-signal. And rightly so, since this is the most absurd argument that I've ever heard: that somehow they're going to discover some problem in the bank because they're cutting the dividends. What's remarkable is rather the idea that a company that has no profits would even be considering giving a dividend, let alone giving bonuses.

TARP has thus to be restructured. That is going to be one of the big issues facing the next president, because there will be many people in the financial markets, including some of his potential advisors, who will be saying, "A deal's a deal". Paulson made a bad deal, but now we have to honor it.

The opposite view is that every contract has unspecified terms. Everybody understood what the intent of the Congress was. All the time the Fed is giving gifts to the banks that were not part

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of the contract. No one ever said that the Fed had to take junk as collateral, which is what they've been doing. You can just say to the banks: "If you don't do what you're supposed to do, you'll lose access to the Fed window where junk is accepted as collateral". I think there are a variety of ways in which the regulator can help in providing incentives for them behaving better than they've been behaving. There's a little bit of evidence that they're doing that.

Finally, let me just make a remark about one other issue, which is going to be a contentious issue; and that is regulation. In his speech yesterday, President Bush seemed to suggest that we have to be careful about overreacting. And that is the mantra that went off and that we're beginning to hear: Regulation will stifle innovation. Well, what is very clear is that innovation in the financial sector has been what we might call self-referential, like a lot of research in academia. It can only be explained as talking to other academics. This is a case where the only benefit was for financial sector. It did increase their profits to the point where they're at 30 percent of all corporate profits. But shouldn't the financial sector be a means to an end, the end being to make our economy more efficient? If an economy has a huge financial sector, that's a sign that something is wrong – except if it's exporting it to other foolish people. In the United Kingdom you can justify it, because they found a lot of other foolish people to buy their services. And we do a little bit of that, but most of the time, we're selling it to ourselves. So what we are doing is having this means to an end becoming an end in itself. But as an end in itself, it didn't do what it was supposed to do; it didn't manage risk and it didn't allocate capital well. And yet, it took an enormous amount of money away from the rest of the economy.

I'm head of a commission called the Commission of the Measurement of Economic Performance and Social Progress. One of the issues that we've been discussing is whether we should include, or rather how much of the financial sector we should include, in GDP. The point is that most financial innovation was engaged in repertory arbitrage, accounting arbitrage; that is in methods trying to get around the regulation. They succeeded, but at great cost to the rest of us. So it was innovation; but they didn't do what they should have done, since what do people care most about in risk management? The ability to stay in their homes. But 3.6 million Americans have lost their homes. Clearly, the financial sector didn't innovate in the ways that would make our economy more efficient.

Good and strong regulation will encourage people to use their creativity, rather than trying to figure out how to scam the rest of us. It will encourage them to use their creativity to create products that will help our economy manage risk and allocate capital better.

## Marshall Auerbach

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Let me first give you my background: I come from the dreaded world of finance, although I spent most of my time analyzing emerging markets. I have seen Wall Street work its magic on many of the countries in which I've lived, in East Asia in particular. I started in Hong Kong in 1982 and saw the Hang Seng index going from 600 to 1100, then back down to 695 again; and I saw the dollar going from 650 to 1250, then the Singapore-Malaysian market declining 50 percent in two years. I started in 1982, but I have a very different perspective from someone who might have started in the U.S. during that period, because that person, having arrived just at the beginning of an amazing bull market, would almost certainly have thought: "this de-regulation policy is absolutely fantastic". Not surprisingly, most of the people with that background really believed the gospel of the market.

**"Some people seem to think that once we take care of the banking system, everything else will take care of itself."**

I, by contrast, saw quite a lot of capital destruction and I would be very cautious about listening to the advice coming out of some of the leading Wall Street banks over the next few months. James Galbraith, at the beginning of his presentation, observed that the financial crisis is now metastasizing into an economic crisis; but there is an implicit argument from many of the people that are now proposing solutions, which is that once we take care of the banking system, everything else will take care of itself. And that is, I think, laying the groundwork for a counter-attack for some of the more dynamic fiscal measures which are likely to be proposed by the new administration. There is a sense, for example, that we can't afford to let the government spend too much money. This is typical IMF thinking, which has become prevalent in the last 25 years.

I was in East Asia in 1997, and I remember that when the East Asian economies were confronted with a similar type of crisis, the advice given to them by the IMF was, "well, raise your interest rates and appreciate your currencies" – the exactly wrong advice that any

sensible person would have given. I know that Professor Stiglitz was one of the courageous voices criticizing the IMF at the time – fortunately, those countries ultimately did ignore everything that the IMF told them. They let their currencies go and began to export. They made other mistakes subsequent to that, but the point is that the IMF has been giving bad advice for the last 25 years, defending the interests of the financial sector at the expense of the real economy.

Did the IMF learn from the experience? Of course, subsequent to the recoveries of those economies, it did say: “we’re not going to make the same mistakes again”. But I saw recently that in the discussions with Iceland, for instance, one of the provisions of the loan is to raise the interest rates from, I think, 12 percent to 18 percent. So I wonder how much has actually been learned by the IMF. This type of snake oil seems to be very prevalent, despite all the evidence that it hasn’t worked in the past.

I also spent time in Japan, and Japan was a wonderfully efficient, well-run economy for most of the 1980s. Things worked like clockwork. They had low inflation and high growth. Then the U.S. Treasury said in 1985-86: “you’re doing this all the wrong way. You must deregulate your financial markets because your allocation of capital is highly inefficient, and this doesn’t work for us at all, it’s very unfair”. And of course the Japanese, with great reluctance, did exactly what the Treasury told them, and this, I think, is what sowed the seeds for their own bubble economy: they essentially lost control of their own economy and credit system. 25 years later, they still feel the after-effects of that.

I think that’s a very salutary example of the challenges that we face ahead in this country. Just think about what happened in Japan. A few weeks ago, the Nikkei index touched a level that it hadn’t hit since 1982, a 25-year low. So it’s not going to be a quick solution to our problems. And Japan, I might add, was a creditor nation with a substantial pool of savings, which is not the case of the U.S.

The other argument you hear these days goes as follows: “well, we can’t spend too much because we risk having a dollar crisis. Foreign creditors are likely to withdraw their capital supporting us”. I accept that there is a risk, although if the Chinese or the Japanese would do such a thing right now, it would be the economic equivalent of playing the nuclear option. It is very possible that there will be some private sector creditor revulsion, but I think we just cannot afford going small; if we do, the problem is likely to



get worse. And my experience from observing emerging markets tells me that hemorrhaging economies tend to provoke more capital flight than growing ones. So I sincerely hope that President-elect Obama will be bold and courageous in terms of introducing the fiscal stimulus in the U.S. economy. You probably need something in the range of \$5-600 billion. So don't go small, don't be cautious; because I think the alternative is likely to be far worse.

I also hope that he will be similarly bold on regulation. The idea that regulation is always invariably bad is one of those persisting myths. There has been a tendency, I think, during the last 25 years, to denigrate the achievements of the New Deal, to suggest that it wasn't really that effective, and that the only thing that really sorted out the U.S. economy's problems was World War II. The historic record does not indicate that at all, but there is a great deal of self-serving historical revisionism to support a neo-liberal agenda, which I think has, for the most part, been highly destructive, not just for the U.S., but also for global economies. I'm hoping that the onset of the new administration will mark a change in that approach.

### **Pierre Calame**

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I am not American, so allow me to put the questions we discuss in an international perspective. The coming G20 summit will focus on the financial regulation and bond supervision; but there is a risk that it addresses only the symptoms, not the causes of the current situation. If world's leaders don't look closely at structural changes to be done, the summit will be of limited interest.

Stabilizing the banking system, as mentioned by James, is but a first step, necessary but not sufficient. You mentioned the recovery of the U.S. economy; I would like to focus on the global economy. To do that, let us go back to the root of the problem and grasp what is really at stake here. It will give us, I hope, the guidelines to cast a new monetary, financial, and energetic global system.

As for the structural causes of the current crisis, I would like to make eight observations, each of them being well-known; nevertheless, putting them together and looking at their consequences might open new perspectives.

The first one concerns the slow but steady decline of the U.S. in the global economy. The U.S. made up half of the world GNP at the

moment of the first Bretton Woods conference; today it's roughly a quarter. This means that a more multilateral system is not a choice; it simply reflects reality. The new system should rely on the relations between major regions of the world, and this will represent a major change in the current world order.

My second observation: since the 1970s, there has been a growing trend to "financialize" the economy. What do I mean by "financialization"? Let me define it by two main characteristics: creation of a unified financial market, with a continuous flow of transactions that pay no regard to national frontiers nor physical distance, and a gradual power shift within the market economy from non-financial firms to international finance. We have to trace back the causes of this change and look closely at its consequences, if we want to respond properly.

Which leads me to my third observation: financialization took off in 1971 when Richard Nixon decided to suspend the gold convertibility of the dollar. This had three major consequences. First, dealing

**"Shareholders should have the right to vote only once they have owned their stocks for a certain period of time."**

with foreign exchange risks became a major concern for non-financial international firms, and these firms developed strategies in order to minimize the risks and exploit the possibilities. Second, currency trading grew very rapidly and

represents today 97 percent of all financial flows, which has nothing to do with real creation of wealth. And third, the role played by the dollar in global financialization allowed the U.S. economy to escape from macroeconomic discipline.

The next observation concerns the oil shock of 1973. It proved that oil plays a central role in the monetary and financial change. First, the TOE, the ton of oil equivalent, become at that time a full-fledged currency, a medium of exchange, and a standard of value. Second, the oil shock created a large surplus of petrodollars and gave a new impetus to financialization.

My fifth observation is about demography: the aging of rich societies led to the accumulation of savings, and the storage of value function of the currency, of money, has acquired a new meaning. The \$15 trillion managed by the pension funds is the third most important driving force of financialization.

My sixth observation concerns the technical systems that led to the progressive merger of money and finance. The Society for Worldwide Interbank Financial Telecommunications (SWIFT) was

created in 1973; combined with parceling long-term risks, it has contributed to the merger of money and finance. In this way, finance has transformed interpersonal relationships and concrete forms of risk sharing into myriads of anonymous transactions.

It was also in the 1970s that shareholders began to take revenge on firms, asking for more and more shareholder value. This made short-term financial results increasingly important in defining business strategy. If family businesses are doing as well as they do, it is because they still focus on the long-term interest and try to foster solidarity between top management and the rest of the staff.

At last my eighth observation, made already by Joseph Stiglitz: The financial system has become an end in itself. It has developed techniques and compensation schemes which only benefit itself. In the U.S. between the 70s and today, the profits of the financial sector passed from 15 to 30 percent of the total amount of profit.

These observations define the scope of the new framework that has to be invented and put in place. As we see, that framework must encompass money, finance and energy. It should give priority to long-term thinking, and it has to focus on true-wealth creators instead of financial institutions.

Where do these considerations lead us? I would like to make following suggestions. First, we need a global agreement, a new Bretton-Woods to address three interconnected issues: monetary systems, financial regulation, and energy regulation. My point is that we cannot treat them separately.

Second, we need to do this with a multilateral approach in mind, at the level of world's major regions. The main candidates for the building blocks of the new international system are America, Europe, East Asia, that is China and surrounding countries, and probably South Asia, that is India and surrounding countries.

Third, we need stable exchange rates between the four regions, monitored by an international organization, probably by the IMF, and regularly revised. And we need an internal monetary union within each region.

Fourth, we need new regulation mechanisms. I will not comment on that, because all of the other participants talked about it.

Fifth, we need to stabilize the cost of energy and of basic commodities through the creation of global stocks that should become a means of payment between multinational companies.

Sixth, we need to create negotiable energy quotas as a full-fledged currency. It makes no sense to use the same money, the same currency,

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to pay for human labor and for non-renewable sources energy. Money will therefore play at least two roles: it will help us moving toward sustainable development and curb climate change, and it will stimulate the demand on human labor *without* raising the demand on non-renewable energy.

Seventh, we need to review the economic and financial systems in order to create incentives for long-term thinking and responsible behavior. It is not, or at least not only, a matter of personal ethics and individual responsibility; it is also a matter of measures like suppressing schemes of financial reward based on the number of transactions, banning stock options or granting voting rights to shareholders only once they have owned stocks for a certain period of time. When you think of it, you don't give the U.S. passport to a tourist that just arrived in the country; and yet it is exactly what we do in economic life. As soon as you buy a stock, you can participate in decision making. It's an enormous incentive for speculation and a premium for the raiders.

And eight: We need to invent a new function for money: money as storage of a reserve of assets that will be used in the future. The principle seems clear: such a currency should measure the conditions for future prosperity of the world; having a share of that specific asset is the only legitimate way a generation can claim a part of future prosperity when it gets old. The real gold of tomorrow is the natural, human, immaterial and material capital of the planet. The practical means to have it, to move in that direction, have yet to be invented; but if we would spend half the energy we spend for the so-called innovative finance and accounting, we would certainly find solutions. When there is true commitment, there is always a way out.

Let me add a last point: we need a large diversity of currencies. Global trade can go along with communities of different scales and different natures, organizing their own internal exchanges, as it happens with complementary currencies. Our world is and has to be a world of both increased universality and increased diversity.

**Marcellus Andrews**

As we know, we are in the middle of an economic crisis and facing a short-term problem. We *need* major stimulus and smart stimulus if we are to survive. But when I think about all that, I also think about what we see right now. We have a bailout that reminds me of

nothing so much as a hostage situation, where the kidnapper grabs somebody and says, "My feelings are hurt because you didn't pay me enough money. So if you don't pay me enough money, I'm going to cry, and then I'm going to hurt this person, and then I'm going to snatch somebody else". And see, the thing is, they're doing this in the living room with police, and the police just give up more money. That seems crazy, doesn't it ?

I'm studying institutions, banks, financial markets. I'm trying to explain to my students things I barely understand myself. I'm trying to tell them that we have institutions that are supposed to price, manage and mitigate risk, but that what these institutions actually are doing is manufacturing and amplifying risk, and that they do it through hiding the risk from the regulators, from the markets, from the public. My students say to me: "we read the textbooks, aren't financial markets supposed to allocate capital to its most efficient use? But haven't all these foreclosures and bankruptcies, and these empty houses and people killing themselves because they lost their jobs and their houses, wouldn't all this suggest that there's been a massive misallocation? And now the people who massively misallocated capital are telling us what to do?"

I've been thinking about all that. And I arrived at some conclusions that I would like to share with you. If we go back and think about how all this started, then everything that has been said today seems to me absolutely right. But I also think about the political economy of this, political economy of low taxes and low regulation in a country where the majority – well, a minority at the time, but perhaps the majority now – couldn't afford the American dream. We had made a social deal, which essentially was

**"We made a social deal to finance consumption by debt, and we asked Wall Street to lend money to people who could not afford it."**

to finance consumption by debt and at the expense of people who had been abandoned by the elites of this country. And we asked Wall Street to find a way to lend money to, and to manage the risk of, people who really could not afford to borrow money. Steelworkers in Cleveland who don't have jobs, poorly educated and suffering folks who work in bodegas in the Bronx, folks who want the big house, who want the TV, but who can't really afford it, whose incomes will never allow them to afford it, folks who have to use their credit cards to pay their health insurance. And Wall Street did it. Because we ceded power to an instrument, a corporate form of financial management. And we

asked markets to solve social problems. Somewhere along the line we seem to have forgotten that the corporation is not a part of the social infrastructure, and that its performance, particularly in risk management, is to be judged by whether or not our social needs are enhanced by the use of various forms of financial instruments, by various forms of financial institutions.

Our automobile companies are now on the brink of bankruptcy. We are afraid of bankruptcy because of the long-term economic and financial consequences involved. We are afraid of bankruptcy with regard to Bear Stearns because we were afraid that if Bear Stearns went away, the plumbing of the financial system would collapse, and we would have to face an economic crisis. Is this not a hostage situation?

This drove me back to Charles Lindblom and even Karl Polanyi, and I asked myself: does the corporation fit anymore? In our current system, as we built it, the corporation is a device for accumulating capital, for managing our productive affairs; and we somehow let the financing of this entity dominate. And I keep wondering to myself: once we have dealt with the most urgent problems, maybe the most radical and important thing to do is to revisit the nature of the corporation, revisit it at its basic level? Who and what is it for? Who are its stakeholders? How do we finance this in such a way that we manage risks effectively and punish those whose risk-taking behavior threatens the entire system?

I'm sitting next to Joseph Stiglitz, author of so many articles and books about what prices can and cannot do, which risks can and which cannot be managed, about negative externalities and market failure associated with private management of risk. And we have a mechanism for the chartering and for the bare management of corporations charged with accumulating capital through financial markets and managing, allocating, and mitigating risk; and yet we manage to pay no attention to what this man writes. Somehow we manage to pay no attention to the fact that we have organized our economy and our society in such a way that the management of risk is not an essential part of how we design our institutions. While those who managed these risks and failed still impose their views because of their political influence on the regulation system and the writing of the laws.

We design and use institutions that cannot possibly operate safely. We structure a social contract that deliberately ignores the needs of the majority of the people in circumstances with declining real incomes and growing inequality. We use debts to do something that cannot possibly be done. And then, when it all fails, we allow the

same people to have a say in recovery and reconstruction. This seems insane. Once this urgent crisis is over, we need to revisit the nature of the productive enterprise, the way it is financed and why it should be silent – being just a tool and not a voice in politics or anything else.

#### **Question from the audience**

*I have two remarks. The first one is about hidden problems: we knew all the time there were problems when you over-leverage things and make loans. It didn't come as a surprise. But the real question is how to get a new international payment system, which I think is the point. We cannot do anything in the United States until we solve that problem.*

*The second one is about regulation. The problem will be as follows: Robert Rubin, Alan Greenspan and others will say: "if you put regulation on United States financial institutions, they will just go somewhere else. People will work through the Swiss banking system, since it's so easy to move your money around the world. So, you cannot regulate at all unless you regulate globally, which is not likely to occur, certainly not in Switzerland anyhow". What is needed is some form of capital flow constraints until we handle the international problem. We no longer can have a currency hegemony system. We have to have some sort of international payment system that doesn't rely on the dollar. That's going to be the hard part.*

### **Joseph Stiglitz**

First, I think that the concern you have raised is one that has been weighing on the minds of people like Barney Frank<sup>1</sup>, who are trying to redesign the financial system; and it's one of the ways in which people try to scare away regulation. There is some evidence that countries that have good financial markets, including sound regulation, will actually do better than those that are more volatile because they have weak financial regulation. That's the first point. I'm not sure that it's that bad, that it is necessarily a race to the bottom. Though I do know that many of the G-7 members are worried about trying to coordinate our efforts to get a global regulatory system.

The second point is that we can do a lot in what I call ring fencing. That is to say, "I don't care if people go and gamble in Las Vegas,

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<sup>(1)</sup> American politician, member of the House of Representatives since 1981. Chairman of the House Financial Services Committee since 2007.

and I don't care if they go gamble in the Cayman Islands; I just care if they gamble in ways that affect me". The question is, can we make sure that our financial system isn't touched by gambling going on elsewhere? And I think the answer is yes, provided we impose one simple rule: that no American bank can engage in any transaction with a bank from any country that does not subscribe to the common standards. And that will end the Cayman Islands, or at least induce it to improve. The issue isn't whether we can do it; it's really the political economy issue that was being raised. Someone who had been working at Lehman Brothers told me that when he got hired, they opened up an account for him in the Cayman Islands, as part of the welcome package. That's part of the framework. And these loopholes are not there by accident. But I think we have turned a corner, that we may be able to use this occasion for doing something about it.

Two other points, very briefly. The nature of our current problems has long been anticipated. There are no surprises here except for those who wanted to be surprised. I just reread one of the papers I wrote in 1990, at the beginning of the securitization process. I actually predicted what would happen, I even went down to predict the details, like that they were going to underestimate the degree of the correlation and underestimate the probability that the prices would fall.

