ATLANTIC COUNCIL

IDEAS. INFLUENCE. IMPACT.

MAPPING THE ECONOMIC AND FINANCIAL FUTURE

A SPEAKERS' FORUM HOSTED IN PARTNERSHIP WITH

Deutsche Bank

The Atlantic Council is a nonpartisan organization that promotes constructive U.S. leadership and engagement in international affairs based on the central role of the Atlantic community in meeting today's global challenges.

Atlantic Council

IDEAS. INFLUENCE. IMPACT.

MAPPING THE ECONOMIC AND FINANCIAL FUTURE

A SPEAKERS' FORUM HOSTED IN PARTNERSHIP WITH

Deutsche Bank

A Special Series from the Atlantic Council and Deutsche Bank

The global financial and economic crisis that began in earnest with the fall of Lehman Brothers in September 2008 has fundamentally changed our world. It marked the end of a boom in finance-driven economic growth that began in the late 1970s and culminated in the bursting of the U.S. housing bubble in 2007. We are now at an inflection point that marks a period of transition in how we think of our global economy and the role of the financial sector. Our ultimate destination is by no means certain.

In March of 2009 the Atlantic Council and Deutsche Bank partnered to develop a speakers' forum that would help build the intellectual foundation for understanding the crisis, and shed light on how the global economy could recover. We have entitled this effort "Mapping the Economic and Financial Future."

For the past two years we have brought together the top minds from business, government, and global financial institutions to provide their insight into the causes of the crisis, assess the likely effects, and, most importantly, identify solutions.

This report is an effort to summarize two years' worth of rich and deep discussions. We have done our best to capture the essence of our speakers' thoughts, but we encourage you to read the transcripts or listen to the audio of the discussions, which can be found on the Atlantic Council's website (www.acus.org). We believe you'll find this a remarkable collection of knowledge and wisdom.

We wish to thank Deutsche Bank, and in particular its chief executive, Josef Ackermann, for his vision in pioneering this project as a member of the International Advisory Board. We also wish to thank both Caio Koch-Weser and Frank Kelly of Deutsche Bank for their support of Atlantic Council activities and stewardship of this series. Caio has been a tremendous leader of our Business and Economics Advisory Group, and Frank has long been a distinguished board director here at the Atlantic Council. This project is a flagship effort of our Global Business and Economics program, directed by Alexei Monsarrat. We would also like to think Darrell Delamaide for putting all of the fantastic ideas generated throughout this series onto paper.

The Atlantic Council is rooted in the belief that the transatlantic relationship is essential to solving global problems. The global economy has begun a slow and tentative recovery. Transatlantic leadership is crucial to cementing that growth and ensuring that the unprecedented benefits of our combined economies continue to serve as a model for global prosperity.

Chuck Hagel
Chairman

Frederick Kempe
President and CEO

June 2011

Table of Contents

Featured Speakers

Neelie Kroes
EU Commissioner, Competition
March 26, 2009

From 2005 to 2009, Kroes led the Directorate General for Competition at the European Commission. She was the senior European Union leader overseeing policy for state aid and bailouts, and was responsible for promoting fair and open competition throughout the 27 member states of the EU. Since 2010, Kroes has been EU Commissioner for the Digital Agenda, and is a vice president of the European Commission.

Josef Ackermann
Chairman of the Management Board, Deutsche Bank
May 1, 2009

Dr. Josef Ackermann serves as the chief executive officer of Deutsche Bank AG. Dr. Ackermann has been the chairman of the Management Board and the Group Executive Committee of Deutsche Bank AG since February 1, 2006, and has also been a member of the Management Board since 1996. Under his leadership, the investment banking business became one of Deutsche Bank's principal sources of revenue, joining the top tier of global investment banks within a few years. Additionally, Dr. Ackermann is a member of the Atlantic Council's International Advisory Board.

Youssef Boutros Ghali
Finance Minister, Egypt
May 13, 2009

In addition to serving as Egyptian finance minister, Dr. Boutros Ghali serves concurrently as the chair of the IMF's International Monetary and Financial Committee. He is credited with implementing a series of reforms that helped modernize and reinvigorate the Egyptian economy and deepen its global integration. Chief among these are major income tax and trade reforms, coupled with deregulation and liberalization in key areas of economic activity.

Charles McCreevy
EU Commissioner, Internal Market and Services
June 1, 2009

Charles McCreevy was the European commissioner for the Internal Market and Services from 2004 until 2009. In this capacity, McCreevy had a crucial role in overseeing the European financial system and the regulations governing the banking system, and the development of a single market in financial services throughout the European Union.

Timothy Adams
Managing Director, the Lindsey Group
June 18, 2009

Tim Adams is managing director of the Lindsey Group, and previously worked as Under Secretary of the Treasury for International Affairs during the Bush Administration. Prior to that, he held posts in the White House Office of Policy Development working on economic issues, as well as serving as the chief of staff at the Treasury Department. In addition, Mr. Adams is a member of the Atlantic Council's Board of Directors and its Business and Economics Advisory Group.

Nancy Birdsall
President, Center for Global Development
October 13, 2009

Nancy Birdsall is the Center for Global Development's founding president. Prior to launching the Center, she served for three years as senior associate and director of the Economic Reform Project at the Carnegie Endowment for International Peace. Previously, she was executive vice president of the Inter-American Development Bank, the largest of the regional development banks, where she oversaw a $30 billion public and private loan portfolio. Dr. Birdsall also serves on the Atlantic Council's Business and Economics Advisory Board.

Robert Zoellick
President, The World Bank
December 10, 2009

Since 2007, Robert B. Zoellick has been the 11th president of the World Bank Group. He formerly served as vice chairman (international division) of the Goldman Sachs Group, managing director, and chairman of Goldman Sachs's Board of International Advisors. Before that, Mr. Zoellick served as the Deputy Secretary of the U.S. State Department—the Department's chief operating officer and policy alternate for the Secretary of State. He previously served as the 13th U.S. Trade Representative.

Gary Gensler
Chairman, Commodity Futures Trading Commission
January 12, 2010

Gary Gensler was sworn in as the chairman of the Commodity Futures Trading Commission on May 26, 2009. Chairman Gensler previously served at the U.S. Department of the Treasury as Under Secretary of Domestic Finance and as Assistant Secretary of Financial Markets. He subsequently served as a senior advisor to the Chairman of the U.S. Senate Banking Committee, Senator Paul Sarbanes, on the Sarbanes-Oxley Act, reforming corporate responsibility, accounting, and securities laws.

Leszek Balcerowicz
Former Finance Minister, Poland
February 25, 2010

Dr. Leszek Balcerowicz is a professor of economics at the Warsaw School of Economics (WSE), a former deputy prime minister and minister of finance of Poland, and the former president of the National Bank of Poland (NBP). He was the chief architect of Poland's economic reforms initiated in 1989, and has been at the center of Poland's economic and political life since the fall of communism in Poland in 1989. Balcerowicz is also a member of the Atlantic Council's Business and Economics Advisory Group.

Christine Lagarde
Finance Minister, France
April 22, 2010

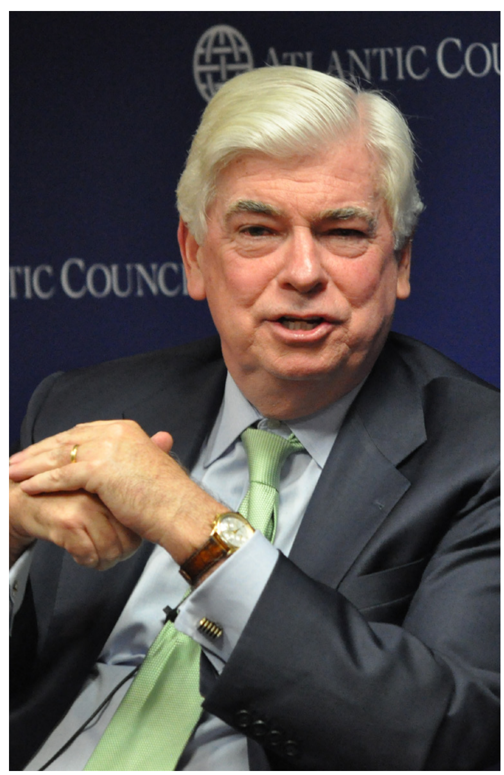
Christine Lagarde is the current minister of finance of France, appointed in June 2007. She was previously minister of agriculture and fishing and minister of trade in the government of Dominique de Villepin. Lagarde is the first woman ever to become finance minister of a G8 economy. Previously, she served as the first-ever female chairman of the international law firm of Baker & McKenzie. In 2009, she was named the best finance minister in the Eurozone by the *Financial Times*.

Christopher Dodd
Former Chairman, U.S. Senate Banking Committee
August 4, 2010

Chris Dodd was the senior U.S. senator from Connecticut until 2010. He was the first U.S. senator in Connecticut history to serve five consecutive terms. During three decades in the Senate, Dodd gained the top position on the Senate Banking Committee, where he spearheaded the successful drive for financial regulatory reform following the 2008–2009 financial crisis. The landmark Dodd-Frank Act was enacted in July 2010.

Michel Barnier
EU Commissioner, Internal Market and Services
October 29, 2010

As Commissioner for the Internal Market and Services, Barnier is responsible for giving a new momentum to the Single Market while driving the Commission's initiatives in the field of financial services, public procurement, free movement of services, intellectual property, and professional qualifications. He has previously served as president of the French delegation of the European People's Party, French Minister of Agriculture, as well as French Minister of Foreign Affairs.



