THE GLOBAL ECONOMIC OUTLOOK FOR EUROPE AND THE U.S.

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Keynote Address

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I welcome this opportunity to talk about this important issue : the role of economic ideas in shaping the current financial crisis. In many ways, the problems that we are facing in the United States and in Europe are the result of the influence of certain ideas—and especially certain flawed ideas—about economic policy, that have held sway for a quarter of a century now. Perhaps the silver lining on this particular cloud is that these flawed ideas will have less influence going forward.

The failure of the solutions that have been proposed in the United States are themselves a result of the failure to use the knowledge that we already had. Keynes talked about the importance of the influence of ideas in shaping economic policy. Unfortunately, many of the ideas that have gained fashion among central bankers and economic policy-makers—and which they have helped to propagate—are based on a very narrow set of views, and many of them do not reflect advances in economic science in recent decades.

It was mentioned in the introduction that I was chief economist at the World Bank. At that time, a decade ago, the world was going through another global financial crisis, which had begun as the East Asian crisis. I have a sense of déjà vu, seeing what is happening today. In fact, some of the same people responsible for the current crisis were responsible for the mismanagement of the problems in that crisis. One of the important warnings from the East Asian crisis was that badly designed bailouts do not work. Not only do they not work, but they can also make things worse, because, as I'll explain, one of the problems is lack of confidence. When you see billions and billions spent and things still not improving, people do not feel very good. Of course, in the case of the United States, we just passed a bill providing a bailout to the banks of $700 billion dollars. That's a lot of money, no matter how you look at it. Just to put it in perspective, it is equal to the amount of money that the advanced industrial countries will spend in foreign aid for all the developing countries for a decade – and we're spending it *just* to bail out Wall Street this year. And it's not working. As the plan was announced, stock markets

around the world fell. It is really a vote of no confidence in the solutions that have been proposed.

What I want to do this afternoon is, first, to try to provide a description, or a diagnosis, of the problems. Next, I will explain, on the basis of that diagnosis, why it is that this bailout probably will not work, though I do think it was better than nothing. Then I will modestly suggest what should have been done, my own proposal. Finally I will conclude with some prospects of where Europe and America are likely to be going.

President Bush, who is not known for his economic insight, provided what was actually a deep diagnosis of America's problem. He said : "We built too many houses." If he had gone on, he would have said, "We built them in the wrong place," but that was going a little bit too deep into the analysis. Economies usually don't build too many houses in the wrong place for people beyond their ability to pay, so it is useful to ask the question : why did the market fail ? What went wrong ?

There are three key problems plaguing the economy, which are separate but interrelated, and part of the problem is that they have not been adequately distinguished. First, there is a liquidity problem ; second, there is a deeper problem in the financial system that centers on the fact that it made loans that people could not repay ; and finally, there is a macroeconomic problem that actually gave rise to the first two problems but is now being exacerbated by them.

There is also a fourth problem, of course, which is the crisis of confidence, one that Wall Street worked very hard to earn, as did our political leadership. The Central Bank, the Federal Reserve, Secretary Ben Bernanke of the Treasury, and President George W. Bush have all earned the lack of confidence that Americans feel towards this political leadership. The consequence is that, in a way, the crisis could not have come at a worse time, because we have what has been described as a "lame duck President," making it very difficult,

even if he wanted to or had the capacity, for him to address the problem. It is not clear, however, that he has either the capability or interest to do so.

Underlying all this is a more fundamental problem : the financial markets did not do what they are supposed to do. It is important to understand what the financial markets should do. There has been a lot of berating of Wall Street. It was interesting to watch the Vice-Presidential debates on CNN, as they had these instant indicators where members of the audience turned a dial either up or down, when one of the two candidates said something they liked or disliked. One thing that came out very strongly was that when a candidate said that Wall Street was evil, the indicator soared to the top. There seems to be a national consensus on that.

The problem is that financial markets are really important. You cannot have a well-functioning modern economy without sound financial markets. Thus, while there is a sense in which they need to be berated for their failures, we cannot do without them.

There are at least three important functions that financial markets should perform : they are supposed to mobilise savings, help allocate capital, and manage risk. In return for performing these functions, they receive rewards. The idea is that if they do these functions well, they so increase the productivity of our society and of our economy that they deserve a high return for these contributions. In fact, in the United States, the UK, and some other countries, they have received 30 % of corporate profits in recent years, not including bonuses and executive pay. If you believe in traditional economic theory, that private rewards are commensurate with social returns, the inference you would make is that they have had enormous social returns. However, if we look at what has happened, I would say that they have had a negative social return. That suggests there is a real problem with our standard economic theory, a disparity between private rewards and social returns. I will come back to this problem later on in this talk.