#### **Question from the audience**

*There were some stories recently in the press about how retail sales collapsed in October. But there was one exception to that, which was that Wal-Mart sales went up. Now in the short run that can be interpreted as people moving down-market because their incomes are tight. But I think it also indicates a longer-run problem: Wal-Mart is successful not just because they import from China or have supply-chain management, but because the demand for their products grow as incomes stagnate.*

*We all know median income in real terms has been roughly stagnant, which of course is one reason why debt has expanded: people were trying to maintain living standards. I wonder whether this isn't part of the long-term problem that we're discussing, and part of the long-term structural solution. To give you one example: I went back and looked at, for example, flow of funds data right after the 2003 tax cut. As you know, flow of funds indicates where asset purchases and sales are going. And there was a sharp increase in the personal purchases of foreign assets, foreign financial assets, which suggested that the people receiving the tax cut used the money to buy foreign financial assets, that they moved the money out of the country.*



*So I think what we are getting is a real imbalance, where the driving force of consumer demand has moved down-market, while the upper part of the income distribution, which is supposed to generate the savings, according to the trickle-down theory, has actually been buying assets all over the world. How much of that comes back, we don't know; but it does suggest a structural problem which was at least hinted at in the campaign because of Obama's notion of raising taxes on the upper income and lowering it for others.*

*The other issue we need to raise, given that Economists for Peace and Security are co-organizers of this conference, is the military budget, which in real terms is higher than it has been at any point since World War II. And although it's not quite as high in terms of its share in the economy, there's going to be pressure to keep pushing it up. There's no indication from the Obama staff about where they would stand on this or whether they would even address issues about all the inefficiencies, which are absolutely immense, within the National Security apparatus. Usually people talk about, well, non-military government spending, which is primarily health, education, and infrastructure, which is exactly what we need, both to deal with some of the causes of inequality, but also because economic growth is increasingly dependent on human capital, knowledge, and infrastructure.*

## **Marcellus Andrews**

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I agree with your interpretation of the shift in consumption spending towards Wal-Mart; but this brings up another interesting issue. I have come to the view that part of our long-term problem is not just inequality but also declining incomes for people in the bottom 60 or even maybe 70 percent of the income distribution scale: declining real incomes and rising costs for education, health care, and so forth. These problems were managed to some degree by the debt-based social contract pioneered by those who gave us supply-side economics. The popping of that bubble is consistent with the economic collapse we seem to be facing, and that is made worse by the recklessness in the financial markets. The political challenge we face while trying to reconstruct the social contract along the lines that you mentioned is that there's going to be a fight over the use of public resources: should we or should we not have high levels of social infrastructure expenditure and public consumption? This is not just a question of regulation, but of power, of whether certain sectors of the system

have a voice in the restructuring of the social contract. I hear a certain fear about the abandonment of the American social contract in an age where capital is global. Unless we confront the political challenge, we won't be able to do the things we need to do.

## Joseph Stiglitz

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Two comments, both somewhat theoretical. The first is that the point that several people have raised about the change in the distribution of income towards upper income and away from lower income is related to in a way, an old argument that goes back to pre-World War II discussions. There was a worry, as we emerged from World War I, that there would not be sufficient aggregate demand. There was a theory of under-consumption. According to modern economic theories like the theory of adjustment, we don't have to worry about that; the economy always gravitates to full employment. Keynes's view, of course, was very clear: this might happen, but it would happen too slowly and not necessarily in a stable way. And I think that this really is something that ought to be given some attention. What are the processes of adjustment, where do they take us, and why are they unstable? If we don't address the underlying inequalities, which is another way of trying to get up consumption, where will the current system lead us? Because there will be some adjustment, but the question is: which one?

The second comment is an idea that one of my colleagues, Bruce Greenwald, has suggested. I just throw it out, because I haven't yet figured out the extent to which I agree with it; though I think it is an interesting idea. Greenwald suggested that the Great Depression was a defining moment where we realized that the U.S. was no longer an agricultural economy, that it was a part of the structural adjustment. Today, we have a very prosperous agricultural sector, but it only employs 2 to 3 percent of our work force, because we had an enormous productivity increase. So it's both an achievement and a problem.

Manufacturing was the base of our economy for the last 75 years and we have had enormous success in our manufacturing sector, enormous productivity increases. Then the globalization transmitted a lot of this know-how around the world. Now if you take that view, it suggests that America, together with other advanced industrial countries, may be going through a wrenching adjustment. The adjustment meaning that manufacturing is no longer our competitive com-

parative advantage and will not absorb as many jobs as it did in the past, and that we'll be able to have all the television sets in the world that we want – one in every room, one in every closet – and that providing all these goods to most of the people in the world will still not employ very many people, just like providing all the food will not employ very many people.

Now, if that's true, obviously some adjustment is going to be entailed in our economy – in America in particular, but also in the global economy – and if that's true, then we ought to be thinking about, as we look for short-term responses to the crisis, how our spending can help us to make the transition to the new economy. This is what the debate we didn't mention so far, about the bailout of the automobile industry, is about. It is an attempt to preserve the old economy, an old economy whose CEOs have proven their incompetence. And now we want to maintain them. Or is there another way of facilitating the transition, making them a different kind of manufacturing, green economy, and so forth? I just raise that as an idea that I'm not sure how to evaluate, but I think it is an interesting perspective.

#### **Question from the audience**

*If you accept the Federal Reserve data – and I don't know who else's to use – the U.S. financial sector had \$63 trillion in assets and \$4.5 trillion of equity capital at the beginning of the year. Let's say we're down to about \$55 trillion in assets and \$1.5 trillion in equity capital right now. If we went back to 1997 capital ratios, which probably were too aggressive, it would imply that the U.S. financial system needs somewhere between \$6 and \$7 trillion of new equity capital. It makes the \$250 billion first tranche of TARP look like a really bad joke. It can't do anything. But \$5, 6, 7 trillion to recapitalize existing balance sheets, that's 50 percent of our GDP. I guess the only way out of this is a whole-scale nationalization of financial systems. How do we manage that? How on earth do we manage shrinking this balance sheet that there's no way we can support?*

#### **Question from the audience**

*There is of course an immediate challenge before us, but what if the stage that we have entered, the financialization stage, is actually a third stage of our history, moving our economy from manufacturing to finance capital? And if the finance capital now also is finished, what should we expect next?*

## Marcellus Andrews

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What next? Well, to take Professor Stiglitz's discussion of the automobile industry and why it may not be a very good idea to save that particular company, or to save the CEO's, we have to figure out what to do with workers and regions concerned by this. Some of my colleagues spent a lot of time wondering how the United States can take advantage of the so-called green economy. The economists need to figure out a way to turn our country into a place that generates clean technologies, clean ways of living, clean ways of moving, not simply for ourselves, but for the rest of the world. We must pioneer a form of progressive, green capitalism that makes the proper use of markets, that figures out how to price carbon, how to dispose of it, how to deal with the difficult question of coal. Gradually, we have to develop the technologies and the ways of life that we then export to the rest of the world. This would require a redefinition of the role of the state, a redefinition of the nature of the mixed economy, and a fight over who ultimately owns the state.

## Joseph Stiglitz

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Let me answer the first question. We have a certain amount of assets in our society. We have human capital, physical capital, land – all that's here. It hasn't been destroyed – a little of it has, but most of it has not been destroyed. All you're talking about are claims on those assets. And our system of claims on assets has gotten a little jumbled up. People were betting large amounts of money, so much that A owed B, B owed C, but B can't pay C because A can't pay B. And one way of thinking about this crisis is this: everybody was gambling with other people's money, and our whole system of claims on these assets has gotten jumbled up. So, what we need to do is straighten it out. And that's what bankruptcy is about. It doesn't destroy the assets. The car company is still there, the machines are there. It's important, because who controls the claims not only determines future income, but also determines decisions. If you allow the same guys who made the bad decisions to still be in the place of making the decisions, they'll make probably the same bad decisions. And going back to the automobile company, these guys are the guys who said, "I don't want to think about global warming, I don't want to think about making energy-efficient cars". Every time anybody proposed a regulation, they

went to their lawyers to try to stop it. So why should we trust these guys to go into a green economy? That's not where their heart is. That's why there has to be change in management of a massive kind.

Going forward, to keep an economy going, you have to have credit. Credit is basically claims on future resources. The banks are just a vehicle for certifying credit worthiness. Who should I give assets to today in exchange of a promise to pay back in the future? Our investment banks have shown that they are not capable of making those judgments. So again, my view is just, get rid of them. I'm being a little bit extreme, but what I want to do is to raise the conceptual issue, and the issue is that there are some people, some regional banks that have done not too badly. They were caught up and made some judgment mistakes. So it's trying to recreate a system of credit flow which is necessary in order to maintain the production flow and to straighten out the whole set of complicated claims – when you talk about trillions, people say there are trillions of dollars of CDO's (collateralized debt obligation), well beyond the global GDP. What are those? Those are just massive gambles. How do you make the massive gambles? People owe you trillions, so you can owe other people trillions. And that whole system of massive gambling on other people's money has fallen apart. I don't think it's a big deal.

**“No American bank can engage in any transaction with a bank from any country that does not subscribe to the common standards.”**

#### **Question from the audience**

*Private assessment of risk, credit worthiness of individuals and firms, all this has been badly shaken up. And there have been several reform proposals recently, for instance to reform the credit rating agencies and create a centralized agency that would be quasi-independent. I would like to know what the panel thinks about that.*

#### **Question from the audience**

*There's a lot of talk about stimulus, big stimulus, but very little about where we should spend this money and where we shouldn't spend it, or how we should raise it and how we shouldn't. Surely, military spending is the absolutely worst kind of spending, we should rather spend on human capital. But let's look more closely at what we should and shouldn't spend, because just any “old” spending could be terrible.*

## Marshall Auerbach

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I agree with that last question. Beyond obvious things like extending unemployment claims and food stamps, I do believe in the general thrust of “green” infrastructure, and generally public infrastructure in general. You have bridges falling apart in Minnesota. That in itself should be a clear indication of what we should be doing. And I would also substantially cut military expenditure and transfer the funds to something else. Unfortunately, the Pentagon has such a powerful influence on U.S. politics that I wonder if there will be a serious cut in military expenditures. But obviously we need that. The U.S. spends more on its defense than the next 20 countries combined.

As for the rating agencies, today we have market-based agencies rating the products of their customers. This leads to conflicts of interest that would be best eliminated by having third-party independent agencies. But I have also been wondering about securitization as a whole. My wife is a theoretical physicist, and when I described what securitization was, she said: “you used the techniques of statistical mechanics to treat asset prices like subatomic particles. Now the thing is, there are a lot of subatomic particles. They all move around more or less on their own. Now you’re treating these things like asset prices in people’s portfolios, but all these people think more or less the same way, so even if they never talk to each other, the asset prices are automatically correlated”. When you think about it: we’ve got all kinds of financial instruments that come from using even more esoteric techniques in mathematics, but wouldn’t it behoove somebody to actually do the math first, before going out and selling it? You would think that the people who came up with these instruments would at least try it out first, wouldn’t you?

session 2 moderator **Jeff Madrick**

# Policies for the United States

**Allen Sinai**

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I think everybody knows by now that the U.S. economy is in a full-fledged recession, probably the longest and deepest since the 1981-82 and 1973-75 recessions, possibly worse. This downturn began with the collapse of the housing sector several years ago, after an incredible boom and a housing asset price bubble. We have entered a major, probably secular decline in the levels and growth of consumer spending. That counts, because consumer spending in real terms represents 71 percent of the real GDP, and it is a major lever for the rest of the U.S. economy – as it is for the global economy, considering how much of what is exported to us is exported to the American consumer as the end buyer.

With declining sales profits and cash flow for American businesses, major cutbacks are being prepared as we speak for production inventories and jobs and in capital spending. There will be rising unemployment – 6.5 percent at the moment we speak, up to 8 percent in 2009, maybe a little more. (It would be even more, some 10-12 percent, if we didn't have the demographics of the labor force in play that we actually have.)

That suggests there will be less consumption as a consequence, less sales, less earnings and business spending and worsening financial conditions for households and corporations, which in turn will lead to higher credit risk for financial institutions, already chock-full of credit risks and imploding at this point.

## Looking for Solutions to the Crisis

There is also a global recession. In part it comes from reductions in exports of many countries to the United States and to each other, and with lags that will take down the growth of U.S. exports and prolong our downturn.

And then there is the U.S. financial crisis. That crisis is about massive declines in asset prices, large contractions in the balance sheets and numbers of U.S. and global financial intermediaries, and an implosion of credit.

The consumer is at the heart of all this. Of course, housing and residential construction is still declining as well but that's only some 3 percent of real GDP, while real consumption is, as I said, 71 percent of real GDP. It used to be 67 percent or so, then it got a bit higher, now it will regress again. This is both a secular and a cyclical adjustment.

Actually, consumer spending growth was far below its historical trend long before the 3 percent decline in the third quarter of 2008: it was already running at about 1.5 percent annualized. Which is not so much, considering that over the last 45 years, growth of consumer spending has been about 3.5 percent a year (adjusted for inflation). This is an incredible number that says something about our culture and what we do as consumers. Or rather what we used to do, since the current long-run and short-run indicators show a very dark picture. And a couple of them – the household financial position, job losses and an unemployment rate to come – suggest that the consumption downturn (-3 in the third quarter 2008) will remain negative for two or three quarters.

I would add to this the psychological element. I think American consumers understand by now that the world has changed, that they can't go on the way they have in the past. We're going to have to spend less, borrow less, accumulate less debt, get our balance sheets in better shape. And we will have a much higher personal savings rate. The weak consumption will result in less growth in sales and earnings, and businesses will have to cut back.

The two areas of our economy I just mentioned add up to 84 percent of total real GDP. Think of what will happen to Chinese, South-Korean and Japanese exports when 84 percent of total U.S. demand is in decline. Of course, those countries also trade with one another, and yes, not all of them are as exposed to the U.S. decline as China, but they are nevertheless exposed. Some 27 countries have dropped into the recession by now, including the United States. That's 80 percent of global output as we measure it, and I think it will be some 40 countries before we see the end of it.



If we now turn to the policy responses, these responses must come both on the monetary side and on the fiscal side. It is absolutely necessary to pour liquidity into the system. Of course we need lower interest rates, but once the illness is in train, lower interest rates can't touch it. Even if they fall to zero, it wouldn't help unless the rest of the system heals. Only once we start to pick up will low interest rates help.

The same goes for the liquidity that's being pumped into the system, in the U.S. and other places, mostly focused on recapitalizing banks. There's no way to prevent the private sector financial institutions, whose balance sheets are contracting as we speak, from swallowing the funds that come in, putting them into treasuries, shoring up their capital ratios – unless we reduce, which we ought to do, those capital ratios during this time of extremis. There's no way to stop them from holding it, not lending to each other, and not putting it out to consumers and businesses. And when finally banks decide to do all that, we might discover something even worse: that nobody will want to borrow.

**“American consumers understand by now that they can't go on the way they have in the past.”**

Let's turn to fiscal policy. We have a wave of fiscal stimulus packages in the U.S. and across the world, including increased government spending and other means of using the government in the private sector to shore it up. In the United States we see the government involved in the private sector, taking stakes on behalf of the shareholders or the stakeholders. That is very new, and I would rather see more incentives for the private sector to participate in putting money up rather than the government doing it; because as a consequence, our credit rating will probably get lowered by those credit-rating agencies which, if we reform our regulations right, will no longer be the hired hands of Wall Street.

The effect of fiscal stimulus and government spending in most cases helps; but it is transitory unless you keep doing it, and sooner or later you run into the problem of how to finance the deficits. Normally it's with higher taxes, and we may go down that road. But the composition of this stimulus matters. Since the problem is the consumer, I tend to suggest tax cuts, permanent tax cuts, as a part of the stimulus, along with heavy-duty Keynesian government spending stimulus. And I tend to think that middle- and lower-income families should benefit most from it.

On the government spending side – you'll hear this again and again in Washington – there'll be a lot of infrastructure spending

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intelligently crafted for the short and long run. Part of the stimulus should go where it would be curative. Nothing we have done so far will really stop housing prices from falling. Neither the Paulson plan, the original one, which was going to help the balance sheets of banks, nor the current measures against foreclosures and bankruptcies, did do anything for the demand and supply of housing. I'm a free-market person, but I've suggested measures like in the 1930s, where the government goes into the housing business. The supply of all the vacant housing and the inventories of housing have to be squeezed down, while on the demand side, given that the consumer indicators will continue to go down, the cat will never catch its tail. If we let the deflation continue, if stock markets continue to do poorly, we will end up with a severe episode – not the 1930s, but the worst situation that we've had since the 1930s.

**Theresa Ghilarducci**

If comments can have titles, my title would be, "Three Cheers for Automatic Stabilizers: Where Goes Detroit Goes the Rest of the Nation," because I'm going to talk about the big part of the stimulus package that's being ignored, and give you four recommendations for the stimulus package that go beyond tax cuts for the income taxes, and beyond federal spending in terms of roads and bridges and other kinds of infrastructure.

**"We should focus on health care as a stimulus package, not just on roads and bridges or the green economy."**

The financial crisis reveals the importance of income streams that are not related to labor or financial markets. Not only is it important to get money into pockets of families that aren't related to finance markets and labor markets but it's also a way to get us out of the recession. We redouble our appreciations for government deficits, and this gives us a chance to rethink those sneaky aspects of our federal architecture, our fiscal policy architecture, that actually deliver stimulus and meet the criteria that we want from all of our fiscal stimulus programs: these programs have to be timely, targeted and temporary.

The part of the fiscal policy I'm talking about is called automatic stabilizers. These are programs and systems that, as soon as a recession hits, inject money into the economy. The most obvious one comes from the progressive income tax structure: since in recession

people are losing income, they fall down the ladder into lower and lower tax breaks, and we get an instant tax cut that does not require an act of Congress. Usually we stop there, but right now, during this unusual time, we have to go beyond that usual thinking.

The other automatic stabilizer is, of course, unemployment benefits. Unemployment benefits are triggered by a recession they are paid out the week a claim is made, so it's timely; if you extend it or increase it, it becomes targeted to those families that need the money the most; and, from a macroeconomic point of view, it actually is targeted to the areas of the country that need it the most.

But we're ignoring all sorts of other automatic stabilizers that we need now. The first one is Social Security. Social Security works just like unemployment benefits. Many people retire or accelerate their retirement plans in a recession, or find a yet different way to leave the labor market: either through disability – even in cases where it is not required; in all OECD countries disability works as a de facto unemployment insurance system – or through collecting Social Security early benefits if they can.

Another, indirect but important part of our automatic stabilizer infrastructure comes through fiscal policy. It comes through the collective bargaining agreements or labor agreements, and it comes from the architecture of our employee benefits and wage structure. Defined benefit plans and traditional pension plans work as automatic stabilizers. Because people can retire early from a shrinking employer or shrinking industry, they can often retire much earlier than Social Security retirement age, which only starts at 62. You have automobile industry workers, coal mine workers and steel workers retiring at 55. We have a whole history of industrial policy that has been implemented through the defined benefits system. So we have all these early retirees collecting their traditional benefits, and those benefits are pre-funded, they're a guaranteed payout; so they're not related to the ups and downs of the financial market. We actually have a nation that is in much better shape thanks to traditional pensions, Social Security early retirement benefits and disability payments. And you didn't appreciate that, did you? That's because they're very underappreciated. But they're vital.

After 30 years of a shift away from these traditional benefits to a defined contribution or 401-K-type world – our federal tax system has given more and more indulgence to the 401-K system, saying to employers and government: “you no longer take the risk of retirement or layoffs; we're going to give that to the worker” – we actually

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transformed an automatic stabilizer into a destabilizer. We see it in the newspapers right now: young people are having a hard time getting jobs because the older people are fearful, panicked about the strength of their own 401-K plans, and are hanging onto their jobs. So just when you want the elderly to withdraw from the labor market (or not to come back to it), you have them clinging on to the labor market. That's precisely the reverse of the behavior that you want from an automatic stabilizer.

