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Shadow G*n* Meeting

Columbia University
February 4-5, 2009

Rapporteur's Summary

Day 1

Morning Session 1

Joseph Stiglitz opened proceedings by outlining the philosophy behind the Shadow G*n* meetings, namely the need to broaden the formal G8 agenda which was constrained thanks to old network ties and political considerations. He made the following points:

- The meetings have had positive effects both in terms of broadening the G8 agenda, to include Africa and climate change, and in terms of widening the scope of participation to new countries in recognition of the shifting global balance of power. The formation of the G20 is critical in this regard.
- There remains the question of the size and structure of *n*.
- The immediate issue is the May G8 meeting in Italy, so this meeting ought to be focused on the advice it can give the Italian government.

There then followed a broad discussion about the politics of agenda-setting between the various “G” groups, with some participants highlighting the critical importance of the G20 moving forward. Kemal Dervis made a point of distinguishing between those “Gs” that include leaders and those that do not, while Stiglitz noted that there ought to be a “variable geometry” in the structure of *n*, as every issue did not require the participation of the same set of participants.

Rob Vos then made the first presentation of the morning, on the global outlook. He made the following points:

- At the end of last year, the baseline scenario was with the assumption that within 8-9 months the financial system would be normalized. We're closer to the pessimistic scenario now with -0.5% shrinkage for the world economy.
- There is no decoupling. The average growth rate for developing countries is 2%, which means negative per capita income growth.
- We would not expect any recovery during 2009, it may come in 2010 assuming that we get fiscal stimulus packages. If the fiscal stimulus doesn't come in a coordinated way it will be difficult.
- Deficit financing without the dollar seen as a safe haven will give us a risk of hard landing. That risk has increased tremendously.

- Factors contributing to a hard landing: The gradual depreciation of the dollar since 2002 resumes. Since August, the dollar has appreciated because its seen as a safe haven. A lot of capital has moved back to the US to refinance dollars assets at financial institutions. However, over the past two months, the dollar has become a lot more volatile. This indicates a return to the downward trajectory of the dollar.
- If the dollar declines it will be more difficult for the US to finance its stimulus, except by printing money.

Discussion:

Meghnad Desai initiated the discussion by noting that Keynes had nothing to say about the interaction between financial and macroeconomic crises, and most macroeconomists remained faithful to the Keynesian IS/LM framework. While the fiscal stimulus was paramount for the macroeconomic crisis, he noted, the time it takes to “unblock” the financial system will determine the effectiveness of the stimulus.

Dervis noted that both the size of the stimulus, at the global level, and its distribution are critical. On the latter, if the bulk of the stimulus were to come from the US, the global imbalances that got us into this crisis would not be corrected.

Jose Antonio Ocampo asked what effect the doubling of the US monetary base would have on the dollar. He noted that the US has the privilege of a collapsing dollar and the ability to reducing interest rates at the same time. All other currencies have collapsing together with rising rates, which is nothing but a market outcome. When will the US submit to this outcome?

Valpy FitzGerald extrapolated from the poor data available that the size of the negative wealth effect from the housing slump indicated at least a 4-5 year recovery period. He also noted that the dollar hadn't collapsed because it was the global reserve currency with the deepest and most liquid bond markets in the world. The Maastricht-constrained Euro bond market was too small to satisfy global demand.

Stiglitz noted that there were deep structural problems with the insufficiency of global aggregate demand that stemmed from serious distributional issues. The problem in the US was solved by unsustainable lending, leading to the crisis. Even if the financial system were to be fixed, a grave problem given the estimated $900 billion “hole” it is in, this deeper problems would remain unless addressed head on.

Paul Martin noted that despite all the cuts in interest rates from central banks, the real interest rates charged by banks remained very high. This, in turn, was because banks are facing severely demand-constrained firms. Firms either don't want to take on more debt in a potentially deflationary scenario, or they are constrained by the covenants on their existing credit facilities.

Patrick Bolton noted that, with the distribution model dead (ie. syndication and securitization), recapitalization did nothing to alter the problems that the banks face. The Geithner plan to use TARP money as a base that can be leveraged to buy real estate is nothing but a re-run of the “Super SIV” of late 2007, and will similarly fail.

Jane D'Arista noted that small businesses starved of credit were being served by the securitized mortgage markets as many home loans were in fact business loans. This sector therefore needed more

securitization.

Howard Stein noted that the socialization of the risk was the only coherent way to deal with the present uncertainty.

Jean-Paul Fitoussi noted that we are in the situation of fearing both deflation and inflation. Inflation is a possible outcome if indeed our recovery plan works, hence inflation isn't too much of a worry. But deflation is the outcome if the plans do not work. But the deeper distributional issues at the global level remain.

John Evans noted that there was a lot of pressure on worker's wages in the current environment, and Stiglitz added that the drive for flexibility in wages has added to the risk of both inflation and deflation. Between the two, he noted, the Fed would rather risk a recession than inflation and will never do what is in working people's interest.

This returned the discussion to the deep structural issues Stiglitz mentioned earlier, and Desai noted that the UK had already paid its dues by means of its own structural adjustment in the 1980s in killing-off manufacturing. The Obama administration now faced the same choice while trying to stimulate the economy. Stiglitz then concluded the morning session by noting that the US might be on the cusp on a fundamental structural adjustment akin to the shift from agriculture to industry that was precipitated by the Great Depression.

Morning Session 2

The second morning session began with a presentation by Dervis on the global fiscal stimulus. He made the following points:

- The main issue in the global stimulus is coordination thanks to the threat of leaks. The way to avoid protectionism is to coordinate macroeconomic policy. The IMF has to have a role here in terms of G20-IMF relations.
- In EU if one percent of stimulus is all that's possible, then we're in big trouble. The Germans fear having to save the Euro. They may be projecting that at some point they may have to bail out countries that are struggling.
- In developing countries that aren't big surplus countries like the oil ones and China, current account deficits are sometimes large, they don't have huge reserves, and are facing tourism collapse and remittances collapse. So this has been a major shock to them. As a group, these countries are worth about 10 to 15% of global GDP, so not systemically important individually, but not insignificant taken as a group. The IMF is wavering between its traditional response and something different.
- Clearly what's needed is a massive lending program, an IMF led liquidity solution. But the reform of the IMF won't come in time, so maybe an interim solution of credit lines from the IMF. Their $100 billion credit line, the “Short-term liquidity facility,” is currently unused.

