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FINANCIAL AND MONETARY ISSUES AS THE CRISIS UNFOLDS

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Preface

A group of experts associated with the Economists for Peace and Security and the Initiative for Rethinking the Economy met recently in Paris to discuss financial and monetary issues. Senior Scholar James K. Galbraith summarizes the group's viewpoints, which are largely at odds with the global political and economic establishment. Despite some success in averting a catastrophic collapse of liquidity and a decline in output, the group was pessimistic that there would be sustained economic recovery and a return of high employment. There was general consensus among the group that the precrisis financial system should not be restored, that reviving the financial sector first was not the way to revive the economy, and that governments should not pursue exit strategies that permit a return to the status quo. Rather, the crisis exposes the need for profound reform to meet a range of physical and social objectives.

The group's outlook was based on the belief that the influence of private equity on global investment patterns will not return, and that the growth of rich-country consumer debt will not be restored. Moreover, there is no region outside the United States that is prepared to step up and play the role of consumer of last resort, and no offset to the global demand for savings. Thus, the world economy will not grow its way out of depression and unemployment without major and sustained public inititative.

Neoliberal reform and neoclassical economics have veered away from general welfare by substituting the market for the functions of the state. The concept of public interest disappears from theory, and markets, by definition, serve only private interests; that is, an alliance of the rich against the middle class and the poor. The slippage from liberal to neoliberal thinking has been especially clear in banking and is present in the U.S. administration's response to the crisis. Fundamental reform and "bottom up" recovery strategies are blocked by preserving the existing (unstable) system and by failing to prosecute fraud. The group favors a major strengthening of national and transnational regulatory agencies, including rules for citizens dealing with such agencies (e.g., rules of taxation and for mortgages); aligning the reach of banks with the regulatory framework, and government enforcement (i.e., public power). Moreover, there is merit in achieving (smaller) public-purpose financial structures that are not "too big to fail."

There was broad agreement that a mixed financial system, with liberal (public-private) institutional underpinnings and a market context, requires regulation of both institutional conduct and governance, as well as market instruments. In this context, the reform packages in both the United States and Europe fall short. And there is no particular need for the U.S. Treasury to establish separate entities as receptacles for toxic assets, and no excuse for the government to fail to redefine and set economic accounting standards for the conduct of banks, or to fully employ human potential.

The design of economic policy has delegated environmental, health, and inequality indicators to secondary roles in favor of the monetarist goal that ties central bank conduct to the drive for price stability. A preferred alternative is to design policy that focuses on global public goods, nonrenewable resources, human resource use, and the sharing of knowledge goods. The correct approach to increase economic activity and employment includes a program of general fiscal assistance or revenue sharing, relief from payroll taxes, and expanded Social Security benefits. Moreover, a public job at a fixed wage for all takers functions like a buffer stock for human labor, stabilizing both total employment and the bottom tier of the wage structure.

According to the group, the historic justifications for a dollar-based system are no longer persuasive, and present international monetary institutions are weak and dysfunctional (e.g., the International Monetary Fund is, essentially, beyond repair). The group favors the development of regional monetary authorities and freeing developing countries from a compulsive need to serve the export sector on any terms. They note that the problem of unemployment is easily cured without threat to profitability or as a source of inflation, and that the problem of liquidity can be solved only at the level of the currency unit. In sum, the group warns that the crisis is not over, that policies set in motion are not sufficient, and that the goals set by the authorities are neither desirable nor possible.

As always, I welcome your comments.

Dimitri B. Papadimitriou, *President*
August 2009

Financial and Monetary Issues as the Crisis Unfolds

Introduction

On June 15 and 16, 2009, the working group on financial and monetary issues of Economists for Peace and Security (EPS) and the Initiative for Rethinking the Economy (IRE) met in Paris for a closed discussion of the ongoing crisis and resulting reform proposals, including the new initiatives of the G-20 and the Obama administration.[1] This brief provides a structured summary of the major points of those meetings. It reflects in general terms the center of gravity of the views expressed, drawing on the expertise and careful reflection of the specialists and experts who were there.

Nevertheless, it is written on my personal responsibility, with only limited attribution to particular persons and the specific consent of none. The authority of this particular group was established in June 2008, when it met and thereafter issued one of the first comprehensive warnings about the impending (global) financial collapse. That warning helped to place several members of the group in position to influence the legislative discussion of the Troubled Asset Relief Program (TARP) and to the fiscal expansion package in the United States, and to the development of the G-20 position in early 2009.

State of Play

As the group met, prominent voices, including Chancellor Merkel of Germany and other leaders of the European Union (EU), were preparing to issue statements declaring the world economic crisis substantially resolved, and urging a shift in focus to "exit strategies" aimed mainly at fiscal deficit reduction. The Paris group took a very different view.

Participants recognized that emergency action and automatic stabilization had worked, in the most violent phase of the crisis, to avert a catastrophic collapse of liquidity in the world system, and to place a floor under the decline of output in the more advanced countries. They recognized the favorable impact of fiscal expansion policies undertaken in the United States and China, and the likely positive effects of an end to inventory liquidation in the months ahead.

