ROAD TO RECOVERY

AN ECONOMIC ROUNDTABLE

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Professor David Dapice is an Associate Professor of economics at Tufts University and a former department chair. Since 1990, he has conducted research with the Vietnam Program, now located within the Asia Programs at the Kennedy School of Government at Harvard University. In recent years his research has examined an array of topics, including provincial development, public investment and infrastructure development, and the urbanization and creation of affordable housing markets. Earlier in his career, Professor Dapice served as advisor to the Indonesian Ministry of Finance, and during the 1980s he advised the Bank Rakyat Indonesia (BRI) as it grew to become the country's largest financial institution. Currently, he helps to direct the Fulbright School in Ho Chi Minh City, Vietnam where he also teaches. He has also worked in Thailand, Cambodia, Myanmar/Burma, Mongolia, Cuba, and Ukraine. Professor Dapice is the Chair of the Institute for Global Leadership's Faculty Advisory Committee.

James S. Henry is an investigative journalist. He has written extensively about economic issues and pioneered investigations of economic mismanagement, dirty banking, corruption and money laundering in countries all over the globe. He is the author of *Blood Bankers: Tales from the Global Underground Economy*. He served as chief economist for McKinsey & Company. In the 1990s, he founded the Sag Harbor Group, a strategy consulting firm that focused on competitive strategies and acquisitions for technology-based businesses. He is also the founder and editor of *Submerging Markets* (www.submergingmarkets.com), an online investigative magazine that specializes in political and economic development. In 2009, he was an INSPIRE Fellow at the Institute for Global Leadership and the Edward R. Murrow Fellow at The Fletcher School of Diplomacy at Tufts University.

Jian-Ye Wang was educated at Peking University and received his Ph.D. in economics from Columbia University. He now serves as the Chief Economist for the Export-Import Bank of China. His main areas of interest are international economics and economic development. He was formerly with the International Monetary Fund, where among other issues, he focused on China's role in African development and monetary policy in Southern Africa.

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The world found itself in an unprecedented, unexpected financial crisis in the fall of 2008 following the bankruptcy and collapse of Lehman Brothers. In the months that followed, the economic world has been scrambling to understand why the collapse happened, who was to blame, and how to change markets so that it will not happen again. Amidst a flurry of new regulations on the part of the government and serious introspection in financial circles, *Discourse* editors Hena Kapadia and Cody Valdes gathered economic experts Professor David Dapice, James Henry, and Jian-ye Wang to discuss the causes and effects of the global financial crisis.

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Cody Valdes: What led to the current financial crisis? Was it caused by a variety of factors such as an increasing aversion to regulation over the past 30 years, disastrous innovations in risk-trading, the passing of laws encouraging sub-prime mortgages, and "Nina" (no income no asset) loans?

David Dapice: The U.S. was running a large deficit, which was partly sterilized by not only China – though they have been getting most of the blame – but Japan, Taiwan, Hong Kong, and others who have been supplying cheap money for years. That pool of money allowed the U.S. to have very low savings rates and a sort of unsustainable housing boom without ever paying the piper very quickly.

Jian-Ye Wang: Actually, I beg to differ. This crisis fundamentally is not a liquidity crisis; it is a solvency crisis in the U.S. and other, mostly industrialized countries, including the U.K. A root cause is that the U.S. lived far beyond its means. Then came lack of proper regulation in

the face of rapid financial innovation, with the greed of Wall Street as a secondary issue. What we will see post-crisis, particularly in the U.S., Europe and Japan, is that these countries have accumulated and will continue to accumulate very large public debt. How this fiscal problem is going to play out, we have yet to see. How these countries manage their public finances will have a major impact on whether this recovery will be sustainable or not.

James Henry: The "Bernanke, supply side, savings glut" explanation does not wholly account for why the crisis showed up where it showed up and when it showed up. The basic point about those who favor emphasis on – as I do – the extraordinary number of regulatory failures in the U.S. is that not every capitalist country went into the tank here like the United States did. You really can only go so far by talking about low savings rates and global imbalances and the kind of "Bernanke" explanations for the crisis. That created the possibility for misbehavior, but what really sealed the deal was the unprecedented, systematic influence over many decades that the banking industry and Washington has had on regulatory behavior. That's where we would look for certainly one explanation, and there's no one explanation for the crisis. It's proven a multi-factored phenomenon. In the United States, there are things that we could have done to prevent the extraordinary $3.4 trillion of bank losses, the 240 million unemployed around the world, and the 50 million people added to the poverty ranks; this is an extremely costly crisis.