I am going to be talking more about financial markets in the United States, but those of you who know European financial markets will understand that a lot of this (not all of it, but a lot) applies to Europe as well.

The financial markets in the United States did not mobilise savings : household savings in the United States in the last few years have been close to 0.6 %, which is much lower than they were before. Those of you who have studied economics may know that there is a basic idea taught in economic courses in many universities called Ricardian equivalence, which argues that if the government dissaves, private savings offsets that. Anybody who still teaches that, or anybody who still believes that, needs their head examined. While there has been ample econometric evidence refuting this idea, what has happened in the United States in the last few years shows how badly off the mark it is. The government dissaved : we had a huge deficit, and America's national debt has gone from 5.7 trillion dollars to 9.3 trillion dollars. As our national debt was soaring, our national saving and our household saving were plummeting, as I said, close to zero. Those numbers do not include the unfunded liabilities for the future, for instance, the more than half-trillion dollars that America will have to pay for the disabled returning veterans. Of the 1.7 million Americans who have been deployed to Iraq and Afghanistan, more than 40 % of them are coming back with disabilities, some of them very severe, and we will have to pay for them for decades to come. This is not even included in the 9.3 trillion dollar national debt that we have. Standard economic theory that is taught all over Europe and the United States says that, under these circumstances, household savings ought to go up. The evidence is unambiguous that it has gone down.

Financial markets did not mobilise savings, and furthermore, they did not manage risk. They actually created risk. However, it is worse than that. They talked a lot about innovation, but if you look more carefully at their innovation, it was geared at what we call tax arbitrage, regulatory arbitrage, and accounting arbitrage. In other words, their innovations were in circumventing the regulations that were

designed to ensure the stability of the financial system and to ensure that people could know what was going on. But they did not innovate in ways that would enable Americans, or other countries' ordinary citizens, to manage the risk that they face. Already, 3 million Americans have lost their home, and we expect in the next year another 2 million will lose their homes. The markets did not create financial products that would allow ordinary Americans to manage the risk of interest rate volatility, price volatility, and income volatility ; they created mortgages which exposed them to more risk than the old mortgages, which is why they are losing their homes.

There are a host of other innovations that they should have made but did not. In fact, they resisted innovations. When I was Chairman and a member of the Council of Economic Advisors in President Clinton's cabinet, I pushed, for instance, for inflation-indexed bonds. One of the problems that we have (which is not a major problem right now but will be over the long run) is that inflation rates have gone up and down. People who are saving for their retirement 30 or 40 years from now ought to worry about inflation ; even if it is low today, it may increase—a worry growing as the national debt increases and the Federal Reserve balance sheet balloons—but no one really can know for sure what will happen. It is a risk that people should get insurance for, but you cannot buy that insurance on the market. It is actually very difficult to put together a portfolio of assets that will insure you against the risk of inflation. We proposed creating inflation-indexed bonds and actually selling long-term insurance against inflation. The government has a responsibility to maintain price stability at a reasonable level, and therefore it ought to provide insurance. If it fails at maintaining price stability, it ought to pay the consequences. However, Wall Street opposed our initiative. Why ? Because they were concerned with maximising their revenue, which they achieve by maximising transaction costs. Their complaint about this innovation was that people who bought these inflation-indexed bonds would just hold them until their retirement, which should be a good thing ! But it was not good for Wall Street, because if people hold the bonds until their retirement, it does not generate any transaction costs.

Argentina, after its financial crisis, did not know how much it could repay its creditors, so they proposed an interesting innovation. Rather than trying to pay more than they could, which would lead to a debt crisis a few years down the line (which has happened to many developing countries), they came up with an innovation : a GDP-bond. This bond would pay more if Argentina's income went up and they could afford it, and it would pay less if GDP did not go up. That way, creditors' interests would be aligned with Argentina's interests, and they would work to try to help Argentina grow.

Wall Street resisted this GDP-bond. A little earlier, some economists came up with a better way of selling Treasury bills (through auctions) that would lower transaction costs, make it more transparent, and ensure that the government got a higher return for the bonds that they were selling. Again, Wall Street resisted this. Why ? For an obvious reason : they did not want to maximise government revenue. Instead, they wanted to minimise it, because the difference was their income. I just want to illustrate several points here, that while Wall Street talked a great deal about innovation, it didn't actually produce any innovations that were good for our society. It actually resisted those innovations that would help Americans manage their risk.

Finally, in the run up to this crisis, financial markets did not allocate capital very well, and we see the consequences : hundreds of billions of dollars were spent on housing beyond people's ability to afford, in the wrong places. Many of those houses are now vacant, and they are being destroyed just a few years after they were created. It is a massive waste of resources. In fact, I think, there are few instances of the government wasting resources on this scale (with the obvious exception of the Iraq war).