Over the last 10 recessions we've seen the elderly withdraw from the labor market, especially men. But in this last recession: we're actually seeing a big increase in labor force participation of the elderly, and that comes from the lack of secure pensions.

Let me take the example of Detroit. If it wasn't for the automatic stabilizers that we have in Detroit, the city would be much worse off. And believe me, Detroit and many other parts of the country are much worse off than any federal statistics, any national statistics that Mr. Sinai and others have invoked. The unemployment rate is at 6.5 here in New York; in many other parts of the country, like Detroit, it's three times that amount. The situation would be even worse if it wasn't for Social Security. The work-force in Detroit is 2.8 million in the metro area of the city. Seventy thousand former workers are getting Social Security benefits. Twenty-five percent of the work-force is actually getting money from former attachment to the labor force – and they got a 5.4 increase in their “wages”, as Social Security went up last month 5.4 percent. It went up while every other source of income went down.

Negotiated pensions, defined benefit pensions are a very important source of income for that region. Some twenty years ago, thirty percent of the workers in Detroit were in unions. They got defined benefit plans, not 401-Ks. Those negotiated benefits are paying their dues now. The incomes in that area are going up.

Equally important, and this leads to my solutions, is how the health insurance industry is constructed. In Michigan, it has been built up by the health insurance benefits contracted at work. But the health insurance model varies from region to region: some areas of the country have more generous health insurance plans than others. So if ex-auto workers and their families are getting new jobs in Detroit – there are all sorts of programs to turn tool and dye-makers into nurses – it is because there was an auto industry and rich benefit plans. That contour gives you a flavor for why I'm going to propose what I'm going to propose.

Here is what I propose: instead of just focusing on cutting income tax rates, we actually should look at how the tax structure can choose winners and losers among industries and pump money into the economy. That's the hidden aspect of our tax system, the tax expenditure side. Professor Stiglitz alluded to the housing industry being promoted by the tax deduction. He mentioned that the tax deduction might be a very poor way to expand home ownership and to provide subsidies for home ownership in this country, because you're actually delivering the highest subsidy to the people who need it the least. I have done the same thing for the 401-K industry. It now comes through a tax deduction, not a tax credit. I'm attacked today in *The Wall Street Journal* op-ed piece for precisely that suggestion: that we turn the deduction into a credit; Professor Stiglitz, let this be a warning to you what might happen to you also.

I also agree with Professor Galbraith that we should immediately suspend the FICA tax for employers and employees, but with an important proviso: rather than suspending it, we have the government pay it, so that the income is still going into the Social Security system. We give relief to employers and lower the cost of hiring – that's a jobs program if I ever heard one – and we also increase the net take-home pay of lower-income workers the most – that's a stimulus program if I ever heard it. In other words, I would suggest we focus away from that income tax and talk more about the payroll tax.

The third proposal I have is to raise Social Security benefits. A way that would really help employers hobble through this period of time is to lower the Medicare age from 65 to 55. In one stroke, a lots of elderly people clinging onto their jobs will suddenly be able to retire; at the same time you lower the health insurance costs of many employers all over the country, especially in the manufacturing regions where they actually pay health insurance.

The last proposal I have buys my ticket into a conference on peace and security: we focus on health care as a stimulus package, not just on roads and bridges or the green economy. Since investing in the health care industry is also a way to create jobs. But we can't have national health insurance or universal health insurance without finding a way to finance them. We can't just give health insurance to everybody and watch the costs go up; we have to do something about the infrastructure of health care delivery.

As it is, we've already done that with the Veterans Administration. It's becoming the best delivery system for health care, especially for elderly people, in this country. It has automated its medical records and

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created a distribution of doctors and nurse practitioners that provides the best health care for the least cost. Now most of us in fee-for-service have to go to specialists to get our good advice. The best way to deliver health care is to do it through internists or general family practitioners and that's what the Veterans Administration has developed.

So here's my proposal: Expand the Veterans Administration with the Iraq war budget, build new clinics everywhere in this country, and then allow private sector groups to buy into the Veterans Administration. I am a trustee of the largest health care plan on the planet if it gets implemented: for retirees from GM, Ford and Chrysler. Our members have retired mainly in the metro area. We have one of the best, newest Veterans facilities in the country in Detroit. If our health care trust could just buy into the Veterans Administration, the negotiations that are happening now in Washington over the fate of the big Detroit auto firms could actually be moved along very substantially; because a big part of the cash flow problems of GM and Ford and Chrysler are caused by the health care obligations. Let the government help reduce that obligation in a creative way – and a fast one as well; we could do it in a couple of weeks.

To summarize: we have to rethink the way that we can do fiscal stimulus, and do it through the payroll tax and tax expenditure, making them much more progressive. That will immediately raise consumer demand. And we have to consider national health insurance as an infrastructure and jobs creating program.

### Perry Mehrling

Three years ago, I published a biography of Fischer Black<sup>1</sup>. As a monetary economist, this was my way of coming to terms with the modern world and our financialized economy. Writing in the 1970s, Fischer Black imagined a world yet to come: “a long-term corporate bond could actually be sold to three separate persons. One would supply the money for the bond; one would bear the interest rate risk; one would bear the risk of default. The last two would not have to put any capital for the bonds, although they might have to post some sort of collateral.” What is the financial product of the second person, the one

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(1) Fischer Black And The Revolutionary Idea Of Finance, John Wiley & Sons 2005. Fischer Sheffey Black (1938 -1995) was an American economist, best known as co-author of the famous Black-Scholes equation (presented in the article “The Pricing of Options and Corporate Liabilities”, *Journal of Political Economy* 81/3 May-June 1973, pp. 637-54.)

that bears the interest rate risk? Obviously, it is an interest rate swap. The third person holds a credit default swap. In other words, in the 1970s Fischer Black was imagining a world that we live in today.

I see the current crisis as the first actual test of that world. This is the first serious downturn of our new financial system, and we discover where its weak spots are, where it breaks. The temptation is to throw it out, but then we will redo 40 years and that's a recipe for a very long recession. Another proposal would be to look where and how it broke, and how we can fix it. This is a story about free markets and their failures: where are the externalities? What is the role for government? What regulation do we need in order to control this brave new world?

I'll tell you a little story about how I came to that proposal: in April of this year, I wrote my first letter to the *Financial Times* about credit default swaps, saying that the problem is that credit default swaps are actually quite old. The bankers' acceptance is basically a kind of credit default swap; it's a kind of insurance where a bank says, "if this person doesn't pay, I'll pay". It was the key to the organization of the British banking system in the 19<sup>th</sup> century. The entire banking system was built on bankers' acceptances, basically what we call today commercial papers.

I happen to know that because I know monetary history. And so I said to myself what's different about the modern system is that this credit default swap floats freely, it's not attached to a particular instrument. The second difference is that there's no lender of last resort. There's no support for it. What's happening right now is that these instruments are getting dislocated from the actual underlying credit risks. And what's even worse, those prices are the prices that we're using to mark to market on actual balance sheets. This sort of free-floating instrument is driving down valuations away from their fundamentals.

That was a short letter, on the basis of which I got invited to a meeting that Joseph Stiglitz held in Manchester in June, and I turned it into a short paper. And they liked the paper and suggested I turn it into a chapter for the book. I spent about a month in the summer, revising it for the book. Then, when the crisis came in mid-September, when AIG went down, the penny dropped for me and I said, "Okay, I get it. I see what's happening, and I now think I know what we can do to fix it". And I wrote another letter to the *Financial Times*, which they published September 19. I immediately started working on expanding that into a proposal, which was published in the Economists' Forum in the *Financial Times* a couple of days later, called "Budget plus RFC (Reconstruction Finance Corporation) Equals

the Right Financial Fix.” I suggested the government should go into the business of writing credit insurance, as premiums you would accept payments with preferred stock. I proposed that while TARP was being designed and eventually got involved in the legislation process. I don’t know if I can take any credit for that but in fact there’s a Section 102 in that legislation that allows TARP to write credit insurance. Nobody seems to have noticed that, the press has not written about it, but it’s there.

The idea is thus that the government should be serving as credit insurer of last resort. AIG and others were serving this function, but they aren’t anymore. They’re certainly not writing any new policies. Nobody is writing new policies, and as a consequence, the securitized credit markets are just completely frozen. The reason they are frozen is because there’s no insurance backstop. So I’m proposing that we create one and that the government should be in that business.

The first idea is that it could use existing credit default swap markets; this goes back to what I said about the 19<sup>th</sup> century, that we need a lender of last resort to backstop this thing. More generally, the government should be in the business of selling insurance against disaster risks. Most of the time, it does exactly the opposite; it feeds “the next 10 percent of losses we’ll help you with”. What I suggest is that we don’t pay for the next 10 percent but for the bottom 90, or the bottom 50; so that we create a floor. This insurance would then be a new policy instrument, just like bank rate was a new policy instrument invented by the Bank of England in the 19th century.

The price of this insurance would be the price of systemic risk, because you’re insuring the triple-A securitized credits, the very best ones. Those are the ones that go down only when the system is in systemic crisis. No private insurer can actually fulfill an insurance contract like that, but the government can. And actually it is fulfilling that function right now, but without getting any premiums for it beforehand.

The idea behind pricing the systemic risk is to change the behavior of people in this market. If you had priced the systemic risk right, if AIG was charging 15 basis points to insure the triple-A super-senior CDO tranches held by UBS – it’s in their report; they were charging 15 basis points – UBS was doing an arbitrage on this that they were earning about 15 basis points on. And they leveraged this to the hilt because they were allowed to treat this as tier one capital under Basel II. If you charged 30 basis points for that insurance, that arbitrage would go away. They would never have done that in the first place, since it would not have been profitable. And we know retrospectively



that it wasn't profitable socially; what I suggest is to make it unprofitable before it starts.

There are other benefits with this. For instance, you could use this measure counter-cyclically; changing the price of insurance cyclically, independently of the discount rate. You could also choose what instruments you're going to insure and which ones you're not. You can use it as an oversight of the ratings agency; because what counts is a triple-A securitized credit. It could be up to the government, not just up to the ratings agency.

Instead of doing that, the government has been doing the Central Bank balance sheet. The TARP is in fact a sort of side issue; they spent hardly any money. Everything that has happened in the last six weeks or even in the last year has happened on the balance sheet of the Fed. A year ago, the balance sheet of the Fed looked as follows: \$900 billion-worth of Treasury bills on one side; \$900 billion-worth of currency on the other side, then a few small items (bank reserves, a couple of billion dollars here or there). The major numbers were Treasury bills and currency.

**"The idea behind pricing the systemic risk is to change the behavior of banks and financial institutions."**

The currency is still there; the Treasury bills have all been sold, and the proceeds have been lent out to banks. Which means that the first trillion dollars of support for this system came from stripping the Central Bank of all of its Treasury bills. (Then the Central Bank balance sheet was expanded by \$527 billion, up to \$2.3 trillion.) And then another trillion dollars worth of lending went to private banks against mortgage-backed security collateral. In parallel, we see how banks' reserve balance grows: the required reserve in our system is \$50 billion; today it's \$550 billion. It all happens on the balance sheet of the Fed because the Fed has the freedom to maneuver.

The point I want to make is that most of it was triple-A loans. When you hear about "toxic assets", you imagine that somehow it's all garbage. In fact, most of the CDO tranches out there have not defaulted and will not default. But they are trading at 60 cents on the dollar, and they're being marked on the books of the banks at 60 cents on the dollar.

What happened since? We had the collapse of asset-backed commercial paper and we're moving the entire wholesale money market onto the balance sheet of the Fed – little by little, but eventually those "littles" add up, and you get trillions and trillions. We have new facilities for this: The Money Market Investment Funding Facility, with some \$540 billion, and the Commercial Paper funding Facility with

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\$300 billion. In sum, our policymakers are saying “we must make it possible for them to hold these mortgage-backed securities, so we’re going to help them with their unsecured funding. We’re going to take credit risks, and our credit risk is going to be to the banks themselves. We’re going to give them unsecured funding, non-recourse loans, etc. And we’re going to give them capital.” What I’m suggesting is to do it the other way around: Support the value of these assets, even at a very low level, and then they can get their own funding. Then you can use secured funding instead of using them at the discount window of the Fed.

At the moment we speak the Federal Reserve Bank has given some \$2.2 trillion in credit, of which \$615 billion to foreign central banks, in order to help foreign bankers hold dollar-denominated mortgage-backed securities they never intended to hold – they were in SIVS somewhere, and the SIVS collapsed. We’re lending them money: to the ECB, the ECB lending it on to their banks, and to Switzerland, and so forth.

The Central Bank used to issue currency at 0 percent rate of interest in order to hold the Treasury bills. The U.S. Fed used to be about financing the government. Now the government is about financing the Fed, the Fed is issuing liabilities to the Treasury and using those proceeds to lend to private banking.

## Gary Dimsky

There are many things to be said about what we should do in the current situation, but let me focus on main themes. First, our banking and financial markets need to be fixed. Banking firms must play their appropriate roles in our economy. If they function well then the use they serve will be sustainable and have expanded wealth positions. If not, then it’s the financial system, not those units, that fail. That means that we have let the predators take prey rather than constructing a functional system. That also means that we cannot afford to think of our financial sector as a source of national competitive advantage, as we have been thinking about it up to now.

Secondly, the borrower-lender relationship which is at the core of banking has been compromised and must be restored. There’s a mismatch between the units engaged in risk-taking and those engaged in risk-bearing. Perry just offered one kind of solution to that, which is to try to find an anchor for the risk-bearing side of it, and I think we need to have a debate about that. The zone of businesses

and households encompassed by normal bank lending has shrunk as banks moved towards standardized metrics. These standardized metrics have sometimes been used wisely, but more often they have been used to fine-tune either financial exclusion or, more lately, financial exploitation. This has to stop. Banks must lend to borrowers and bear the risks of their lending. They must make loans they do not expect to fail. We cannot insure against that. We have similar discussions about wildfires in California. Some of my policy friends, geologists and others, want to insure against wildfire risk with bearer bonds. My point would be, if houses burn, you must put out the fire.

Something like that is going on right now in the banking sector. Banks must, in my view, be clearly distinguished from financial firms that are involved in risk exchange and in zero-sum speculative bets. There should be a firewall between these markets, the markets that trade risk in real time and markets that originate credit and capital and nurture it through time.

In my view, at the hub of this is this question of what a bank holding company really is. And I suggest going back to this very simple definition: A bank holding company is an entity whose principal reason for being is commercial banking. It may engage in activities closely related to banking, as was said in the 1956 Bank Holding Company Act, but not much more than that. You should not be able to become the bank holding company because it serves your convenience, and you must not be able to maintain your strategies, as Morgan Stanley promised the other day, while maintaining that cover of privilege. It's just wrong. It's predatory, in James Galbraith words.

The scope and purpose of government guarantees of banking must be reconsidered. The expansion of implicit government underwriting has to be reconsidered as well. I think 100-percent guarantees must be carefully nurtured.

This brings us to the problem of regulation and the control of abuse of market relations by banks and the players in financial markets. There are two areas to control: speculation and financial exploitation and/or exclusion. As for the speculation, I think we have to be very careful about allowing our mega-banks to directly or indirectly position themselves to make money from either side or both sides of zero-sum trade-offs for borrowers. We have to make sure that our regulatory authorities have adequate scope of coverage, so that any intermediary that offloads risks must do so in such a way that those risks can be monitored transparently and in a timely manner. AIG is a case in point. We must insure that there's principle agent responsi-

bility in funds and sub-funds. And I think the idea of passive financial intermediaries has got to be retired.

The second aspect of regulation is about fighting against financial exploitation and exclusion. There must be meaningful regulatory inspections and expanded public reporting on the volumes and prices in all lines of financial business, both its formal and informal sectors. This regulatory power must include penalties for the denial of credit to areas, individuals, and businesses on the basis of race and gender, as well as penalties for selling overly risky credit contracts to them. That's basically the Community Reinvestment Act. And that's a key part. One must keep in mind that the African-American community was one of the key components in bringing Barack Obama to power and that it was the very first victim of the sub-prime crisis. The growth of sub-prime loans in the inner cities of our country was 900 percent between 1993 and 1999; while forms of regular mortgages went down. That is a political fact that has to be kept in mind.

Large banks, if they are too big to fail, must meet a higher community reinvestment standard, and we've got, I think, to remove the Federal Reserve from the business of bank regulatory oversight since it interprets safety far too narrowly.

Let me move on to housing and mortgages. I think in the short term we've got to keep people in their houses. The powerful finance system that we now have for mortgages is designed to flush foreclosures through. But allowing people to sell

**“There must be meaningful regulatory inspections and expanded public reporting in all lines of financial business.”**

their homes for non-viable mortgages stabilizes nothing – what we obviously need is a balanced mix of fairness and incentive incompatibility that has to be found.

We should start by taking an inventory of houses that are delinquent and divide them into owner-occupied and others. It's not the right time to try to find the market value in markets like California or Detroit. Let's find out the basics: how much are these people actually paying? Can they make it? And what relief on a sliding scale can we offer them? The government can take an interest in your home with you and keep it until you sell it, at which point it cashes in, as do you. That's something like the Homeowner's Loan Corporation that Paul has suggested reviving.

In addition, we might need incentives for housing construction. In California we have about 500,000 people a year moving in, and we're building about 225,000 units of housing every year. Thus, we're housing less than half of our increment. That's a big source of the

housing bubble. According to my colleagues from state government, restoring the federal rental housing credit would be very useful. The 1986 reforms really took the teeth out of it and resulted in a downward bump, especially in multi-family housing, which is where we really need some help right now. In the longer term, we should use land-use taxes in order to remove funds from areas where there has been inadequate attention to the need to create lower-income housing or mixed-use housing and to use proceeds from such peoples' homes to build affordable housing somewhere.

My third point is about the stimulus to state and local governments. I had a chance to reread Cary Brown's wonderful analysis from 1957 about the Great Depression and fiscal policy. The point he made is that it didn't really kick in for a long time, and the reason for this were the tax increases, especially at the state and local level, that almost offset the impact of the federal stimulus. That is going to happen today in states like California and others. In California, we have about a \$20 billion deficit. If you take into account state, county, cities, and municipalities, some part of it's self-inflicted, but not all of it; and basically we're now facing the Republican Caucus in our state, which is fierce, pointing out that raising taxes is the wrong thing to do in a recession. Of course they're right; and the advocates on the other side, like my friends at the California Budget Project who talk about things like maintaining unemployment insurance and stabilizing Medicaid, think that this is no time to cut poor people's expenditures either. They're both right, and that's why we need some form of revenue sharing. James Galbraith has been calling for it for a long time, and we have to hope that it happens.

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### Jeff Madrick

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I would like to make three quick comments about this session: We focused a lot on financial issues. If and when we get past this crisis, we've got to turn to what I think is the more fundamental crisis, and some people have addressed it. We've had a wage crisis in America for 30-35 years and we don't necessarily need a lot of federal spending to deal with it. We need enforcement of labor laws, we need enforcement of union organizing laws. The list goes on and on. I won't list everything we can think of. Some of it has to do with the dollar policy; some of it has to do with some adjustment to fed policy. And I think some of it has to do with the attitude of the President:

who should not be afraid to say the truth when CEOs make unconscionable amounts of money, and their workers make less money. Business is afraid to be singled out and scolded by presidents, and we haven't done that for many years.