Yet all of this falls far short of creating conditions for sustained economic recovery and a return to high employment. On this crucial question, members of the Paris group were strikingly pessimistic—a pessimism shared despite a wide range of underlying theoretical perspectives.

One speaker summarized the general position as a "Minskyan supercycle" —a crisis of underconsumption and overproduction occasioned on one side by a vast overhang of private debts, which households would like to get rid of but largely cannot; and on the other by the unwillingness of governments to allow major corporations and (especially) banks to disappear—a step that would be necessary to adjust supply, and therefore profitability, to demand. Not incidental to this is an undoing of globalization, caused by the collapse of trade finance, revealing the fragility of the previous world economic structures and the weakness of existing economic institutions—global, regional, and national.

A second speaker invoked the metaphor of the eye of a hurricane. The first wall of the storm has passed over us: the collapse of the banking system, which engendered panic and a massive public sector rescue effort. At rest in the eye, we face the second: the bankruptcy of states, provinces, cities, and even some national governments, from California, USA, to Belgium. Since this is a slower process involving weaker players, complicated questions of politics, fairness, and solidarity, and more diffused system risk, there is no assurance that the response by capable actors at the national or transnational level will be either timely or sufficient, either in the United States or in Europe.

A still larger issue concerns the backdrop of the Kondratieff cycle: the long waves of technical change that generally underlie major economic depressions. In the slump, governments come under pressure to save fading or dying industries, such as automobiles—an industry based on a 19th-century combustion engine and the eternal promise of cheap oil. Meanwhile, they fail to put adequate resources behind the sectors whose growth is most promising—notably, sustainable energy, greenhouse gas reductions, and public health. In these matters, organized politics and rational foresight stand at cross-purposes, and the cause of economic recovery is not served.

Speaking from a Kaldorian perspective, one participant asked whether it is possible to return to the structures of economic growth that had developed worldwide in the decade before the crash. This was, practically for the first time since the Bretton Woods era, a time of worldwide expansion, including

Latin America, Africa, and all of Asia. It was based on high productivity growth, low inflation, and profitability higher even than in the 1950s and 1960s, with real wages rising in the developing countries but not in the developed regions, and therefore a decline in global pay inequalities between nations. But a global expansion produced a global crisis, as private equity promoted outsourcing, globalizing production, and the United States provided deficit financing that sustained worldwide demand. Meanwhile, commodity prices rose, improving terms of trade for developing countries, largely due to the rise of speculative purchasing through commodity funds. There was in addition a massive flow of foreign direct investment into oil and biofuels, which led to a buildup of foreign exchange reserves (mostly in dollars), while the normal exchange rate adjustment mechanisms were blocked.

The question now posed is, *How much of this system can be saved?* In simple terms, the influence of private equity on global investment patterns will not return. Nor will the growth of rich-country consumer debt be restored. The one enduring component of the old global system is commodity speculation, meaning that a rise in demand (if it occurs) is likely to be reflected quite quickly in higher energy prices. But getting adequate demand into the world system remains a critical problem. If it does not come from the United States, where will it come from? At the world level, there is no effective alternative mechanism to offset the desire for savings and its depressing effect on total demand.

One way to think about this issue is to consider the power of the locomotive in relation to the length of the train. As the world economy has grown larger over time, in relation to the U.S. economy, the train becomes larger in relation to the locomotive. Thus, the scale of demand provided to the world system by the country supplying the reserve currency declines. To maintain world demand, either the United States must provide an ever-larger current account deficit in relation to U.S. GDP (running the engine hotter), or else some other major player must move into a substantial current account deficit to play a similar role (adding a locomotive). Failing either of these options, there is no offset to the global desire for savings, and the world economy cannot grow its way out of depression and unemployment. The train slows, and some of the cars will perforce be abandoned.

Therefore, the problem is in part that there is no major region outside the United States that is prepared to step up and play the role of consumer of last resort. In particular, Europe is failing to play this role, and the European participants in the conference gave exceptionally harsh assessments, especially of the German and French governments at the heart of the euro system. One said that they "do not understand the world crisis" but remain fixed on an agenda of "destroying the state and cutting public services" in a futile effort to control budget deficits. Meanwhile, parts of Eastern Europe are approaching collapse, with the International Monetary Fund (IMF) demanding severe cuts in public spending in Latvia, Estonia, and Moldova, with public order to be maintained by force, if necessary. The decline in Eastern and Central Europe resembles the subprime crisis in the United States, absent the element of fraud: as falling currency values place mortgages denominated in euros or Swiss francs under stress, the highly leveraged banking systems in Western Europe come under more pressure. Hungary and Ukraine pose significant dangers in this regard.