This is not the first time that there have been these failures, and we need to remember this as we think about both the problems and the solution. In fact, over the last 25 years, we have had a lot of Wall Street and financial market bailouts. We haven't called them "Wall

Street bailouts," but they've been basically that. We had the S&L bailout in the United States in the mid-1980s, which was very closely related to deregulation. The outlay of the U.S. government at that time in dollars was close to half a trillion. They recovered a large fraction of that, so that the net cost in current dollars to the U.S. government is conventionally estimated to be "only 200 billion." The important thing to keep in mind is that was a problem in a small fraction of our banking system, the savings and loan associations. The problems that we have today are much larger. That financial crisis led in turn, a couple of years later, to the recession of 1990-93. That suggests that our prospects going forward are not very positive.

We have had other crises : the Mexican bailout, the Korean bailout, and bailouts in Indonesia, Thailand, Argentina, Brazil, and Russia. It's an impressive record ! I want to emphasise that, although these bailouts have the name of the country, it was really a bailout of banks in the United States and in Europe, who were lending money to these countries beyond their ability to repay. There is a real track record of bad judgements in allocating capital and managing risk. It has to do, as I will say later, with a flawed regulatory structure. This long history certainly suggests that there is something fundamental at issue, a fundamental problem.

A closer look at the liquidity problem

What I want to do now is talk about each of the three issues that I mentioned : liquidity, lending, and the macroeconomic problem. The liquidity problem is actually fairly easy to understand. It goes back to the point I made that banks gave loans to people who couldn't repay them. Then, they took those loans and "sliced and diced" them. They believed in financial alchemy. In the old days, alchemists took a base metal such as lead and tried to convert it into gold. Modern alchemy takes F-rated mortgages and "slices and dices" them, and then the rating agencies give them a blessing. The result was that these F-rated mortgages became A-rated securities that were safe enough to be put in pension funds.

But in the process of "slicing and dicing" there was an added layer of non-transparency. More generally, the financial institutions were engaged in creating more complicated products which involved very hard-to-assess risks and liabilities. The products had a variety of names. However, that's not important. The important thing is that they created these products that were so complicated that not even the institutions that created them fully understood the risks. Warren Buffett has accurately described some of these products as "financial weapons of mass destruction." They have succeeded in destroying our financial system.

It is clear that once banks realize that they do not know their own balance sheet, they also realize that they do not know the balance sheet of anybody to whom they might lend. The resulting situation is, in some ways, even worse than that which arises with asymmetric information : it's no information. Nobody is willing to lend to each other, and the result of that, of course, is a freezing of credit markets. That is the liquidity problem.

A closer look at the problem of bad lending and risk management

The liquidity problem actually arises, as I say, because of the second problem, the bad lending, lending to people who couldn't repay. In a way the financial problems at this level are a new version of an old problem. There have been problems with financial markets throughout history, and they often are associated with two things. One of them is excess of leverage. People borrow and borrow and borrow, and on the basis of that, they invest, in the hope that they can get a little bit of excess return. One way of thinking about it is by listening to some of the bankers. They said, "We need (and that was a peculiar word) to get a 20 % return." However, it is very hard to get a 20 % real return on ordinary investments in a competitive economy. If you have a monopoly, like Microsoft, maybe you can do it, but there are no monopolies in banking. It is a fairly competitive market, so it is very hard.

So how do you get high returns ? You take very big gambles. You borrow a great deal and make a little bit on each dollar that you borrow, but you borrow so much that, compared to your equity, your returns are very high. But this is not sustainable, or it is at least very risky. However, the bankers did not appreciate the risk that they were taking.

Some of what was going on could be thought of as a version of a pyramid scheme. A pyramid scheme is, as many of you know, a system of letters, where you write to four people who are supposed to write to four more people to get sixteen, and then those sixteen are supposed to write to four more people, and they are all supposed to send you back a dollar. Through this scheme you are supposed to get wealthy : you send one dollar and get back a thousand dollars. However, those kinds of schemes never work because there is only a finite number of people in the world. Pyramid schemes have really been a feature of financial markets forever. There is a related phenomenon, called "bubbles." Here, a person is willing to pay a high price (say for tulips), because he believes he can sell it on to someone else, at a still higher price. Its success too depends on an infinite chain ; and bubbles, like pyramid schemes, always end in disaster.

We had that kind of scheme in our housing market. Banks lent money to people beyond their ability to pay, but they said, "Don't worry about it." They actually created mortgages that were negative amortization, which meant that at the end of the year you owed more than you did at the beginning of the year. Again, they said, "Don't worry about it." Why did the banks say this ? Because they said the prices were going to go up by 20 %, so the more you borrow, the richer you will be.