**“As Rahm Emanuel once said, a good crisis should never be wasted”.**

Number two: Ideology. Ideology is often a cover for self-interest, but ideology has carried us where we are, a free-market ideology that's widely adopted not only by a conservative group of economists and policy makers, but I think by the media as well. There is push-back on it. Fannie Mae did this to us. Some people try to explain to us that it was really Roosevelt that caused the Great Depression. There are serious papers about all that these days. And there will be more of push-back. As Rahm Emmanuel said, “a good crisis should never be wasted”; I think those words will live on, much like “there's nothing to fear but fear itself”. They are an echo of Milton Friedman's, who said something similar in 1982, after the fact, and attributed his own success to the crisis of the 1970s.

And finally, one quick word about the nature of the corporation. We're talking about financial firms allocating risk. There is a serious agency problem, as economists call it, in these financial firms: the people making the decisions weren't taking risks. There was a joke always on Wall Street about IBGYBG – “I'll be gone, you'll be gone. Let's just do it”. Stan O'Neill, after putting Merrill Lynch under, took away \$190 million. Raines at Fannie Mae almost took away \$90 million. It didn't seem to me they were taking on much risk. They put their institutions and the nation at risk and made a heck of a lot of money themselves. I think the nation has to address the issue of the corporation and the agency problem.

Now a question to Allen Sinai: why are you so timid about your stimulus plan when Goldman Sachs is calling for \$500 billion in stimulus?

### Allen Sinai

Because I think you should start slowly. There's a lot of liquidity being pumped in at very low interest rates, the world is joining the parade, so we'll have a global fiscal stimulus, and let's not forget that we do have huge deficits coming, deficits that are unimaginable in terms of the numbers and a sharply rising debt-to-GDP ratio. I want to start on the lower side because I don't want to see those debt-to-

GDP ratios skyrocket, and then short-sellers and the global financial people attack the U.S. government by selling the dollar – because that is ultimately what stops our ability to finance our own problems, is what could happen to the dollar. But I'm prepared to go higher, depending how deep the downturn goes. And it all depends on how you do it. If you do it with government spending, I don't find that you get, other than certain kinds of infrastructure, as long-lasting effects on the economy, but you do have higher deficits and higher debt.

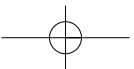
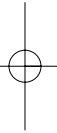
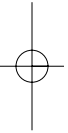
**Question from the audience**

*Someone mentioned the American corporation, the agency problem, the fact that the people that cause all these problems were not risking their money. I think we should discuss the difference between this group of people. They are not classical capitalists at all.*

**Allen Sinai**

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I absolutely agree with that. What we did have – and I think we should think about it – was unconstrained maximized shareholder value and aligning all stockholders and shareholders with that goal. That is simply maximizing the value of the stock. All these innovations, the twists and turns of business, the way that Wall Street took advantage of low interest rates and the smart part our best graduates from our best universities went there because they could make a lot of money on the shares of stocks – is that really what the objective should be? That is absolutely a totally corrupt objective that we've all been following here for about 15 or 20 years, and we've seen it unravel.





## Key note speech

Bernard Schwartz

Over the last decade we got used to healthy economic indicators. We seemed to have achieved a global economy, one that expanded markets, lowered prices and spread the risks. We had historically low interest rates. The emerging economies were creating new demand everywhere. And new methods of securitizing debt provided abundant liquidity.

Then, all at once, the music stopped. The indicators turned out to be misleading. Many people talk about a systemic failure or a latent defect in capitalism. Others try to explain that we should leave it alone, that market prices will kiss it and make it better. Unfortunately, their explanations don't work. What we have witnessed is a collective breakdown of responsible behavior. We just stopped acting smart and responsibly. And our behavior was further confounded by a willful confusion that obfuscated the obvious facts. It is not that we did not see it coming; we all saw it coming. Our government's distorted vision of the economy, incompetent regulators and corporate greed – all this prompted our confusion and eventually led to the financial disaster.

Throughout the 2007-8 financial crisis, the single most consistent reaction has been, and continues to be, confusion. This is evident when we consider the erratic behavior of our government leaders and corporate executives, the extreme volatility of our stock markets, the arrogance of an administration that could submit a two-and-a-half-page policy proposal that effectively sidestepped 190 years of our nation's historic commitment against economic concentration, and particularly concentration in the banking sector. You saw the confusion in the inane shallowness of the media reportage during this crisis, and in the 40, 50, 100 times multiple capital leverage employed by investment bankers. You saw it in the repeated assurances of the president, the treasury secretary, the Fed chairman, leading right up to their sudden admission that the catastrophe can only be managed by an emergency process.

We saw the confusion when regulators first said "yes" to Bear Sterns and then "no" to Lehman. We saw it in the successive bailouts for AIG, none of which as worked so far. And do you remember the

## Looking for Solutions to the Crisis

endless discussions about whether or not we were in a recession? About the calculation of \$700 billion as the estimated price of capitulation? We did not have a clue then, and we don't have one now, of what the true exposure actually is. As incredible as it sounds, even today no one knows the extent of the securitized debt that remains outstanding, no one can respond to the question: "what is the size of the problem"? But if you don't know the size of the problem, it seems hard to address it. You would have thought that, somewhere in our government and the economic channels, somebody would have been keeping track of this immense new capability that we lauded as being a liquidity provider, that somebody bothered to count how much was outstanding.

So there was plenty of confusion about the crisis. But perhaps it was nothing more than professional stupidity? I would argue that the meltdown was not a systemic failure: it was a human failure. After all, the conditions of the crisis did not arise suddenly like a tsunami. The warning signs were readily apparent to all. The housing bubble took years to develop to its full height of excess speculation. Everyone talked about that. Political leaders boasted of pressuring financial institutions like Freddie Mac and Fannie Mae that they should ignore lending standards. Lenders, bankers, mortgage brokers hid owners' covenants in small print from naive home buyers. Home builders raffled off applications to purchase tract homes which were sold several times – the applications – before the house was even built. Credit card issuers indiscriminately made out credit cards to published mailing lists that they didn't know anything about. All of this is well-known. Our collective non-reaction to danger was a behavioral breakdown.

Where were the rating agencies who were compensated for their irresponsible credit ratings? Where were the corporate boards who granted huge bonuses for overstated performances? Where the public accountants who certified reports with understated liabilities and inadequate reserves? And the regulators, where were they? But more to the point, where were we? And where are we now? Are we in any better position to judge what our corporate and political leaders are doing? Are we more skeptical about what they do? I think not.

These questions were relevant last year, they were relevant five years ago, maybe a decade ago. The circumstances are more complex today, oversight is more lax, economic performance has substantially deteriorated. What's more, these adversities are global, compounding the negative impact on all the leading economies. And still, there are tried and true remedies that can help if we have the political will to legislate their adoption.

What should we do then? We should enforce the regulations, limit or eliminate the excessive corporate rewards, demand more transparency and accountability. We should finally lay to rest the ideology that the free market is self-regulating and does not need governmental intervention.

On the other hand, the last stimulus package, rushed through Congress, provides an example of misdirected policy in times of crisis. As a consumer-based, short-term and tax-generated cash refund it was timely, targeted and temporary – the three things the people in charge were looking for. But unfortunately, it was the wrong medicine, and the patient almost died.

A much better stimulus package would have been the proposed Infrastructure Investment Bank that can leverage its capital four to five times, create jobs, create wealth at middle-class levels, improve our competitiveness, and improve national security, and improve productivity and the quality of life. Such a government investment plan is not novel or experimental; it has been used throughout our nation's history. It is gaining some consensus now; but its enactment remains politically difficult.

**“The idea that the market would self-adjust has infected our economics and our political consciousness.”**

There are other policy issues to be addressed and resolved. In the current predicament, do we adopt inflationary or dis-inflationary counter-measures? Should we enact fiscal reform that eliminates unfair and inappropriate tax measures? How do we reverse the trend towards deteriorating middle-class incomes? Can we regulate without over-regulating?

We also must address the suffering inflicted on our citizens by this crisis by extending unemployment insurance and renegotiating troubled mortgages with principle amortization changes and interest adjustments. We should force the banks and financial institutions to put the bailout money into the economy, not into stock repurchase programs or dividends. We should force the banks to open credit to small and large businesses, making sure that these resources reach not only the giant lenders, but also lenders who directly serve small businesses.

Our economy is deeply wounded – and I use deliberately the term “wounded economy”, not the politically more acceptable and weaker terms like “in need of market adjustments.” Market adjustments happen very quickly and get corrected very quickly. But we heard a lot of evidence today that that's not going to happen in this case. And it's against that background that we must renew and redou-

ble our efforts for a national investment program, create a \$60 billion-dollar national infrastructure bank, the one that has been proposed in the Dodd-Hegel Bill [establishing a National Infrastructure Bank] in the Senate, which is now languishing in committee. Such a program would provide for a combination of private and federal financing. It would provide up to \$300 billion of fresh capital to rebuild our society. Further, it would foster a responsible partnership between the government, local and regional municipalities, the private sector and the financial markets. The new bank would be able to access markets that are not available to municipal bonds today. It would create millions of skilled jobs, bring higher productivity, introduce new technologies, enhance national security and begin to restore our economy.

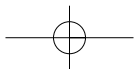
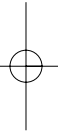
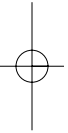
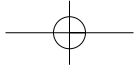
Think about what our situation would be today if we would have passed such a program five years ago. The fact that we didn't is a reflection of our societal failure, our political ineptitude. Our leaders lacked the vision and the will to sidestep doctrinaire politics. The idea that the market would self-adjust has infected our economics and our political consciousness, and it is the worst kind of doctrinaire ideology. That's why I claim that it is human, not systemic failure that has brought us to this failure, and one we have to address.

Another example is the automobile industry dilemma that we were talking about earlier today. The idea that our leaders will be defeated from bringing financial resources to save our nation's premier industrial manufacturing resource is ludicrous. And I use the word "resource" advisedly. We're talking about one of our nation's great assets. To find ourselves in a straightjacket because of the market discipline of the extreme budget balances of this country is bizarre. Certainly our leaders could be expected to step forward and formulate a plan that preserves balance and control. I would prefer an alternate approach, focused on energy: take away the development costs and activities from the three automobile industries and make it a government program. That would be an alternative to a bailout and a bankruptcy. The federal government would assume the long-term R&D effort to find a solution for car and fuels. In return, at the end of that development, it will return, for nothing, that technology to the automobile industries and all other companies that wanted to participate in it.

The benefits of such a program are self-evident: firstly, we would have one R&D program instead of three. The economies of scale would be tremendous. Secondly, that program would be driven by national objectives, not narrow corporate self-interest. Thirdly, it would give car manufactures billions of dollars in cash and cost reductions. And a very

important step towards energy adaptation would be taken. The government has proven it can do the job when it is motivated to do so – it does it all the time in the Defense Department. Governments can act at a very large scale – maybe they're less efficient than private actors but they get work done. Our industry, on the other hand, has demonstrated abundantly that it has neither the skills, the motivation or the organization to find an energy alternative.

As you see, good ideas are not missing. But we seem locked down into an approach that makes it impossible to think outside the box. In a sense, the current crisis and confusion present an opportunity for the new administration: a new vision with vigorous leadership can lead to more social equality and, most of all, to a balanced and growing global economy. Do we have the economic clarity and the political will to do this?



session 3 | moderator **Dimitri Papadimitriou**

# A new Financial Architecture for the United States

## Jack Blum

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First of all, I have a confession to make: I have never taken a formal course in economics, which makes me a rather unusual speaker for this kind of meeting. But what I have had is 40 years experience of investigating financial crime and fraud. And I'm going to shock you: The first time I investigated sub-prime mortgage fraud was in 1969. A hundred-and-some-odd people went to jail. What happened was that Senator which would then be bundled and sold off to Fannie Mae and Freddie Mac. And lo and behold, Freddie Mac and Fannie Mae sold securities to brokerage firms, and many of those firms went bust because those instruments became known as "pass-through" – and the brokers, after they were unemployed, were called "pass-outs".

Now, you would say, 1969 – why didn't you fix it if you knew about it? The answer is that the strongest lobby in Congress are the local real estate agents, mortgage bankers and builders, so the prospect of getting reform through the banking committee was zero.

This story would be interesting, historical, whatever, except for the fact that one of the firms we put out of business was called Eastern Services Corporation, owned by a husband and wife named

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(1) A mortgage with federally sponsored mortgage guaranty insurance provided through the Federal Housing Administration.

Bernstein, and they had an adult son who escaped prosecution. Then in 1989, while reading *The New York Times*, I learned that the son was being prosecuted for the same thing, only this time it was regulatory, and he has taken it up an order of magnitude. *The Times* story was a complete recounting of the earlier episode.

So when I pick up *The New York Times* today, and read stories about foreclosures, and they show a street in Boston, I'm practically nauseated – it's the same street I stood on for the anti-trust sub-committee in 1969. Everything in the current financial mess has been out there in plain sight for everybody to see for the last 20 years at the very least; and if you look carefully, for much longer than that.

Instead of recounting all the different warning signals, I would like to talk about what has to be done, what's going on in the regulatory structure and why anyone who's interested in finding a solution

**“UBS had written a note to all their people saying: ‘we’re politically connected in the U.S., so don’t worry about pressure from the U.S. government.’”**

has to get into the nuts and bolts of these institutions, understand how they work and what's wrong with them.

First of all, in our globalized economy, there are some 90 jurisdictions who have no accounting laws. There are corporate laws that allow you to incorporate with no responsibility whatsoever,

where the directors have no fiduciary responsibility, where the directors have no idea what the business of the corporation is or any records of what the corporation is doing.

To be blunt about it, these jurisdictions give every financial institution in the world a place to go hide the crap. And they do. Many of these institutions operate in ways that put off their balance sheets what's really going on. So for example, right now, if credit markets are frozen, it's because every financial institution knows what they have hidden, and they know that all their counter-parties have hidden the same kinds of things in the same places. Since they don't know what the counter-parties have, they won't deal with them.

You can't run a regulated banking system without knowing what's going on, and that requires regulators to be able to see through and actually get an idea of the world-wide position of an institution. But we don't have a system capable of doing that. You would think that after Enron – and again, this is another one of the many warning signs that things had run amok – when we discovered 300-and-some-odd offshore entities, that somebody might have said “you can't have ‘em”.



But no, nobody said that, on the contrary: the banks thought this is a terrific idea, and we came up with SIVs<sup>2</sup>. This to me is an intolerable situation. You can't solve any of these problems through regulation in a system where the players can arbitrage the rules of jurisdiction and move to places where there is no regulation. It just can't work.

Now there's a second part to this problem which is equally obnoxious: by moving it all offshore, they took whatever speculative financial products they had and actually injected steroids in it by the fact that it's all tax-free. And they did not report it. So if you have any doubt about the dimension of tax evasion, read yesterday's *Wall Street Journal*: the most senior official in private banking at UBS was indicted because UBS had 19,000 undeclared accounts for Americans. And I really urge you to read the indictment: UBS had written a note to all their people saying "we're so politically connected in the U.S., you don't have to worry about pressure from the U.S. government to get the information."

You might think that it was an overstatement. Let me put that in context. How much money is it in these 19,000 accounts? \$20 billion dollars. \$200 million a year in fees to UBS. UBS turned up with dollar obligations outstanding four times the GDP of Switzerland and needed \$40 billion to keep going. The Swiss central bank could not provide U.S. dollars. It had to go to the Fed because if it tries to go to the open market, a Swiss franc would be worth about what last year's Kleenex on a New York City subway platform would be worth. So they go to the Fed – and the Fed, instead of asking them to turn over the names or play transparency, the Fed said: "Here, take the money on a swap. We do that. We're central bankers. We don't regulate anything". This can't continue, it has to change.

How does regulation work inside financial institutions? Every financial institution has a risk-management department. These people are supposed to do either risk management or risk oversight – they're supposed to know what's going on in the place. Some of them know what's going on; but they also know that you don't tell anybody else in the place, and you most certainly don't tell your boss not to do it, because that's a very career-disruptive move. The job that the people in compliance and risk management tend to have is akin to the people in the circus who follow the elephants sweeping up the droppings. And unless government absolutely reinforces the role of those people through regulation, they're there as window dressing.

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(2) Structured investment vehicle, used in the shadow banking system.

## Looking for Solutions to the Crisis

Now the question is, where is the government in all this? In deep anesthesia. Take a look at the last four election cycles, at the largest contributors to both political parties and all presidential campaigns. And we all know that these matters are so complicated that ordinary people have no idea of what it really means or how it works. The average Congressman is slightly better than that but not much; when they're told by the people who have just given them all this money that there are no problems, who are they to argue?

We have to get them out of this anesthesia. And the only way we can do that is by going back to something that happened in the 1930s, when a commission was set up, and a judge, Ferdinand Pecora, was put in charge of it. The commission could dig into the detail of what had occurred: who did what to who, how things were manipulated, and what the real problems were. And out of that we got very specific legislation. We need the same thing now because without public understanding, without real disclosure of the depth of the manipulation, of the nonsensical instruments, of these 400-page prospectuses that didn't mean anything, that weren't vetted by the SEC because somebody ruled they weren't financial instruments – all of this has to be put out in public and discussed.

Let me mention another aspect of this: the weakness of the regulators in the face of complexity and the size of the financial institutions. These regulatory agencies hire kids fresh out of law school, out of accounting school, some of your finer students; but they have no idea how the institutions they're looking at work, and they have no idea how the instruments that they're supposedly looking at work. Now how can I say this? Well, I've been on the other side, I've watched them trying to figure out what's going on, and I've watched them spun; what's really depressing is how easily they're spun. And just about at the point where they can figure out what's really happening, they get a much better job. This is not a working regulatory system.

We also have a business of chipping away at the law. This goes on in the tax law all the time, where ingenious lawyers figure out how to put together code sections, or write opinions, and all of this sort of sneaks something past the current understanding and rules of IRS [Internal Revenue Service], which then has to be corrected. It's sort of an ongoing game. This has been going on in the securities industry for 40 years. You explain to me how a credit default swap isn't an insurance policy, and I'll take you back to a whole series of quiet opinion letter and interpretations; and lo and behold, it's not regulated. Well, if it's not that, maybe it is a financial instrument that needs a

certain kind of prospectus and review? But then again, we have another ways to take it out from under the law. You really have to be in the business to understand it.

I would argue that we can discuss economic theory to the end of time if we don't get into those nuts and bolts; if we don't start looking at the globalization arbitrage problem – that is, the arbitraging of different jurisdictions and different national laws – and get some idea of what's really going on through accounting, so this off-the-books, contingent liability, we-don't-know-what-we-owe-anybody is gone; and change the system so the risk managers, the ones who are supposed to be saying “no” get more than a shovel and a broom, we're never going to fix it.

## Bill Black

I was asked to talk about financial architecture; but it only makes sense in terms of the environment where you're going to put that architecture. Let me thus broaden that discussion to include the environment as well. I would like to suggest the old saw is the best saw here, and that it's not so much the things that you don't know that produce disaster; it's the things that *you know aren't true* that produce disaster.

The first such thing is that, naturally, fraud couldn't happen. Even in a meeting like this, where it's not so much the old fogies, the f-word is almost never used. We have George Akerlof's famous article<sup>3</sup>, every single example of which is about fraud; but the word fraud is never used. Akerlof came back with his article on looting, an article for which he got the Nobel Prize<sup>4</sup>; and that article is virtually never quoted by people discussing these crises, even though it is the most relevant single piece in the conventional economics literature.

Instead, we have a theory telling us that fraud cannot occur. And we “know” fraud cannot occur because if there were substantial fraud, markets wouldn't be efficient; and since markets are efficient, there can't be fraud. The small little fact that there were over a thousand insider convictions, senior insider convictions, in the Savings and Loan debacle<sup>5</sup>, was no particular reason to revisit that issue; nor the fact that since

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(3) George A. Akerlof, “The Market for “Lemons”: Quality Uncertainty and the Market Mechanism”, *The Quarterly Journal of Economics*, Vol. 84, No. 3, August 1970, pp. 488-500.