Clockwise from top: Bertelsmann executive director **Annette Heuser**; EU Commissioner for Internal Market and Services **Michel Barnier**; Atlantic Council chairman, U.S. Senator **Chuck Hagel**; U.S. Senator **Christopher Dodd**; French Finance Minister **Christine Lagarde**; Atlantic Council President and CEO **Frederick Kempe** and EU Commissioner of Internal Market and Services **Charles McCreevy**

Clockwise from top left: Deutsche Bank chief executive **Josef Ackermann**; World Bank president **Robert Zoellick**; Deutsche Bank vice chairman **Caio Koch-Weser**; Former Under Secretary of the U.S. Department of the Treasury **Timothy Adams**; and EU Commissioner for Competition **Neelie Kroes**

"This is a crisis of monumental proportions; it has features that we have not seen in any of the crises we have gone through in the past several decades—namely a coincidence of a financial collapse with an economic collapse."

Egyptian Finance Minister Youssef Boutros Ghali

"The fact is that we have a series of earthquakes, and even worse: ever-changing epicenters. So once it was the subprime, then it was the leveraged loan, then it was commercial real estate and another one."

Deutsche Bank Chief Executive Josef Ackermann

"I think that 2010 and onwards might be years of subtlety, where we have to both combine this continuation of the stimulus packages that we have under way in many places around the world, while at the same time removing some of these public support programs so that we can restore public finance and bring our deficits back, as well as reduce our debt-to-GDP numbers."

French Finance Minister Christine Lagarde

INTRODUCTION

In 2008 and 2009 political and business leaders scrambled to stabilize the financial system and avert a slide into world-wide depression as a financial crisis of historic proportions spread across the globe. A series of bold emergency measures succeeded in defusing the crisis, and these same leaders began searching for ways to avoid a similar breakdown in the future. At the same time, the effort to restart economic growth and job creation began in earnest.

The Atlantic Council, in partnership with Deutsche Bank, launched a series of public discussions designed to engage top officials on the front lines of this fight in the search to understand the crisis, and to seek solutions. The series, titled "Mapping the Economic and Financial Future," began in March 2009 and continues today. This report charts the themes of the discussions through 2010, and offers the wisdom and foresight of some of the world's leading minds on financial issues.

Speakers included current and former finance ministers, European commissioners, the president of the World Bank, the head of the International Monetary and Financial Committee, the chief executive of Deutsche Bank, the chairman of the Senate Banking Committee, and other leading experts.

As a group these speakers examined:

- the causes and effects of the economic crisis;
- the role of state intervention in dealing with it;
- methods to address global imbalances;
- reform of the financial sector;
- the importance of international coordination; and
- ways to put the global economy back on the road to growth.

As a group, the speakers presented a remarkably lucid picture of the crisis, and made a substantial contribution to building the intellectual framework for understanding the crisis. They often anticipated subsequent developments with clairvoyant accuracy, and the discussions form a timeline of coping with a crisis that is still not fully over.

Key Messages

- The crisis began in the United States, but Europe and other countries also bear responsibility.
- The interconnectedness of global financial markets made this an unprecedented crisis.
- The speed and global reach of the crisis, and its deep impact on the real economy, will drive lasting, fundamental changes to:

  - Public trust in the financial services sector: Citizens are challenging the value of unfettered financial markets.

  - Government's oversight of financial markets: In response, governments will drive an era of reregulation.

  - Financial market structure: New rules will more aggressively manage risky activities.

Effects of the Economic Crisis

The Unraveling

The story of how the crisis unfolded is by now reasonably well understood and agreed upon: The popping of the U.S. housing bubble triggered a chain reaction that stunned leaders in the public and private sector alike. The decline in housing prices led to defaults on subprime mortgages, which in turn devalued structured securities that had been around these mortgages.

The inability to understand the composition of these structured securities made pricing them nearly impossible, sparking fear that the entities holding these assets—many of which were deeply interconnected—could no longer cover the potential losses. This therefore threatened the solvency of many of the banks, insurance companies, and hedge funds holding structured debt.

When the government let one of these banks—Lehman Brothers—go bankrupt, short-term credit markets dried up overnight, creating a liquidity crisis that froze the global financial system, sent global trade plunging off a cliff, and ultimately drove the global economy into the deepest recession since the 1930s.

"People always said this was a financial tsunami," Deutsche Bank CEO Josef Ackermann said at a May 2009 event. "That is absolute nonsense. A tsunami is—the way I understand it, and from what we have seen in Asia—is one big wave or maybe a second big wave. If the subprime crisis would have been the tsunami, it would have been more or less okay. I think we would have coped with that in the global context."

Ackermann, who is also chairman of the Institute of International Finance, a group comprising the world's major banks, found another metaphor more descriptive. "The fact is that we have a series of earthquakes, and even worse: ever-changing epicenters," he said. "So once it was the subprime, then it was the leveraged loan, then it was commercial real estate and another one."

For this reason, Ackermann concluded, "The current financial crisis will prove to be a watershed event—not just because of the severity of the recession, but also as a period that reshapes our political system."

From his vantage point as chairman of the International Monetary and Financial Committee of the IMF, Egypt's Boutros Ghali viewed the 2007–09 crisis as distinctively dangerous because of the worldwide economic repercussions.

"Financial collapses alone are manageable," he said. "The crisis of the late '80s in Wall Street, and again in the early '90s. Even the crisis of Southeast Asia in '97, which was mostly financial, spilled over into economic crisis but, in a sense, was contained." This was not the case with the recent crisis.

> ***"The fact is that we have a series of earthquakes, and even worse: ever-changing epicenters. So once it was the subprime, then it was the leveraged loan, then it was commercial real estate and another one."***

International Failure with Global Impact

Speakers rejected the notion that even though subprime mortgages in the U.S. triggered the crisis, it should be seen as an exclusively American phenomenon.

"There are some of you who would like to delude themselves that this was a purely American virus," said Charles McCreevy, European commissioner for the Internal Market and Services. "Let me say this here and let me say it clearly: There were business and regulatory failures on both sides of the Atlantic."

In a June 2009 event, McCreevy, a former Irish finance minister, bemoaned the lost jobs, evictions, and ravaged retirement savings on both sides of the Atlantic. "The pain and uncertainty is felt just as much in Dublin, Ireland, as in Dublin, Maryland," he said (well before subsequent turbulence in the eurozone roiled the Irish economy even further). "Many people have seen the value of their savings plunge and may need to work longer before taking their well-deserved retirement."

"I think it's most likely that in the United States and much of Europe, you're going to see persistent high unemployment."

The economic impact was especially painful because the crisis synchronized the business cycle throughout the world, Boutros Ghali said. "Everybody is suffering," he said in May 2009. "Previously we had somebody at the bottom of the cycle and somebody else at the top of the cycle. Right now everybody is at the bottom."

Economic recovery began to take hold in the U.S. and other countries in the second half of 2009, but the story was not going to end there.

"I think it's most likely that in the United States and much of Europe, you're going to see persistent high unemployment," World Bank president Robert Zoellick said at a December 2009 event. "And what that is going to mean, is that while you've had a certain wave of bad loan effects that started with this crisis, particularly in the mortgage area, now, you're going to see some continued troublesome credits in areas such as consumer loans, credit card loans, mortgages—not because of the problem mortgages that people started out with, but if you've got 10 percent unemployment, it's just going to be harder for people to pay their mortgages."

Bitter Medicine

For Zoellick, who served as U.S. Trade Representative from 2001 to 2005, one of the consequences of a high jobless rate would be political pressure for protectionist measures. By late 2009, protectionist actions had proliferated but remained relatively small in size.

"The fact is, there are no alternatives to what we are doing and the governments are doing because of what we have seen in the Lehman case."

"So it's what I describe as a low-grade fever, not a full influenza," Zoellick said. "But playing with protectionism is always playing with fire. And so one of the dangers is, if you get into 2010 and you start to see the political pressures that could happen in different countries for people to do things to protect local markets, it can start to spiral." (His prediction proved accurate when in the summer and fall of 2010, nations complained of currency wars and competitive devaluations.)

The crisis impacted financial institutions most directly. The imminent failure of many large banks forced governments into bailouts in order to preserve the financial system. Deutsche Bank's Ackermann said there was no alternative to such actions, even though such intervention went against his principles as a free-market advocate.

"The fact is, there are no alternatives to what we are doing and the governments are doing because of what we have seen in the Lehman case," Ackermann said.

On the one hand, he continued, it was probably the right decision to let Lehman collapse for moral hazard reasons—so that people understand you can lose money when banks collapse. On the other hand, it was the wrong decision in such a volatile situation because Lehman's failure led to the loss of confidence in other banks.

"So in that sense, it was the wrong moment, but the right message," the Deutsche Bank executive said.

Several weaker players were merged into stronger institutions while others remained on life support from government funds, or in a fairly fragile state.

"The banking structure has changed dramatically," Ackermann said in mid-2009. "Let's say in the wholesale investment banking arena, we normally talked about 8 to 10 global players. This number is now down to probably 5. Some have lost out and are no longer operating in this market. And some others have clearly been so affected that they had to reduce their risk appetite."

Confidence in banks and in the global financial system has been profoundly shaken by the crisis, speakers said.