But this is not new. Capitalism has had banking crises regularly ever since its beginnings, and it seems to be a structural problem that every time we have a deep crisis like this we tend to point to particular factors without critiquing the construct of the system as a whole. And at a certain stage, the financial markets and the real economy kind of go to war, and the banking sector takes us into casino mode if it is not properly regulated.

Dapice: It's really been the last decade, since the Asian crisis when the interest rates were periodically brought down to extraordinarily low levels after the crash in 2001, that funded this excess. I agree with you that one of several ingredients, extraordinarily cheap money, provided the sort of "moonshine" that bankers needed to leverage and speculate. That, and a complete lack of regulation; even when there were laws on the books, the regulators walked away. And in some cases, when they tried to get laws passed, they were left frustrated, as we saw in the case of high-risk derivative trading. We have a complicated story where the major blame, I would say, falls on the private and government sectors in the U.S. for taking this cheap money that was available and using it in irresponsible and highly speculative ways that really had almost no chance of succeeding over time. You can call it a principle agent problem because financial executives were rewarded very richly for what was essentially a one-sided bet: heads they win, tails the taxpayers pay. And they did that by becoming too big to fail or thinking that they were.

Wang: I want to emphasize two points though. First, the existing international monetary system has drawbacks that contributed to this crisis. One should not overplay the role of innovation and speculation. It was always innovation rather than banking supervisors' decisions that drove the market. In a globalized world, when a country whose currency

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is a dominant medium of international exchange and store of value, that country's monetary policy should no longer only target its domestic economic objectives. Because as long as that currency plays the role of a global public good, like the American dollar does, then policies related to its supply have a global effect. And that effect has been neglected in the past. In the first half of this decade, the Federal Reserve under Mr. Alan Greenspan kept an expansionary monetary policy for too long. Maybe it was appropriate for the U.S., but it was too loose for the world. Of course, the issue here is not just the monetary policy of a major reserve currency country; it is the problem of an international monetary system that does not reflect the profound structural changes taking place in the world economy.

The second point is that from this point on, a new approach ("macro-prudential" approach) is needed in conducting monetary policy. We can no longer afford to ignore monetary policy's impact on asset prices, from the real estate sector to capital markets.

Dapice: Greenspan was way too loose. I think he was more worried about the U.S. economy than the world economy. On the other hand, if the surplus nations had simply stopped buying treasury bills and dollar assets, the dollar would have fallen and he would have had to raise interest rates.

Henry: You also have China managing its own inflation rate by sterilizing their reserves. And other countries also, but it wasn't just failed U.S. monetary policy here at work; it was also a kind of monetary consensus at work. No one wanted to see the dollar plunge. And frankly, I don't think anyone had proposed an alternative basket of reserve currency that would have made sense to people at that point in time. I have real problems with just blaming the Fed for this crisis.

Wang: The point here is not to blame anyone, but to learn a real lesson going forward. What's required is fundamental changes instead of a narrow focus on limited issues. Just focusing on monetary policy is not enough; beyond that is the international monetary system and balance sheet management in major countries, both in the non-government (households and corporate) sector and in the government sector. If you cannot manage your own balance sheets, you can forget about your monetary policy and your banking regulations.

Valdes: In the wake of the latest G20 meeting in Pittsburgh in September 2009, where do we stand in terms of a financial recovery, and what shape does it appear to be taking? Which parts of the world will see a faster recovery than others?

Henry: We have a bit of a Potemkin recovery because it largely depends on what you measure. When we measure by nominal GDP, by that standard it appears to be that most countries in the world are growing this quarter. But if you look at unemployment statistics and other utilization around the world, capacity utilization is quite low. The International Monetary Fund reported that about half of the bank losses in 2009 have yet to be written off the books. There is an enormous longer-term legacy; we've had a tremendously negative impact on research and development spending and the venture capital business to the point where some people are lowering the expected potential growth rate of the United States' economy to below two percent. "Recovery" is in the eye of the beholder. The latest statistics from the Federal Reserve show that about ten percent of all Americans own 80 percent of stocks and bonds on Wall Street. For bonds, it's even higher. That's both direct and indirect ownership by way of pension funds and retirement accounts. And so, that ten percent has seen a nice increase in their stock value since February. Many other Americans are experiencing unemployment, foreclosures, and lots of other hardships in these times. When you talk about recovery, you have to look at: in whose eyes, and from what perspective?