(4) Akerlof, George A. and Romer, Paul M., “Looting: The Economic Underworld of Bankruptcy for Profit”, April 1994. NBER Working Paper No. R1869.

(5) In reference to the crisis of local Savings and Loan associations in the 1980s.

September 2004, the FBI has been testifying that there is an “epidemic” of mortgage fraud developing; nor the fact that only 20 percent of those who make home loans are required to make criminal referrals, and that 20 percent made over 50,000 referrals for mortgage fraud; nor the fact that according to the FBI, 80 percent of mortgage fraud is induced by the companies, not by the borrowers.

By the way, most of the frauds are never discovered; so you have to multiply not just by 5 to get the total number, but probably by 10. International ratings agencies like Fitch and others have looked at small samples and found in sub-prime an incidence of fraud of over 40 percent; indeed, typically 40-60 percent. So we have a massive problem which we don’t talk about, and we certainly don’t provide resources to resolve it. We have 200 FBI agents chasing roughly a half-million frauds a year.

We can talk about architecture all you want but that’s the environment. You can have any architecture you want; it’s not going to work in those circumstances.

Thus, we knew that fraud couldn’t occur so even when we knew fraud was occurring, and knew it was occurring on massive scale, we didn’t even bother to put that in the literature. If you search scientific databases and the Social Science Research Network (SSRN), you may find a footnote buried here and there, admitting that there maybe could be a little fraud, too – with no numbers, typically.

Beyond that, our methodology that we are so proud of, econometrics, produces, in the expansion phase of a bubble, the worst possible policy advice conceivable, and it must do so whenever there is a substantial amount of accounting fraud. Because whatever practices you choose for accounting fraud, you’ll have to show the strongest R-squared, positive R-squared, with profitability, and that flows through earnings per share and such in terms of stock market. Why the worst possible? Because the way you optimize accounting fraud, and these are accounting frauds, is to loan to the worst possible borrowers. Why? Because they’ll agree to pay the highest fees and interest rates. Note that I stress the word *agree*. It’s not actual cash flow. There are ways to scam that as well, through refinancing, and that is the story and has been the story in this crisis and in other crises.

By the way, who did the FBI decide to make its strategic partner in dealing with mortgage fraud? The Mortgage Bankers Association, the organization of perks. Can you imagine that happening in the blue-collar sphere? It is the apparent legitimacy that makes these white-collar crimes so devastating.

So the first thing that we knew was true, but actually wasn't, was that you couldn't have fraud. And it certainly couldn't amount to anything like an economic variable in its own right, something like a bubble.

The second thing that we "knew" was that regulation couldn't work. And so it became a self-fulfilling prophesy. You have people in charge that believe that regulation won't work. Naturally, they'll succeed in proving that it doesn't work; all the appointees in the Bush administration succeeded in doing that.

The third: as long as you can think of any conceivable place where some aspect of this might be beneficial, you shouldn't ban. So even the fact that it helps produce the largest economic disaster of our lifetime isn't sufficient reason to say "no, we're not going to do this activity".

By the way, when people say that CDOs [Collateralized Debt Obligations] haven't defaulted, well, they're structured so they don't default. That doesn't mean they don't lose their economic value. Of course, if you structure it so it doesn't default, you simply have the right to whatever the first bit of cash is and then it's tiered. It won't default because by its terms it doesn't require any payment. That doesn't mean it doesn't lose virtually all its economic value; in many cases that is precisely what happened.

**"According to the FBI, 80% of mortgage fraud is induced by the companies, not by the borrowers."**

Bill Cosby said once there are a lot of things in life that are absolutely inexplicable unless you assume there was a coin toss and that somebody lost it. You remember the joke about General Washington and General Cornwall having a coin toss? Obviously Washington won, and Cornwall said: "You have won the toss; what do you choose?" And Washington replied, "We will have rifle barrels, we'll have camouflage, we'll stand behind trees, we'll shoot at you and you have to stand in long red lines with muskets and get shot". You need something like that to understand the architecture that was set up for regulation – which is, of course, essentially non-regulation in all of this.

First, standard economics, or at least classical economics: reputation trumps all, and therefore conflicts of interest are irrelevant. Indeed, the literature claimed that it's a good thing to usurp corporate opportunities, because that gives it to the highest and best use, and it just reduces overall compensation, and it's really a great thing. It was a good thing that outside auditors would also be consultants, because then they'd be so much more knowledgeable and efficient. Alan

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Greenspan was the leading purveyor of this view. Go back to his speeches, which are on the website at the Federal Reserve, and you will see these odes to reputation and how reputation conquers all.

Second, private market discipline removes any need for regulation. Indeed, it means that regulation is counter-productive, because regulation will commonly reduce the incentives for private market discipline, and therefore it's bad.

Third, a specific example of that rule: we should encourage subordinated debt and rely on subordinated debt as one of our principle forms of regulating bank institutions. How many people here have actually been financial regulators? How many people have actually investigated these things directly? There's always a handful in these kinds of groupings. I've never been able to find anyone who would show me where a subordinated debt holder prevented a single one of these frauds. And I've raised this issue in many groupings.

The same goes for executive compensation – extreme executive compensation is good because it aligns the interests and therefore we needn't worry about incentive incompatibility. The agency problem has been dealt with. You see again this theme that everything is fine, and therefore we don't much need regulation.

International competition means we must respond by progressively weakening our regulation. We must get rid of the Glass Steagall Act<sup>6</sup> because we have to compete with the universal banks of the Germans.

Any remaining problems can be dealt with prompt corrective action. Because now, as soon as there's a problem, we mandate by statute, regulators go in and firms like Washington Mutual, Wachovia and others are closed before there are any significant losses. And of course these actions forget all about accounting fraud. So we have prompt corrective action, but driven off of numbers that are created through accounting fraud. And what happens when you engage in accounting fraud? You use it to make sure that you're one of the most profitable institutions in the country, because that's what allows you to pay that very large compensation and, in a way that dramatically reduces the risk of prosecution, convert firm assets into your personal benefit through normal corporate mechanisms – dividends, stock appreciation, etc.

In addition, the theory claimed that we have backup regulation. We have the Federal Deposit Insurance Corporation (FDIC). But it turns out the FDIC regulation only kicks in when you're failing

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(6) Separating investment and commercial banking activities.

your capital requirements, which comes back to accounting fraud, which makes it look like you have extraordinary unprofitability.

According to President Bush, the problem was that we had old-fashioned regulation that didn't have sufficient capital requirements. But Basel II was designed specifically to reduce capital requirements and specifically capital requirements for those holding large amounts of mortgage assets. And it specifically encouraged the largest banks to use proprietary models to value their assets, even though everybody knew that that was a recipe for disaster. So it's not just the United States. We have infected the rest of the world with a deficient economic theory. In the United States, the competition and laxity among the federal regulator agencies constantly pushed towards the weakest control at the federal level. And we decided to preempt any states that were vigorous in trying to enforce against things like predator lending.

Control frauds, the most audacious ones, were able to create black holes in the regulation. The most famous one is Enron, and the one that Enron exploited to create the California energy crisis through its cartel operation. And note what happened then. Who did we take our policy advice from to deal with the California energy crisis? Anyone remember? Enron's CEO Ken Lay was able to arrange a meeting with the Vice President of the United States of America giving talking points, opposing any efforts to deal with the price rise. And Vice President Cheney, the next day, read pretty much from those talking points, encouraged the Federal Energy Regulatory Commission to take no action on behalf of California.

I took the notes at the Keating Five meeting<sup>7</sup>. Where was the intervention in that case? Once again, the regulators were fooled by the apparent legitimacy of the entities and the fact that they reported record profits – Lincoln Savings reported it was the most profitable savings and loan company in America. It's easy if you use accounting fraud.

In addition to all these forms of deregulation, do not forget desupervision. You can have all the rules in place you want; if you put in leaders who do not believe in regulating, you will get completely ineffective regulation. Do you recall James Gilleran, the head of OTS (Office of Thrift Supervision), first appointed by President Bush, who came to the press conference with a chainsaw and the federal regis-

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<sup>(7)</sup> In 1987, in the middle of the Savings and Loan crisis, a group of U.S. senators met federal savings and loan regulators at the request of Charles Keating from Lincoln Savings and Loan. "The Keating Five meeting was the event that transformed the savings and loan debacle from a story buried in the business section to one of the worst financial and political scandals in U.S. history (though the current financial crises have proven even worse)". William K. Black, "The Keating Five Legacy", April 9th, 2008, available at <http://www.ourfuture.org/progressive-opinion/keating-five-legacy>

ter to demonstrate his commitment to destroy all regulation?

To summarize, we have to think more broadly than just about the regulatory structure. When you deregulate a financial industry, de facto you decriminalize it. The FBI cannot make these cases on its own. I spend a huge amount of my time doing this at the agency. We are the ones who make the substantial criminal referrals. We are the ones who identified the leading purveyors, the weak points, the Achilles heels in these systems. We are the people that train the FBI agents. We detail our staff to serve on the grand juries if they're going to be effective; we serve as their expert witnesses. I did this on a number of occasions. When those things do not exist, the industry is decriminalized de facto. Nobody calls the Houston Police Department and says, "I think there's a problem at Enron. Could you come on over and look?" It seems absurd to even think of that.

Similarly, we have gutted the ability of plaintiffs to bring civil fraud suits, and we have put in place frequently, in the Securities and Exchange Commission, people who did not believe in doing it at all. The other thing that you do when you deregulate or de-supervise is that you make an area opaque. Often one of the problems of the Treasury and Fed was they simply didn't know who the counter-parties were. They didn't know within \$5 trillion what the notional amount of credit default swap was. Plus or minus \$5 trillion is a little off.

## **Barkley Rosser**

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I would like to raise five issues, and maybe the tone will be little different from the previous two speakers, who have talked about catching crooks. The first issue has to do with how much time we should spend on worrying about new institutions. The second one is about battling bubbles. The third deals with the infamous mark-to-marketing. The fourth with what should be done about housing. Finally, I would like to say some words about the safest banks in the world, the Canadian banks.

As for the first issue, I want to raise a cautionary point. We have this glorious moment of crisis. We're all enjoying it to some degree, those of us who haven't gone broke, and partly that's because there's this chance to do all sorts of new things. But even in a situation like this, there is, as they say, a limited amount of political capital. What do you focus your political capital on? I would say that what you should focus on is getting good rules, good regulations and good peo-



ple in it – not so much on trying to create new bodies or new institutions. I don't want to pick on any; there have been quite a few thrown out during our discussions. But most of the actions that have been proposed can be accomplished by existing institutions. As James Galbraith pointed out, we have all array of institutions that were created in the New Deal and the Great Society. Many of them have been sort of moribund or at least not very active; they have had bad leaders or even corrupt leaders. But with better leaders and new rules, many of them can do many of the very desirable things that have been proposed today.

An example in my mind of bad organization activity – and I fear the Democrats are more prone to this – comes from the Homeland Security Department. This was supposed to solve our problems. We made a huge restructuring, pulling all these agencies together and creating a new level of bureaucracy, focused on keeping out terrorists from abroad. But then hurricanes hit New Orleans, and we discover that FEMA<sup>8</sup> is under the Department of Homeland Security, and that the Department of Homeland Security didn't give a hoot about hurricanes, so we can't count on assistance from FEMA. In other words, you can really mess things up through restructuring.

**“Interest rates are an overly blunt instrument to battle market bubbles.”**

I understand that there is a big argument about this. The central bankers say, “don't do much. Tweak the existing institutions”. Others say, “let's create new institutions”. But I think you can have really new policies and major reforms and focus on that rather than on the question whether we should create this or that entity.

Now that doesn't mean I'm totally against creating new entities. At least one of them we might be able to fit into an existing entity is Paul Davidson's Homeowners Loan Corporation, HOLC. I suspect we could probably put that activity into the Housing and Urban Development Department, which of course was created in the 1960s, while HOLC was a creation of the 1930s. I think this is a very good activity, we need something like that; but I think we could probably do it with existing institutions.

There has also been some talk, especially for credit default swaps, that we need a central exchange and stop having them being exchanged over the counter. This will give us more transparency, we'll know how much of them are out there – and it looks to me like something

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(8) FEMA : Federal Emergency Management Agency

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we really need to have. But it may well be that we can do that through the Commodity Futures Trading Corporation or something else.

The fewer new entities we create, the better off we are. We should be focusing on the actual policies, the actual activities, and getting people into these places that have the right attitudes and are committed to doing something. The institutional structure should be lean and clean and mean.

Now the second question, the question about battling bubbles. I've talked about some of the things I'm talking about today to a number of colleagues, some of whom are very pro-free market. This is the one that really gets them upset. And I'm also going to give warnings about this. This is a very difficult one. In fact, let me note the warnings up front, and then I'll suggest what we should do:

We have seen some efforts to do this in the past, and some of them were really disastrous. Here's the tool that shouldn't be used: interest rates. Having the Federal Reserve use interest rates to battle bubbles is, I think, using an overly blunt instrument. What is the great awful example? 1929 and 1930. Why did the Federal Reserve not have an expansionary monetary policy when the Stock Market crashed in 1929? Well, they were trying to squeeze the bubble out of the stock market. They succeeded but we also got the Great Depression.

By the way, how do you know there is a bubble? Alan Greenspan resisted trying to battle bubbles precisely for that reason. Some people laughed and said, "he should have seen it. Why didn't he do something?" And I do think he should have done something. But a lot of people have forgotten that he made a vague effort to do something about the Stock Market bubble, making a complete fool of himself. It was his famous speech warning against irrational exuberance in 1996. The market dropped the next day but then it turned around and went roaring off; and I'm not sure that the dollar has ever been back down that low again. And Greenspan really doesn't like being caught and made to look silly. And he looked silly.

After that he was burned. He said, "I don't want to get into this business". And there are huge theoretical arguments here that I'm not going to get into. Still, I think that the body that ought to keep track of this is the Council of Economic Advisors. Let it be the body that tries to figure out if there are bubbles in certain markets.

So how should we respond? We need a variety of flexible policies and actual agencies that carry them out. The actual reaction depends on the bubble: different bubbles go different ways. Some go up and then they suddenly crash – you see that more in commodities

– some go up gradually and come down gradually – mostly in the housing sector – and others still do the period of financial distress – this, by the way, is the most common. This third kind of bubble goes up, declines for a while and then crashes. That's what happened with the credit and financial derivatives market. It peaked in August of 2007, crashed on September 17, thirteen months later. I warmly recommend you Charles P. Kindleberger's great book, *Maniacs, Panics, and Crashes*: Kindleberger shows that out of 47 historical bubbles, 37 looked like that.

Now part of what you do depends on what kind of a bubble it is, since you can attack them in various ways. I think what we need today is innovative approaches. Margin requirements are an obvious thing for certain kinds of markets, restricting certain kinds of lending practices and housing, building housing. Paul Davidson talked about buffer stocks. We had an oil bubble earlier that was tough, and we made a mistake: we shouldn't have been adding a strategic petroleum reserve. Sell oil out of the strategic petroleum reserve.

In any case, you use particular bodies to deal with particular bubbles. If it's an agricultural commodity, you go through United States Department of Agriculture, and your measures must be very precise – not some blunt instrument that hits the whole economy. I realize that this is very difficult and probably most controversial; but I think it should be attempted.

As for mark-to-marketing accounting, I don't think I need to go through the argument of why this is destabilizing. We forced banks to sell off assets to raise capital. When the value of the assets goes down, of course the selling itself pushes these values further down. So naturally this must be destabilizing.

This is a quite complicated issue. The mark-to-marketing accounting has come in from the Basel II accord, combined with capitalization requirements; and this agreement is something that took a very long time to be achieved. I've talked to a number of accountants, and they really don't want to see mark-to-marketing gotten rid of. I can see that there's a very valid argument for using mark-to-marketing. So you don't get rid of it. Rather, you try to go around it. And one way to do it is what they're doing in Germany – apparently the Fed is thinking about this as well. If a German bank promises to hold an asset to maturity, you allow it to value it at what they bought it for, or what it's going to be paid in for, whatever. You don't apply the mark-to-market rule. This moves some assets from that rule without getting rid of the whole system. Now, as some people have pointed out, what you do here is to

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make banks promise. But how do you know they will keep their promise? That can be quite tough.

Another idea is to look at the nature of the funding. A lot of the mark-to-marketing is a day-to-day evaluation. But let's say you're being funded by longer-term securities; then you can base it on that. In both cases, what it boils down to is to find a way to tweak the mark-to-marketing system, to smooth things out, without creating volatility.

Now let me say a word about the housing sector. First, some people have proposed foreclosure vouchers as a possible solution. There are some problems with this, but I think it's an interesting idea. What you do is issue these vouchers based on income so poorer people will get more of them. You can use them to help pay a mortgage if you're in danger of being foreclosed. There's been a lot of discussion about how can we help poor people who are in danger of losing their homes, and how we save their houses from being dumped on the market in a forced way. I have some questions about this proposal, but I think it's an interesting idea.

Another interesting idea is the so-called shared appreciation mortgage. This is apparently something that had been done in the past: you renegotiate a mortgage with the lender and get a lower principle, while the lender gets the right to share in any appreciation of the housing value that might occur later on. This presumably encourages lenders to allow some renegotiation of a mortgage to a lower amount.

But there's a real deep conflict here. A lot of people have been arguing, and I largely agree, that as long as housing is going down in value – and we're probably only about halfway down from the bubble; if you want a rough estimate of how long it's going to take us to get down, I would say another two years – the sub-prime mortgage crisis will continue. We have had this giant house of cards built on ultimately bad sub-prime mortgages that are blowing up. As long as housing prices keep going down, we're going to have more of these things blowing up. So a lot of people want to stop them from going down.

There's certainly a very strong argument for this, but I guess I'm in the camp of those who think that we actually must get the housing prices down. Who likes expensive housing? Well, people who own their own house and want to use it to borrow. I want to use my home equity loan to send my kid to college. But housing is very expensive and lower-cost housing is a good thing for people trying to get in on the market. People say, "we have these people who can't afford their mortgages"; but if the housing prices aren't too high, then they can

afford the mortgages. I mean, part of this whole sub-prime and exotic mortgage thing was trying to get people in these overblown bubble-priced houses that they couldn't afford, offering them interest-rate-only and negative amortization mortgage. I nevertheless think we need mechanisms to help people and try to keep them in their houses while this process is going on.

Finally, let me just mention that we should take a closer look at the Canadian banking system. They are heavily capitalized, very conservative and they are not failing. They're clean and lean and mean. The regulations are pretty simple, but they work.

And then one last thing: I disagree with Bill Black about the need to revive Glass-Steagall, we don't need it back.

## Paul Davidson

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I have two points: one is about Bill Black's account of fraud, which obviously is correct. Just think about this: Economists do not make their own data, they rely on accountants to provide them. Now what does that tell you about econometric studies, particularly of GNP, GDP, etc? If it's pig iron production or something like that, where they measure tons, I assume they don't lie about the number of tons.

Barkley, I was with you until you mentioned the Glass-Steagall Act at the very end. The reason why Glass-Steagall Act was enacted in the first place is that banks had been underwriting all sorts of strange things during the 1920s and before and selling them off. Remember, with a 5 percent margin, every individual was a hedge fund at that time. You put down 5 percent and you borrow 19 times that; that was one of the reasons the market eventually collapsed. And the Glass-Steagall Act said: "if you're a financial institution, you have to decide whether or not you're going to make loans". These loans were illiquid assets and had to be carried on the books till the person either paid off the mortgage or defaulted. Before making a loan, the banker checked the classical three C's: collateral, credit history and character of the borrower.