American participants were almost equally skeptical of the effectiveness of the U.S. approach to date. As one put it, "Diabetes is a metabolic disease." Elements of a metabolic disease can be treated (here, "stimulus" plays the role of insulin), but the key to success is to deal with the underlying metabolic problem. In the economic sphere, that problem lies essentially with the transfer of resources and power to the top and the dismantling of effective taxing power over those at the top of the system. (The speaker noted that the effective corporate tax rate for the top 20 firms in the United States is under 2 percent.) The effect of this is to create a "trained professional class of retainers" who devote themselves to preserving the existing (unstable) system. Further, there were massive frauds in the origination of mortgages, in the ratings processes that led to securitization, and in the credit default swaps that were supposed to insure against loss. In the policy approach so far, there is a consistent failure to address, analyze, remedy, and prosecute these frauds.

Fundamental reform and "bottom-up" recovery strategies based on social insurance and public investment are therefore blocked from the outset. President Obama has his equivalents of Lewis Douglas, the conservative budget director under FDR, but no one to play the roles of Harry Hopkins, Harold Ickes, and Frances Perkins—the architects of the New Deal employment policy, of public works and improved labor conditions. Meanwhile, major legislation from health care to bank reform continues to be written in consultation with the lobbies; as one speaker noted, legislation on credit default swaps was being prepared by "Jamie Dimon and his lobbyists."[2]

One of the gravest dangers to economic recovery, finally, lies precisely in the crisis-fatigue of the political classes, in their lack of patience with a deep and intractable problem, and with their inflexible commitment to the preceding economic order. This feeds denial of the problem, a deep desire to move back to familiar rhetorical and political ground, and the urge to declare victory, groundlessly and prematurely. As one speaker argued, the U.S. discussion of "green shoots" amounts to little more than politically inspired wishful thinking—a substitute for action, at least so far as hopes for the recovery of employment are concerned. The talk among European leaders of "exit strategies" also perfectly illustrates this phenomenon.

A General Framework: Liberal and Neoliberal Reform

All agree that the financial system needs "reform." And the program of the Obama administration, prefigured by a June 15 *Washington Post* op-ed by Treasury Secretary Timothy Geithner and top economic adviser Lawrence Summers, emphasizes what is plainly true: the crisis arose from failures of regulation, and the remedies will require fundamental change. The question is, *What changes count as fundamental?*

Luiz Carlos Bresser-Pereira provided a framework for thinking about this question in historical context, distinguishing between "liberal" and "neoliberal" reform. Liberalism, he argued, was a doctrine of the 18th-century middle class, which was then rising against an oppressive state, then dominated by landowners and the military. The liberal state that then emerged was by turns republican, democratic, progressive, Keynesian, and social democratic—which is to say, ever more deeply concerned with the general welfare and ever more willing to take responsibility for it. Neoliberalism, in political terms, appropriated the symbols of the liberal revolution (notably, Adam Smith), in a new alliance of the rich against the middle class and the poor.

In neoclassical economics (the metatheory of neoliberalism), the market comes to substitute for the functions of the state. But without the state, the concept of the public interest disappears from the theory. Markets, by definition, serve only private interests. And the project of neoliberal reform becomes one of making the markets serve private interests more completely or more efficiently, rather than the attempt to define and serve the broader public interest.

The slippage from liberal to neoliberal thinking occurs in every domain of economic discourse, and it is especially clear in banking. Banks are institutions, chartered by public authority, to serve public purpose. It is clearly understood, in law and in practice, that banks have responsibilities as well as rights, and that the state has power over the conduct of banks, including the power and the duty to take them over and run them when they are troubled enough to threaten the public guarantee that lies behind bank deposits.

"Financial markets," on the other hand, and especially the "shadow banking system" of modern times, are neoliberal creations: they exist to place in the domain of private market transactions what previously existed in a clearly defined relationship to public purpose. They escape both regulation and insurance. The result has been to vitiate the concept of public purpose, creating in banks privileged and powerful market-oriented institutions that use and largely control the state rather than respond to it.

The Geithner-Summers plan recognizes the deficiencies of the financial market system, including the shadow banking system. It strongly acknowledges the need for comprehensive reform. Certain of the specific proposals in the plan, especially that for a "Consumer Financial Safety Commission" with broad powers to oversee the financial products offered to consumers, are promising. Equally promising is the push to bring over-the-counter derivatives under control and to institute clearinghouses, implying obligatory standardization of contracts.

The fact that these proposals are engendering opposition from the bank lobbies is a marker of their merit. Nevertheless, the U.S. administration's approach remains anchored in a neoliberal vision of financial markets and not in the older, liberal vision of banking institutions. In this respect, it does not depart from the Basel II emphasis on capital requirements and transparency, as formulae to provide a margin of safety and assurance of honesty—in what is otherwise accepted as properly a sphere for the market rather than for the state. This remains, likewise, substantially (though not entirely) the approach of the European regulatory authorities.

The difficulty and deficiencies of this way of thinking are twofold. First, one cannot escape institutional history. Banks are creatures of the state, subject to state deposit insurance and prudential regulation. This reality cannot be overturned or neglected without exposing the state to uncontrollable financial losses. The attempt in the neoliberal era to escape from deposit insurance by allowing it to wither away (by declining to increase insurance limits as the economy grew) proved completely unworkable, as British authorities discovered with Northern Rock, as the Paulson Treasury realized with the enactment of TARP, and as the Irish and, later, all the European authorities realized as the crisis spread. Deposit insurance is the one proven antidote to panic, and it entails a need for in-depth prudential regulation, not just of the markets but of the institutions themselves.