Wang: When talking about recovery, we have to be mindful of the context, i.e., which part of the world we are referring to. As for the origin of the crisis, for those countries that lived beyond their means, they are in the process of repairing their balance sheets. Restructuring is going on in the overextended sectors like the financial sector and non-tradable sectors in general. These sectors have to lay off people – that process will go on for one or two years if you believe the historical experiences of the 1991 and 2001 crises. The U.S. unemployment rate will continue to go up and will peak maybe in 2010. Because of the balance sheet adjustments, consumption in developed countries, which has driven 70 percent of U.S. GDP, would have to grow slower than the increase of disposable income for the next few years. That reality applies to a number of major industrialized countries. They will have a weak, slow recovery. As for emerging market and developing economies, countries like China, which started recovery earlier, they will have to ensure sustainability of their recovery and growth over the medium term. Their quick rebound in a large part is government spending and public investment driven. For growth to be sustainable, consumption will have to be sustained without fiscal incentives, private spending particularly and private sector investment will have to go up. The good news is that the Chinese market is expanding, consumption is growing very fast, and it is already the world's largest automobile market, larger than the U.S. this year. And as of October, available data show auto sales so far this year are up 45 percent compared to the same period of 2008.

Dapice: Do you think that's sustainable? I agree with you that China has popped with a large deficit and irresponsible lending, but I'm dubious that can continue.

Wang: I am optimistic on China's domestic market. China's retail sales have been growing year on year at about 15 percent in the last few years and will continue. We have had a slight retail sale acceleration in real terms even during this crisis. Two things drive this recovery in China in the last two quarters: one is the real estate sector, the housing rebound is very strong. The other is the sales of consumer durables, including automobiles. On investment, a large part is infrastructure, which is needed for the country's ongoing urbanization, and is in not expanding overcapacity of the export sectors. Nevertheless, China has an overcapacity problem, and adjustment is needed in those sectors such as iron and steel, cement, shipbuilding, etc.

Dapice: I would just add to this discussion, leaving China for a moment, that we haven't mentioned the sort of fiscal unsustainably of a lot of countries, both in the short and particularly in the medium to longer term. It's certainly an issue in the U.S., where we just have not come to grips with soaring health costs. Social security on a net basis is going into a negative area now, and we have to start cashing the IOUs. As someone correctly said, we haven't de-leveraged as an economy, we've merely shifted leverage to a large extent from the private to the public sector. The ability of a number of nations to continue doing that will determine whether we have a sluggish recovery or a "W" with a kind of second dip, which is a real possibility.

Henry: One of the issues with medium term recovery is to what extent we generate any learning from this crisis that translates itself into reform. The G20 succeeded in having this kind of rhetorical commitment to balancing surplus and deficits around the country and around the world, but that had no teeth. This is the same issue that the world has been arguing about since Bretton Woods, when Keynes proposed a global authority with reserve currencies. Unless we actually have the political will to implement these reforms, you're going to have a sort of modest recovery at best and a fundamental lack of confidence on the part of investors in the traditional sectors that have been financed by so much foreign investment.

Wang: The U.S., Europe and Japan will have to make a significant adjustment to regain fiscal sustainability – public debt sustainability. For the Obama administration, such adjustments could include increasing taxes, containing spending, strengthening bank regulations, including higher capital–adequacy ratio and using simple leverage ratio. Banks may have to operate at higher cost; financial globalization may to some extent have to be curled back. The developed economies may grow slower. But that's not necessarily a bad thing. Why must we have to go back to the old mode of growth if that is not sustainable? Sustainable growth should be the objective we aim for.

Hena Kapadia: Do you think that Wall Street as the global financial market will change in the light of new regulations? Has the culture and mindset of investors changed? Or, is everyone just looking for a new creative, stable way to make money?

Wang: From Asia I do have the following observations: Wall Street is changing and will continue to change in light of the new economic and financial reality brought about by this "once-a-century" crisis; U.S. households and other non-government sectors need to repair their balance sheets and while deleveraging is a long process, the U.S. public finances will have to regain sustainability; financial regulations need reform, although it is not clear at this point what these "new regulations" really are; extraordinary bailouts have altered the structure of the U.S. financial industry and adjustment is unavoidable; and last but not least, the world economy has experienced a fundamental shift and large growth differentials will persist between "developed" and "emerging" economies, which will have a long term impact on capital flows and hence on the relative rise and fall of "financial centers." Against the above big picture, individuals will adjust their behavior, perhaps even profiting from this change.