Jean-Paul Fitoussi then made the following points:

- World Economic Outlook of October 2008 echoed the orthodoxy in saying that counter-cyclical policies are not good for developing countries. Fiscal policy was ruled out as past government behavior has been procyclical. Without this option, developing nations are limited to pro-

cyclical actions.
- Yet fiscal policy can work well. A constraint on its stimulus-potential is inequality, which has been on the increase in Germany while this isn't true of France. Two directions for an effective stimulus are: a) technology, b) social safety nets, especially for the elderly and young workers.
- Europe is indeed doing some free-riding as its stimulus will be smaller, especially as the stated program is greater than the effective program. One solution to generate more Euro bonds within the bounds of Maastricht is to have the European Investment Bank issue them.

Discussion:

Maria Juao Rodrigues noted that was was needed was a Global New Deal with the following components: coordinated stimulus plans, global financial regulation, global climate change, trade, development. While the present crisis was the first order of business, the deeper structural changes would have to be attended to in order to create a virtuous cycle between domestic consumption and global competitiveness. “Recovery” is not the right word for this process as it implies going back to the old system.

John Evans summarized the declaration that the union movement made at the recent IMF meetings:
- Job loss was extremely serious globally, and the the US this meant losing your health care and your home.
- There was serious disagreement between the IMF and the unions over the structure of the stimulus, with the latter wanting more infrastructure spending and green jobs.
- Labour market policies cost a fraction of GDP compared to what is currently being spent on banking, and yet the work-force really needs these policies to hold together.
- IMF policies towards non-OECD nations is horrible and maybe a new IMF is needed. The markets won't react badly to this as there are no markets left.
- There is a tremendous sense of injustice regarding the bank bailouts. Thus if the present closed-door attitude to market institutions is maintained, any financial bailouts will be a very hard sell politically.

Paul Martin echoed Heiner Flassbeck's point that there was a need to bridge the time gap between now and when any returns from infrastructure spending comes online. He noted that recessions were the time to make major infrastructure improvements and labor and materials were cheaper. He cited Canada's experience of simultaneously tackling a high fiscal deficit and infrastructure needs as proof that it could be done, but noted that short-term safety nets like unemployment insurance were critical to both secure people and build a coalition around the recovery plan. Lord Desai echoed Paul Martin's point regarding this two-step between long-term and short-term actions.

Stiglitz noted that the US has automatic destabilizers, such as balanced-budget provisions at the state level, rather than the required automatic destabilizers, a point affirmed by Fitoussi.

Afternoon Session 1

FitzGerald began the afternoon session's presentations by making the following points:
- The distinction between middle income developing and LDCs is not about income. It is better to look at whether there are local capital markets or not as this indicates the extent of the macroeconomic vulnerability of the nation.

- What we need in the present crisis, therefore, is a combination of safety nets and long-term investment vehicles, such as local municipal bond markets for infrastructure and long bond funds that require pension funds to get involved.
- Export credit guarantees are very important as is more infrastructure investment.
- The World Bank dismantled Investment Banks throughout the 1980s. They need to be resuscitated.
- Prudential regulation should cover all institutions, not just banks. In Brazil, regulation is by clients not by asset classes (holders not instruments).

Brian Pinto then made a presentation on counter-cyclical policies pursued by developing nations. He made the following points:

- The main criteria when pursuing such policies is the inter-temporal budget constraint. What effect does the stimulus have on long-run debt/GDP ratio? If the infrastructure is a limit on it, then targeting infrastructure makes sense. Also, what are the contingent liabilities that they're facing?
- On design and implementation, all the talk over the last 10 years has been on independence of central banks. Yet now we need close coordination instead.
- In countries with clear fiscal constraint, one possibility is what the President to the World Bank suggested, namely that part of the rich country fiscal stimulus be channeled to the South.

Diouf then made the following points on Africa:

- What is the nature of the crisis in Africa? People have solutions about fixing the situation. It's a tradition. But what is the problem they're trying to fix? They don't know.
- Migrants and decreases of remittances is a major problem. But how are Africans discussing the crisis themselves? What is the institutional framework in which it is being debated? Compare this to the national and EU based conversation in Europe. The global financial system has always worked to the disadvantage of developing countries. Is that going to change?
- In Senegal, we disbanded the development banking system more than 20 years ago. We have French banks and some Moroccan banks. Is that going to change?
- Lastly, every time Africa is being taken into account, it is in the mode of protection, that Africa should be protected not looked at as participants in the discussion.

Discussion:

Stiglitz outlined five points of discussion:

- First, is there any support for the IMF view that counter-cyclical policy is undesirable if countries can manage it?
- Second, on the problems of financial liberalization in developing nations viz. the institutional framework of the banking system, are there too many foreign banks in Africa and Eastern Europe? Does their presence aggravate financial crises via capital flight?
- Third, the recreation of development banks in Latin America have worked quite well. Should we push regional development banks?
- Fourth, the need for a new international credit facility is compromised by the fact that the new players have the capital but not the control over the old institutions. The latter need new governance structures if they are going to get the required capital. So it is a question of administrative capacity versus capital availability. Should the World Bank or IMF be involved?
- Fifth, following World Bank President Zoellick's ideas, should some stimulus and bailout in developed countries be siphoned off a little to developing countries for infrastructure spending

and the like?

Brian Pinto noted that the problem for developing nations was not cycles per se by crises. Fiscal head-room was the key to dealing with such crisis, and this is a very country-specific question.

Kemal Dervis noted the threat of capital flight for those developing nations engaging in counter-cyclical policies during a crisis.

Heiner Flassbeck noted the importance of speculation in the international currency markets, recently in the context of the carry trade.