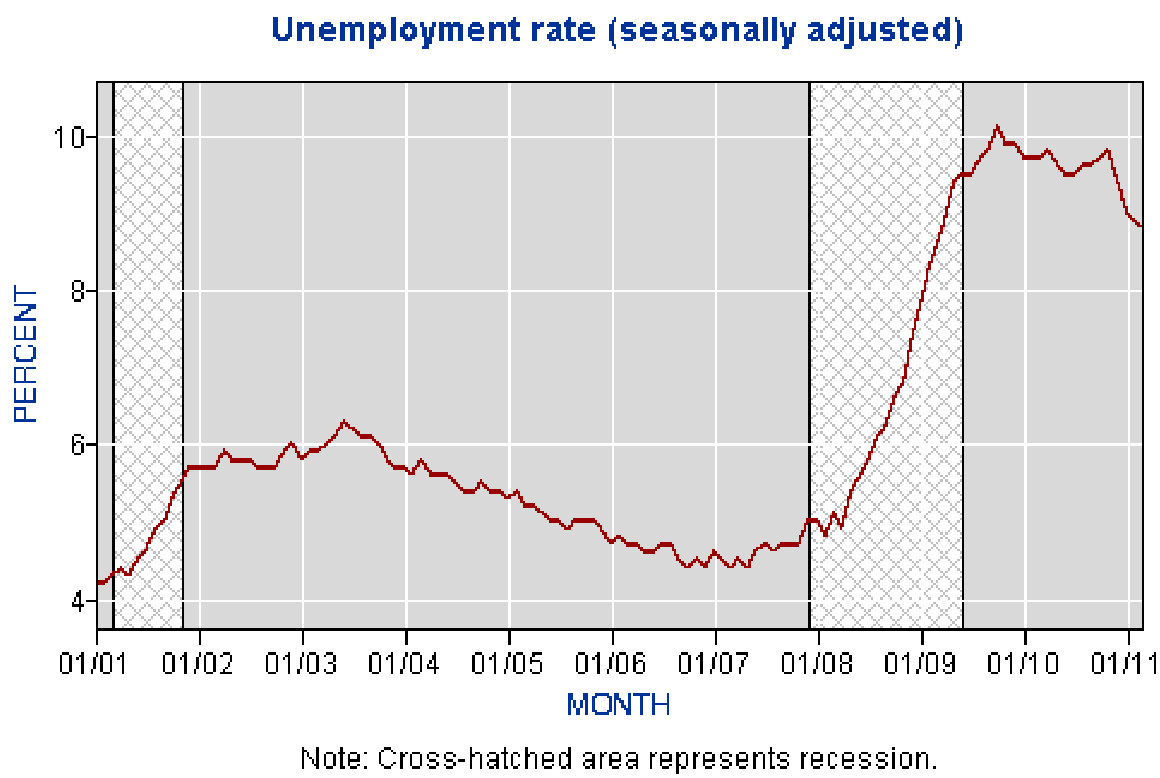
"We can no longer rely on wholesale financial markets to look after our own long-term interests," European Commissioner McCreevy said. "We can no longer rely on empty assertions that if nothing has gone wrong so far in a particular sector, [it means] that nothing will."

This is particularly true of the United States, the world's financial leader. Senator Christopher Dodd, who as chairman of the Senate Banking Committee helped shepherd landmark financial-reform legislation through Congress, saw restoring confidence as something urgently necessary in the wake of the crisis.

"We can no longer rely on wholesale financial markets to look after our own long-term interests. We can no longer rely on empty assertions that if nothing has gone wrong so far in a particular sector, [it means] that nothing will."

Dodd said that the 2,300-page bill that President Barack Obama signed into law in July 2010 was really just the beginning of a regulatory response to the crisis. Congress and regulatory agencies will have to fine-tune the law's provisions in succeeding years.

"There will be another economic crisis, I guarantee you," Dodd said. "And the question is, have we built in the structures that will allow us to respond to it intelligently?"



The skyrocketing U.S. unemployment rate was one of the most immediately apparent impacts of the 2007-09 economic crisis.

Source: Bureau of Labor Statistics, Current Population Survey. http://data.bls.gov/pdq/SurveyOutputServlet?request_action=wh&graph_name=LN_cpsbref3."Graph: Unemployment rate (seasonally adjusted)," Bureau of Labor Statistics, U.S. Department of Labor, accessed April 1, 2011.

KEY MESSAGES

- The public and private sectors have reluctantly agreed that the role of the state needed to be expanded to address the effects of the crisis, but only on the condition that intervention is temporary.
- We are deeply questioning the appropriate balance between finance-driven growth versus manufacturing-driven growth. Government will have an increased role in answering this question.
- The crisis has profoundly increased the fiscal constraints that have been building over the last three decades. This will limit the ability of government to drive growth in the medium and long term.

State Intervention

Looking for Where to Draw the Line

The financial crisis required governments to intervene to rescue banks, stabilize financial markets, and stimulate the economy. There was intense debate within countries and internationally about the right timing, amount, and methods for intervention. But early on there was strong consensus for swift, dramatic action.

> ***"I can tell you that approving dozens of bank rescues was the last thing I expected to do in 2008."***

State engagement made many of the speakers deeply uneasy because it contradicted their free-market principles. In the European Union, state intervention seemed at odds with one of the anchors of European integration—a ban on government bailouts.

"I am a strong believer in free markets," Neelie Kroes, European Commissioner for Competition, said. "With the job that normally involves fighting for less and better-targeted state aid, I can tell you that approving dozens of bank rescues was the last thing I expected to do in 2008."

Deutsche Bank CEO Josef Ackermann also reluctantly agreed that state intervention was necessary given the scope of the crisis. The financial system needed a tremendous injection of liquidity from central banks and the help of the government to restore confidence in the system: "We are confronted with a systemic banking crisis," he said in May 2009. "Hence, a trusted third party was needed. That is—and I hate to say this as a market economist—that is the state."

> ***"This ought not to become entrenched. History teaches us that private business and enterprise create wealth, and normally not the state."***

As the financial crisis drove the global economy into recession, governments had to step in again to provide some stimulus for economic recovery. European countries adopted various recovery plans in late 2008, and the incoming Obama administration in the U.S. got right to work on a stimulus package in early 2009.

"For those who are not in favor of fiscal expansions, this plan is clearly a step out of the comfort zone," Kroes, speaking in March 2009, said of the European effort. "And I am sure it was also a step out of the comfort zone for the U.S. to spend taxpayers' money to save ailing financial institutions."

The emphasis should be on the temporary nature of this state intervention, speakers said. "This ought not to become entrenched," Deutsche Bank's Ackermann said. "History teaches us that private business and enterprise create wealth, and normally not the state."

Deregulation and liberalization measures in the 1980s helped to boost growth rates, he said. Particularly in financial services, studies have shown that countries with high state ownership are less innovative and experience lower economic growth.

So states should resist the temptation to make their greater role in the economy or their partial ownership of banks permanent, Ackermann said. "Under the assumption that the private sector is normally more efficient in doing a better job to create wealth over time, only one challenge remains—namely, that governments can exit now," Ackermann said in spring 2009.

Will the Medicine Kill the Doctor?

Aside from any ideological consideration, governments need to retrench because the extraordinary support for the economy and financial system is difficult for them to sustain.

"The greater role now, seen in the context of emergency measures, risks overburdening the state in the long run," Ackermann said. "Fiscal deficits have risen to unimaginable levels approaching 10 percent of GDP in this country, and in the UK. These large fiscal expenditures burden future generations at a time when we should be reducing budget deficits rather than increasing them in light of demographic developments."

A year after Ackermann spoke, these strains began to show with a second wave of turbulence in Europe, as Greece and other countries on the periphery came under scrutiny for their unsustainable deficits.

"The greater role now, seen in the context of emergency measures, risks overburdening the state in the long run. Fiscal deficits have risen to unimaginable levels approaching10 percent of GDP in this country, and in the UK. These large fiscal expenditures burden future generations at a time when we should be reducing budget deficits rather than increasing them in light of demographic developments."

The latest revision of the European Union's Lisbon Treaty provided no mechanism for rescuing countries participating in the joint currency, even when their financial troubles disturbed the equilibrium of the whole euro area, French Finance Minister Christine Lagarde observed at an April 2010 event.

"There was, effectively, a no-bailout clause," she said, speaking of the Greek crisis in the spring of 2010. "We had to work around the treaty to make sure that we could put in place a system whereby we would build the package in association with the IMF."

"In Europe, capitalism was always less in fashion and only grudgingly accepted even after the Reagan-Thatcher revolution. Now critics of the model have been provided with new fodder. It is fairly likely that this will result in a permanently [larger] role for the state."

In the end, officials found a way to circumvent the no-bailout clause that still was in accordance with the treaty, Lagarde said. While Europe may not be known for its ability to adjust, this type of problem-solving had enabled the construction of the European Union to proceed for half a century, she said.