Dapice: I would add that the financial adjustments have to be reflected in the real economy. An unsustainable portion of jobs and output had been transferred to the financial sector and this will have to be reversed. Up to now, large federal deficits have somewhat offset the deleveraging of banks and consumers, but this cannot continue at its current pace. A large part of the U.S. manufacturing base has disappeared and some of it will have to be recreated, including attracting bright young workers who now do not even consider the sector. This will require not so much a general decline of the dollar as a rise in the Yuan, an obviously managed currency. Responsible estimates put it 20-30 percent

undervalued against the dollar. But it will also take a change in U.S. savings rates and lower fiscal deficits. The two steps would complement each other. If adjustments are not made, protectionism will result, causing much more economic pain.

Henry: "Wall Street" doesn't exist anymore – this is one of the most tangible impacts of this latest crisis. So perhaps we should stop using the term. In another sense, "Wall Street" has just been recreated, stronger, and more influential than ever. So this still being capitalism, with – I will argue – financial markets more in the driver's seat than ever, it is entirely appropriate for us to focus on what the next crisis will look like. Because how we've just dealt with this latest crisis certainly ensures that there will be more of them. Market concentration in global financial markets has soared in the last two years, even while the political power and under-regulated character of the global banking industry has survived largely intact. A second key fact is that this increased concentration has been enabled by the largest extension of government assistance to the financial services industry in history. By now we've seen that for the most part, despite the innumerable market screw-ups that led to this debacle and its huge costs, it has come with surprisingly few strings or tougher global regulations attached.

This episode is yet another demonstration of the fundamental problem at the core of this situation: The outsize political influence of the financial services industry, not only in the U.S., but in every world capital. True, key financial centers like New York ("Wall Street V.1"), London, and Frankfurt have lost share, while Asian centers like Singapore and Hong Kong are gloating. This is too bad for New York City and London taxpayers – and the universities, media, and other cultural institutions that depended on them.

As noted, this crisis has created an enormous publicly-subsidized wealth transfer, actually increasing the market share, margins, net worth and political clout of top institutions like Goldman and JPMorgan and Credit Suisse, on the back of government bailouts. On the other hand, many people around the world have not "recovered" from this crisis in any meaningful sense, nor will they do so for years. Lots of ordinary people have been completely wiped out, and remain unemployed or homeless, or know people who are. Millions of young people are struggling to find jobs to amortize their highly priced, largely useless liberal educations – they are kicking themselves for not studying engineering. Millions of retired or semi-retired people are finding their life plans completely upset.

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I'm totally skeptical about the ability of cap and trade to be an efficient way to limit carbon dioxide. It could become tens or hundreds of billions of dollars. We're talking something that is potentially huge through derivatives trading. The question is do you know who's emitting carbon dioxide and who's saving or avoiding carbon dioxide.

Valdes: What is the "next big thing" in the international market?

Henry: We [the U.S.] have a vibrant technology sector. We have, I would say, a leading edge in many of the green technologies that are coming down the pipe –that's a whole growth area that we haven't talked about. So there is opportunity out there if we can marshal support for these industries. One of the things we need to recognize here is that apart from the macro-economic problems there's also a major climate change issue that we have to deal with. I would say that the immediate challenge for developing countries outside of China and India is to come up with about $150 billion a year of development finance for mitigating environmental damage and reducing emissions so that these emission caps mean something. That's an unsolved economic issue that the world faces, and it wasn't solved by the G20. They pushed it down the road.

This "next big thing" could indeed be the global carbon trading market, which already passed $100 billion in 2008 even without much U.S. participation, and will get a big boost when Obama's cap and trade legislation is enacted. Over time, it could surpass the global mortgage market in size, and certain segments will provide even larger securitization opportunities and global regulatory challenges.

Dapice: I think China in many ways is doing better than the U.S. They don't have coal senators like we do. We could easily shift into natural gas, but the politics of that in the U.S. is very difficult.

Wang: There is a broad consensus in China now that the old mode of growth – highly energy intensive – is not sustainable. It's not environmentally sustainable. People have realized that the greener, lower carbon route could be very profitable. For example, in the auto industry, there is a rare chance for a real manufacturing and consumption revolution. There's a lot of money that could be made in this area. Any entrepreneurs with foresight will take advantage of this opportunity; it's no wonder that Mr. Warren Buffet has invested in BYD [a Chinese electric car battery company]. The U.S. can export more to China, with good quality and competitive prices. I don't think that China has restrictions on solar products from the U.S., does it?

David Dapice: China signed a large contract with First Solar, which is a western U.S. producer of the thin-film solar panels, and it's for 12000 megawatts by 2019 I believe. But that will involve transfer of technology, not simply exports.

James Henry: We want to make sure that in these green areas especially that there is no protectionism as well. But the other issue that rears its head here is cap and trade and the enormous global market that will be created for instruments in that area. If we couldn't regulate banking appropriately, how are we going to regulate cap and trade effectively? If nothing else, let's learn something from the financial debacle about how we regulate the new exciting cap and trade market.