Howard Stein noted the huge failure in African manufacturing and its eclipse by primary-commodity exports, especially oil. IMF policies towards Africa hadn't changed in the context of its thirty-year depression. The remittances problem will be massive. The crash in commodity prices is going to hit Africa very hard.

Akbar Noman noted that even while the Fund has insisted on pro-cyclical policies, developing nations without a Fund program get hit by the markets so that the danger of not having a Fund program creates a crisis as well.

Stephany Griffith-Jones noted that the Brazilian example of development banking success should show the way. Her personal experience working in a developing bank indicated that they are indeed adept at lending to small businesses, a usual criticism. Further, South-South flows ought to be looked at more seriously in crisis periods.

John Evans moved the discussion to SDR reform, and Kemal Dervis noted that a combination of an IMF umbrella with a regional component would be both feasible and desirable as the IMF has the resources. One could think also of a construction of swap lines and credit lines from regional powers via a geographical allocation (Europe for Eastern Europe and the Mediterranean; US in Latin America). IMF could orchestrate that, but there would be a need for a separate agreement for that in order to alter the allocation model.

FitzGerald noted that the IMF's Short-term Liquidity Facility was not a proper Lender of Last Resort facility, it is simply a means for a new loan and not a rolling over mechanism. Central banks do not have a new loaning system. Rediscounting loans that the banks are making is not what the IMF want to do. The IMF should just make markets in the government bonds themselves.

Alicia Barcena and Juan Antonio Morales ended the first afternoon session by referring, respectively, to the lack of coordination amongst Latin American nations and the threats faced by developing nations with open economies and finite reserves. Morales noted that decentralized fiscal stimuli worked well in Latin America in the 1980s but have since gone out of fashion.

Afternoon Session 2

Keya Chatterjee led the second afternoon session with a presentation on climate change that made the following points:

- With our climate, we are where we were two or three years ago with the economy: a few people warning us but we were not getting the message out to the public. There are few people who

understand the nature and scale of the problem.

- It is actually not a long term issue in the sense that the political timetable on completing a deal is very short. Global emissions will have to hit an inflexion point within a decade. Decoupling growth and emissions is going to be hard.
- The G8 have been the big free riders. The narrative has changed since Kyoto: It is developing countries that have come up with plans on change. G8 in particular are very important this year, first to reassure the public that the economic situation will not effect climate change proposals.
- It is not just making stimulus package green but, way beyond that, to ways to reduce deforestation, financing mitigation, and increase adaption to climate change.

Fulai Sheng, Hussein Abaza, and Juanita Castano then made several follow-up points regarding the possibility of win-win situations with stimulus packages and green jobs, a potential "Global Green New Deal," and the desperate need for coordination on the issue, for which the UN system is ideally placed. Paul Martin then outlined some of the work he is doing with the Congo Basin Forest Fund, and noted that, with the severe lack of expertise on both Africa and climate change in the US administration, the African Continent tends to fall in between the US/Europe and China/India debates.

Barcena then made the following points on climate change:

- A reduction of 80% emissions by 2050 is needed. The Greenhouse Gas *stock* is going to take 100 years to go away.
- Option one is to follow the Kyoto protocol, but it is not working. As a second option, US will have to cut 35% between 2011 and 2025, the EU 27%, China 9%. In Copenhagen, should we go by Kyoto protocol but by more than 5.2%. The EU is trying to do 20% by 2020. A third option, Nicholas Stern's calls for China and India to come up with a reduction plan by 2020.
- So basically, there's no deal. There are two schools of thought: Kyoto protocol is bad, but should we replace it and start from scratch?
- There is a serious confusion between energy security and climate security. The latter means that humanity cannot go beyond a 3.5 degree centigrade increase. The problem is not the science anymore. It's just political, as the situation with the trading mechanism indicates.

Discussion:

Damon Silvers initiated the discussion with the following points:

- The challenge is what happens in Copenhagen. Within the labour movement, there is a brutal struggle for a clear statement of intention at Copenhagen. In the end, the US labour did not object to that position, ie. having hard targets.
- The numbers involved in stimulus package are not big enough to meet the Copenhagen problems, especially when tied to taxes.
- Manufacturing has lost 100,000 members in the last 6 weeks. And there's no way around that green measures will have a bad effect on those numbers. Unless we up the stimulus way higher than where it is now---and we're having trouble as it is now politically.
- His organization is trying to move pension funds into green investing. But we have a big liquidity problem: there is no money to move. If they were to sell their assets in current market conditions they would lock-in losses.
- A re-engineering of energy policy/industry in the US is the only solution. Putting this discussion off till after the crisis means missing a huge opportunity. The kind of scale we need is a refitting of 10 million homes a year.

Desai noted that the world's skepticism on climate change is indicated by the price of carbon. Copenhagen is going to fail. The only thing to do is to think of second- and third-best routes to greening the government packages. Dervis echoed this view.

Stiglitz outlined the debate over Kyoto vs a carbon tax. Kyoto and market-based solutions entail pricing the carbon at levels that would lead to huge transfers from developed to developing countries, while a carbon tax makes explicit and open the transfers entailed by all this. Second, business requires certainty about the price of carbon in the future. Third, the market is so easily distorted by speculators, there is lack of confidence by the business community in the market. Cap and trade, with floors and ceilings, might work and would be a hybrid system between a pure market system and a tax.

Final Session: Reforming the Governance System

Martin opened the final session with the following points:

- The G8 is dead, going forward it has to be a G*n*.
- The elephant in the room in hedge fund regulation.
- National boundaries are meaningless when it comes to financial regulation. Without mandatory regulation, how would be have coordination?
- Yet the point is not to frame the question of regulation in opposition to sovereignty. Global institutions do not restrict sovereignty but protect it by dealing with problems that can't be dealt with internally.
- Emerging markets ought to realize that they will have their own big banks one day that will need rescuing. They ought to seek to set up global institutions accordingly.
- The US Congress might not want to give up its sovereignty, but Canada already has by virtue of suffering from a crisis it didn't create.