Now, as an economist, one should have been suspect. While one of the basic laws of economics is that there is no such thing as a free lunch, they were saying, in effect, that there was. All you have to do is borrow, and you will be wealthy. If the banks were that confident, why did they not invest it themselves ? There is no way that this

could continue, and it was especially obvious that it could not continue in the United States because, while housing prices were going up, most people's real income was declining. Real incomes of most Americans today are lower than they were eight years ago. There has been no increase in real income for the median American in eight years. So you ask, "How could people spend more and more on housing when their income is getting lower and lower ?" You do not need to have a Nobel prize to figure out that there is a problem here.

It was especially a problem in the subprime mortgages, which are those mortgages given to low-income individuals. A lot of the lending was what is called "predatory lending," where lenders attempt to take advantage of unsophisticated people who do not understand the mortgage markets. The intent was to get these people to pay as much in fees and interest as they could. They had provisions that said in effect, "Your interest rate may soar in three years, but don't worry, you'll get a new loan then. Forget about the transaction costs, since you'll be wealthy because of the house price going up."

Our financial markets innovated in other very clever ways—which generated fees in the short run but created problems in the long. They invented something called the "No Doc Loan," which was a mortgage where you did not have to have any documentation. The more familiar name was "liar loan." People would just make up a figure for their income to get their mortgage.

What was going on was actually very simple. It was based on the hypothesis that had some validity : a fool was being born every minute, and Wall Street would find them wherever they were in the world. Furthermore, globalisation had opened up a whole new set of opportunities to find these fools. In the old days, the mortgage originators held onto their mortgages ; if they made a bad loan, they bore the consequence. But in the new era, mortgages were 'securitized' and sold around the world. We managed to sell about half of these liar loans in Europe. We are actually very thankful that Europe bought so many of our toxic mortgages, because if it had not, the American

downturn would be much, much worse. Rather than talking about a 700 billion dollar bailout, we would have begun with a one and a half trillion dollar bailout, and that is just the down payment. So, we really do thank Europe a great deal for its help. For us, globalization has worked out well.

Securitization was actually a big part of the problem. I sometimes felt that my students only listened to the first third of my lecture before they ran down to Wall Street to try to make money. Securitization is the notion that you take a set of assets, in this case mortgages, package them together, and then sell them. By combining them together you can diversify the risk, and then you spread the risk all over the world. The first part of the lecture on securitization explains the principles of diversification and risk-spreading. This is an important idea ; diversification lowers the cost of risk. But there are the second and third parts of the lecture that the students should have listened to.

The second part of the lecture is about correlated risk : you do not get the full advantages of diversification if the risks are highly correlated. One of the problems with the mortgages was that they were not independent risks. That is to say, if housing prices fall together, in most markets, a very large number of the mortgages would go bad. If interest rates rose, a very large fraction of the mortgages would go bad. If unemployment went up throughout the economy, as it would if the economy went into a recession, there would be problems. They did not understand that the mortgage risks were correlated, and this meant that they had underestimated the extent of risk—and overestimated the advantages of diversification.

They made another mistake in using probability models that were very badly flawed in valuing the risks, in particular, the risks of failure. They said, "Look, we have not had high defaults in the mortgage market for twenty years" ; beyond twenty years was outside the data set. Since none of them had studied any history, they forgot about the Great Depression. They forgot about the episodes, all over the world

actually, where there had been declines in housing prices. So, yes it had not happened in Iowa in the last twenty years, but it happened historically in many places around the world.

They also did not understand what are called the "tails" of the probability distribution—the likelihood of rare events. This was actually a problem that we had known about for a very long time. We had a financial crisis in 1987, when stock prices went down. People had created a particular kind of financial innovation that forgot about these kinds of small probability events. We have been having events every ten years that are supposed to happen (in their models) only once in a century. That should have told them that their models were wrong. They ignored the warning.

One of the ironies, of course, is that Myron Scholes and Bob Merton got a Nobel Prize for their work in asset valuation, using a particular model based on the log normal distribution. Using that model they set up a hedge fund, which had to be bailed out in 1998, because it underestimated these small probability events. Their model was wrong.

Again, one might have thought, having seen over and over again that the standard finance models failed in multiple ways are (including in anticipating the problems posed by the occasional disappearance of liquidity), that participants in financial markets would have learned. But people are very resistant to learning, and so we have exactly the same problem.