Dapice: I'm totally skeptical about the ability of cap and trade to be an efficient way to limit carbon dioxide. It could become tens or hundreds of billions of dollars. We're talking something that is potentially huge through derivatives trading. The question is do you know who's emitting carbon dioxide and who's saving or avoiding carbon dioxide. The concept is great, and it works if you can certify it. I'm not against it in principle, just in practice. I think carbon taxes would be, in this case, much more efficient.

Henry: Cap and trade under current regulatory regimes would still be regulated under the House Agricultural Committee. They are commodity derivatives. It's potentially the next big financial market and the next big financial crisis.

Wang: I don't know much about carbon tax, but developing countries need billions of dollars for investment. We always ask where is the money going to come from? Why can the world market not handle this need? We have already mentioned that there is a surplus pool of money in the world. Perhaps a key task of the international community post-crisis is to create the necessary conditions for capital to flow to where it is needed most and with the highest marginal productivity. This will help reduce poverty and promote more balanced growth in the world.

Henry: One of the lessons we can learn from this crisis is that intelligent, competent, state regulation and some guidance from government authorities is not a bad thing for markets. It's a precondition for the functioning of stable, efficient markets. It's not a substitute for markets. With regard to cap and trade, I'm suggesting that you need some kind of intelligent international government action to help establish a well-regulated, well-behaved market that people can trust.

Kapadia: What is the legacy that this financial debacle is going to leave behind for the world?

Dapice: The outcome will be a power shift towards the surplus nations in financial and other terms. I think there will be slower growth for an extended period in the rich countries that got overleveraged. It will be a failure if, as seems likely, we do an inadequate amount of re-tinkering of regulation on our financial system. To quote Bernie Sanders, "If a bank is too big to fail, it is too big." That is the approach we need to take.

Henry: If we did learn, we would learn, as my colleagues have said, the unsustainability of the old model that was debt heavy, energy intensive, and pushed consumer-led growth. And countries like the United States need an economic strategy that does not depend on that kind of model.

Millions of taxpayers, who are still assigned to those quaint geographically-defined entities called "countries," were required to foot the bill for trillions in cash and guarantees demanded by the otherwise supranational, super-sophisticated financial institutions, lest they "fail." All of this macro-insanity is creating a rather unstable brew at the level of mass politics – a political side effect of the crisis that gets lost in all the talk about regulation and savings ratios. Certainly this not the kind of solid political bedrock for market capitalism that we got used to taking for granted, at least in the U.S.

So, it is very hard to make this latest crisis look like an achievement for our excessively banker-driven model. The clearest lessons are for the U.S. Clearly, it is faced with an enormous economic burden if it wants to continue being "the world hegemon." It should frankly admit that this might be too costly, and seek a more moderate role – one that also, by the way, is less easily exploited by others.

Both our public and private savings are exhausted; private consumption and government can clearly no longer be the growth engines. Yet to grow our share of global trade and exports, even in financial services, will be tough in this environment.

The only good news is that the real side of the U.S. economy, venture capital and innovation, has an extraordinary track record, and we have extraordinary human capital. Furthermore, we should not undervalue our other key contributions, from the standpoint of attracting the world's best minds to come here, innovate and build social and personal wealth.

There is another policy option that the U.S. might want to consider, in addition to punitive budget balancing. Of course, it isn't one that Wall Street or its foreign clients would favor. But at some point, as Brazil, Argentina, Venezuela, and indeed China and Russia have agreed at various times, a moratorium on debt payments, or even a debt default, may become optimal, especially once foreign creditors have come to be the dominant lenders. I'm hoping that the U.S. can avoid this, but given our situation and the fact that so many have loaned much to us without asking where it was going, it is no longer unthinkable.

Dapice: I have to disagree with Jim there. The other countries did not have the power to print currency to pay off their debts, as the US still does. We are far more likely to have a higher rate of inflation, but pay off our nominal debts. If we start having to issue large amounts of foreign currency debt, then the situation would be more comparable to Latin America.

EDITOR'S NOTE:

AS THIS WAS BEING PUBLISHED. JAMES HENRY INDICATED THAT SOME OF HIS VIEWS HAD CHANGED AND DISCOURSE HAS OFFERED HIM THE OPPORTUNITY TO CLARIFY THE CHANGES IN HIS THINKING BOTH ON ITS WEBSITE AND IN THE NEXT ISSUE OF DISCOURSE.

– HENA KAPADIA
– CODY VALDES