Discussion:

Fitoussi noted that all global institutions have legitimacy problems, who which Martin replied that J.P. Morgan had the same problems in 1907, as did the ECB. Desai noted that the discussion of sovereignty is common in the UK viz. the Euro, and that the very existence of a global financial protocol like Basel II was something to be marveled at. He noted that small could be beautiful, with less sweeping arrangements like common accounting standards being both preferable and feasible.

Ocampo called for the counter-cyclical use of SDRs once the allocation quotas were corrected, and noted the huge asymmetry in private and official flows. He also suggested that the IMF could buy bonds of development banks and a sovereign debt workout model. Finally, he suggested that the IMF ought to be thought of as a system of reserve funds, not a single institution. Bolton echoed the call for IMF reform, noting the the US had to give up its veto power and Europe had to consolidate its vote. Desai noted that the creditor countries ought to call the shots at the IMF else it ought to be abolished.

Silvers noted that the Special Report of the Congressional Oversight Panel suggested a global financial regulatory floor. The Panel made clear to Congress that “Fortress America” is not the right operation. Regulation ought to move from protecting the vulnerable to a broader mandate. Martin brought up the collective action problems of this suggestion, while Giorgio Di Giorgio thought that the notion of a global regulator was too far off to be seriously discussed, which brought to the fore the “boundary problem” in regulation.

Stein noted that the IMF is far from marginalized and is now back in business. He also noted that autonomous global agencies like the World Bank, the IMF and the WTO have enormous asymmetries of power which are very bad for developing countries. It may be better to create new norms and instruments and regulations, he noted, not new authorities. Stiglitz noted that there was a trade-off between continuity and inertia with the IMF as the institutional capacity there is hard to create over night while the staff have a deeply ingrained deregulatory culture.

Evans noted that “Maybe by being too pragmatic we're missing an opportunity,” while Desai pointed out that global leadership had to be shown by Obama if anything was going to get done at the international level.

Day 2

Session I: Financial Sector Bail-outs

The day started with a presentation by Silvers on the Congressional Oversight Panel's Valuing Treasurys Acquisitions report issued that day and his thoughts as a participant in the Panel. Silvers made the following points:

- The origins of TARP are with the failure of Bear Stearns. The rescue undid the structure of US financial regulation. Bear was a broker, not a bank, and there was a long history of letting stock brokers go before then. The Treasury department then spent a lot of time thinking about how to return to capitalism. Lehman was obviously the next weakest firm. Six months in they decided that they could let Lehman go because there was no systemic risk. I believe it was an honest decision, but they were wrong.
- Until then Treasury had rescued by infusing of credit: AIG, Fannie, Freddie, thrift banks like WaMu, and so on. When AIG was rescued with a $80 billion credit line, AIG gave warrants to the Treasury department, tantamount to nationalization.
- TARP was proposed on the basis that the market needed liquidity. The underlying aim was to create orderly prices in the face of a seemingly irrational market panic. The bill passed, but markets responded very poorly. TARP was transformed into an equity infusion institution via purchases of preferred stock. The sole criteria was that the banks receiving the money should be healthy, meaning you can only get it if you don't need it. The coupon was 6% on the preferred stock and the warrants were set at 15% of the preferred infusion, struck at 20 day moving average. Under TARP, warrants were a small amount (unlike with AIG).
- Another program, the Systemically Significant Failing Institutions Program, was also set up under TARP. Only one firm apparently fit that description: AIG. A $40 billion infusion was used to pay down the loan from the Feds. But AIG didn't hold on to it: the money went directly from the Feds to the creditors of AIG, namely their counterparties in their massive Credit Default Swap business; $20 billion went directly to Goldman, some more to several French banks. The Congressional Oversight Panel does not know where the money went.
- TARP has two programs. One is to give money to healthy banks: Citigroup, Bank of America, Wells Fargo, Bank of New York, PNC, State Street, Morgan Stanly, and Goldman Sachs. The other program is for AIG and other systemic firms. In late October, the worldview of TARP was about injecting liquidity into healthy banks. Paulson then says that he would now go back to Plan A, ie. asset purchases. But then 2 weeks later, he changes his mind. He said this because he was faced with the following dilemma: he had spent about half the initial tranche from TARP. He could have used that to set some market prices in a token way, given the money he had to work with. But he

knew that if he did that it would reveal bad banks and he wouldn't have anything left over to rescue them. He could hardly have gone back to Congress for more money in the middle of an election.

- The markets didn't take this well. Citigroup stock prices fell and they asked for a rescue, which came in the form of $20 billion more preferred stock at 8% and 15% of face of preferred as warrants. The Fed further guaranteed the value of $300 billion of assets. We believed at the time that this was done under the Systemically Significant Fund. But it was not. And it was not a grant under Capital Purchase program (because Citigroup was not healthy). It was under no program at all but through the FDIC and the Fed itself, who got $5 billion in preferred for the insurance.
- That TARP is for healthy banks has created a lot of political problems, especially for smaller banks of which there are plenty. What it meant to show was that US financial institutions were healthy. That effort has been an utter failure. No one believes that today. Further, TARP was structured in a way that has made it very expensive for the government. The facade of health meant that all banks should get capital at the same price, providing a subsidy to the smaller and weaker banks, and costs should be relevant to private money terms for capital.
- With Citi, the Treasury made a conscious decision was made to rescue the equity holders. The reason that was articulated was that there would be a successful bear raid on other otherwise healthy banks. That sounds plausible, but is not actually an answer that makes any sense. The other stocks were not weak, they did not move with Citibank. And there were plenty of people sitting on the sidelines with a lot of capital (venture funds, Berkshire, etc.). So there's no reason to believe this unless everyone knew in November that Citi were actually not viable, but then it's not a bear raid.
- Stock prices as such don't have legal meaning. The FDIC however have rules about stock prices and when to step in on the basis that a sufficiently low price would trigger a run around the world away from, say, Citi. It's easy to fix that, namely guarantee the things you don't want to run. FDIC has used indeed emergency powers to guarantee all bank debt, including bond holders. It's bigger than TARP and it's not clear where the money would come from if it were called. (The other thing they did was guarantee individual deposits to double the amount. That's $250,000 dollars.)
- It's my belief, expressed to both administrations, that the effort to buy time is profoundly destructive. Not because you can't do it; you can with enough money. But everyone is now an options holder in the banks so their incentives are around pretending that the assets on their balance sheets are worth more than they're actually worth, particularly in mortgages. We know that if the house owner has a job, you can renegotiate to about 60 percent of the loan, but if you pretend that its worth 100%...that's why there's no clearing in real estate markets. So by pretending, extending time, we're accelerating the downward move in the economy. That gets us to Sweden.
- We need to have a clear sense of what our objectives are. The process so far is partly conscious and partly a confusion between rescuing stock holders of banks and the banks themselves. Someone has to take the hit. We have two objectives that we should accomplish: make the banks function again and minimize the costs of doing so. We need to control the management of the assets on the balance sheets and we need to get into deeper layers of the capital structure. And we need owners who have full exposure to the downside, or only the tax payer will.