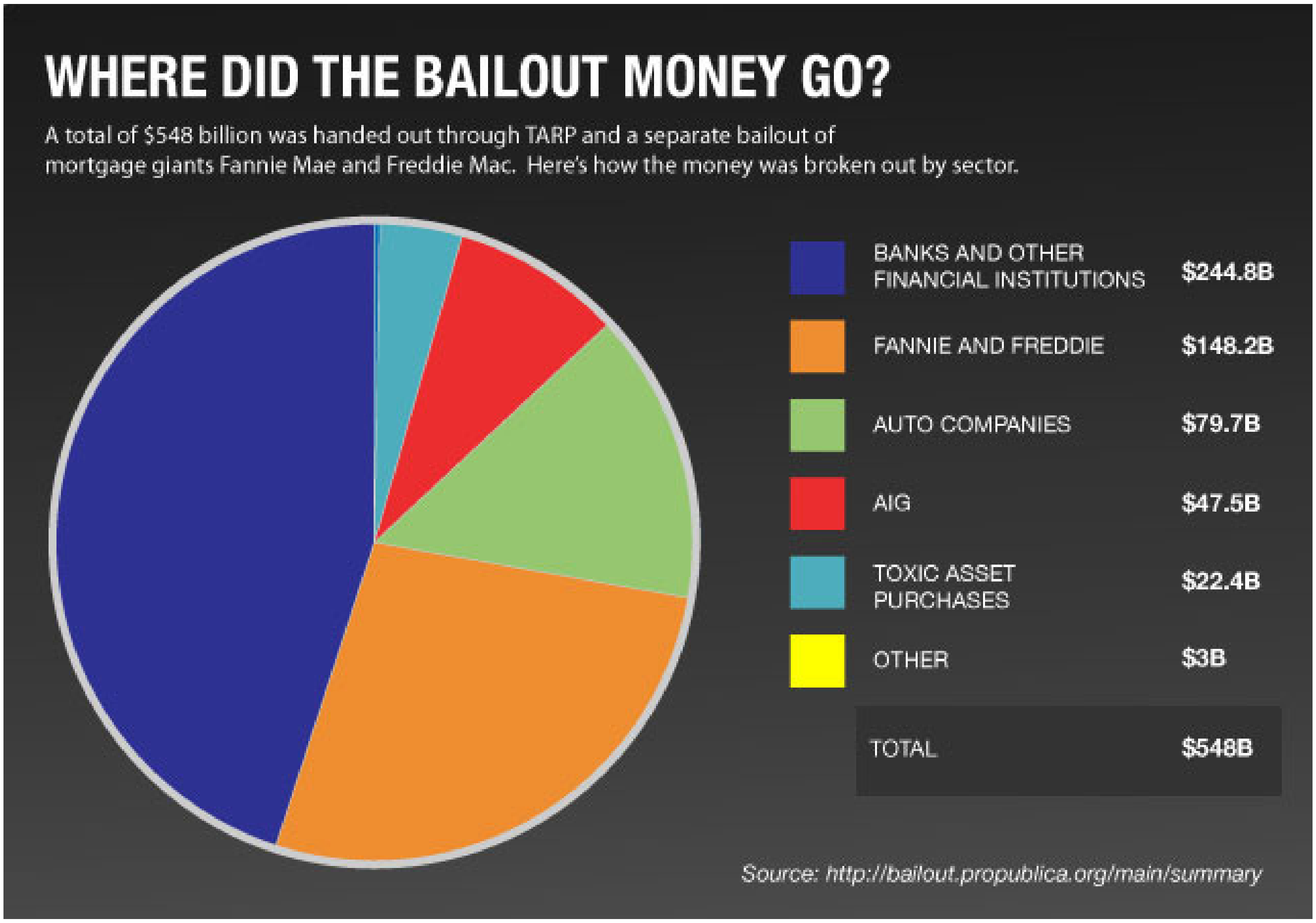
Speakers discussed the potential long-term effects of the state intervention in the wake of the financial crisis.

"You haven't seen this crisis spark a rejection of capitalism and markets," Robert Zoellick, president of the World Bank, said in December 2009. "However, what it clearly has done is opened the door to additional consideration of the role of state and markets."

The economic success of some of the developing countries as well as the actions of developed countries has encouraged the World Bank to beef up the research it does on this subject. "It's not that there's any simple formula," Zoellick said.

For some fragile states, the government has a role in institutional development, he said. "I actually think that this crisis, in a sense, has broken away some of the constrictors of thinking in this area that have developed over the past 10 or 20 years," Zoellick said.

State intervention in the crisis may leave a legacy even in developed countries, Deutsche Bank's Ackermann said.



In response to the crisis, the state intervened on an unprecedented scale to save endangered financial institutions like AIG, Citibank, Freddie Mac, and Fannie Mae.

Source: http://marketplace.publicradio.org/features/bailout-follow-the-money. Paranada, Daryl, "Infographics: Follow the Financial Bailout Money," Marketplace from American Public Media, September 30, 2010, accessed April 1, 2011.

"In Europe, capitalism was always less in fashion and only grudgingly accepted even after the Reagan-Thatcher revolution," he said. "Now critics of the model have been provided with new fodder. It is fairly likely that this will result in a permanently larger role for the state."

Ackermann cited French president Nicolas Sarkozy as capturing the impact of the crisis when he said the notion of the all-powerful market that is always right is finished.

Ackermann noted that it vindicated his own belief that markets cannot always be self-healing in the short term, and added that he was criticized for saying at the onset of the crisis that financial markets could not wait for the disequilibrium in the real estate market to correct itself.

In the wake of the crisis, there will be a new consensus on the balance between growth and equality, the banker predicted. "There will be a new trade-off between the creativity of the financial industry and its benefits for the economy as a whole, and stability," he said, predicting stricter state regulation. "The balance has clearly shifted towards advocating stability, even the willingness to forgo the benefits of a more dynamic financial sector."

KEY MESSAGES

- **Global disequilibrium in saving and consumption was a major contributor to the financial crisis.**
- **While much feared, the crisis did not significantly increase trade protectionism, but the longer recovery takes, the more political pressure will build to raise trade and capital barriers.**
- **Savers and consumers both need to participate in rebalancing, and governments need to make tangible progress on lowering trade barriers (i.e., completing the Doha round) and exchange-rate adjustments.**

Global Imbalances

Imbalances in trade and finance have direct effects on jobs and prosperity, and the factors that drove this global disequilibrium in saving and consumption have been widely cited as fundamental causes of the crisis. Rebalancing therefore becomes a solution for returning to more broadly shared economic growth.

Against this backdrop, the discussion of trade and exchange rates becomes as much a political issue as an economic one, particularly in relations between the U.S. and China.

Officials in Beijing try to keep the term *global imbalances* out of the discussion because it seems pejorative, says Tim Adams, a U.S. Treasury official in the Bush administration, but realize it is an issue that must be dealt with.

"We always need villains, and China is a convenient villain when we want to vilify someone."

"They do understand that they have a role to play, going forward, if we are to grasp these imbalances," Adams said during a June 2009 event, "if not for economic reasons, then certainly for political reasons—especially as unemployment continues to rise in the U.S."

While U.S. animosity toward China had abated somewhat by mid-2009, Adams warned that it could revive if the economy failed to recover. "We always need villains, and China is a convenient villain when we want to vilify someone," said Adams, who is now managing director of the Lindsey Group, an economic advisory firm.

"The implication is that the IMF is supposed to whisper even more in the ear of the Chinese on the exchange-rate issues, and whisper more in the ear of the U.S."

For their part, Chinese officials are consistent in their efforts to extract even the language of global imbalances from the discussion, this former U.S. official said.

"Their view is that *global imbalance* is an emotive term that is pejorative in the sense that it's [interpreted] as 'China's the problem'," Adams said.

They were successful in the Group of 20 meetings in keeping that discussion and that language out of the communiqués and trying to shift the debate. But, informally, the hope is for a more-empowered IMF to speak more bluntly with both China and the United States.

Nancy Birdsall, the president of the Center for Global Development, noted that coming out of the Pittsburgh G-20 Summit, "The implication is that the IMF is supposed to whisper even more in the ear of the Chinese on the exchange-rate issues, and whisper more in the ear of the U.S."

For China, the global financial crisis was a rapid and unexpected event. Coming on the heels of their own policy of popping the real estate bubble, there was a sense of "fear and astonishment" at how quickly the global crisis spread through the Chinese economy, Adams said.

"I suspect they wouldn't have been as aggressive in popping that bubble had they known what would succeed that," he said, "which is the collapse in global trade and collapse in exports to the U.S. and Europe and other places."

The debate between the U.S. and China about the imbalance of trade between the two countries—which had raged during Adams's time at Treasury, and which would revive again in 2010—will not lend itself to an easy resolution.

"I kept asking, 'Why can't the export sector simply reengineer itself to produce domestically?' " Adams said in recounting his trip.

Before the crisis, current account imbalances between large deficit countries like the United States and large surplus countries like China were large and getting larger quickly. Once the global economy returns to normal growth, this process looks likely to continue.

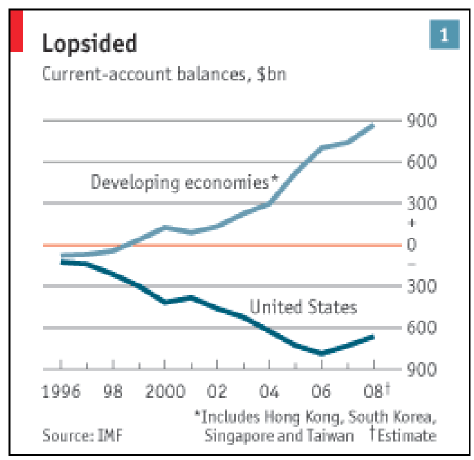
Source: http://www.economist.com/node/18011858. "Global imbalances," The Economist, January 27, 2011, accessed April 1, 2011.

Chinese officials gave him several responses. For starters, the transportation costs of moving goods from the coast to the Chinese interior are significantly higher than putting them on a ship to the U.S. or Europe. Second, producers in the interior protected their markets against the exporters moving in with anticompetitive behavior. Third, the payment risk for a sale within China was greater than for exports to the U.S. or Europe, where you get a standard letter of credit from a bank.

"So it sounded to me like many of the export firms were wedded to the export sector," Adams said. "They couldn't simply engineer and supply whatever those goods are for domestic consumption."

With regard to the perennial issue of China's currency peg to the dollar—which most economists see as a major source of the trade imbalance—Adams also found little indication of flexibility in Beijing. "We don't see much change at all, actually," he said. "I think they have decided that they're going to keep the exchange-rate issue off the front page of the newspapers, out of the headlines."

U.S. Treasury officials will tread cautiously because of the volume of debt the U.S. wants the Chinese to absorb. "I get the impression that the exchange rate is basically locked in place," Adams said.



The current account surpluses of the developing economies are growing ever-more rapidly as they export increasingly to other developing economies, becoming less dependent on traditional trade partners like the United States and Europe.

Source: http://www.economist.com/node/12972083?story_id=12972083 "Global economic imbalances: When a flow becomes a flood," The Economist, January 22, 2009, accessed April 1, 2011.