When you securitize mortgage you don't care about the risk, because you're going to pass it off. You can choose to be either a banker, and make these illiquid loans and hold them until the end because you couldn't sell them, or to be an underwriter. The very purpose of this was to create a secondary market for mortgage loans. You pointed out the 1960s but the real start of the shadow banking system was in the 1970s, when we allowed money market accounts to create

checking deposits. Then, in 1987, the Federal Reserve permitted bank holding companies to have up to 25 percent of their revenues in collateralized loans. And finally the dam broke in 1999, when Glass-Steagall Act was repealed. At that time, nobody thought they had to hold a mortgage for more than 30 days and that's what created our problems.

Who is responsible for repealing the Glass-Steagall Act? We usually blame the Senator Phil Gramm. But as *The Wall Street Journal* recently pointed out, he didn't have enough votes to get it repealed, and so he told a Citibank lobbyist to call Sandy Weill<sup>9</sup> and ask him to call the White House. Three days later Clinton twisted Democrats arms, and we got repeal. Who in the White House did that? We don't know, but Robert Rubin resigns the next week and takes a job at Citibank.

## Bill Black

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Let me just add to this that bankers have been trying to get out of the banking business for at least the last 40 years. The problem is that being a banker is a lousy business. You have to do real loan underwriting. You have to figure out if the borrower will repay the loan. You have to check his books, and half the time you're going to say no. It's expensive, time-consuming. And then, how much can you charge? If it's a really well underwritten loan you're not going to make a lot of profit. Routine banking business is computerized, and it's commodity, nobody makes any money on it. So, sometime around the 1970s, bankers got the following advice from business consultants: "The only way for you to increase your earnings is to get out of this business. Let other people do the underwriting. What you do is give them a line of credit so they can make the loan, and then you securitize and sell off". Following this advice, banks literally got out of the banking business.

I learned this in 1974, at a meeting in San Francisco where the treasurer of the Bank of America was explaining to me how brilliant their strategy was. Before the 1970s, the Bank of America was a community banker. They made loans on houses and really dealt with ordinary people. But as explained by the treasurer, this was far too expensive. "What we're going to do is lend to developing countries. We all know they never default. And the beauty of dealing with developing countries is that we can put together a bank syndicate and lend them \$500 million or a billion at once. It's one shot, there's no underwriting

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<sup>(9)</sup> Former chairman of Citibank.

cost, and we get much better return on that than we do making all these local loans". So one by one, all of the banks that did the banking job got out of the business, to the point where they didn't even bother doing the intermediary function, because they farmed out their treasury operations to institutional money market funds. So what we have is banks rejecting their social function and a society that's now stuck with the fact that nobody did the underwriting, that the people who did the underwriting made money by cooking the books, the people who bought it had no idea what they were buying, and the banks are collecting outrageous fees for doing this. That has to stop.

### **Barkley Rosser**

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Let me respond to Paul, and this is partly a follow-up on Jack's comments. I think the problem isn't so much the nature of the investment banks; the problem is elsewhere, in low margin requirements, in lack of good supervision of such things. If you have a highly unregulated banking system like ours, then yes, you have a problem. I would suggest something like Canada or Germany – Canada in particular – where you put all banks together and apply more serious regulations. Now maybe that's not going to work in the U.S., but in fact, they are already back together, which means that we're basically going in that direction anyway. Frankly, I prefer to see Morgan Stanley and Goldman in commercial banking roles rather than doing what they were doing until now.

### **Bill Black**

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But who, in the regulatory world, has a clue about what they're doing and has the possibility to regulate them? All it does is putting a fig leaf over what's going on. That doesn't help anyone, on the contrary: it gets the federal government deeper in trouble.

### **Barkley Rosser**

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Will reinstituting the Glass Steagall system resolve that problem?

## Bill Black

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No, we're talking about a much broader problem and that's why I said we have to look at the world as it is and look for the holes, and what has to be done to fill them. I'm not asking for a reinvention of the wheel, I'm not asking for creation of mega-agencies; what I am saying is that we really must take a look at where the regulations have been undercut, what's wrong with the current regulatory system, why the people in charge of risk management can't actually manage risk.

## Gary Dymski

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Let me make a couple of comments and then ask a question to the entire panel. Barkley, I was going too fast to clearly indicate that I was talking about shared appreciation mortgages. The counter-party could be either the government or a private party, but it's something to look at. And local governments could, were they positioned and given the capacity, maybe with some kind of infrastructure fund backing, take charge of housing in their own neighborhoods. They know the cost of abandoned subdivisions, they know what it means when the police force can't take care of the problems in the neighborhood.

Secondly, when Nation's Bank bought Bank of America, the first thing they did was to eliminate something called the Bank of America Community Development Bank, which had been fought for by community activists over many years. It makes one wonder that there's an offloading of this core banking function, how we need to really envision that in this rethinking.

**“When you securitize mortgage you don't care about the risk, because you're going to pass it off.”**

Now to my question. It seems that there's some kind of square-root law at work: the more locations there are to do activities, the more kinds of activities you can do, the more assets you can trade. And the more things you can do with these assets, the more fraud can be perpetrated. So if we focus on simplifying activities, on reducing the number of locations of markets and so on, what direction should we take, given your experience and your frustration over what you see as years of fraud? Where should we begin if we want to cut down the fraud?



## Bill Black

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In terms of cutting down fraud and dealing with bubbles, I think we're one of the unusual entities that did deliberately target a bubble. We targeted it through the years 1984-87. It was a commercial real estate bubble. I shouldn't be the one saying this but I will argue that we were extraordinarily successful, and that it's a far better tool than monetary policy. What we realized, of course, was that the bubble was built on Ponzi schemes. That's how you optimize an accounting fraud. And if you put a series of Ponzis together, they will hyper-inflate and extend a financial bubble, and they will also send false price signals. This is pretty standard economics and finance. So one of the best things to do is to look for the Achilles heel – and the Achilles heel, every time you deal with Ponzi, is growth. So we restricted growth, and that killed every single one of the Ponzi schemes. There were roughly 300 of them. We did it through a requirement that directly restricted growth. Because if you make it against capital, they simply inflate the capital through the accounting and you don't achieve your goal.

The other thing you do is to look for perverse incentive structures. I'm a white-collar criminologist, and it's very similar to economics. We think in terms of what we call criminogenic environments, environments that lead to crime. So where do we look? You look for assets that have no readily verifiable market value, because it's far easier to inflate them, to create phony accounting income and hide real losses. So it is not true that they use just about anything for making fraud. Typically, fraud is not about the risk. These methods are not risks in any conventional sense. These are sure things in terms of accounting fraud, sure in both senses: you know for sure that you'll report record profits, and you know for sure that you will fail.

## Jack Blum

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I want to turn our conversation to commodities. Most of you probably don't know how commodities contracts work; but before a contract can start trading, the Exchange has to approve it, the Commodity Futures Trading Commission (CFTC) has to sign off on it. And when a contract is traded, the selling firm is responsible for insuring the contract. And then, would that firm fail, the whole exchange is responsible.

Some people started then to move commodities trading into an unregulated offshore arena, and that gave us companies like Refco,

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which went bust. It gave us unregulated oil contracts, traded offshore, which allowed the most amazing manipulation by people like Bernie Kornfeld or some Russians speculators, which is why we got to \$140 a barrel and why, just a few months later, we're back down to \$60. And nobody, absolutely nobody wants to look at it; because as long as I've known the Commodity Futures Trading Commission, you got the job by a letter of recommendation from one or another of the brokerage firms to say you're a good guy.

**Barkley Rosser**

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I'm not sure what the disagreement is. I think one way to get at this, and I think this is relatively easy, is simply to outlaw certain kinds of financial instruments like interest-only mortgages or negative amortization mortgages. I understood that the housing bubble was about to blow when I read in *The Washington Post*, in early 2005, that a majority of the mortgages that were being issued in the metropolitan area were interest-only. This showed that things have gotten out of control. But we know from economic experiments that even when people know that the bubble is going to blow, they still like to go on because, while they go on, people are making money, and that is very pleasurable.

**Marshall Auerback**

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On the question of fraud, I think it's interesting to note that the FBI seems to be examining Fannie and Freddie a little bit more closely – and as we know from the history of Watergate, once the FBI gets involved, a law of unintended political consequences comes in and sometimes things actually get done. So I wonder what you think the impact of that investigation might be.

My second question is to Barkley Rosser, and it's about the mark-to-market debate. I've seen how some of these derivatives work, and I think the analogy generally used is the Latin American crisis in the 1980s. You say you hold the bond on the bank's book until maturity and thereby avoid the problematic issue of marking it to market. But we're dealing with something which is much more complex. We're dealing in many cases with derivatives of derivatives. There's no real definable cash flows for these products, so I'm not sure how

you can value it as a hold-to-maturity proposition either. That, I think, is the real problem you get into when you use that as a solution. So I'm interested in hearing your thoughts on that.

### **Barkley Rosser**

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Marshall, I'm not quite sure whether you were asking me whether altering mark to marketing was difficult, or whether mark to marketing itself is difficult. I would certainly agree that these exotic derivatives are very hard to value. We know that even some of the people who have issued them don't know how to value them. So there are very difficult problems, and I don't really have the answer.

### **Jack Blum**

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Let me answer the first question: I was an expert witness for the entity that was supposed to regulate Fannie and Freddie in the administrative enforcement action against the former senior management. It was a classical case of accounting control fraud, run from the top. The Securities and Exchange Commission did not investigate it in terms of going after the senior leadership. It looked at it and said that the accounting is all wrong, but it did not move at all vigorously. The FBI, as I noted, has treated this as a retail problem. It has focused on people ripping off. And it does some 600 cases a year of that; it's like throwing sand into the ocean. Had they created task forces early on, they might have identified the real problem. Maybe we can't put undercover agents in Al-Qaida but it's easy to put FBI agents in firms like WaMu.

### **Bill Black**

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Believe it or not but it's worse than you think. The FBI actually had a mortgage fraud squad working in northern Virginia for several years. I know it because I handled the case involving a totally falsified mortgage where they tricked non-English-speaking immigrants into signing all the papers. We brought the agent in and gave him all the information. He rolls his eyes. I ask him, "You must have seen these cases before. Why haven't these people been prosecuted?" Because he

## Looking for Solutions to the Crisis

even knew the people who were doing it. And he said: “no prosecutor would pick up the case because no one had lost any money. I can’t sell that to a jury”.

The other part of it is that the FBI pulled most of its agents of white-collar crime to do counter-terrorism. And let me put it like this: the ones left are like a group of sumo wrestlers doing needlepoint.

session 4 moderator **James K. Galbraith**

# A new International Financial Architecture

**Lord John Eatwell**

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I will start with two rather separate themes, which I then hope to bring together to confront international problems. The first one derives from the nature of financial regulation itself and the way that the regulators, or regulatory theory and practice, have developed over the past 10, 20 years. It was very well summed up in Alan Greenspan's confession when he said he had thought that firms would manage their financial risks themselves. That's revealing in two ways: First of all, it reveals that, like most of the regulatory community, Greenspan had bought the argument that modern risk management technologies, based on statistical financial theory and data processing, have developed techniques that, if applied by firms, would reduce risk for the system as a whole.

What I think Greenspan should have said on that occasion was not "I thought firms *would* manage"; but "I thought they *could* manage". Because one of my two themes is that risk management by firms themselves, however well-practiced and sophisticated, does not reduce systemic risk for the system as a whole. There are risks which the firm itself cannot measure. And the standard bit of theory behind this is the simple economics of externalities, the one about the factory owner who produces dirty smoke, takes into account the cost of mate-

rials and the returns that they get from selling the products, but not the cost of the smoke in terms of its impact on the health, on the life quality of the local region and general pollution.

That same idea carries over into finance: the risks that an individual firm takes may be measured in terms of its own risk exposure; but that doesn't take into account the consequences of its risk exposure for the system as a whole. The obvious example is the idea of a bank run: Bank A fails because it has made inappropriate loans or been imprudent. Bank B is perfectly prudent, and solvent, and careful. But because Bank A has failed, everybody starts to think that the whole banking system is not as safe as they thought. They rush down to take all their money out of Bank B, and Bank B fails because it can't produce the cash fast enough, even though it's perfectly solvent, perfectly prudent, and perfectly well-run. So the risks that were created by Bank A included risks to Bank B, which of course it didn't take into account. It didn't price. And this is what is meant by systemic risk: it is the risk characteristic of the system as a whole which individual firms, however expert they might be in managing their own risks, cannot actually evaluate. It's not their fault. They just can't do it. It's an externality. It has to be measured and managed by those who manage the market as a whole; in this case, the financial regulators. As I said, the regulators bought into the argument that new risk management techniques were sufficient, but they were not.

That's the first theme. The other theme is the way in which institutions, international regulatory institutions, have developed since financial markets began the long road to liberalization in the early 1970s. It was in January 1974, after the turmoil at the end of the fixed exchange rate system of Bretton Woods, that financial markets were effectively liberalized one after the other: in the United States, in Germany, in Switzerland and so on. In the next three to four years, most of the OECD countries liberalized and opened their financial market.

The first international financial crisis occurred at the very start of this process, in summer 1974. I'm referring to the so-called Herstatt Crisis: a West-German bank called Herstatt Bank was trading in futures on the New York money markets. It got things wrong and it failed, and informed its regulator in West Germany about it. The regulator said, "at 4:00 on Friday afternoon, when the exchanges are closed, you will fail, and we will close you down, and then we'll come in and clean up the operation", not taking into account that at 4:00 on Friday afternoon in Frankfurt, it's only 10:00 a.m. in New York and the mar-

kets are open. You may think this is funny today, but at that time people were sitting in national jurisdictions.

There was consequent chaos on the New York money markets, and settlement procedures froze. The settlement structures of the entire U.S. banking system were threatened by this crisis. The Federal Reserve asked the German Bundesbank what it was going to do about it and the Bundesbank responded: "Nothing. It's in New York, so it's your problem. What are you going to do about it?" The Federal Reserve replied: "Nothing. It's a German bank. It's your problem". This was the first time people recognized that you needed some form of international procedure for managing the risks in the new liberalized system.

As a result of that, the G10, a quite unknown international organization composed by the main European countries, Canada, the U.S. and Japan, set up a new organization called the Basel Committee on Banking Supervision, with different committees: one charged with settlements and one with structures of international markets. These committees were set up as an informal system; it was, if you like, committees of consenting adults. What they did was to develop rules. In this case, how to solve the Herstatt risk in a responsible way? Which regulator should be in charge, the home regulator or the host regulator?

Over the next 30 years, these committees have developed more and more rules. For example, they are actually the people behind the definition of the amount of capital the banks must hold, first in the Basel I agreement of 1988 and then the Basel II agreement, which has just come into force, and behind a whole series of other principles and codes that define how banking is supposed to work.

The interesting thing is that this is a consensual organization. It is what the lawyers call soft law; that is, that they develop rules which then have to be incorporated by national jurisdictions into their law. They have no powers as such, and yet they're the main international rule-making organization.

Then, at the time of the Mexican peso crisis in December 1994, the G7 leaders themselves started to worry about international financial regulation. They hadn't really been involved as an organization before. Following the 1997-98 Russian and Asian crises, the G7 set up the Financial Stability Forum, a committee which consists of central bankers, regulators, and treasury departments from G7 countries, plus some international organizations like the IMF, the World Bank and the Bank for International Settlements. This organization is really in charge now; it decides what is to be done with respect to financial regulation. It was making the running before the current cri-

sis, and they're making the running now. It published recommendations as to what to do in April 2007 and their recommendations were endorsed by the G7 finance ministers. In October 2008, they published a follow-up setting the framework for the meeting in Washington that will take place today and tomorrow.

So the Financial Stability Forum is the intellectual force. And they have three basic themes in their argument. The first is transparency, the second is disclosure – there is a difference between transparency and disclosure: transparency is about the instruments you should be able to understand, while disclosure is about revealing the actual procedures of the firm – and more effective risk-management by firms. In other words, they still accept the argument that more effective risk-management by firms, combined with market sensitivity and more information, will be enough. They are ignoring externalities and systemic risk.

The other organization that has become increasingly involved is the IMF. The IMF started reinventing itself around 1998-99 as a financial regulator. It took the intellectual lead from the Basel committees and from the Financial Stability Forum, and used its treaty powers to start doing inspections of countries' financial systems, the so-called Financial Sector Appraisal Program. They have now inspected financial regulatory systems around the world and produced a whole number of reports. They haven't done anything, but they have collected a lot of data, actually some rather useful data.

This is the institutional landscape today. We have structured institutions and we have a particular theory. Now the theory is very useful, because suppose that we did have an international regulatory organization charged with managing systemic risk, operating at the level of the system as a whole). Let's take an example of a policy proposal which deals with systemic risk, which is so called pro-cyclical provisioning, requiring banks to put aside more capital in the time of a boon and allowing them to run some of it down in the time of a slump. Suppose you try to implement that policy internationally. It's easy to do at the national level perhaps – well, maybe it's not so easy, but you can understand how you can do it legally – but how would you do it at an international level? Suppose, for instance, that one area of the world is in a boon while another area of the world is in a slump. That means the capital requirements will be different in these two parts of the world. And lo and behold, banking operations would move very rapidly into the part of the world which had the lower capital requirements. Which means that once you start thinking



about systemic regulation, which is what we need on an international level, then you run into significant difficulties, analytical difficulties. International regulation has developed a framework, a quite successful framework until now, because it hasn't faced that problem. But the problem is real. International regulation has simply left the control of risk to the firms: all it does is to develop better rules for firms, rather than addressing this systemic problem.

Still, this systemic problem is a major issue. Our liberalized financial markets need regulation to manage systemic risk, but the regulators are still trapped in irrelevant national boundaries, national juridical boundaries. They don't have international regulatory powers. And therefore you have ineffectual international regulation; you have the ability of financial institutions to practice regulatory arbitrage and to move to those areas where regulation is slacker; and even though there is a clear global connection, especially these days, between the financial markets, it is not matched on the regulatory scale.

I said before that the Financial Stability Forum has come up with a framework, essentially the same as the one that had dominated the development of regulation for the last 20 years – transparency, disclosure, risk-management by firms – paying no attention to systemic risk. That's not entirely fair, because they did have one very good proposal which they have actually taken over from some European Union proposals, which is that there should be colleges

of supervisors responsible for large international firms. Let's take HSBC, the biggest bank in the world, stretching all over from Asia into the Americas. Its regulator would be a collectivity of the regulators from its major jurisdictions: a college put together from Singapore, from Hong Kong, from London, from New York and so forth, in charge of regulating that institution. This is an attempt to develop a framework that actually would deal with global institutions.

But we do have a problem. There's a lot of institutions involved, but they don't have a framework. Apart from this one good idea, they don't really have a framework within which to operate. The British government's main line is that the Financial Stability Forum has the ideas and no power, and the IMF has power and no ideas. And therefore the two should be put together, because the IMF is a treaty organization with legal rights and responsibilities, defined by the Articles of Association, and also because it overcomes some of the democratic

**“The Financial Stability Forum has left the risk control to private firms: it invents rules but does not address the systemic risk.”**

deficit in the G7 organization. The IMF may have an imperfect governance structure, but at least everybody's involved; it's not just the G7 telling the rest of the world what to do.

What we are going to see over the next few years, I think, is a great effort to reinvent the IMF, reinventing it as a financial regulator. Therefore, if we want to influence this debate and develop a structure that actually confronts the problem of systemic risk, that's where our interests should be targeted.

### Paul Davidson

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Let me quote the last two lines of a book I published in 2007 about John Maynard Keynes: "When, not if, the next Great Depression hits the global economy, then perhaps economists will rediscover Keynes's analytical system that contributed the golden age of the post-World War II. For Keynes, however, it will be Pyrrhic victory". I didn't think the time would come that quickly. The question is, do you have to have a theory in order to know what policies should be implemented? And what do you think Keynes's theory is about? Often people say, "it's about sticky wages". But Keynes didn't say it was about sticky wages. "Oh, then it's the liquidity trap". But he said in the general theory that there is no such thing as a liquidity trap. Then they say, "Keynes didn't say anything about international things in the general theory". But there are actually 15 passages in the general theory which mention how the general theory will be modified if it's an open economy. And of course we have all his work on Bretton Woods. And he wrote an essay called "Self-sufficiency," in which he said the law of comparative advantage is really irrelevant in trade patterns today. The only time comparative advantage works is if you have natural resources, or something that has to do with the climate. Obviously you don't want to go to Iceland to do sunbathing. But for all the other things, as long as capital is mobile across national borders, it is the absolute advantage, not comparative advantage that determines trade patterns.