Discussion

Stiglitz made the following remarks:

- First, a distribution issue. It's really a fight between taxpayers and equity holders. In terms of dollars the value of the equity is now small, but we may a big price for it.
- Second, division between ownership and control. First, the stock options problem. Second, we the taxpayers bear the downside, They get the upside. We can see this right now with the asset-stripping that's going on.

- Third, the broad notion of capital and transparency. The form of the bailout effects how much capital various parties need. The bad bank idea for example---you'd have to give them double to do it. The insurance proposal doesn't require any capital apparently. However, if the market sees through all of this there'd be a major problem---maybe raiding the Treasury for $2 trillion say. Maybe the market will anticipate that that's what we've done.

Dervis suggested that nationalization is not a bad solution and that it won't be as bad as most people seem to think. Ocampo argued that partial nationalization won't work and also noted that in a developing country, equity holders would not be rescued at all. He suggested that capital could be injected through the FDIC and that the basic advantage of nationalization is that it has the same effect as insurance proposals but doesn't require money today.

D'Arista noted that under current legislation the power to close down banks, and then nationalize them, is available, but that we're not closing them. She argued that we would have to protect all depositors and that we would have to have an insurance scheme adequate to this system. She gave as an historical example of nationalization the Reconstruction Finance Corporation. It did a remarkable job in the 1930s. It made loans to the city of Chicago to pay their school teachers, etc. Silvers noted an irony in talking of issuing guarantees because we can do it without capital. He said that that's what AIG was doing. He also said that partial nationalization is the “half-way to Sweden” problem and it's understood in private in DC that that's where we are.

Stigliz suggested that we need to keep in mind the distinction between the real cost and the financial cost and also underscored the importance of incentive issues. He noted that partial nationalization is difficult because getting the incentives right will be a problem. Fitoussi argued that the problem on incentives is compounded by the incestuous relationship between finance and government.

In response to a question from Stiglitz on answering the political objections to nationalization, FitzGerald argued that an emphasis on management-ownership separation is important. He suggested that pensions and mutuals represent everybody and asked whether they could be the share holders and somebody else the managers. Desai commented that Sweden is a good example of the possibility of finite horizon nationalization and reprivatization. He argued that a drastic restructuring of the system might be a problem politically, but that a Sweden style solution with, say, a 5 year horizon might be feasible.

Noman argued that it would be hard to sell the idea of nationalization, but that it's much easier to sell the idea of a development bank on the basis that the private ones aren't working—that the private ones can be judged by how well they compete with the development bank. FitzGerald argued that turning a development bank to social issues and allowing private ones to take the profitable stuff would be problematic. He also noted that in developing countries, governments try to sell banks to foreign investors, and asked whether the US would be willing to have large chunks owned by foreigners.

Vos suggested a framing of the problem as a policy question. He argued that if the assets were to go down, the policy ought to outline how to adjust for that and cover it. He also suggested that we address cross-border problems—which government should be bailing out which banks?

Ocampo suggested that contingent government debt doesn't have the same impact as explicit debt. He argued that nationalization followed by a quick splitting of good and bad assets and sell the good fast, which is the dominant approach in developing countries, then the amount of debt you need to buy the bad assets is very high. He commented further that you would still get the problem of fixing the

mechanism to buy the assets. Stiglitz responded with the observation that in the US we are required by law to record contingent liabilities and their actuarial value, and that it's not clear what the full implications of that would be here and how to go about doing it. Desai suggested that if the net debts are smaller than gross debts then one should either nationalize all of them or get a clearing house and net them out. He argued that this would be much less expensive than getting just one bad bank set up.

D'Arista argued that there are problems outside the banking system too—that the problems are in pensions and mutual funds and insurance funds. She noted that there was $13 trillion in the banking system in 2007, that MBSs are at $6 trillion, ABS at $4 trillion, and that there are other securities too. She commented that putting all our resources in the banking system is a mistake. Stiglitz noted in response that pensions and insurance funds have much longer liabilities.

Silvers argued that that the pension fund issue has to do with sustained enormous book losses. He noted that they haven't liquidated yet, but that regulations are forcing them to do so now. He said that in 2006 we moved closer to marked-to-market from a smoothing system and that a prudent fiduciary institution is required to rebalance their balance sheets. He said that this is done on short-term asset price fixings, so funds are liquidating commercial real estate assets in order to get them priced low enough to balance out their now depressed equity portfolios. He also argued that pensions equity holders have to be willing to lose their financial equity positions and said that if they don't the rest of their equity holdings will disappear.

Session II: Credit Interventions

Stiglitz suggested as topics the role of credit guarantees in creating asymmetries between developing and developed countries. He argued that interventions aimed at facilitating credit flows might result in unfair trade practices. He also suggested, as a second set of questions, the implicit and explicit costs of these programs.