Second, even if one accepted the neoliberal vision of market discipline, the doctrine of "too big to fail" completely perverts it. An institution that is too big to fail has the implicit support of the state, and therefore a crushing weight of market power, compared to all competing institutions. The result of combining too-big-to-fail with neoliberalism is perverse in every way, facilitating and even encouraging dysfunctional risk taking and excessive compensation—incentives for fraud. And when the system crumbles, the perversity redoubles, as in the panic ordinary bank depositors flee from the institutions that are not too big to fail to those that are. No principle of market discipline can work under these conditions; on the contrary, destabilizing and dangerous behavior is actually rewarded.

The Paris group held differing opinions on the proper resolution of this dilemma. Some would favor, in principle, a complete return to the liberal vision, including suppression of the shadow financial system, strict limits on securitization, and a ban on credit default swaps. Others favored a return to a Glass-Steagall separation of functions. Still others took the view that history and evolution cannot be easily unraveled, and that one must therefore learn to live with financial market practices, including innovation and regulatory arbitrage—up to a point. What one participant (a banker) described as "two worlds"—traditional banking and market players—within banks may, to speak realistically, endure. But the group was in broad agreement that a mixed system, with liberal (public-private) institutional underpinnings and a market context, requires regulation of both features: regulation of institutional conduct and governance as well as regulation of the market instruments. And it is in this respect that the reform packages so far seen, both in the United States and in Europe, fall short.

As one participant put it, the United States already has some 7,000 public-private financial partnerships. They are called "banks;" with a capital requirement of 10 percent and insurance (either deposit insurance or ad hoc guarantees) on the rest of their liabilities they are, in effect, 90-10 public-private. There was, and is, no particular need for the U.S. Treasury to attempt (so far, without success) to establish separate entities as receptacles for toxic assets.

There is also no excuse for the government to fail to set the standards it deems appropriate for the conduct of the existing banks. This includes rules for compensation of executives, for the origination (and, at present, renegotiation) of loans, for underwriting of loan-backed securities, and for insurance against risk. Regulators can and should prevent the kind of subprime debacle that just occurred (in the United States they did so in 1990–91). Bankers who do not wish to serve public purpose in this way should not be in the industry.

The Larger Context for Reform: To What End?

Ultimately, the financial system is a means, not an end. It is not justified by its own existence.

Banks are not common property or national mascots, whose growth and profitability are per se matters of pride. They are there to serve public and social purpose. The question then becomes, *What are the larger purposes that economic policy in general, and financial policy in particular, should address?*

This question is always present, but it takes on particular significance at a moment of crisis, when a metastable system, previously driven largely by its own inertia, breaks down. This has happened. It should not be the goal of financial policy to restore the previous system, which had no particular sense of direction, no alignment with public purpose, no intrinsic stability or other grand justification. A difficulty of regulatory reform lies in the underlying desire, sometimes unstated, to return to the previously existing system, without asking whether that system meets social needs and public purpose looking forward.

The purposes of economic policy are tied up with the accounting frameworks in predominant use, and these have specific historical origins and contexts. National income accounts place the emphasis on economic growth; they originated in the Depression and during World War II helped guide the mobilization of war production. Unemployment statistics, which go back to the 19th century but became timely indices of well-being only in the postwar years, place their emphasis on the performance of the job market. The reporting framework for central banks, developed in the 1970s, was strongly influenced by the monetarist goal of tying central bank conduct to the drive for price stability. Environmental, health, and inequality indicators tend to be added on to these as ancillary measures of social progress or regress, and they therefore tend to play secondary roles in the design of economic policy.

The crisis exposes the need for profound reform, not only in the way we do economic policy but also in the way we measure the outcomes. As Pierre Calame put it to the group in stark terms: the system as we have it "has the same brake and accelerator"—that which produces growth is also producing climate change and the prospect for a cataclysmic end to modern human experience. Economic accounts are not designed to deal with this, and the result is a schizophrenic approach to policy. We have an economic counting scheme that celebrates all resource-using activity as growth while remaining suspicious of the full use of human resources, counting "full employment" as a potential threat to profitability and as a source of inflation. This is exactly the reverse of the system of relative values that we know to be needed.

Calame placed before the group a series of principles for an accounting framework that could lead toward a sustainable system. These involved distinguishing between four basic classes of goods:

> Those "that are destroyed when shared"—the historical tragedy of the commons, and in our time, most pressingly, the planet itself. This domain requires the imposition of common regulation, with the goal of preserving the balance between human activity and nature.
>
> Those "that are divided, when shared, in fixed quantities"—the case of nonrenewable resources, for which the use by some precludes the use by others. These require an accounting framework based in part on principles of justice. Purchasing power at a given moment is not an adequate justification for the using up of resources that, when used, are gone for all time.
>
> Those "that are divided, when shared, but reproducible." These, like common services and artistic endeavor, are mainly the product of human energy and skill. They are the proper domain of the market and of conventional national income accounting, whose purpose is to assure the full utilization of human resources.
>
> Those "that are multiplied when shared." These are primarily the fruits of new knowledge, whose production society should encourage (by maximum emphasis on education and research), and whose wide distribution per se serves public purpose and social welfare.