Had the students stayed for the second third of my lecture, I would have explained all of this to them, but they were already down trying to gamble on Wall Street using the first part of the lecture. The third part of the lecture was about how securitization creates a new problem of information asymmetry. As I mentioned, in the old days, when people originated a mortgage, they held on to it, and that meant they had an incentive to make sure it was a good risk. If they made a bad loan, they bore the consequences. However, with the new securitiza-

tion, they found someone in Europe to buy their mortgage, and so the originators did not have to bear the risk. Of course they each tried to pass it on like a hot potato to somebody else. The irony of course is that as they were "slicing and dicing" these loans, they wound up keeping a residual risk, which is the tail of the distribution that they had totally underestimated. That was what blew up on them and is one of the factors that has contributed to this financial disaster.

These are some of the obvious problems that both the regulators and those on Wall Street should have been aware of but were not. There were some other funny things going on that both those on Wall Street and the regulators should have been aware of but, again, were not. Let me give you just a couple of examples. One of them was, I mentioned, these liar mortgages that were close to 100 % of the value of the house. In the United States most of the mortgages are, in effect, what are called non-recourse mortgages. Non-recourse mortgages mean that if the price of the house goes down below the value of the mortgage, you just give the keys to the bank and walk away. The lender has no recourse, that is, he can't go after your other assets. What does that mean ? That means that the mortgage is an option. That is to say, if the price of the house goes up, you get to keep the difference between the price that you paid and the price of the value of the house. If the price goes down, you walk away and leave it with the lender. Giving a mortgage like that was, in effect, giving away, at least potentially, large amounts of money to lower-income individuals.

Now, it is not part of the practice of American banks to give away money, at least to poor people. It is one thing to give money away to CEOs and other executives, but to give away to people you do not even know, and especially poor people, is just not part of standard business practice. Thus, you have to ask the question : "What were they doing ?" The answer is pretty clear. They were manufacturing pieces of paper that had written on them : A Mortgage. They were selling these pieces of paper to people who did not understand the risks, and then they were "slicing and dicing" them, making them

even more complicated. Again, it's one of those things where the regulators should have been aware that something very funny was going on.

The second thing that they should have been aware of, or worried about, was that the rating agencies were being paid by the people that they were rating, which is a conflict of interest. In fact, there was a competition among the rating agencies that made it even worse. The investment banks would go to two different rating agencies and say, "If you don't give me a better rating I'll go to the other guy." Thus, you had, you might say, a race to the bottom, and it is not surprising that the rating agencies' ratings were so out of tune with reality. (Like so many things about this crisis, the problems have arisen many times before. The rating agencies had given Thailand a very good rating in the years before its 1997 crisis, until the day before it collapsed.)

The regulators should also have been worried about the incentive structures which were designed to encourage excessive risk-taking throughout the financial sector. The pay was based on performance year by year, not long term. They got bonuses if things did well, but they did not have to give back money when things went badly. These short-term, asymmetric compensation schemes that were designed, in effect, to combine short-term focus with excessive risk-taking. They worked perfectly, in the sense that they did exactly what they were designed to do. In the years before the crisis, I was surprised when these problems were not showing up. I just had to be a little patient until they did.

These were the obvious problems that should have been of concern even for a regulator who didn't understand much about finance. There were some problems that were more complicated ; although, if people had studied a little history, they would have been aware of potential serious consequences ahead. For instance, some of the financial institutions thought they had bought insurance for some of the risk that they faced, but when you buy life insurance, you want to

make sure the company that you buy insurance from is going to be around when you die. If you are going to buy insurance against the risk of some kind of volatility, you want to make sure that the company from which you buy the insurance is going to be around and does not go bankrupt. Now, we have very strong regulation of life insurance, but we had no regulation of the kind of insurance that financial institutions were buying to manage their risk.

In the East Asian crisis, a decade ago, this was a major problem. Korea thought it had managed a lot of the risk : they thought that they had obtained cover, as it is called, against certain risks from a firm in Hong Kong. However, the company that they had bought the insurance from went bankrupt, and they were left bearing the risk. That is exactly what happened in the United States. For instance, one of the reasons why the government bailed out AIG was that Goldman Sachs and many other companies had bought insurance from AIG to cover the risk which they faced. If AIG went bankrupt, their risk exposure would have gone through the roof. Again, it should have been obvious if they had read a little history. They would have known that you have to be careful. (Indeed, they did take some care—belying concerns that AIG's bankruptcy would have systemic effects. Others, however, do not seem to have done so.)

A closer look at the macro-economic problems

So far, I have described the failure of the financial system to do what it should have done to manage risk and to make good loans. The responsibility of the failure lies with the banks, but inadequate regulation allowed them to get away with it. Behind the whole thing, though, was a macroeconomic problem. It was not only bad regulation, but the Federal Reserve had flooded the economy with liquidity. When I began this discussion, I said, "Why does America invest too much in housing ?" The question is, why did the Fed flood the market with liquidity ? Why did it keep interest rates so low for so long ? The answer to that is actually not that complicated.