On intervention, Stiglitz suggested two principles for central banks. First, that they should be forward looking and give guarantees for new loans not for old institutions. And second, moral hazards should be avoided. He suggested one possibility in Arrow-Debreu insurance: loans would be contingent on some state of the world (as defined by GDP index or some such) meaning that lenders receive a certain amount if that state changes. He noted that in that scenario if you make a good loan you get returns and if you make a bad loan you don't, but also that Wall Street doesn't like this proposal because they want compensation for bad lending whereas under this proposal compensation would be for bad states rather than bad lending.

Stein commented that his focal point is on the asymmetrical nature of credit in poor developing countries—not middle-income countries—and said that both the resources and the capacity to intervene on social grounds in failed business is starkly lacking. He commented that in Africa there's a never too big to fail problem and that in sub-Saharan Africa there has been a collapse in the formal sector and concluded that the double-standard on the type of solutions available there and here should end.

FitzGerald said that under OECD rules any credit guarantee scheme has to be self-financing, that no export guarantee systems should subsidize firms in the long run, and that therefore developing countries have a problem with export guarantees. He suggested that this is a helpful area for regional development bank activity. He also argued that under systemic uncertainty, pricing assets is really difficult and that the fiscal impact of all of this is going to be difficult to assess in the medium term. He argued that reselling the assets would immediately depress prices, so a resegmentation of asset markets

is necessary. He noted that in the pre-reform era, the mortgage market was different, insurance was different, etc., and that we would have losses in efficiency, but that the gain in stability by having a segmented market would compensate for it. Stiglitz noted that the theory was that diversification would give more stability, but that global diversity gives us contagion instead.

Stiglitz also argued that subsidies to the banks allow them to lend at lower rates than they otherwise would and that it helps exports but doesn't differentiate between export and non-export goods. He noted that in Europe, except for the agricultural sector, trade subsidies are thought to be objectionable but, under those rules, US cotton subsidies would be illegal.

Evans commented that what's been happening over the last 2 years is that business is pushing hard in the UK saying that we are now competing with China etc. As a consequence, he argued that we need a common set of rules over what and how to subsidize. He noted that anti-corruption measures and environmental issues are embedded in export rules and suggested that there is an unfairness problem, but that it is also a mechanism to get business to care about these matters if they want to export.

Rodrigues said that competition policy in Europe is under pressure because of the bailing out of banks and others. She argued that the implications are taken to be that the state aid framework has to be updated, more precise conditions are needed, and that new ones should be included to make sure that bail-outs of banks are short term with no long term advantages. She also suggested that in Europe the room for maneuver under the stability growth pact needs to be greater, that we need regional policy and regional funds for supporting regional firms, and, finally, that a globalization fund for European social policy is needed.

Morales noted that there never has been a level playing field in developing countries because foreign banks could always borrow at lower rates and lend to the best credits, skimming off the best possibilities. On export credit guarantees, he noted that many countries enjoyed a commodity boom until mid-2008, so banks are loaded with liquidity and are very willing to lend to exporters. Stein commented that many countries have gone to 80-90% foreign ownership of banking sector in terms of assets. He suggested that the game is over now, much less us worrying about level playing fields, and also noted that the level of government expenditure in Sub-Saharan Africa is now 13%—a collapse from 20% in the 1980s—so there is no government ability to mobilize credit anymore.

Ocampo argued that the question of stability and segmentation is very important, as is the idea of circuit breakers, and that capital account regulations are essentially a segmentation policy. On guarantees on bonds generating international distortions, he concurred that maybe it does indeed crowd-out flows to developing countries.

Session III: Monetary Policy

Silvers made the following comments on the issue of oversight of central banks as an important theme in the Congressional Oversight Panel's Special Report on Regulatory Reform.

- We treat the Federal Reserve system more and more as a financial regulator and as a conduit for public funds, which is not the same thing as a provider of liquidity. It becomes unsupportable to have passive and private sector governance in that system because the system is obligating the public by making decisions about who to subsidize. Clearly there is systemic risk and therefore rescues will have to happen. We're not going to stop doing that. So ex ante we need rules and specific powers to do this. A new body or an existing body or something for systemic risk. If it's the

Fed, the Fed would have to be different from today. But we don't say how in the report.

- Some people have said a list of top 30 institutions that may need a bail-out is needed. We recommend a ratchet principle, not all or nothing. The bigger you are the more capital you have to set aside. It is a progressive requirement.
- Further, we need a serious reform of those governance institutions that have bad incentive problems. We need to look at credit rating agencies and executive pay, and at creating a public rating agency. Maybe the investor pays for ratings. For executive pay, asymmetries and time horizons are the main issues. They should be viewed liked capital requirements---a black mark if your pay package is all stock options, for example.
- We must also regulate the shadow market in its entirety. Routine transparency and accountability on all market actors based on what they do, not what they say they are.

Discussion

In response to a question from Stiglitz on the justification for regulating non-systemic entities, Silvers commented that it's about contagion and helping insure the consumers. He argued that if you think regulation works then you have to cover everything, said that a global regulatory floor should be an objective of the US, and that the policy posture of globalization of financial markets should be reversed.

FitzGerald asked what the implementation might be, perhaps 100% reserves against any unregulated asset, to which he replied that the report does not get into implementation.

Silvers noted a final recommendation from the report on consumer protection and multi-agency regulatory structures, arguing that there should be core competencies for the agencies. He noted that restructuring the Fed might achieve that, but that's hard, and said that something new might be appropriate.

D'Arista made the following comments on the Volcker Report and market-based guarantee systems:

- The Volcker Report was very general. It says that derivatives should be subject to a clearing house. There's concern about leverage—bring everything off-balance onto the balance sheet. It's very bank based. The most radical thing was a concern about concentration. Building on the point I made this morning, the US taxpayer is losing twice over. We need a new financial guarantee program.
- Now there's no savings in the institutions we do insure, so it's a bridge over a dry stream. We should guarantee people, not institutions—a financial policy for individuals. We already report our individual holdings to the IRS. The new institution would give some amount of coverage to each individual, with the people paying premium of maybe 10% on their earnings. There would be increased pay-outs for households and for retired people.
- It would be a market system for finance for the first time because you could tolerate failure. You wouldn't need deposit guarantees for banks. We need failure, we can't pay off Citibank's deposits anyway. The system is no longer a bank-based system, it's a market-based system, so if you want to cover savings that's how you should do it.