The Calame framework clearly suggests that the world community should press toward a redefinition of economic accounting standards aimed at placing planetary sustainability on the highest accounting level. Thus, an activity should be accounted positively if it reduces greenhouse gas emissions and not if otherwise. This by itself would induce tax and regulatory revisions that could cause a major reevaluation of industrial activity—movement toward sustainable technologies and away from destructive ones. Similarly, an international framework incorporating principles of distributive justice would tend to penalize the waste of nonrenewable resources, especially by richer countries, while rewarding a shift toward conservation and renewable energy.

At the same time, to make life under a sustainable regime supportable, it is essential that the human experience not be degraded—that, in fact, it should actually improve. The key to this is to recognize that there is no operational limit on either the spread of knowledge or the use of human talent. A critical function of government is to ensure that education, research, and scientific development reach their full potential, and also that the resulting human potential is fully employed. Achieving the latter, in a sustainable way, in turn requires dealing with the unsustainable ecological consequences of conventional growth, and with the destabilization that will occur if commodity markets are left to unregulated market forces.

For many years, economists and others have deplored the use of GDP as a catchall indicator of economic welfare, and its deficiencies, including the neglect of environmental consequences and indifference to distribution, are well known. But the usual alternatives, whether to measure "human development" or to incorporate an inequality measure alongside a growth measure (the Sen approach) suffer from the arbitrariness common to the creation of all index numbers. If one changes the weights attributed to various factors, the index changes; yet there is no objective or standard criterion for deciding on the weights best attributed to each factor.

The Calame approach of multiple indicators suggests a way out of this dilemma, at the price of admitting that economic change is often ambiguous in its effect on welfare. Consider a set of indicators for progress or regress with respect to each class of goods considered separately.

Clearly, events that move all four classes in a favorable direction are unambiguously to be preferred. Clearly, events that move all four in an unfavorable direction are unambiguously to be avoided. All other events are ambiguous, and the task of policy design is to fire correctly on as many of the four cylinders—global public goods, nonrenewable resources, human resource use, and the production and sharing of knowledge goods—as possible. The task of economic statistics then becomes to define measures in each of these areas that permits one to say, with some confidence, whether the movement is, or is not, in the correct direction.

Would that we had an effective program for reform of statistical practices along these lines.

An immediate implication of this approach is that one cannot hope to direct sensible economic reform *through* the banking sector, because banks' distorted accounting structures distort their behavior. This has been the pattern of the past generation. With the financial sector in the lead, economic growth has become an ambiguous exercise, fostering manic and unstable overinvestment (in technology, in housing, and, finally, in oil), rapidly increasing economic inequality, and a complete lack of progress on the environmental front. Meanwhile, periodic gains in employment are wiped out in the subsequent crash. The task of reform is to find another way—a way to set the direction of growth along lines that meet a range of important physical and social objectives. As one participant put it, it's not just that the car has a single pedal for accelerator and brake; it's also that it lacks a steering wheel.

As a general proposition, the group also strongly agreed that efforts to revive the economy by first reviving the financial sector cannot work. The correct approach to increase the level of economic activity and employment should instead consist of measures run through the public sector, the household sector, and the business sector. Thus, a program of general fiscal assistance—revenue sharing, in American terms—is the right way to stabilize the finances of state governments in the United States and of national governments in Europe. Relief from taxes on employment—payroll taxes—is an effective and relatively progressive way to stabilize household finances and, indirectly, to help the financial sector by giving households the capacity to meet their financial commitments. Expanding Social Security benefits, as well as unemployment insurance, food stamps, and other direct payments to individuals, is a proven and effective way to strengthen the incomes of dependent populations, particularly the elderly. Foreclosure relief and conversions-to-rental can help reinforce the housing sector by keeping people, as much as possible, in their homes.

Warren Mosler picked up on the theme of human resource utilization and full employment in a particularly useful way. Mosler suggested that stabilization of employment and prices is akin to a buffer stock—something to which surpluses can be added when demand is low, and drawn down when it is high. Normally, a buffer stock works on a price signal: the authorities agree to buy when market prices are below the buffer and to sell when they are above. In this way, prices stabilize at the buffer price. The Strategic Petroleum Reserve is potentially a good example, though political decisions have prevented it from being used as it should be.

The problem with most commodity buffers is elasticity of supply: create a buffer stock in wool, and suddenly it pays to raise sheep. But this problem is cured if the buffer stock is human labor, which cannot be reproduced quickly. A program that provides a public job at a fixed wage for all takers functions exactly like a buffer stock, stabilizing both total employment and the bottom tier of the wage structure. People can move in and out of the buffer as private demand for their services varies. Meanwhile, the work done *in* the buffer—the fact that people are working rather than receiving unemployment insurance—helps keep the buffer "fresh." Private employers like hiring those who already work, and will prefer hiring from the federal jobs program rather than from among those who remain unemployed.