Suppose China built a factory in California that hired child labor, had no occupational safety regulations, polluted the atmosphere and made people work 45 to 60 hours a week at a very low wage. The United States laws would say you are not allowed to trade with that factor. So why is it, if they put the factory in China, we allow the United States to buy? And why did we pass child labor laws in the

first place? Because we believed it's uncivilized to let children under 14 work – not because they didn't want to work, or because their parents didn't want them to work. In other words, there are some limits for people's ability for self-regulation.

What was the Keynesian revolution about? It had to do with taxonomy. Keynes spent ten years trying to figure out what was wrong with the classical theory. He knew by the Treaty of Versailles there was something wrong, but he didn't know what it was. What he did in essence was to change the definition of words that we use in economics. Remember, savings are defined as time preference in the classical theory. It just meant you bought something later rather than now, and since the manufacturer knew when you're going to buy, he built more capital equipment to prepare for this extra demand later. Keynes said no, it's the propensity to consume, when you save you have a liquidity preference; that is, you want to put your savings in liquid assets.

He also wrote a whole chapter about "Essential Properties of Interest and Money" in which he explains that every liquid asset has two essential properties: a) Anything that's liquid cannot be produced in the private sector by the use of labor; b) According to the law of substitution, liquid asset will not be substituted. If its price goes up, you will not substitute products of industry. And what does it mean? It means that if you save, you buy things that couldn't be produced in the private sector; and no matter how the price ran up you would never substitute producible goods for it. And that's what caused unemployment.

The same goes for the financial markets in the international sphere: according to Keynes, these markets are liquidity preference markets. They were not "efficient". That's why he talked about "animal spirits" driving it, and not some strange idea of efficiency – what is an efficient market anyway? I hate when people keep talking about risk management: there is no such thing as risk management because you can't predict the future. Keynes continually said, speaking about Tinbergen's method<sup>1</sup>, that the economic data are not homogeneous over time, which means that the economic behavior is non-ergotic<sup>2</sup>. You can't predict the future, and that's precisely why liquidity is important. When a serious monetary theory will be written, the fact

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(1) In reference to the so called Keynes-Tinbergen debate that took place in *The Economic Journal* in the 1930s, the first debate on econometric difficulties attached to the statistical testing of economic theory.

(2) A behavior that in certain respects remains incomprehensible through observation, and thus impossible to predict.

that contracts are made in the form of money will be the essential part of it. Think about the use of contracts in a global economy: when people in two different countries enter into a contract, what currency do you use? Very often they use a third currency, usually the dollar, especially when they trade commodities. If it's a manufactured good, you usually use the currency of the producer. This creates all sorts of problems for the system. Keynes was very clear about that and suggested a plan at Bretton Woods to solve this problem.

**“If we had capital controls, we could never pass off all the “toxic assets” to Iceland, Germany or Northern Rock.”**

I must confess that I feel today like a broken clock that tells the correct time twice a day every day. Since 1983, I have been warning that the international system is instable, that we have to transform it into something more like the Keynes plan. And every once in a while it turns out I'm right – as at the time of the Mexican crisis, during the default crisis 1998-99 or right now. At least four or five times during the day I've been right. It's a long day, but it's not the long run.

What did Keynes want to have in this Bretton Woods system? First of all, he wanted a global monetary regime that operates without currency hegemony. He didn't want to have the dollar at the heart of the system. He conceived of some supranational central bank with an international currency which only national central banks could deal with, not the public. I've been arguing that you don't need a central bank; what you need is a clearing union.

Secondly, he wanted global trade relationships that support rather than retard domestic development. As soon as a country starts to develop it encounters the following problem: whenever it gets out of step with its trading partners, it runs immediately into balance of payment problems, must tighten its belt and try to succeed by controlling the currency, and therefore never has to worry about the balance of payments.

Third, Keynes wanted capital flow constraints, which is part of China's strategy today, and this strategy seems to work.

Fourth point, a very important one: If there is a balance of payments problem, you want an international currency that puts the major onus on the creditor nation to solve the problem, not on the debtor nation. The problem with all convertible currency – whether with fixed or variable exchange rates, it doesn't make any difference – is that the debtor nation is the one that's required to tighten its belt; whereas the wherewithal for solving the problem is with the creditor

nation. They have the money to solve it and Keynes suggested how this could be done: the creditor nation has to spend its excess reserves – it could spend it on buying products from other people, on foreign direct investment, but it has to get rid of those extra credits. If China doesn't want to buy our products, it can invest in our light rail industries, helping us to solve our transportation problem. We could sell municipal bonds to China to produce light rail, solving two problems at once and getting rid of their excess dollar reserves. Or, if they won't do either of those two, there would be a 100 percent tax to take away these extra reserves. Instead of reserves, we would have something which I would call the Marshall Plan.

Let me remind you of what the Marshall Plan was about. At Bretton Woods, Keynes said that the European nations would need approximately \$10 billion to rebuild. Harry Dexter White replied that the Congress would never give more than \$3 billion, and Keynes' plan was refused. The IMF and the World Bank were supposed to recycle private funds over the \$3 billion that the Congress might allow. But then came 1947, a very bad year for agriculture. Western Europe looked like it was failing; it might even turn Communist; so people eventually convinced General Marshall to do the Marshall Plan. In four years we gave \$15 billion, not 10, to the Europeans. It was good for them, and it was good for the United States.

Why was it good for the United States? It was the first time in history that we didn't have high unemployment after a major war. Think about it: 9 million men and women left the army and came back to the labor force. Where did they find a job? Some of them were absorbed into colleges under the education plan, but there were still a lot more of them. But thanks to the Marshall Plan, export industries grew dramatically and that created jobs. So we gained, and they gained. And that was Keynes's argument: the surplus country will gain from it as well.

The essence of the Keynesian system is that it is liquidity and financial markets that make a monetary entrepreneurial economy run; and that it's a double-edged sword. If it runs as it should, it generates economic growth at a rate that you can't have in a barter economy. If it doesn't, as right now, you get a depressed economy. Keynes once said that in an economy where the real wealth is constant, and where people are handing around pieces of paper to each other, everybody feels better off if each day the price of the paper goes up. But if each day the price of the paper goes down, suddenly they feel worse off. The real economy hasn't changed at all. But it will change if they feel worse off.

This is what we need in an international monetary system. We have to recognize a) that we cannot leave it to the market to solve these problems since capital markets are not efficient; b) that liquidity is the essence of the problem, and that we have to encourage people to spend. What amazes me is how everybody now picks on the poor American consumer because they spent more than they earned, and equity, and so on; we seem to forget that, since 1992, the global economy has been driven by U.S. consumers spending like crazy. As Allen Sinai pointed out, consumer spending went up from 67 percent to 71 percent of GNP in the United States, and of course this created not only the engine of growth for the United States, creating profit opportunities for our people, but also for the rest of the world. China's growth lies in large part in America's ability to buy Chinese goods.

What we need is thus a system based on these principles, an international, global system. The real problem is how we get there. Somebody asked me how this system would solve the Icelandic bankruptcy problem. The answer is that if somebody is in bankruptcy already, then it's too late to solve it. That's why we have bankruptcy laws. They get them out of it with the least penalty to themselves and to the lenders. So I can't solve the Icelandic problem. But I can tell you that if we change the system along the lines indicates above, we will encourage every country to pursue full employment.

And why capital controls? If we had these capital controls, we could never pass off all these "toxic acid", so to speak, to Iceland, Germany, Northern Rock. All these things could have been prevented. Would they have been prevented? Well, this requires regulation and intelligence, and a regulator respecting the rule of meritocracy. Keynes always believed that our regulators, our civil servants, should follow the rule of a meritocracy. Otherwise, no policy will work. So let us have a meritocracy and let us understand the theory and the principles of what we need in this international system.

As John Eatwell pointed out, we should reform the IMF. Maybe that will solve our problems, but I doubt it very much. We need a new institution. Somebody said earlier that we could use old institutions to do new things. I don't care whether you call it IMF or something else; I call it an international clearing union. This international clearing union clears between national central banks. The public never gets hold of the accounting – and hopefully central banks don't do accounting fraud. Each country is permitted to set its exchange rate for one-way convertibility between the clearing union unit of account and its current account. It is permitted to do it, but it does not have

to do it. All it has to do is say: “if you have one IMCU [International Money Clearing Unit], it’s worth so many dollars”. The advantage of this is that every central bank will be willing to hold IMCU’s because they know they can always have products at a fixed exchange rate.

Finally, does the exchange rate ever change in that system? Yes it does. It changes if the efficiency wage – that is, productivity less money wage – improves. Then there’s an advantage in changing the exchange rate. What I’m arguing is that you have relative real efficiency wages between countries that share productivity growth among every nation of the world. And we also have this onus on those countries that run up too big a balance in the clearing unit. They must get rid of their balance by buying something from others, which will allow the debtor nation to work their way out of debt. And that’s what we want people to do, work their way out of debt, not bail them out of debt.

## Ping Chen

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I would like to discuss three dimensions of the current economic crisis: the economic theory, the economic policy and the changing world order<sup>3</sup>. To start with the theory, mainstream economics is ill-prepared to handle the crisis. If we want to adopt new economic policy, we also need new thinking in economic theory itself, since poor policies came from poor theory. As I see it, there are four influential theories that could mislead our analysis.

Number one is the exogenous theory of business cycles, such as the Frisch model noise-driven business cycle. This school believes that the market economy is fundamentally self-stabilizing; any trouble is caused by an external shock. The best thing about the current financial crisis is that people finally seem to realize that the causes of the crisis are to be found within the American economy itself. Since the discovery of economic chaos in 1985, we know that business cycles are driven by endogenous forces. The market economy is inherently unstable – that is the very reason why we need proper regulation and sound management.

Secondly, Friedman’s theory of exogenous money gives an oversimplified account of how to deal with financial crisis. Friedman assumes monetary movement is exogenous, so central banks can do whatever they want. Friedman also claimed expansionary monetary

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[3] The text has been reviewed and modified by the author after the conference.

## Looking for Solutions to the Crisis

policy alone could have prevented the Great Depression, though there's no solid empirical evidence to support that theory. It would be very dangerous for Paulson, Bernanke and central bankers around the world to follow Friedman's theory in dealing with the current crisis. On the contrary: we have solid evidence supporting the Austrian theory of endogenous money and rejecting Friedman. In 1998, China had to confront severe deflation in the aftermath of the Asian financial crisis; it managed to maintain sustained growth mainly by fiscal policy, by large investments in infrastructure.

The third misleading theory is the Lucas theory of micro-foundation and rational expectation. As you know, there is a fundamental debate between the school of micro-foundation and the school of macro-foundation for firms' behavior. Some people today blame Wall Street greed for the financial crisis. But let me ask you: why did American investors like Goldman Sachs behave much better in China than in the United States? They don't make their decisions in a vacuum, but in a certain macro-environment; it was American macroeconomic policies and deregulation that encouraged financial speculation and manipulation.

Lucas ignored the "principle of large numbers" according to which the driving force of business cycles comes mainly from financial intermediation and industrial organization, not from households and firms. We have a large number of households and their fluctuations neutralize each other. But we have many fewer giant firms, and their decisions will generate much larger macro fluctuations than those of households or small firms. This means that the financial crisis was caused by failures of major firms in the financial sector. In dealing with failed giant financial firms, you have a tough choice to make: either you break them up into smaller entities, and encourage competition, or you merge them into even bigger ones, and create even more concentration. American government is encouraging big firms like Citigroup and Bank of America to take over weak financial institutions. China made a similar mistake in the 1980s, but changed its policy in the 1990s. You may soon find out that the larger the firm, the more difficult it is to reform. China's new competitiveness is mainly based on open competition rather than on concentration.

The fourth misleading theory is the Black-Scholes model in option pricing theory. Some people blame rocket scientists<sup>4</sup> for the

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(4) Quantitative analysts employed by investment banks and hedge funds (sometimes also by commercial banks, insurance companies and management consultancies) to design and implement complex models that allow financial firms to price and trade securities.



meltdown of the derivative market, but few realize that the problem lies in the equilibrium theory of option pricing. We found out in 2005 that the Brownian motion model, the basic model in all derivative trading, is explosive in nature. The collapse of the derivative markets is not just driven by greed; it also resulted from poor models of the stock market. When you don't know how to evaluate the price of derivatives by empirical data, you have to count on the so-called efficient market model. However, these equilibrium models completely ignored market instability generated by collective behavior. And the Coase theory of transaction costs cast even more doubt on market regulation.

Combined, these four mainstream economics theories created an illusion of a self-stabilizing market, making policy makers ill-prepared for the situation we have today. And yet, since the 1980s we have empirical and analytical support, not just philosophical arguments, to prove they are erroneous. I would specifically mention the "principle of large numbers" used by Schrödinger, the founder of quantum mechanics, applied to micro-macro relations in biological structures but ignored by economists like Lucas. Let's say we have 1,000 banks and merge them in 10 bigger ones. You think that a bigger bank is more efficient or more stable? On the contrary: its aggregate fluctuation will amplify by 10 times. That's exactly what has been going on in the United States for the last 20 years, ever since financial deregulation stimulated a wave of mergers and acquisitions.

**"The collapse of the derivative markets is not just driven by greed, it also resulted from poor models of the stock market."**

I would also add that Charles Kindleberger's theory about the Great Depression is much more relevant to understand our situation than Milton Friedman's. Friedman believed that the Great Depression was triggered by one single event: the death of New York Fed Governor, Mr. Strong, which left a vacuum in the Fed's monetary policy. Charles Kindleberger pointed out that the world depression was caused by the collapse of a globalization based upon British leadership. The three world powers after World War I – the United Kingdom, the United States, and France – were kicking ball among themselves and eventually provoked a collapse of the whole global system. We have a similar problem today, since the United States has lost its world leadership by excessive military expansion and excessive consumption. The world-order has changed since the 1980: unless the United States, Europe, and China coordinate their efforts, we may face another global depression.

## Looking for Solutions to the Crisis

Before discussing policy issues, we need to address the problem at hand from a global perspective. There are three questions to be asked:

First, what vision do we have of the American economy? Should we treat it as a closed system or as an open system? People used to think that only small countries need to ask this question, not the United States. But we can no longer ignore the interaction between the American economy and globalization.

Second, what is the international background to the current crisis? Bernanke once suggested that American imbalance was rooted not in its excessive consumption but in China's excessive savings. I have a different view on this. The U.S. is much more powerful than China and the other Asian economies combined. Its financial power is still dominating the international financial order. But what we see today is the result of President Reagan's contradictory economic policy in the 1980s: on the one hand, Reagan launched a tremendous military expansion; on the other, he made substantial tax cuts and deregulated the financial sector. The budget deficit that resulted was financed by growing public debt, which drove up both interest rates and the dollar and ruined the competitiveness of American manufacturing industry. As we know, the response to this was outsourcing, first to Japan and East Asia. The U.S. pushed the Japanese to appreciate the yen, but that did not solve its trade deficit. Instead, it threw the manufacturing industry out from Japan and the "Asian tigers" into mainland China. Ever since, the U.S. keeps putting pressure on the Chinese government to appreciate its currency, but this time with no success.

The fundamental problem of the U.S. is that the financial sector has replaced the industrial sector in the "driving seat" of its economy. You cannot cure that disease by playing currency games or monetary games. Since the 1970s, no matter how exchange rate fluctuated, America has a persistent trade deficit, while Germany and Japan have persistent trade surpluses. It has nothing to do with exchange rates but with American foreign policy. The United States has strong technology and abundant resources, but you continue to waste immense resources on military spending and financial speculation. What you need is a fundamental change in your economic structure and in your foreign policy.

As for China, of course it has suffered from the American foreign policy, but it has also benefited from it. Let me explain this.

During the Asian crisis, China did not follow the American recommendation to devalue its currency. Both before and during that crisis, mainstream American economists had one single policy recommenda-

tion to offer Latin America, Hong Kong and China: dollarization, dollarization, and dollarization! Remember that most Chinese reformers tried very hard to learn market economy from American textbooks. They all considered the American Treasury Bill as a risk-free investment compared to risky stocks and corporate bonds. So the Chinese government decided to target China's exchange rate to the dollar and buy American Treasury bills. They thought that this was the best way to preserve the value of Chinese savings, or at least a much better way than to invest them in China's own enterprises. However, once China had chosen that road, American Treasury bills turned out to be a trap. And in that situation, China has fewer options than Japan and European countries in the currency game, because of the asymmetric policy adopted by the United States. When the dollar goes up, Japanese or Europeans can buy American assets, but China cannot, blocked as it is by the American security policy. At the same time, American banks and firms are invited to be strategic partners for China's state-owned firms. Do you think China is blind and will sell their security interests to American firms?

Still, I would claim that this asymmetric trade policy has in fact done more good to China than to the United States. It did not resolve the American deficit problem, but it did accelerate the economic integration of East Asia. How did that happen? If world trade was free and based on rules of symmetry, China would be buying much more American technology than it actually does. But since the United States does not allow exporting high-tech products to China, China can only import second-hand technology. However, the U.S. does export high-tech to Japan and other East Asian countries, and this difference in trade policy has created a tremendous arbitrage opportunity for these countries. It is not by accident that since the 1970s, China has persistent trade deficits with its neighbors: first with Japan, then with Korea and other South-East Asian countries. In fact, these deficits are quite comparable to China's trade surplus with the United States. And what does it mean? It means that the U.S. is giving away a huge trade opportunity to China's neighbors.

But what are the actual results of this policy? After the Asian financial crisis, all these countries realized that China is a more reliable partner in international trade, since it did not devalue its currency in spite of the crisis. They also realized that their economies greatly benefited from China's rapid growth. So, geopolitically speaking, these countries, once China's opponents, became its close friends and their economies became more and more integrated into the Chinese economy.

East Asia is today the third largest economic zone in the world, with stable exchange rates to the dollar, which also helps to stabilize the dollar. If U.S. policy makers realize that this is a base for closer economic cooperation, I would say that our future is bright. But if they consider it as a challenge rather than an opportunity, it would signal troubling future ahead.

This is the geopolitical heritage of the Reagan revolution and the American imbalance. If the U.S. was able to maintain its financial power in spite of increasing deficits, it was because China's exchange rate policy was targeting the dollar as an anchor. So far, both the Chinese and the Americans are happy about the past but worry about the future. Unlike their Asian partners, China did not get any credit from American policy makers; instead, they only get China bashing. American leaders should focus on winning people's trust more than financial profits.

Now my third question, the one about China's high savings rate. Why do the poor countries end up subsidizing the rich ones? My opinion is that China's high saving rate results in part from the monopolistic power of international companies that dominate China's domestic market. More than half of China's exports come from plants owned by foreign firms, and most export channels are controlled by

**"A new financial order can only be achieved if major economies build a system of stable exchange rates and coordinate their policies."**

firms like Wal-Mart. Chinese companies and the Chinese government have no pricing power in international markets. For any Chinese product sold in the United States, Chinese companies get 2 to 5 percent of the sale value. As the result China's domestic market is more

open and more competitive than the United States, Japan, or any other country in Asia and Europe. If we look for instance at China's car industry, we see that the market is not dominated by the "big three" as in the U.S.; you have more than a hundred companies competing with each other. Their profit margins are very thin compared to giant foreign firms – in order to survive, they have to upgrade their technology by self-financed investment, and this gives very high saving rate in Chinese firms.