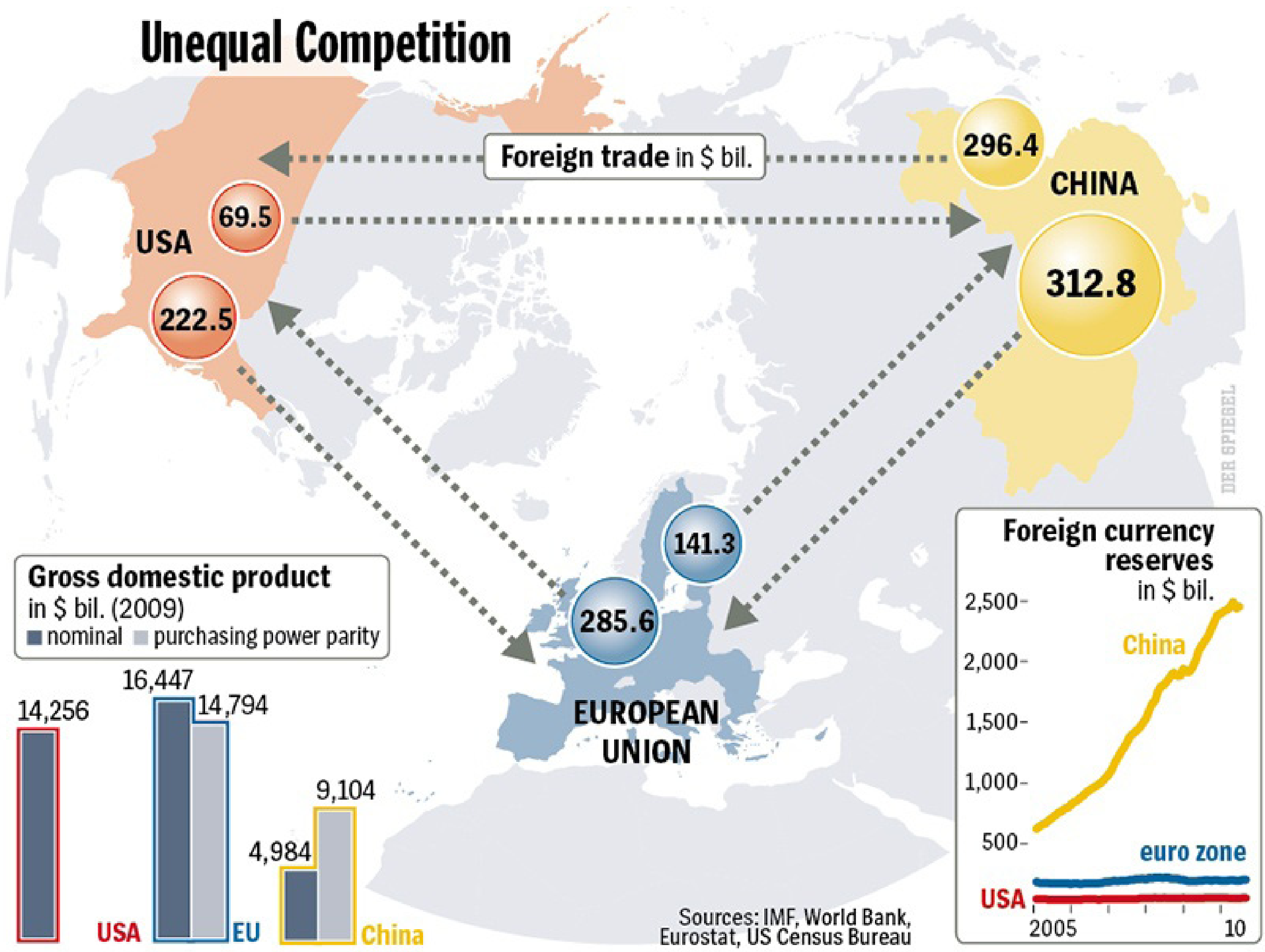
But Chinese officials did seem interested in becoming less dependent on Europe and the U.S., and said they were selling more to the emerging markets. "There is an effort to move away from dependency on the U.S. and Europe," Adams said. "But ultimately the U.S. and Europe drive global growth, whether it's direct exports from China or exports that go to the Gulf because the Gulf is selling oil to the U.S."

Chinese officials seem fairly cognizant of the challenges they face in building the country's social and financial infrastructure, Adams said. In the meantime, however, it will be difficult to bring down the high level of savings in the Chinese populace. Western economists would like for Chinese consumers to spend more and save less to help correct the country's trade imbalance with the rest of the world.

"Those who have lived through big experiments in China have seen that those experiments not only are not positive, but sometimes disastrous," he said. Or they worked in state-owned enterprises with the expectation that their needs would be taken care of for the rest of their lives, only to see that dismantled in the 1990s. These experiences only encourage the Chinese propensity to save.

World Bank president Zoellick noted that the source of imbalance between the two countries can be attributed to their disparate national attitudes toward saving. "If you look at China and the United States, they're almost at opposite poles in terms of consumption and savings," he said in December 2009. "So where the United States was really consuming a huge amount and not saving, China was the reverse—very, very, very high savings rate. These are fundamentally structural issues that both countries are going to need to address."

That means the U.S. has its part to play, too. The United States must try to increase its domestic savings rate, because that's part of the structural imbalance, Zoellick said. "Frankly, unless that gets addressed, you're going to continue to create some of the inputs for the types of problems that we've just been living through," he said.



Source: http://www.spiegel.de/international/world/bild-721044-138065.html. "The Specter of Protectionism: World Faces New Wave of Currency Wars," Der Spiegel, October 5, 2010, accessed April 1, 2011.

KEY MESSAGES

- The financial-reform process has been overly politicized in the United States and Europe.
- Speakers identified four key areas of reform as crucial to the long-term health of the financial system:

  1. Derivatives: Transparency is essential in order to rebuild trust.
  2. Bank capital requirements: Regulators and banks agree that larger capital buffers will lead to healthier banks, but continue to debate the right level.
  3. Ratings agencies: No one has advanced a workable solution.
  4. Bank size: Regulators and bankers are sharply divided over the role that bank size played in the crisis, and how best to address the issue in the future.

Reforming the Financial Sector

A fundamental goal of "Mapping the Economic and Financial Future" is to develop the intellectual framework for understanding the crisis, and to put forward solutions. In the wake of what was first and foremost a financial crisis, each speaker devoted substantial time to how the system should be reformed and who should take responsibility for action.

"We have avoided meltdown, but that's not enough," European Competition Commissioner Neelie Kroes said in March 2009, kicking off the series. "Until we fix the banks, no amount of government spending can fix the real economy."

In August 2010, Senate Banking Committee chairman Chris Dodd, after two years of shepherding through landmark financial-reform legislation bearing his name, told the Council: "If you'd told me at the outset what I'd have to go through to get here, I would have had a good laugh and suggested that you not even try to produce this legislation. But for the crisis, this never would have happened."

Ultimately, Dodd said, the final legislation achieved the committee's four main objectives:

- "End the notion that there would ever again be a paycheck or a check written by the American taxpayer to bail out a financial institution for getting into trouble through its own fault," Dodd said. The resolution authority in the bill achieves that, he said, and ends the too-big-to-fail concept.
- Create an oversight council for systemic stability.
- Strengthen consumer protection with a new specialized agency.
- Set guidelines for supervising non-bank financial institutions—both those existing and those still to be created by some financial genius—that form the shadow banking system.

"I remember a good number of my colleagues wanted to just beat the hell out of Wall Street," Dodd said. "Well, I wasn't writing a bill, really, to deal with those who [had caused the] problem. We're trying to create a 21st-century architecture that could become a model globally for us to deal intelligently with each other on financial services. And it wasn't about penalizing one group over another, but to think it through as best we could, and in as comprehensive a way as we could, to deal with these issues."

> ***"We have avoided meltdown, but that's not enough. Until we fix the banks, no amount of government spending can fix the real economy."***

But for many bank executives, the new regulations and restrictions foreseen in the Dodd-Frank bill do seem punitive—in the sense that higher capital requirements, greater transparency, and limits on certain types of business will certainly reduce profit. In addition, hundreds of new regulations will be fashioned in coming years by regulatory agencies, including the newly created Consumer Finance Protection Agency.

> ***"If you'd told me at the outset what I'd have to go through to get here, I would have had a good laugh and suggested that you not even try to produce this legislation. But for the crisis, this never would have happened."***

Neelie Kroes offered the European view in 2009: "If it takes some tough love to make [the banks] face up to their responsibilities, that is what they will get. I think it's clear to everybody that we need better regulation, tighter supervision of the banks and so on. In Europe, we believe in free markets, but it's now clearer than ever that we can't leave them on autopilot; we need tougher regulations. There can be no more room for tricks and circumventions."

Sunshine as Disinfectant

In the initial phase of the crisis, the first task was to determine the scope of the risk to banks—to find out how many of the "toxic" assets were on the balance sheets of the banks, and how much loss they entailed.

Gary Gensler, chairman of the Commodity Futures Trading Commission, argued that transparency in pricing these assets would be the way to avoid similar crises in the future.

"Some opponents of reform argue that the lack of transparency really wasn't at the center of the crisis," Gensler said at a January 2010 event, "that the crisis had to do with other issues—mortgage sales and underwriting practices, not enough capital in the banks, great imbalances in our savings rates and the like. And yet, I think the inability to price many complex assets was at the center of the crisis."

> ***"I think that corporate treasurers who could see where standard derivatives are priced and traded would be better able to guard themselves against the quick salesmen and the structured product party coming to them to sell them something."***

The mortgage securities derivatives held by the banks were too difficult to price. The reason, according to Gensler: "Because there was no transparent market for pricing either the assets or the components of the risks that were embedded in these contracts, or these assets."

Even as the derivatives market grew from billions to trillions of nominal value, it remained an opaque dealer-dominated market, with Wall Street banks reaping huge profits from the wide bid-ask spreads, Gensler noted. He therefore proposed requirements for standardized derivatives to be traded on market platforms and cleared through facilities that removed counterparty risk. These reforms would bring greater liquidity to the market and more transparency to pricing, reducing the bid-ask spreads and making it easier for corporate hedgers to calculate the cost of the transaction.