Di Giorgio argued that we need an international perspective and some common principles, a real balance between regulation and supervision, when talking about changing the global financial system:

- Adding more rules is demanding because in bad times, you don't need them, and in good times, you have an incentive to wait a little longer. The debate restructuring it all for the last 10 years but we

still don't have any confidence in some one model, say in the EU and in the US.
- Four big objectives: first, systemic stability; second, micro stability; third, investor protection; and, fourth, efficiency.
- My impression is that we've been focusing on micro stability and investor protection. In the UK, the focus is on single regulator discussions. But there has been no discussion on systemic stability. In Europe, the competencies was on legal matters. And the difference in salaries was extraordinary, so no chance of getting strong finance people.
- In our paper, we try to say that even if it's too early to have one global regulator (not for supervision, that requires being close in), maybe it is possible to establish some common principles and apply it to the US and to Europe. We'd have a central agency and then regional agencies, as with the EU structure. Supervision would be delegated to the state level or district level, with rules agreed upon centrally. In Europe, something like this was appearing spontaneously. Market regulation is already based on set of common rules that are then put into national legislation.
- But this implies a lot of restructuring. So political and institutional pushback will be a problem.

Griffith-Jones then made the following remarks on banking systems:
- We should change the old story about attracting outside money through deregulation. We need to go a bit further and think of areas of capital control. Korea has suffered the most from reversals of capital flows. They liberalized to total opening of capital account.
- Then there is the issue of comprehensiveness. Take CDS. It's so complex. Can you regulate these things effectively? The very essence of it is in the realm of the impossible, see Perry Mehrling's argument, for example, on the impossibility of private entities insuring systemic risk. The final position is to get rid of them.
- Developing countries are mainly bank-based. This is not the US problem. But you have problems with speculating on the currency and so: who would regulate them? Could we regulate leverage and hedge funds etc. in the same way? Or could we take into account the types of risk they've taken and their sources of funding? Can we calculate embedded leverage? The instruments themselves are too complicated.
- On the counter-cyclical problem, it is more accepted today in Europe than in the US. The Deputy Governor of the Bank of England is pushing it. The Swiss are pushing it, and maybe the Spanish. The Financial Stability Forum are talking to the accountants. Apparently, there are serious difficulties in adapting the rules. Congress have talked about claw-back provisions for example—a system that is based on long period compensation. Is it better to have claw-backs, or long term compensation? The Basel Committee are looking at this as a code of conduct. Institutions that don't stick to them would have to have higher capital ratios.

In response to Griffith-Jones, Silvers argued that shadow banks are in some sense doing something that's quite ordinary, namely bond insurance—he suggested that CDS sellers are in exactly the same business as municipal bond insurance. He noted that insurance of any kind has always been complex, but said that that's precisely why you're not allowed to do it unless a state regulator reads the contracts and says that its both fair and that you have adequate capital. He concluded that it's all a matter of political will, not complexity.

Stiglitz noted that we know how to price the risk of life insurance, say, from all the event data. He asked whether the fact that there's no data on something like the probability of AIG going bankrupt means that that's not an insurable risk. He commented that there's a distinction between uncertainty and risk.

In response, Silvers argued that catastrophic events are a feature of economic history and therefore

something that can be modeled, suggesting that the point is rather why we regulate insurance and not CDS markets. On credit rating agencies, he suggested that they basically take a bunch of public data and aggregate it into something digestible and compared them to the SEC stamping an investment prospectus.

Patrick Bolton noted one difference: there is a continuous rating of bonds, but the SEC does it once only. He suggested that the idea of a public agency is very dangerous because the state can't just wash its hands of it if it goes wrong.

Desai noted that there was no question of complexity with regard to Northern Rock, saying that they went bust just on bad behavior—there was no opaqueness about what they were doing. Second, on credit ratings, he argued that the efficiency of rating agencies has deteriorated over the last 20 years and noted that the volume of the their business going up tremendously, combined with serious barriers to entry, has lead to a predominance of box ticking people who have no understanding of what they are doing.

Silvers noted that Northern Rock is analogous to the Madoff problem. He commented that the public credit markets are in the SEC's jurisdiction and posed the question of dealing with regulatory capture. He argued that it is a question of the balance of political power, the same as labor law and campaign finance, and suggested that in modern societies the counter balance to captured finance is, for better or worse, the union movement.

In response to a question about discussions about regulation within the Congressional Oversight Panel, Silvers noted that the perception about regulation was that the purpose was to protect the weak, not safeguard the system, and argued that since then we've had an exempting of larger and larger parts of the system from any kind of regulation. He suggested that the politics of it was ugly, and that the intellectual reasoning was plausible but wrong.

Ocampo raised a question regarding the consistency of the regulatory system as a whole and the problem of avoiding regulatory arbitrage. He suggested that we should have single requirements independent of the form that an instrument takes, noting that this means having an institution that can determine which products are the same and apply uniform treatment.

D'Arista asked, in response, how we determine if some or other regulatory change is cosmetic. She argued that the only markets that we have left that are real public markets are the stock markets—the rest are opaque markets—and commented that if derivatives were on exchanges from the beginning we would not have had this problem to begin with.

On the question of exchange trading and OTC trading, Stiglitz argued that we could have viable OTC regulation via compulsory regulation. He argued that we could have a system in which if an instrument is not registered, it's not enforceable in contract law. Further, the social cost with OTC trading, means that you could insist on having, say, five times the margin of the exchange traded equivalent. It'd be a strong incentive without the heavy handed notion that absolutely everything has to be on a exchange. He noted that the point is that if a bank does this stuff for individuals, it imposes risk on the bank. But that we insure the bank, so we charge them.