The point is: the problem of unemployment is easily cured, without threat of inflation. It is merely sufficient to provide jobs, at a fixed wage, to whoever wants them, and to organize work that needs to be done. Such work should be socially useful and environmentally low impact: from child care to teaching and research, to elder care to conservation to arts and culture. Where possible, it should contribute to global public and knowledge goods. It should compete as little as possible with work normally done in the private sector; for instance, by serving those who cannot afford private sector provision of teaching and care. The point is not to socialize the economy but to expand the range of useful activity, so that what needs doing in society actually gets done. The barrier to all this is simply a matter of politics and organization, not of money.

The effect, nevertheless, would be to raise all private sector wages to the buffer-stock minimum (say, $8/hour in the United States), while eliminating the reserve of unemployed used to depress wages in low-skilled private sector industries. There will be no pressure to raise wages *above* the buffer threshold, since private employers providing higher wages can draw on an indefinitely large workforce willing, for the most part, to move from the buffer to the private sector in return for those wages. Hence, the program is not inflationary. There is therefore no excuse for waiting a year or two years on the assumption that unemployment will cure itself, and every reason to believe that at the end of such a policy of "hopeful waiting," the discovery will be made that the problem has not been cured.

Moving on to the problem of global public goods, it is clear that the neoliberal concept of reform—the creation of market mechanisms—is the dominant approach to the problem of climate change at the present time. The Paris group was largely reconciled, or perhaps resigned, to the cap-and-trade approach to marketable carbon permits presently moving through the U.S. Congress and enshrined in the international agreements. However, the weakness of this approach is highly apparent, in at least three important respects:

First, from the outset the market is compromised by exemptions for agriculture, lax treatment of coal, and the potential for speculative manipulation of permit prices. Tightening of coverage and regulation of the conduct of major market players will have to be high on the agenda once the basic framework is in place.

Second, taken by itself, the approach is likely to engender a violent political backlash, as it provides consumers with economic incentives to adjust their behavior but not readily available and low-cost means of doing so. If income effects therefore dominate, so that people feel impoverished by the requirements pressing on them, then the price of dealing with climate change will come to seem, to many people, too high.

Third, an auction mechanism implies a variable price, which increases the uncertainty associated with long-term investment and technological change. So long as the permit price has the potential to fall as well as to rise, the profitability of low-carbon investment is questionable, and the amount provided will likely be too small.

The solution to this problem *can only be* to plan and to invest in the creation of appropriate design, engineering, and technological solutions to the greenhouse gas problem, and to do so in a way that is independent of the short-term profit motive. Such planning and investment are necessarily public functions that will not be provided optimally by any market mechanism.

They will require the inception of new-knowledge goods—planning frameworks for energy sustainability at the local and regional level—that will in turn require a large-scale reorientation/expansion of educational and research resources. They will require the creation of a long-term financing network—such as the National Infrastructure Fund long proposed for the United States—capable of sustaining capital investment activity for long periods and of evaluating the results against the goals and objectives. They will require a national and transnational planning framework, embedded in institutions at the highest levels of government, including ministries in Europe and cabinet departments in the United States.

Banking and finance can play a role in the achievement of these objectives—but only if the regulation to which they are subject directs them toward that public purpose. The group thus turned to a discussion of how best to achieve that goal.

Toward a Functional System of Banking and Finance

The breakdown of the global banking system has activated an instinct to repair. Banks and other powerful financial players want the world returned to the condition that existed before the crash. Governments, responding to political pressure as well as the threat of cataclysmic economic failure, do as the financial players want them to do. The results are always disappointing. The problem is partly that the system *cannot* be put back to as it was and partly that it *should not* be. As one participant stated, "Humpty Dumpty was an egg."

A central dilemma of globalization is that finance escapes from national systems of regulation far more easily than any other activity. It is in the nature of financial transactions that they can be relocated instantly, and often clandestinely, in order to avoid the scrutiny of regulators.

Thus, the problem of effective financial regulation starts with the problem of borders. As matters stand, even where nominally operating as overseas branches banking institutions are effectively broken into subsidiaries, each operating under local rules, each accounting to the standards of the local authorities, and between them taking advantage of every form of tax and regulatory arbitrage. The result is an effective escape from taxation and a substantial escape from regulation. One participant described the existing program of international cooperation in bank regulation as "catastrophic," and the Basel I, Basel II, and Financial Stability Forum approaches as a "collection of fig leaves."

Hopes for an effective international safety-and-soundness regime are frustrated by national political considerations. Countries that provide tax and regulatory havens benefit at the expense of their neighbors. Countries housing major financial markets refuse cooperation so as not to lose competitiveness with other contending centers. The multinational banks form lobbies pressing for least-common-denominator regulation, and these are effective partly because they can dominate national political systems and partly because they can play one government off against another. International institutions are weak and excessively market oriented, placing automatic cushions—specifically, capital requirements—at the heart of the regulatory framework. As they supervise the result, they invariably find that financial institutions are well capitalized—until the day that those institutions fail.