"I think one of the number-one ways to help guard against it [excessive risk] is transparency," he said. "I think that corporate treasurers who could see where standard derivatives are priced and traded would be better able to guard themselves against the quick salesmen and the structured product party coming to them to sell them something."

Banks who opposed the reform or attempted to circumvent it were only serving what they believed to be the best interests of their shareholders, Gensler acknowledged.

"But I think we, in Washington, have a different job," he continued. "I think we have the job to look out for the American public, not only to make sure that there's not a similar crisis in the future, but that we learn the lessons from this crisis to bring greater transparency and lower risk to the system."

Increased Risk Requires Increased Capital

A key point of bipartisan agreement in the debate, according to Senator Dodd, was that capital requirements for banks needed to be higher. "Clearly, one of the concerns people had is inadequate capitalization," Dodd said. "Leverage issues were also at stake."

Even the ranking Republican on the committee, Senator Richard Shelby of Alabama, who resisted further regulation for banks, was on board with the focus on capital requirements.

"If I've heard Richard Shelby say anything, over the two and a half years that I've sat next to him on that committee, day in and day out, it's capital status," Dodd recounted. "Capital, capital, capital—over and over and over again."

Dodd's conclusion: "I think it's one of these areas where you'll find, probably, a lot of common interest: [We want] to have adequate standards here that will not pose the kind of risks that we've been through."

Ratings Agencies Remain at Large

Some issues, such as the credit rating agencies, had to be remanded for further study.

"The rating agencies—of course it's a study!" Dodd said in response to a question. "Frankly, over a year and a half, no one could really figure out how the hell to deal with it."

There were those who wanted to just get rid of the rating agencies, who some blamed for contributing to the crisis by assigning triple-A ratings to what later became toxic assets. But smaller companies could never do the due diligence to investigate all the debt securities on the market.

> ***"I would argue that diversified banks have done much better than focused banks, narrow banks, which are too exposed to one market, to one product, or to one client segment."***

"So there's a study but with a goal in mind of trying to come back with an idea in rating agencies that'll make some sense," Dodd said. "I'm just sorry we couldn't come up with a good answer ourselves, despite a lot of effort to do so."

Separation of Powers

The Dodd-Frank Act takes account of the changes in the financial industry and society since the passage of the Glass-Steagall Act in the 1930s.

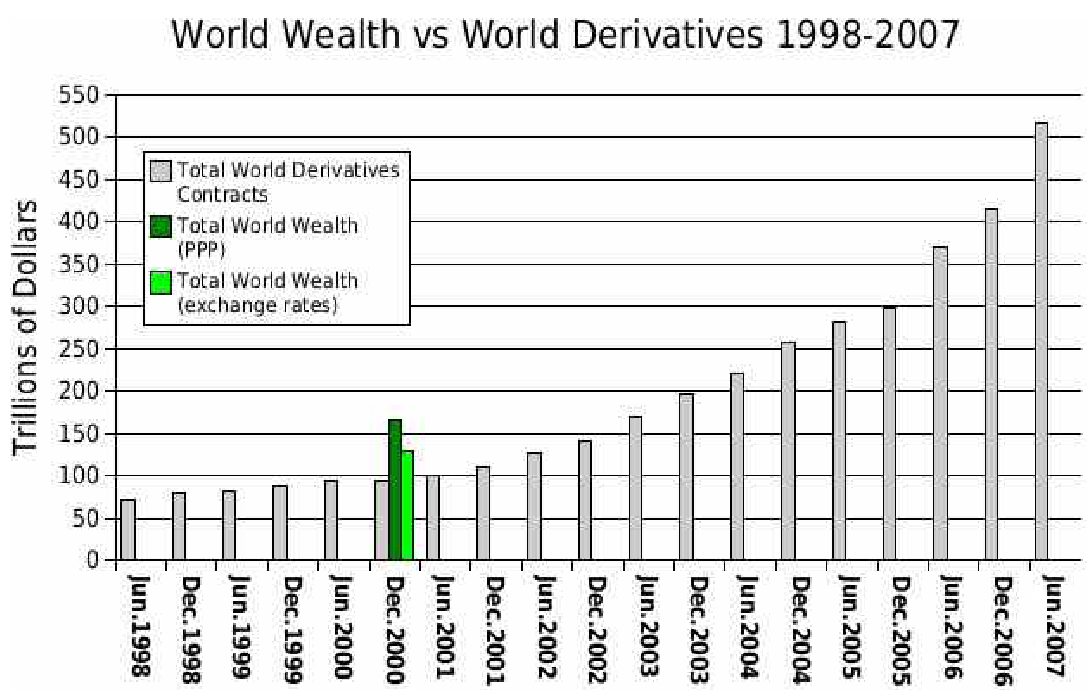
"I think it would be idiotic to go back and entirely try to establish Glass-Steagall again—sort of denying everything that's occurred in the country and the world since then," Dodd said.

Deutsche Bank's Ackermann also rejected calls to reinstate the separation. "People are now talking about narrow banking, about very focused, small banks," he said. "They are talking about reestablishing some sort of a Glass-Steagall Act. Consensus is that a bank which is too big to fail is too big by definition. It is not illogical. However, I would argue that diversified banks have done much better than focused banks, narrow banks, which are too exposed to one market, to one product, or to one client segment."

Instead, Ackermann said, the focus should be on how to make banks more like other companies, so that when one fails, it does not jeopardize the entire banking system.

European Commissioner for the Internal Market and Services Charlie McCreevy seconded that notion in cautioning against a tendency to overregulate in the wake of the crisis. Going bankrupt, he said, is a "fundamental right" in the capitalist economic system.

"I think we have to try and do something rather than let ourselves be run over by people who want to regulate everything out of existence," he said. "There are people who want to regulate risk out of the business. Well, if you do, you'll end the capitalist system."



Derivative markets have exploded in the past decade, and regulatory agencies have struggled to adapt to the changing financial environment.

Source: http://1.bp.blogspot.com/_L0LlEV3Ck08/SOGWcxyenLI/AAAAAAAADmk/bLn60n2dh7E/s1600-h/World_Wealth_Derivatives.jpg. Source: Bank for International Settlements; United Nations

KEY MESSAGES

- The global financial collapse drove unprecedented global cooperation during the crisis management phase, but as the financial impacts continue to burden the real economy, coordination has begun to weaken.
- The institutional questions raised by the crisis remain unsolved—namely, will we create new bodies to oversee global financial governance, or will old groups simply be modified?
- Yet the economic burdens of the crisis have driven the United States and Europe inward as they tend to their own troubles, i.e., persistent unemployment in the United States and an ongoing sovereign debt crisis in Europe.
- The need for coordination is running headlong into economic realities that make independent action politically appealing, making the future of the G-20, and of global cooperation, deeply uncertain.

International Coordination

"How do you modernize multilateralism?" asked Robert Zoellick, president of the World Bank, speaking of the challenge for his institution as it tries to adapt to a world very different from the postwar world it was born in.

Commissioners Kroes and McCreevy each spoke of international coordination on the European level, as well as transatlantic collaboration between Europe and the United States. Other speakers talked about the need for global coordination in dealing with the immediate crisis, in implementing financial reforms across national borders, and in strengthening the institutions for international cooperation.

From the private-sector side, Deutsche Bank chief executive Josef Ackermann listed a catalog of areas for international coordination, laying the emphasis on practical issues.

"We should harmonize accounting rules," he said at a May 2009 event. "We should harmonize regulation—banking, financial market regulations. We should improve the cooperation between central banks. We should improve the cooperation between the regulatory borders."

These should be the issues to tackle before considering any fundamental reform of the Bretton Woods organizations—the World Bank and the International Monetary Fund—or of the overall financial market architecture or the currency system, he said.

Transatlantic Differences

While Senator Dodd was able to give an account of reform measures in the U.S., McCreevy noted that Europe's situation is different.

"The United States government passes a law—this is the way it's going to be done in the United States," McCreevy said. "But in Europe the response really rests with member states."

For instance, McCreevy noted, the EU had recently announced a proposal for a European systemic risk council that would be put under the umbrella of the European Central Bank. "We're still grappling with to whom they are going to report," he said. "But still, they will not be able to enforce their opinion."

In such situations, peer pressure among governments can ensure that rules will be enforced, but the council itself lacks the enforcement authority that a similar council in a single nation like the United States will have.

At least one U.S. lawmaker was ready to acknowledge this difference. "There are different circumstances, obviously, within the European community," Senator Chris Dodd, chairman of the Senate Banking Committee, said. As he shepherded financial-reform legislation through the U.S. Congress, he recognized that his bill would handle some issues differently in an American context than other nations would.

"There are a lot of different models you can use for financial reform," Dodd said in August 2010 after the U.S. legislation had been signed into law. "We chose the one we have here today with you, but there are others. Europe certainly has demonstrated a variety of different models."

The Euro Falters

After the initial crisis, Europe faced another wave of challenges as aftershocks hit some of the economically weaker peripheral countries, testing the construct of the single currency as well as European solidarity.

"The dislocations in the European system are challenging, no doubt about that," Deutsche Bank's Ackermann said. "We are completely different real economies and have completely different strengths in the financial system."

Banks in Greece, or Italy, or Spain, actually fared better in some cases than banks in Germany or the UK, Ackermann noted. But he acknowledged in May 2009 that the sovereign risk troubles that began in Greece that spring and threatened to spread to other peripheral countries posed a significant challenge for the EU.

"I think everybody is willing to support each other whatever it costs, because it will be really very, very dangerous for Europe [otherwise]."