As the country entered the new millennium, the underlying macroeconomics of the United States was not very good. When the tech bubble broke, the economy needed a stimulus, and the Bush administration passed a tax cut that was not designed to stimulate the economy but to give a tax cut for upper-income Americans. It succeeded in making upper-income Americans better off, but it did not provide much of a stimulus.

Then the U.S. went to war in Iraq. The effect of the war was, in part, to help drive up the price of oil. The price of oil was $23 to $25 per barrel before the war, just five years ago, and then it went up to $140 and back to $93. Why is that important ? Americans, in effect, were spending literally several hundred billion dollars a year extra importing oil. In the 1970s when we had the oil price shock and oil prices went through the roof, much of the world went into an economic downturn. There was one region that avoided it, and that was Latin America. We seemed to follow the Latin American example, and I will describe what they did. Unfortunately, we did not study it very carefully—we did not appreciate the long-run consequences.

All that money going to the oil-exporting countries should have weakened the American economy. However, it did not show up in the data. Some people said : "Oh, there are new economic laws." Whenever anybody says that, you ought to be suspect. What was going on was pretty obvious. The Fed recognised the weakness in the U.S. economy and that fiscal policy was not working in the way it should. It also recognised that we were spending a lot of money on the Iraq war, but some of the money was going to hire Nepalese or other foreign contractors in Iraq, who were spending their money in Iraq, which does not come back and stimulate the economy as much as it would if we had actually spent the money in the United States.

The burden was left on the Fed. What did the Fed do ? It kept interest rates lower than it otherwise would have and let there be a flood of liquidity, and it worked, in a short-sighted way. We had a housing bubble, and the result of the housing bubble was that Amer-

icans could take a huge amount of money out of their housing. (Making it easier for people to borrow against the equity in their houses was again one of the innovations of America's financial markets.) In one year alone, Americans took 950 billion dollars in mortgage equity withdrawals, and much of that went into consumption. Our savings rate went down to zero. We made up for the fact that we were spending so much to buy oil from Kuwait, Venezuela, and other countries by consuming so much. We kept our domestic consumption up, but we were living on borrowed money and on borrowed time, and it was unsustainable. It was inevitable that there would be a day of reckoning. The Bush administration hoped it would happen after November. However, like many other things, they did not get it quite right.

I mentioned before that there was one part of the world that managed to avoid a recession in the 1970s, and that was Latin America. How did it do so ? It borrowed and borrowed and borrowed, which allowed it to sustain a consumption boom and to continue to grow even as oil prices remained high. But then what happened ? In 1981 it could not pay the debts. Country after country in Latin America went into a debt crisis. Sound familiar ? Latin America then faced what is called the "lost decade," a decade of stagnation. Hopefully we will not go through that same process, but it is an important warning. It seems as if the Bush administration and the Fed saw the success of Latin America but forgot about the second chapter : what happens after you borrow so much.

These were the macroeconomic forces that actually provided the liquidity that drove the financial problem that drove the liquidity problem – that is the way that all three of these problems are interrelated.

The Bail-out

That brings me now to the second part : what about the bail-out ? One of the candidates in America's presidential election said, "We

would feel a lot better about the bail-out if we stopped calling it a bail-out and called it a rescue." My view is that a rose by any other name is just as sweet. I think Americans can see through the name. It is not the name that is the problem ; it is the policy which is based on a version of "trickle down economics." You throw enough money at Wall Street and the financial markets, and some of it will trickle down to the rest of the economy and solve our problem. That is the hope. A better analogy would be to describe it as giving a massive blood transfusion to somebody with internal haemorrhaging, without doing anything about the internal haemorrhaging, which in this case is the problem of the foreclosures.

For those of you who have not followed the details, the bail-out plan I am discussing is called the Paulson Plan, which basically has the American government buying 700 billion dollars of bad assets from the banking system and the financial institutions. The government is supposed to pay fair market value for these assets. If it does that, it is just changing one asset for another asset but giving it a little liquidity, which is the positive side. However, it does not address the basic problem that I mentioned before, which is that the banks made some bad loans and are going to incur losses on those bad loans. People are not repaying the loans : that is the 3 million foreclosures already, the 2 million that are about to happen. The real estate is really just the beginning of the story ; there are credit card problems and other problems in the financial system. Those are what could be described as the holes in the balance sheet of the banks.