Compared to Basel I, the Basel II framework for banking reduced capital requirements and increased the incentive to rely on ratings agencies, which in turn were allowed to use proprietary models to deliver AAA ratings to private securities, on a fee-for-service basis. This was a formula for producing biased ratings, essentially amounting to ratings fraud, on a global scale. The increased leverage that accompanied the explosion in the securities markets increased the fragility of the institutions, which they attempted to offset, in part, by buying credit default swaps. The effect of this was to vector risk throughout the system, in ways that could not be traced or anticipated by the authorities, so that a serious event in one part of the system could become a catastrophe, arriving from any azimuth at any time. And, with the collapse of Lehman Brothers, the catastrophe arrived. It was vectored, as it happened, to AIG via the latter's financial products division, a small unit based in London and apparently operating beyond the control or supervision of the firm's senior management. And the collapse of AIG brought on a panic that disrupted and came close to destroying the institutional basis of the global financial system.

The response of the system to the panic was to nationalize the provision of liquidity and to absorb the shadow banking system into the state. That is the meaning of the expansion of deposit insurance, the effective guarantees placed behind money market funds, and the taking of commercial paper wholesale onto the balance sheets of the central banks. As Perry Mehrling pointed out, the effect of the Term Asset-Backed Securities Loan Facility (TALF) was to make the Federal Reserve into a de facto investment bank. Meanwhile, the solvency problems of the banks proper are being overlooked, while the government infuses them with cash. A logical next step, Mehrling argued, is for the government to take over the function of providing credit insurance, and to do so for an appropriate fee. In practice, it appears that the Federal Reserve, through its program of nonrecourse lending against risky collateral, is providing a kind of on-balance-sheet version of the AIG credit default swaps.

All of this is to be expected. When things go badly, it is national governments that are called upon to intervene. The problem of liquidity can be solved only at the level of the currency unit, which (except in Europe) is a national issue. Dollars, in the final analysis, can be supplied only by the Federal Reserve; euros, only by the European Central Bank. So long as the underlying conditions persist, the position of government in financial matters cannot be dispensed with.

How long will the underlying conditions persist? When will come the moment when things will "return to normal" and the status quo ante will be restored? Or, to put the question more pointedly, *Will there ever come such a moment?* Current discussion of "exit strategies" for government involvement in finance indicates that governments, the banks themselves, and the financial press are eager to put the recent round of interventions behind them, evading, among other things, the restrictions and scrutiny to which they have been subjected. The question is, *Can they do so? Will they ever be able to do so?*

The Paris group spent considerable time on the character of improved or ideal systems, going back to Keynes's 1944 conception of a world clearing unit of account, and to the postwar system of strictly regulated banks and stable interest rates. Yet there was general agreement that the past cannot be re-created, because the particular conditions of technology, communication, and the global balance of power that characterized life two generations ago cannot be reproduced. By similar argument, the more recent past also cannot be re-created. The basic reason is that the particular institutions that imparted a false sense of stability and apparent trustworthiness to that system have been destroyed: not merely damaged, but destroyed. Their names and forms may persist, with deposit insurance, guarantees, and public capital propping up the roofs. But the functions and activities of the precrisis period cannot be reproduced in the postcrisis atmosphere, and this fact will become increasingly clear as time passes.

The Paris group therefore sees no alternative to the permanent restoration of national or equivalent public power (in the case of the EU, European power) over all financial institutions. Banks are public-private partnerships, funded partly at public risk (via deposit insurance and implicit guarantees). They cannot logically operate independently of the power that guarantees their funding, and the attempt to allow them to do so is intrinsically destabilizing.

Once having extended deposit insurance, governments cannot remove it. The attempt to return to a pre-insurance world, by allowing the value of accounts covered by insurance to erode, as was done in the United Kingdom, merely leads, sooner or later, to the reproduction of conditions for panic—as happened with Northern Rock. Similarly, in the United States, the perception in September 2008 that some banks were too big to fail while others were not led to a flight from the latter to the former—even though it was large banks, not small ones, that were responsible for the conditions leading to collapse.

So, too, in the shadow banking system. Money market mutual funds functioned free of formal government guarantees so long as it was widely believed that they were perfectly liquid and could not "break the buck." The crisis shattered that belief. Placing government guarantees behind the funds effectively turned them into narrow banks. This situation cannot now be reversed. And while the proportion of commercial paper held by the central bank may rise or fall with economic conditions going forward, the fact that the central bank has shown that it will support the commercial paper market has permanent effects. It affects the credibility of that market, and it creates new conditions for the issuance of commercial paper and the assessment of its creditworthiness. A similar situation holds with central bank backing for collateralized debt obligations and mortgage-backed securities. Similarly again, the collapse of confidence in the ratings agencies has permanent effects: it raises a doubt, whether well founded or not in any particular case, as to the credibility of an investment-grade rating.