Since China launched its reforms some 30 years ago, its annual growth rate in residential income and consumption has been about 7 and 6 percent. China's high saving puzzle cannot be explained by households but by firm behavior. If we look at the composition of China's immense bank deposits, residential deposits represent some

50%, more than 30% coming from firms. China's interest rate in the domestic market is also much higher than what U.S. Treasury Bills offer. In rural industry, gray interest rates may reach more than 30-40%. Clearly, strong market competition leads to strong competition in technology investment among all industries and firms. The Chinese government has very limited means to cool down the investment boom since public investments are much smaller than the private ones; in addition, regional governments have strong incentives to promote manufacturing industry.

I would guess that if the U.S. government adopts new anti-trust laws and breaks up monopolistic firms as it did with AT&T, American industries would become more competitive and American households would behave more like Chinese households, investing in education and technology rather than big homes and cars. In the end, you would see more balanced trade in the world market.

When Bernanke points out China's high saving rate, rather than the low saving rate in the U.S., as a possible source of financial instability, you have to reply by posing a more fundamental question about the driving force of growth. It should be consumption or new technology or new industry. American policy for economic stimulus in developed countries is about encouraging consumption, especially about buying new houses and new cars. But can you recommend the same measures in the case of developing countries, saying "if we spend more money you drive up your economy"? You must consider this question from the point of view of the international competition. Let's say that one country spends most of the money on consumption, while another country spends more on innovation. Which country do you think will win the international competition? That's a very simple question, is it not? No matter what natural resources and property rights we take into account. You don't need a grand theory, common sense will do to answer this simple question.

Finally, I would like to discuss some policy issues. I have lived in the United States for 28 years now. I consider myself as a student of American and European civilization. I learned a great deal from Americans. But the time has come for Americans to ask themselves if they can learn something from other people, from the Europeans, from the Japanese, from the Chinese or the Brazilians. I have some suggestions for my American friends, based on China's experience in economic reform.

Mutual understanding is the most important thing in building mutual trust in international affairs. As I see it, China has no inten-

tion to even trying to replace Americans or Europeans as world leaders. Chinese philosophy teaches that you lead when you are modest and you lag behind when you are arrogant. China did achieve some prominent things during the Tang dynasty in the 7<sup>th</sup> and 8<sup>th</sup> centuries, and the Ming dynasty in the 15-16th century, and Chinese people understand very well that the rise and fall of great nations are historical events that are beyond the human will.

We all know China's economic problems were more severe than yours. So what lessons can we learn from China's reform?

I would suggest: growth first, reforms and redistribution second. If you have a shrinking economy, you have little space for institutional reform. A lot of people say we have to increase our pension funds, save this save that. Where will the money come from? You should identify growth opportunity first, then you may convince people to make sacrifices for a better future. Investing in infrastructure, in green technology, and attracting foreign investment are better measures than layoffs and bankruptcies.

Second, the United States must change its consumption-driven growth to export-led growth. What can you export? Exporting Treasury bills or inflation is a destabilizing strategy, both for the U.S. and for the world economy. But you can export, let's say, the all-electrical car of General Motors. In fact some of your products may not sell well in the United States but very well in China and Asia, where the population density is much higher and traveling distance much shorter. And then, the most competitive U.S. firms are universities. Many Chinese families, including poor farmers, want to send their children to American universities to learn. You may accept more Chinese students by developing partnerships with Chinese provinces or cities. They may invest in the American educational system and infrastructure, and you may help China develop better education.

Third, cross-investments will develop mutual trust and cultural exchange around the world. You might ask: why would Americans need Chinese investments? China asked the same question before. Financially speaking, in the 1980s and the 1990s we did need foreign investment, but in the 21<sup>st</sup> century the situation is different, because of our large domestic saving. However, China still accepts large foreign investment if it brings in new technology, new management, new marketing channels. China's open door policy is open for long-term investors, not for short-term speculators. True, Americans have better technologies than the Chinese. However, a lot of patents and technologies controlled by large firms are rarely used. If Chinese

firms are so eager to open business in the U.S. it is mainly to improve their business image, not so much for the profits. They consider America as a world stage. Operating in the U.S. market symbolizes a transition from local business to an international business. On the other hand, if American companies open to Chinese investment, they may find new markets for existing technologies. To build a long-term partnership and change cold war thinking we need national governments acting as political insurance for mutual investment.

Forth, competition policy is more essential than financial consolidation. In almost every American crisis, you observe a wave of mergers and acquisitions leading to concentration, which is the root of the current financial crisis. For example, since AIG is the largest insurance company; as soon as it gets into difficulties it enacts a chain reaction that affects the macroeconomic level. I suggest that you break monopoly firms into smaller competing firms, so that you can diversify risk and encourage innovation. If you let Citigroup take over Merrill Lynch and Bank of America take over another big bank, then you'll just see more troubles ahead. I learned this lesson from transition economies: Russia privatized its state monopolies without breaking them into competing companies; while China split state monopolies without privatizing them. You can see the result today.

Fifth, flexible exchange rates are inherently unstable for globalization. Fixed or relatively stable exchange rates are essential for effective fiscal policies and the international division of labor. Uncoordinated monetary policies conducted by the United States, the European Union and Asian countries may trigger a wave of competitive devaluations, which will hurt most and destabilize countries without enough foreign reserves. The new international financial order can only be achieved if major world economies build a common system of stable exchange rates and coordinate their macroeconomic policies and trade policies. Then other countries could create a basket of major currencies to achieve a relatively stable exchange rate. In other words, we need a new Bretton Woods System, not based on a single currency, the dollar. This will be done only if the three major financial powers (the United States, Europe, and China), create mutual trust and a long-term partnership, without any of them acting as a self-appointed world police or judge.

In other words, we need a new vision of the world order, a vision that will help us to build sustainable globalization. Without this vision, we may see three regional markets emerge and divide the world between them.



## Luiz Carlos Bresser-Pereira

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I think we learned a lot from the current crisis. We learned that financial systems need regulation. We learned that regulation cannot be exclusively national. We learned that the initial financial crisis evolved into a profound economic crisis. And we learned that it is not sufficient to solve the financial crisis to solve the economic crisis that followed: you have to take rapid and strong measures to sustain effective demand.

But I think we forget the major problem. We are addressing the current crisis as if there was only one type of financial crisis, the type that we are facing today, that is, a banking crisis. We forget the balance of payment crisis. This might not be a risk for a great country like the United States or other rich countries, although Great Britain suffered from it in the early 1980s. But for all other countries, the developing countries and middle-income countries, these crises are very relevant. And given the increasing role and weight that these countries have in the world, we might say that the balance of payment crises have systemic consequences. Thus, we should look for measures to prevent them.

The same concern was raised at Bretton Woods. I'm in favor of international currency, but I don't believe that it will solve that particular problem. I'm in favor of increasing the role of developing countries in the new financial architecture, but again, I don't believe this will solve the problem. Rather, we have to address the balance of payment crisis as a problem in its own right.

So, what *will* resolve the problem? National policies, surveillance of the financial system and measures to limit current account deficits and debts. We must remember that growth is supposed to be stimulated through domestic savings, not foreign ones; that foreign savings *are* current account deficit; it's synonymous.

The solution, in my view, is to limit indebtedness. Since what caused the current budget payment crisis in the first place? It's very simple: the country got indebted. If a country starts to have a very large current account deficit, sooner or later creditors will lose confidence and stop renewing the debt. And suspension of the foreign debt causes the crisis. Normally, devaluation of the currency is the response to it.

What's interesting about this question is that neoclassical economists, as hostile to budget deficits as they might be, have nothing against current account deficits. In their view, this is about investing savings, which is a wonderful thing: rich countries invest in developing countries. And they are not the only ones to make that mistake. I believe that most economists, conventional economists in general,



believe that capital-rich countries are supposed to transfer their capital to capital-poor countries. This might seem obvious but in fact, it is not. In my papers I develop the argument why these current account deficits are bad for the economy. I'm not going to present the full argument here, you can read it in *The Journal of Post-Keynesian Economics*. But I will describe the problem as a process in three stages:

The final stage of this process is the actual budget payment crisis. The stage before is a period of financial fragility, when the country is heavily dependent on foreign creditors and on the IMF, and their leaders adopt the confidence-building attitude: "we must do everything that the creditors tell us to do". In the stage before, we have a high rate of substitution of domestic savings by foreign savings. Why is that? Because when you have a current account debt, the exchange rate appreciates.

So what should we do about it? I suggest we should do what the Europeans did about the budget deficit. The European Union established the rule for all its member countries, saying that 3 percent deficit was maximum. Sometimes you can go beyond that; but in general 3 percent is the maximum. This is a good idea. We can discuss whether the limit is too low or too high, but all in all I think that this level is reasonable. The same thing should be done with current account deficits. This should be discussed seriously, then we'll see if we arrive at 3 percent or 2 percent – the important thing is to have a rule.

**"The EU established the 3 percent budget rule for all its member countries. The same thing should be done with current account deficits."**

I am perfectly aware of the fact that the idea is both new and old. Actually, it is about 10 years old. Since it is, roughly speaking, ten years ago that developing countries began to make current account surpluses.

My friend James Galbraith had an explanation for the U.S. current account deficit. I agree with him. But I don't think this is the main reason, yet alone the only reason. The main reason is that developing countries learned that current account deficits are disastrous. And those who really learned the lesson were the Asian countries, the four Asian countries that run into a major financial crisis in 1997 precisely because they were running high current account deficits.

I think that in the future, it is the developed economies – the United States but also Europe and Japan – rather than the developing countries, that will have to worry about current account deficit. And I suggest that the idea that the market is able to control that, to adjust global financial indebtedness, is absurd. We need regulation to solve that problem and this should be put on the agenda.

**Question from the audience**

*It seems to me that whether we follow Paul Davidson's advice to create an international clearing union, or John Eatwell's to "upgrade" the IMF, or opt for some sort of international coordination, we have to face a trade-off, and we need to be very clear about it. We have a conflict between things that make the financial system apparently more efficient, maybe even more stable in the short run; but that undermine the resilience of the entire system. We need increased regulation, for instance we need to forbid certain kinds of financial transactions. This might reduce certain kinds of short-run efficiencies, and yet it is necessary to do that in order to protect the global resilience of our entire system. Anybody have any comments on that?*

**Paul Davidson**

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A comment about current account imbalances: the United States has 12 central banks. A bill might be issued from the Central Bank of Richmond, from the Central Bank of Philadelphia, etc. There are current account imbalances between them, but we don't change the exchange rate between these dollars. How do we solve the problem? Roosevelt solved it very easily: by a progressive income tax where the surplus countries, because they're growing income more rapidly, paid more taxes, and then they were spent in places like the Tennessee Valley, creating jobs over there.

Also, remember the old Savings & Loans. Initially, the Savings & Loans and most commercial banks could only service their local area, which they knew well. They knew who were the good loans and who weren't good loans, and they had to worry about that. Then we suddenly said: you could service anything. A Savings & Loans in Princeton, New Jersey, would finance a golf course in Tucson, Arizona, knowing nothing about any of this; and this led to bad banking.

The financial system that I'm suggesting here, which is the equivalent of the international system, says that we stop at national borders and create a system where each nation has the incentive and the responsibility to create full employment and rising wages for its workers. We can do it without worrying about balance of payments problems, and without worrying about getting stuck with somebody else's "toxic assets". There's no other way of solving those kinds of problems.

## Luis Carlos Bresser-Pereira

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You need to remember who is in charge, at least to some extent: the IMF. And the fact is that I don't trust the IMF. I don't believe that the IMF is there to regulate and put order in international finance in a way that would be profitable for all. It is controlled by rich countries, controlled very clearly in terms of stocks, and it represents the interests of these countries. And given the fact that cooperation among countries is essential, and that an organization like the IMF is necessarily the outcome of cooperation among countries, I believe that competition among countries is very strong. So we have to solve the problem of the legitimacy of the IMF, if the IMF is supposed to continue to exist.

### Question from the audience

*We have already seen trillions of dollars of wealth being wiped out, we are witnessing a collapse of incomes. This will have an enormous impact on the real economy and on people. Why did we permit the development of a financial sector which grew from somewhere around 10 percent of GDP in the 1960s, to somewhere around 20 percent today, and absorbed a great deal of our intellectual human capital? What did it give us in return, to the society as a whole? What does the financial sector do for us?*

*There are some obvious answers: it provides the currency. But that concerns the payment system, and the payment system is not necessarily connected to capital markets or the financial sector in general. Indeed, it is the process of securitization that has connected it to capital markets, and it is precisely what makes the present situation so dangerous, particularly with some \$62 or \$64 trillion of derivatives, some significant percentage of which are expected to lose value. That's going to be a very big loss. So what are the services which the financial sector delivers to the rest of the society?*

## Luis Carlos Bresser-Pereira

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What do financial markets do for us? I think that the Brazilian president Lula, a very intelligent man, responded to this question, saying that finances finance production. But of course, you have to finance economic activities and not speculation.

What we have seen during the last decades was an enormous

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capture of wealth by predation, by the financial system. But part of this process was created by our way of measuring the wealth, profits and bonds and stocks of a country. There are measures that have nothing to do with production, like the number of transactions made one over the other. And what these measures showed for the last 20 years was an enormous increase in wealth. The GDP was growing in an abnormal way. All this seemed to make sense because the capitalists became richer thanks to their assets; but did the producers became much richer? Well, MBA golden boys and banks directors did. And the money they put in their pockets was quite real. What I mean is that when you discuss regulation, you should not only discuss how to prevent future crises; you should think how to make it less socially acceptable, how to make it more difficult for the financial sector to capture the resources from the rest of the society.

## Concluding remarks

George Papandreou

I share your profound concern about the financial crisis, which began here in New York and spread throughout the world. As the president of the Socialists International, I usually had great difficulties mentioning my title in the United States without provoking shock and awe. That changed slightly when I came here last time. It was the very day when Wall Street crashed. When I presented myself at a charity meeting, a lady told me: “we need more people like you here in the United States”. Some time later I felt that I was in great company when Barack Obama was accused of being a socialist.

In all honesty, I’m very proud to be heading this movement, which has had active leaders in the past, such as Willy Brandt or François Mitterrand. Our movement represents more than 160 parties around the world, from Latin America to

Asia. Yet the world order has been dominated by the neo-liberal and the neo-conservative agenda over the past decades, an agenda that loathes words like social justice, empowerment, equity, democratic accountability and oversight, transparency, solidarity, stimulus packages, regulation of markets, unemployment benefits and fair distribution of wealth for green development. So we’re presently surprised and delighted to see that these words are once again *à la mode*.

Solving the financial crisis is certainly not a technical matter, even though it is very important that we look at the technical aspects. It is fundamentally, I believe, a political task. It concerns the most fundamental global choices that we have to face in the 21<sup>st</sup> century. We need to solve today’s crisis in a way that empowers our citizens, peoples, societies, and with them, empowers our global, political, and financial institutions so that we can deal with daunting planetary challenges.

International institutions are important, but they need legitimacy, I would say the necessary powers. Who are the decision makers in global governance? This is a fundamental question for a new geopolitical balance. And what do we mean by a democratic governance at a global

**“Solving the current crisis is not just a technical matter; it is fundamentally a political task.”**

scale? Unless we believe in an enlightened global aristocracy that will govern the world, the challenge is basic. It is about democracy. We need democratic change for democratic global governance, one that ensures the participation of the disempowered, the poor, the middle class, the small and medium-sized enterprises, the productive forces of the world; one that democratically sets new priorities at a global scale and uses our common resources in a sustainable way.

When we think about international institutions, whether it's the IMF or some new institution, we need to remember that these institutions have to be founded on a set of rules, which may seem technical but behind which there are true values and political principles. And this means that there are some basic values which we all must share. I often have been involved in the dialogue of cultures and religions, where the idea is precisely the quest for common values. Coming from Greece, as foreign minister I had many occasions to work together with Turkey; as you know the part of the world I come from is that of great cultural and religious diversity; there are Greek Orthodox, Catholics, Jews, Muslims – quite a mishmash, and it has been that way for many centuries. And I truly believe that we need to establish a set of principles based on our common values. At the same time we must respect the diversity, whether it is political, cultural or economic. That balance is crucial. We need both: central control and consensus, but also decentralized power, innovation, a dynamic in our societies. In that respect, I think the European experience is important; we have been able to unite quite different cultures and different political traditions and make them work together as nation-states in a coordinated system. New rules must emerge from a new understanding of democracy as both a global condition and a philosophy that includes economic institutions, not just political institutions. This is the challenge. How do our nation-states, our democratic institutions, cope with globalization?

Humanity has amazing capacities – technological prowess, wealth, innovation, knowledge, and creativity – to influence our lives for the better. Yet we very often feel disempowered. Our generation, and certainly the generation that follows, is facing the most difficult and complex issues humanity has ever faced. Climate change on a vast scale linked to carbon-based energy consumption, new and old pandemics, poverty, the bottom billion, arms, drugs, and human trafficking bringing in profits that overshadow the GDP of many countries in the world – issues that we can deal with if we had concerted, coordinated, global efforts.

But what do we see? Instead of global solutions, our problems are compounded by the financial crisis, one which has revealed major flaws: the amazing concentration of money by the few, only paralleled by the concentration of media power, the concentration of political power, the corruption of our democratic institutions – the uncontrolled power.

This is a democratic challenge. Our democratic institutions, the rule of law have either been captured or circumscribed, as Paul Davidson said concerning labor relations and labor laws, by big interests. The state, the markets, politics have been captured. Today we have, in a sense, a welfare system for the rich and the powerful.

It's in this spirit that I invited Joseph Stiglitz to the commission we set up for a global social-democratic response to the financial crisis. We've come up with an interim report where we state that we need more cooperation in order to limit the consequences of this dramatic failure of unregulated markets, not just in the U.S., but globally. As markets freeze and recession begins, our duty is not only to think about Wall Street. If we are to save banks, we should do so in a way that, first of all, saves the right to employment, to pensions, to education and health services – in short: in a way that strengthens the real economy. Regulation of global financial markets must be thoroughgoing, must reestablish public control of the private markets, and must be prepared at every turn to combat the excesses of speculation and greed that have brought us where we are.

Secondly, we need to put a floor under the slide into recession, maintaining and enhancing social protection systems, supporting working men and women, insuring productive enterprises, avoiding layoffs, limiting damage to our productive capacity. We certainly need to continue assisting the less developed countries and show solidarity beyond borders.

And thirdly, we need investments – and certainly public investments – in order to stimulate our economies and create a new engine of growth around the concept of green development. Mobilizing resources in a time of crisis has been done mostly in times of war; our challenge is to show that we can do this in a peaceful way. I would go as far as to say that either we move towards green development or towards conflict and war. Either we move towards democratic empowerment, social justice, solidarity and green development; or we move towards global barbarism.

No country will do this alone, but the U.S. will have a key role to play, for three reasons: First of all, it has a huge responsibility in having

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created the mess in the first place. Secondly, not even the U.S. can escape from the global interdependency. And thirdly, there is a new administration which will command great respect, and therefore legitimacy, around the world. But it cannot lead by force or dictate; it can only lead by example. Preventive diplomacy rather than preventive wars, globalization for the people and by the people, markets that serve people.

The challenge of global governance is immense. If we fail, our citizens will be prey to all forms of extremisms, absolutisms, fundamentalisms and populisms. They will retreat either into passivity or into violence.

I see Barack Obama's victory as a revolt against the demise of our democracy, as a hope to re-empower our citizens and societies, certainly in the United States, but I think that's seen as the same sign and symbolism throughout the world. It is a daunting challenge, a huge responsibility and also a huge opportunity. A new page is to be written, and it must not be written in haste. Your role as economists, as progressive economists, is and will be crucial in writing these new pages of our global, political and economic history.