Many people suspect that the real agenda in the Paulson Plan is to pay more than these assets are worth, and by paying more you have a hidden recapitalisation of the banks. In effect, you are giving money to the banks by overpaying for these assets. That is at least one of the interpretations for why in the original bill they said there was going to be no oversight and no judicial review of the purchase prices or anything about the acquisition of these assets. You can understand why Congress felt a little nervous about giving a blank cheque of 700 billion dollars to somebody so closely connected with

Wall Street, so they put in some oversight but did not address the fundamental problem.

The bailout does not address the holes in the balance sheets (except surreptitiously, through overpaying for the assets) or the underlying problem of the foreclosures.

The fundamental problem is that we had a housing bubble. Prices were too high, and now they are coming down. They have only come down about half that they eventually will, assuming that there is no overshooting. If there is overshooting, which means that prices go below where we are going to be in the long-run and then bounce up, things will be even worse. Even if there is no overshooting, there is likely to be many more foreclosures unless we do something about it.

The Impending Recession

Even if the programme works, the economy is headed for a real economic slowdown. There already is a credit crunch, balance sheets have been weakened, and people have seen share values and housing prices go down. Standard economic theory would predict, under these circumstances, that there would be a slowdown in economic activity. State and localities are facing a financial crisis. Revenues have plummeted in New York, California, and all over the country, and because they all have balanced budget frameworks, they have to cut back expenditures if their revenues go down. As they cut back expenditures, the economy slows down even more. We are just in the beginning of the slowdown of our economy.

The bank bail-out does not, however, provide any direct stimulus to the economy. In fact, the President has threatened to veto a bill that would provide extended unemployment insurance. America has probably the worst unemployment insurance system of any of the advanced industrial countries : 26 weeks, with very low replacement rate and very low coverage. Members of Congress wanted only to extend coverage duration from 26 weeks to 39 weeks, as it becomes

increasingly clear that many people are running out of their 26 weeks as the economic slowdown extends. There have been no net jobs created this year in the American economy. Last month, as you know, about 150,000 jobs were lost. Every month more and more jobs have been lost, and yet the President has said he will veto a bill that would increase unemployment insurance and extend it to 39 weeks. The consequence of this is that the underlying problems are not being addressed.

What is to be Done ?

Where do we go from here ? What should be done ? What is my set of proposals ? Right now the prospects for the economy both in the U.S. and in Europe are bleak. The United States not only exported its toxic mortgages to Europe, but it has also been exporting our economic downturn. About six months ago, there was a lot of discussion in Europe about decoupling, saying that Europe is now decoupled from the U.S. and that if the U.S. goes into a downturn Europe will be immune. I do not think that anybody is talking about that anymore. That was always a myth, and there are actually serious concerns about a slowdown in Europe. There would have been a slowdown simply because of the problem of exports. That is to say, the euro has been very high while the dollar has been low, which has been good for U.S. exports but bad for Europe's exports. In fact, in the second quarter of this year, U.S. growth would have been negative but for our increase in our net exports. The U.S. has been sending thank-you-notes on a regular basis to Trichet for keeping interest rates high, which kept the euro high. This was good for the American economy, but it has at the same time hurt Europe. In our globalized world, we are all linked together.

It is worse, obviously, because some of the financial practices and the deregulation mantra spread from the United States to Europe. We are seeing now some of the weaknesses in the European financial institutions, and that is feeding back into the United States. Some of the reasons that the United States' markets have been weak today are the worries about what is going on in European financial markets.

I mentioned earlier the political problems in the United States, because of the election, and the difficulty that we have in addressing the crisis. Europe has two of its own problems. The first is that in some parts of Europe there remains a strong ideology that makes it difficult for them to deal with the crisis. Let me give you an example : There is a strong view in some parts of Europe that there should not be comprehensive deposit insurance. The notion is that individuals should be responsible for oversight of where they put their money. I believe in individual responsibility, but think for a minute about what the suggestion that individuals oversee the banks in which they deposit their money implies. If the banks do not know their own balance sheets, and if the regulators cannot figure out the banks' balance sheets, how are any of you supposed to figure out the balance sheets of the banks in which you are putting money ? I sometimes jokingly say, if I were to do that job, I would have to stop working and would not have any money to put in the bank. Even if I did it full-time, however, I could not assess what the prospects of Citibank were. I have no way of knowing what their liabilities are. Oversight has to be a public function. It is what economists call a public good. One way of thinking about deposit insurance is that it simply reflects the government's guarantee that it has done its job appropriately. In times of crisis it is even more imperative, because if you do not provide deposit insurance, it is so clear what rational individuals will do : they will find some place to put it safely. They can put it in government Treasury bills, or they will put it in some country that does provide deposit insurance. In effect, by saying that you are not going to provide comprehensive deposit insurance, you are inviting a run on the financial system.