French Finance Minister Christine Lagarde affirmed this sentiment. In response to a question at an April 2009 event, she said that European leaders discussing the situation in Greece during a conference call earlier that month were univocal in their support.

"What I can tell you is that around the conference call that we had for two and a half hours on that April 11th, there was not a single disagreement among ourselves," she said. "There was not a single moment of disagreement as to how, what, and when."

In the fall of 2010, however, when the sovereign risk crisis spread to Ireland, some European politicians, particularly in Germany, were somewhat less forthright in their solidarity.

Eastern Europe, too, faced a variety of challenges in the wake of the financial crisis, Ackermann said in the spring of 2009. Some fared better than others, but the recently established market economies in the region remain fragile.

"But even here, I think it is important, although it is politically more difficult, to support Eastern Europe," he warned, "because to fall back into the situation where we have almost a Cold War situation, that will be very, very negative. So whatever it costs, I think we have to keep Europe together, and we have to work [to ensure] that Europe is not suffering too much."

Cracks Emerge

The specific challenge of coordinating financial reform became more difficult in this environment. Failure to coordinate new bank regulations could open the door to regulatory arbitrage, as globally operating banks shift business to jurisdictions with the least onerous restrictions.

Senator Dodd cited the example of regulating OTC derivatives. "In the European community…I'd like to see them do what we're doing. I think we did the right thing and it makes some sense; they're not inclined to have mandatory exchanges," Dodd said.

Failure to match the U.S. measure could undermine the reform, he warned. "The temptation is to race to the bottom if we don't get a commonality," Dodd said, encouraging financial institutions to play national regulators off each other.

CFTC chairman Gary Gensler also chimed in on the derivatives issue. "We have to do the reform here because if we don't do it here, then it won't occur overseas," he said in January 2010, while the Dodd-Frank legislation was still being debated in Congress. "It appears right now that Europe's with us, and I think if Europe's with us—and from my conversations with other countries—I think we will bring this together in a largely consistent manner."

G-20 to the Rescue?

Senator Dodd asserted that the international dimension to U.S. financial reform was never far from the minds of the U.S. legislators. "If you track what we did in the bill and track it next to the principles outlined by the G-20, you'll find that we follow them very [closely] almost to the letter. So if you're looking for any model of our legislation, it is in fact the principles laid out by the G-20."

Chairman Gensler noted that the derivatives issue was dealt with by the heads of state themselves at the G-20 summit in Pittsburgh, following the lines proposed by the U.S. "It's remarkable, but in the heads-of-state statement, it said that we would require standardized derivatives to be centrally cleared and brought to transparent trading facilities," Gensler said.

Speakers grappled with the question of how this international coordination would work going forward. "What I find fascinating is, as a minister of finance at the moment, in a country that is engaged and that will be engaged in 2011 as a chairman of the G-20, and chairman of the G-7 at the same time," France's Lagarde said, "is how are we going to better design our institutions? How are we going to have an architecture that will actually address those issues that we are facing at the moment?

"We've clearly realized—whether it was as a result of the H1N1 virus or the financial crisis—that we were equipped, but not equipped to the point where we could actually address the risk of contagion to stop it, ring-fence it and redress our respective situation," Lagarde said.

> ***"How are we going to better design our institutions? How are we going to have an architecture that will actually address those issues that we are facing at the moment?"***

Zoellick welcomed the advent of the G-20 but warned against making it too bureaucratic. "I think one has to be careful about making it too heavy—secretariats, big working groups," he said. "The G-20 should use the existing institutional structure—the World Bank, the IMF, the WTO, the Financial Stability Board—which not only taps the expertise but actually broadens the inclusions because we're a G-186."

The G-20, Zoellick noted, was created 10 years ago as a "generalized talk shop" for finance ministers, and has now moved to a different role in policy coordination. "In the context of crisis, where everybody was staring into the abyss, it led people to come together on some fundamental issues," he said.

The core challenge for the G-20, the World Bank president said, will be whether "people still feel that sense of need to try to cooperate in solutions" once the crisis itself has passed. The group needs to be aware that "one-size-fits-all solutions" will be less appealing at that point.

Zoellick also welcomed the G-20's upgrading of the Financial Stability Forum. "A loose group chaired by Mario Draghi, the very effective head of Italy's central bank, has now been expanded to become a Financial Stability Board so it includes developing as well as developed countries," he said.

IMF Reform

For their part, Youssef Boutros Ghali and Nancy Birdsall argued strongly in favor of reforming the existing Bretton Woods institutions.

"It is crucial for us to reform the international financial institutions," Boutros Ghali said during a May 2009 event. "Their inability to keep up with developments in the world economy, their inability to upgrade their surveillance mechanisms, to keep an eye on what's happening in the world economy, made it such that when the crisis happened, the international financial institutions were bystanders watching the crisis unfold, not being able to intervene either by know-how or by funding or by any other means to help the countries affected by this crisis."

Boutros Ghali, the Egyptian finance minister, noted that the IMF did in fact point out the major current account imbalances in the global economy. "Of course, the Fund then did not have much clout on the U.S. economy, or on any large, developed economy, for that matter, and therefore nobody listened," he said. "Had the Fund been able to influence U.S. policy, the deficit would have been addressed."

By the same token, Boutros Ghali continued, had the IMF been able to influence the other side of the equation (China), "maybe, maybe, we would not be in the mess we're in today, or maybe we would be in that mess, but a smaller mess."

Calling for an increase in the legitimacy and the credibility of international financial institutions, Boutros Ghali said, "These institutions need to be upgraded, and they need to be upgraded in a way that makes them in tune with 21st-century realities."

Nancy Birdsall echoed these sentiments, and pointed out the challenges for the transatlantic community in helping to reform the IMF. With 10 of the 24 chairs on the IMF Board, Europe has "more voice than votes," but still a disproportionate presence on the Board, she said. By the same token, the United States has just 17 percent of voting shares.

"This means more tension and a greater premium on effective collaboration between the EU and the U.S., where I think interests and values are very heavily aligned," she said. "But when you get down to brass tacks, there's going to have to be some reduction of power, voice, and responsibility that is shared between them," Birdsall continued.

Despite the fact that these issues have been recognized for some time, Boutros Ghali responded to a questioner with some exasperation: "No, the reforms that we need are not presently on the table."

Key Messages

- The financial bubble allowed deep structural problems to persist in most developed economies, including unsustainable government and private debt, unaddressed entitlement burdens, and weakening competitiveness.
- The divide between countries pursuing austerity and those increasing stimulus is growing increasingly deep and bitter.
- Emerging economies continue to prosper, but remain unable to drive global growth on their own, and increasingly worry about massive capital inflows seeking higher returns.
- As economic recovery lags, pressure mounts to move in opposite directions, policy coordination and cooperation break down, and we risk sowing the seeds of the next crisis.

Searching for Growth

Even as they took emergency measures to stabilize the financial system during the financial crisis, policymakers were looking ahead and trying to figure out how to restore economic growth. They recognized even as the global economy slipped into recession that renewed growth would be the best antidote for both ailing banks and a shell-shocked public.

But they also realized that this new growth would have to be sustainable—not the result of financial pyrotechnics or highly leveraged consumption.

French Finance Minister Christine Lagarde listed a return to growth as her first priority. "I think that 2009 was a year of brutality, a year where we had to inject massive funding, where we had to fuel and refuel the economy because there was nobody else to do so," Lagarde said. "I think that 2010 and onwards might be years of subtlety, where we have to both combine this continuation of the stimulus packages that we have under way in many places around the world, while at the same time removing some of these public support programs so that we can restore public finance and bring our deficits back, as well as reduce our debt-to-GDP numbers."

In that context, Lagarde mentioned some fundamental reforms, such as the pension overhaul in France, which the government subsequently carried out in the face of sometimes-violent public protests.

In fact, one of the key economic debates coming out of the crisis was how to balance the need for stimulus with the need for fiscal discipline. European countries, as a general rule, were quicker to come down on the side of fiscal discipline.

When asked at a June 2009 event about where the next growth spurt comes from, Charlie McCreevy, European commissioner for the Internal Market and Services, was cautious about the prospect of further stimulus in Europe.

"You'll remember, there's not universal agreement in Europe about stimulus packages," McCreevy said. "We have had a stimulus package in Europe, and there have been some differences of opinion there."

At that point in 2009, the former Irish finance minister felt he could, without being overly optimistic, discern signs of some economic recovery in parts of Europe. (Germany, in particular, got back on a growth track fairly quickly, later data would show.)

Particularly given the structure of the eurozone, some policymakers felt the emphasis should quickly be placed on fiscal discipline, even though it seemed to exacerbate the effects of the financial crisis.

For former Polish finance minister Leszek Balcerowicz, this combination of economic and fiscal shock was precisely the cure that some of the peripheral eurozone countries needed.

"Shocks from time to time are great educators. I don't know of any country which would have suffered because of excessive fiscal discipline."

Citing the "shock therapy" of Poland in transitioning from communism to a market economy when he was in charge of economic policy, Balcerowicz said in February 2010, "Shocks from time to time are great educators. I don't know of any country which would have suffered because of excessive fiscal discipline."

In general, France's Lagarde said, Europe needs to narrow the performance gap between the economies to keep the bloc as a whole on a sustainable path to growth.

"Clearly, within the same monetary zone, we need to narrow that gap, and we need to bring economies back together [in a better way," she said.

This meant first and foremost that Greece and other periphery countries would need to make a strong effort to reduce their trade and budget deficits. "It will require a much bigger effort and a priority effort on the part of those that are in deficit of competitiveness—that are in deficit altogether in terms of budget," she said.

But surplus countries also needed to adopt measures to help European economies converge. "It will require everybody to make an effort," Lagarde said. "For instance, Germany and other member states that are at the other end of the spectrum have to do their part as well."