Session IV: Regulatory Policy

Flassbeck opened the session with some remarks on interest rates and inflation:

- I don't think that relaxed policy in 2000 was responsible for the crisis. Rather, with a endogenous monetary theory we can see that there's no money supply, so if central bank fixes at 1% then that's where the level is. Leverage as such is discouraged by low interest rates. Internationally, Japan had zero rates without getting into the mess we had. UK did have high rates and yet got a housing bubble. It's about deregulation, not monetary policy.
- In developing countries. Higher rates don't make sense. It's the result of speculation in currencies, and they don't have means to stop it.
- The main problem is that of deflation. Central banks have some kind of successful record on fighting inflation and no record of fighting deflation. It's not just about having an inflation target, but also about the art of central banks looking at low inflation plus growth and employment.
- Wage deflation is the really dangerous thing here, like in Japan. Two systems that avoided this in the past were labor market rigidity and friction from politicians and unions. The other was the US system with energetic government policy on indirect effects and fiscal policy. In Europe we have flexibilized the labor market. And in the US we don't have enough action this time around.

In response, Stiglitz noted that saying that we should not worry about inflation sounded a little like Greenspan's comments about financial derivatives.

Morales made the following remarks on monetary policy in developing countries:
- A rough characterization of developing countries and how they are responding to the crisis: they mostly have incipient capital market institutions with weak transmission mechanisms for monetary policy. Most of the signaling for the market is via the exchange rate rather than the interest rate.
- So there are two kinds of developing nations, roughly: fixed or semi-fixed rate countries and the inflation-targeting countries with floating rates. Also, countries that are more or less integrated and ones that are not. The former have been suffering a lot more.
- Inflation was thus transmitted, quite suddenly, through the exchange rate. So you went from a situation of high exchange rates to then the crisis happening. They were not prepared in the second half of 2008. They did not know what they were going to do. There was a very rapid depreciation of exchange rates. The answer has been to raise interest rates. We know that this doesn't work. The channels of transmission are almost non-existent. And also this is mostly a confidence crisis. If there is lack of confidence, this kind of action won't help.

On developing countries and an interest-rates defense, Pinto argued that you could have an unsustainable situation of public and private debt finance. He fully agreed that inflation-targeting can't be sustainable in developing nations, saying that it's inter-temporal budget constraints that matter because pegging in the context of an open capital account exposes yourself to interest volatility that can harm a fragile fisc.

Ocampo noted that no central bank in a developing country can ignore their exchange rate—arguing that pure inflation targeting actions, even counter-cyclical types, can't work. He suggested that in the past the risk of over-valuation in a period of foreign capital abundance was the problem, whereas we now have the opposite problem. He argued that when a crisis strikes the best that the bank can do is reduce interest rates, but noted that at the same time you would face rising risk premia in external borrowing, leading to pro-cyclical shocks. He commented that the only way to get out is to have massive reserves or massive external support.

Flassbeck argued that the revaluation and devaluation of developing country currencies were driven by carry trades, and suggested that the market is not efficient over many years, that economic theory is totally wrong here, and that the countries are put into a serious dilemma that comes from floating

exchange rates. He also argued that massive exchange rate reserves don't always help, noting that Russia had the second largest reserves in the world but it came down by one third in four months.

Di Giorgio made the following remark on Europe and the ECB:

- I'm going to try and do a mission impossible and defend the ECB a little. They have a mandate to target inflation. We gave them the target. We should ask for reassessing the stability pact.
- The way they're using their instruments is pretty good. Before the crisis, the Feds had very limited instruments. The discount rate is no good as an instrument. Open Market Operations is with only 20 dealers. All the liquidity in the first five months went to them, not to the banks because the prime dealers also needed liquidity. Only after 5 or 6 months, they invented extra instruments at the Fed.
- The ECB already had the instruments in place. No one on the monetary side realized the limited nature of their instruments.

Agenda for future meetings and conclusions

Desai commented that inflation was considered a big problem only last year during the commodity bubble. He also noted that the difference between the risk-free rate and the market rate for risk is indeterminate, arguing that right now credit risk is the real problem and suggesting that the task of monetary policy now is to do something with confidence levels. He also argued that Maastricht will ever be revised, so we have to find ways in which the ECB will simply ignore it.

Evans noted that the ECB constitution contains a commitment there to contribute to economic policy, and we should emphasize that part of it. He noted that the ECB is on the other side on every part of the current discussion—they have a focus on the wrong battles even though they had the right instruments and we're still getting the language of wage flexibility from them.

Ocampo noted that lending ought to be the target of policy, during both booms and busts, given our Minskian cyclicality. He argued that here's an endogenous reduction in the perception of risk and thus a pro-cyclical effect on leverage—in the North this shows up as the Shadow Banking System, in the South as bloated non-banking finance companies—and suggested that more and more credit to the banks may not increase lending.

Stiglitz argued, as a theoretical point, that markets aren't necessarily stabilizing. On the problems of mixed public/private solutions, he suggested that the price of risk in capital adequacy requirements is sometimes too high and sometimes too low but is not set by the market but rather fixed by regulation. He noted that after the 1989 crisis, the Fed decided to treat long term US treasuries as perfectly safe, so there was huge regulatory arbitrage and lending to the government and not the private sector. He concluded that we need to emphasize avoiding regulatory arbitrage.

Barcena noted that central banks have lowered legal reserves, tripled credit lines for local banks in Argentina, and have broadened powers to bail-out financial institutions. She noted that the result has been increasing tensions between Finance ministries and central banks, sometimes even within countries, fiscal and monetary policy are not talking to each other, much less coordinating policy between nations.

Fitoussi listed the following topics: If we want global cooperation, do central banks have to give up some control? What risk is attached to the debt/GDP ratio for advanced nations? What is the limit of providing insurance to the financial system? What are the Fed's balance sheet risks and how long can we bear them?

Regarding the draft G8 communique, Rodrigues suggested that we make a critical assessment of the document—a short list of missing points. She noted that it is an ambitious document from the G8 that covers a lot of terrain, including governance issues and a division of labour between G8 and G20.