It seems to be a policy issue with a fairly clear answer, but ideology in some countries is stopping what would be a reasonable policy.

The second problem in Europe is the fragmentation of decision-making, the fact that there is not cohesiveness in the decision-making process.

A bail-out plan

Let me just very quickly describe what I would argue for. One of the underlying problems is the lack of capital in the financial system, so there is a need for capital injections. An efficient way is to do what Sweden and many of the other Scandinavian countries did, through nationalisation of the banking systems and then re-privatizing them.

There are other ways. In the United States we talk about the way that Buffett did it. He gave Goldman Sachs some capital and in return got preferred shares and warrants. He protected his interests. The question is, will Paulson protect America's interests as it goes about this financial restructuring ?

A Mortgage Plan

In those parts of Europe, like the UK, and in the United States, we have to do something about the foreclosure problem. I will suggest a few simple remedies. In the United States we need bankruptcy reform, or what I have called "Homeowners' Chapter 11." We also need to help poor people stay in their homes. In the U.S. we pay 50 % of the housing cost of rich people by tax deductions of interest payments and real estate taxes, but we pay nothing for poor people. This is a very strange social policy. We ought to convert that tax deduction to a tax credit, which would help lower-income individuals stay in their homes. Additionally, we need to have a government lending programme, because the private lending programme is going to be contracting. A government loan programme could also provide funds at lower interest rates. The unavailability of mortgages will mean that housing prices will be depressed even more and the problems will be exacerbated.

Restoring Confidence

Everybody agrees that one of the essential aspects of recovery will be restoring confidence, but the question is : how do you restore con-

fidence ? In my own mind, you have to restore confidence by doing something real, not just talking, which means you have to have policies that address the underlying problems, such as the ones I have discussed. Additionally, the reason we got into this crisis was excessive deregulation, though to put it more accurately, it is not deregulation or regulation but designing a regulation system for the 21st century to take into account the amazing changes that have occurred in our economy in the last 75 years. We need a new regulatory system, and we have to remember one of the problems was that our regulators did not do their job—they did not even enforce the inadequate regulations that we had.

Traditionally the regulators' job is to take away the punch bowl when the party gets too raucous and people get too drunk. The problem was that Alan Greenspan kept refilling the punch bowl as the party got more raucous. Nobody wanted to be a party-pooper. I understand that, but by letting the party go on and on, it meant that the clean-up was a lot messier than it would have been if we had stopped it a little bit earlier. That highlights the point that we need to think about regulatory structures, incentives of regulators, and the design of the regulations to make them simpler to implement. For instance, we need to focus on changing the incentive structures, making them more transparent and more balanced. We need speed-limits. We need a financial product safety commission, since a lot of these financial products were unsafe for human consumption. We have a food safety commission to make sure that the food we eat is safe ; we ought to have a financial product safety commission to make sure that the financial products are safe, or at least safe enough to be put into pension funds or commercial banks that are guaranteed by taxpayers.

I am one of those who believe that consenting adults should be allowed to do a lot of things as long as they do not harm other people. However, the financial institutions have harmed other people : they have asked the taxpayers to come to their rescue to the tune of a trillion dollars or more. Those who harm others have to face regulations stopping them from doing so.

We also need a financial market stability commission. One of the problems is that we have created systemic leverage that is different from the old kind of leverage. We need to understand it better, and we need to regulate that systemic leverage that we have actually not even tried to deal with.

Finally, a question I often get asked is : are we headed for another depression ? One of the answers that I have is that we have the knowledge to avoid it. There is no reason why this financial turmoil should turn into a downturn of the magnitude that we had during the Great Depression. The question is, however, will we use that knowledge ? In the past we have failed, and we should be aware of that. For instance, the IMF and the U.S. Treasury went into Indonesia in 1997 and closed 16 banks. They said, "By the way, we're going to close some more. We're not going to give you deposit insurance, but we're not going to tell you which ones we're going to close." What do you think happened the next day ? There was a run on the financial system. They followed with a series of bail-outs for the country that were badly designed, and in the end they managed to provoke a deep depression. Unemployment on the main island of Java reached 40 %. They outdid America's Great Depression, and that is what bad policy can do.

I do not mean to scare any of you. Remember, we were forcing a policy onto Indonesia, and Indonesian voters really did not have much say. We have a democracy, which will protect us from those kinds of abuses to which we have subjected countries around the world. The point that it does bring home is that we have not always used the knowledge that we have to avoid downturns and to manage these situations as well as we should. In many ways, the prospects for the U.S. and Europe depend on how well we use the knowledge that we have to avoid converting this financial crisis into a serious economic downturn.

Thank you.