For her part, the French finance minister said, she was very focused on domestic consumption in her country. "I think that everybody has to contribute to this objective of resuming sustainable and probably different kinds of growth going forward," she said. "To that end, it seems to me that it's not just a matter of straight, strict, and exclusive exports but it has to be exports, and consumption and investment, which are the two drivers of growth."

"I think the topic today is, will China lead us out of this? And I don't think so."

Salvation by Emerging Economies?

On a global scale, the picture was more complicated. The previous drivers of global growth, U.S. consumption and Chinese exports, no longer seemed to offer a sustainable model.

"Clearly we need to look at rebalancing better, and this rebalancing has to do with the U.S. consumer consuming maybe a little less, saving a little more," Lagarde said. "It has to do with China and the United States sort of reaching a better equilibrium—all of that has to converge into a direction that is in the best interests of all, and not just in the best interest of one or two major areas."

World Bank president Robert Zoellick shared this view. "Traditionally, the U.S. consumer has been the source of resurgent demand," he said at a December 2009 event. "I think that's unlikely to be the case this time, for the simple reason that U.S. consumers are de-leveraging. They're paying down debt. They're rebuilding their savings."

"Clearly we need to look at rebalancing better, and this rebalancing has to do with the U.S. consumer consuming maybe a little less, saving a little more."

The big question then, said Zoellick, is what can become an alternative source of demand. Here he saw a role for emerging market economies and for the World Bank. "In this crisis, unlike some earlier ones, you have a number of developing countries that have paid down debt," he said. "They have relatively good fiscal positions and they do have the ability to expand demand if they can get the financing. And that's a lot of what we've been doing."

In fact, Zoellick suggested, given the transformations in the global economy over the past 10 years alone, there are great possibilities for South-South development. For instance, he said, Chinese investment in sub-Saharan Africa could be a breakthrough that this region hasn't experienced before, opening the door to the type of growth seen in East Asia, starting with Japan, 50 or 60 years ago.

But one expert cautioned against counting on China as the engine for global growth. Tim Adams, a former U.S. Treasury official now working as a consultant on the Chinese economy, said the Chinese economic model is still too dependent on the American consumer.

"If anyone believes that the U.S. consumer is going to come roaring back anytime soon and be a driver of growth anywhere in the U.S. or in China, I think we're going to be waiting a very long time," Adams said during a June 2009 event. "The U.S. consumer in certainly the bottom half of the country is tapped out, probably technically bankrupt, credit constrained, and we, at the top of the pyramid, have been hit with such enormous wealth loss.

I can't see how the U.S. is going to be a driving force going forward."

Adams's conclusion: "I think the topic today is, will China lead us out of this? And I don't think so."

Adams saw the global economy caught in a conundrum: While the old model seemed unlikely to work, there seemed to be little progress toward a new model.

"China is going to have to be a key part of that by consuming more and exporting less," Adams said. "What we're not seeing is a quick jump to the new growth model which we've been talking about here. Officials have been talking out of Beijing for at least five years, and that is a more-domestic consumption-based growth trajectory, one more reliant on services than on heavy industry, and obviously bringing in small and medium enterprises as a key to that growth."

China has written all the white papers, made all the speeches, devised all the five-year plans for rebalancing growth going forward. But, Adams stressed, "That is incredibly tough to do."

"I just wonder if at some point in the future, 10 or 15 years from now, some future generation of leaders won't look back on this period and weep with the sorrow of how little growth they got out of the massive amount of investment they put in place."

China maintained its growth with the help of a massive government stimulus. "As this stimulus burns off in the next 18 months, one must wonder where growth will come from," Adams said. "If this is a bridge to something else, will that something else be consumption-based trajectory, and will it happen fast enough and significantly enough to make a difference, or might this be a W-shaped recovery in the medium term?"

The crisis, in fact, has revealed some of the shortcomings of the Chinese economic model, Adams said. The centrally planned economy, for instance, can muster massive amounts of capital for whatever priorities it chooses. The flip side, though, is that this capital is often deployed in a very inefficient manner.

"Their style of government is obviously attractive when you've got a dramatic downturn and you can turn all the dials, pull all the levers, and overwhelm the system with stimulus," Adams said. "But there is a question about how efficient the use of capital is; I would argue, quite low."

"How are we going to deal with all this massive liquidity that has been pumped into the world economy?"

It has been an issue for some time, looking at the numbers for investment in China and wondering why they are not getting greater growth from it. "I just wonder if at some point in the future, 10 or 15 years from now, some future generation of leaders won't look back on this period and weep with the sorrow of how little growth they got out of the massive amount of investment they put in place," Adams said.

Too Much Money Chasing Too Few Goods

Another aspect of the global economic recovery that raised concern among the speakers was the impact of liquidity from all the monetary and fiscal stimulus programs adopted during the crisis.

"Now that the catastrophe has happened and now that we are at the bottom, or near the bottom of it, and now that we know how we're going to get out of it," Egyptian finance minister Youssef Boutros Ghali said in May 2009, "how are we going to deal with all this massive liquidity that has been pumped into the world economy?"

Boutros Ghali recalled a similar situation in the early 2000s. "There were huge deficits in the United States, matched by huge surpluses in Southeast Asia and other emerging market economies," he said.

This led to a massive influx of liquidity, lowering the cost of that liquidity and pushing the international financial institutions to grab for yields—ultimately leading to "the mess" we are in today.

"We don't want to repeat this," Boutros Ghali said. "Therefore, all this massive liquidity will have to be marked back one way or the other.

The question is, how do we do that without choking up the recovery that we hope will be put in gear by the beginning of next year?"

For the World Bank's Zoellick, this is a new challenge posed by the policy response to this crisis. "You see a lot of discussion about trying to avoid some of the mistakes of the '30s—the lack of central banks providing liquidity, avoiding protectionism, taking the appropriate fiscal policy actions," he said. "But you always have to check to see whether something has changed in the international environment. And in this case, I think one of the changes is, there's a lot of liquidity."

During the financial crisis, central banks used the tool they had at hand to deal with the problem of the day, which was the risk of counterparty failures, Zoellick said.

"The tool didn't fit exactly, but that's the tool they had," he said. "So they provided immense liquidity, not only through traditional monetary policy, but also through some very innovative steps—important and creative steps in terms of buying assets, what some people have talked about as a *quantitative easing*."

The Federal Reserve and other central banks just wanted to make sure that financial markets continued to work. "But it's created a situation where as you start to see a recovery in some markets, particularly in East Asia, the question is, where will all this money go?" Zoellick said.

Sowing the Seeds of the Next Crisis

It is unlikely that companies will be able to increase prices, so traditional product price inflation won't be the consequence. Likewise, unions or labor forces won't be able to push for great wage increases.

"But you could see money start to move into asset markets," Zoellick said. "And you had some evidence of this if you looked at some of the real estate and some of the other markets, particularly in East Asia."

In short, according to Zoellick's analysis, the massive liquidity injected into the system to cope with a crisis caused by the bursting of asset bubbles could lead to new asset bubbles—bringing us back to square one.

However, central banks are unlikely to look at new asset bubbles the way they used to, when it was deemed less dangerous to let the bubbles burst and then clean them up. "That view has clearly lost ground in the context of this crisis," Zoellick said with a chuckle.

But whether policymakers should counter the formation of new bubbles by raising interest rates, as the Australian central bank did already in 2009, or by reintroducing old concepts like margin requirements, remains to be seen, he said.

"You see a lot of discussion about trying to avoid some of the mistakes of the '30s—the lack of central banks providing liquidity, avoiding protectionism, taking the appropriate fiscal policy actions. But you always have to check to see whether something has changed in the international environment. And in this case, I think one of the changes is, there's a lot of liquidity."

Conclusion

In 2011, the vision of the global economic and financial future remains stubbornly myopic. The United States and Europe must lead the process of remaking the global financial system, and the return to global growth. To do so, the United States will have to overcome serious political gridlock—which is likely to persist through 2012—and the European Union will have to rapidly adjust its institutions to save the euro, and thereby the Union.

While not impossible, it is difficult to see how the world's two largest economic blocs will meet these challenges. The collected insight of several of the world's top business leaders, government officials, and managers of international financial institutions provides some important guideposts:

1. Political leadership will define success or failure: It is not surprising or unjustified that voters in the United States and Europe are angry and want solutions. By definition these domestic constituencies will care most about themselves, and not want to hear about the need for international cooperation or the effects of domestic policies on the global economy. Politicians must see further, and make the case for a strong, stable, and safe global economic framework.

2. Competitiveness is the path toward balanced growth: While governments have provided much-needed stimulus, sustainable and balanced growth will result only from a reorientation to manufacturing and production. This requires far-sighted, long-term investments in education and innovation by the public and private sectors. It also demands difficult adjustments to social priorities and benefits. These are challenges the United States and Europe have met before, and we can meet them now.

3. The financial sector is a means, not an end: There is a deep but unarticulated debate in developed economies about the appropriate role of the financial sector. While this has at times manifested itself in outrage over executive pay and bonuses, or the utility of risky financial instruments, the real question is simply, What do we want our financial sector to do? The answer seems increasingly to be that we support a lucrative financial sector, but only if it serves to provide the means for the real economy to thrive. Once we definitively answer this question, we will know what kinds of risk we can tolerate, how big we are willing to let financial institutions be, and how we should evaluate them.

The Atlantic Council remains committed to charting the map of the economic and financial future. Only through continued discussion will we develop the intellectual basis for understanding the political, social, and economic drivers that shape our world.

Atlantic Council

Board of Directors

International Advisory Board

ATLANTIC COUNCIL

IDEAS. INFLUENCE. IMPACT.

1101 15TH STREET, NW, 11TH FLOOR • WASHINGTON, D.C. 20005 • (202) 778-4950 • WWW.ACUS.ORG