Nor will the problem be solved by increasing capital requirements. The idea that bank risk taking can be effectively limited by capital requirements is a neoliberal illusion, stemming directly from the concepts of perfect information (banks' proprietary models calculate rationally the optimal risk to take) and market discipline (ratings agencies give honest and unbiased ratings.) In reality, capital requirements are neither a barrier to risk taking nor a cushion against losses. They are a tax on the operation of institutions, a source of conflict with the desire to promote credit expansion, and a "conduit to insolvency," as one speaker put it, as declining valuations wipe out the cushion for individual institutions and increase the pressure on the system as a whole. Yet the problem is not to tax risk or size in general, but to minimize financial behaviors that are likely to bring down the system. The plain lesson of history is that this can only be achieved by national (or transnational) regulation of institutional behavior.

Therefore, the task of governments going forward is not to find exit strategies that permit a return to the status quo ante. It is to establish and enforce effective rules for institutions operating on national territory and for citizens dealing with such institutions. Rules for banks, such as: thou shalt not maintain shell corporations, off-balance-sheet special purpose vehicles, conduct business in specified tax havens, or engage in proprietary trading, or establish compensation rules that encourage looting. Rules of taxation, stipulating that national taxes shall be in proportion to the national share of global corporate income, whether booked in the country or not. Rules for mortgages, returning mortgage finance to its public purpose, which is to stabilize households and communities. And rules for citizens, such as, one may not structure or restructure a corporation for the purpose of evading tax or regulation in one's own country.

In the case of credit default swaps, there is a strong argument for the position that they be banned outright, or simply declared unenforceable. Short of that, rules should stipulate that they are not enforceable unless written with standard terms and traded on an open exchange.

The difficulty of writing *and enforcing* appropriate rules of this type is evident. Doing so, however, remains the only serious antidote to reckless finance.

Enforcement is essential. The crisis originated in one of the great financial frauds of history, the issuance and securitization of subprime and Alt-A mortgages that were designed to generate fee income on origination, leaving the originators with no incentive to monitor loan quality. Fraud and misrepresentation were not merely epidemic, not merely rampant: they were pervasive. The failure of market-based solutions to the toxic asset problem can be traced to this fact; independent investors realize this, and therefore know that these assets are permanently impaired. So long as the financial system is not thoroughly purged of those responsible for financial crimes—through investigation and prosecution before the law—the system itself will not regain credibility, nor the trust of domestic or international clients. It makes no sense to repair the system merely to allow the same players to return to their posts.

It follows that the group favors a major strengthening of independent audit and enforcement capabilities in the regulatory agencies. This is an issue of staff, resources, and leadership, first and foremost. But it is also an issue of knowledge and capability. The regulatory agencies need useful expertise. They need criminologists as much as—perhaps more than—they need economists.

The ultimate result of applying this perspective to the redesign of financial systems would be twofold. First, it would largely reconcentrate financial activity in banks—which is to say, in chartered and regulated public or public-private institutions, with defined functions aligned with public purpose. Thus, it would shrink the shadow banking system. (This result can be further assured by requiring the registration of nonbank entities and subjecting them to oversight as appropriate.) Second, it would align the reach of particular banks with the regulatory frontiers applicable to that bank, ending the reach of banks into countries and regions that cannot control their activities. These steps would permit examination regimes to inspect the full range of a bank's activities, reducing the scale of unregulated speculations and making it easier to detect and prosecute fraud. Together, they would begin to change the culture of the financial sector, promoting a more conservative, less predatory, and less reckless approach to financial services.

A further advantage of this approach is that, within banking, it would tend to shrink the largest and most transnational banking institutions relative to smaller, national and regional banks. In a financial sector that is destined in any event to shrink, relative to the economy, in the postcrisis period, a crucial policy question is, *Which institutions should shrink by the most?* The group generally took the view that extreme bigness in banks conveys no technical, competitive, or national advantages. Banks are legal institutions, in the sense that they exist largely to write financial contracts. Big international banks exist largely to take advantage of differences in national tax regimes, accounting standards, and regulations, and to exercise political power. Theirs is an example of institutional evolution adapted to private, not public, purpose, and the object of a structured downsizing should be to achieve a structure that is aligned to public purpose: a universe of stable, numerous, competitive institutions that can be regulated effectively and that are individually not too big to fail.

Where there may exist "critical system infrastructure" presently administered by large banks, there is no reason why such infrastructure should not be managed in the public sector, as a public utility. The possession of such infrastructure is not *per se* a reason to keep an otherwise failed or failing institution alive. "Too big to fail," in other words, should be considered a temporary condition. Once a company is designated, under President Obama's plan, a "Tier One Financial Holding Company," the task of policy should be to shrink and simplify that company to the point where it no longer poses a distinct risk to the system. Clearly, the place to start would be with undersupervised international divisions of the largest banks.

Transnational companies would thenceforward seek funding for local activities in the local banking system. Since many countries are below the scale of efficient banking operations, this consequence implies a boost for the ongoing process of regional monetary management. This process is most advanced in Europe, but it is emerging as well in Asia and in Latin America. The Paris group regards this development as a positive step, on the whole. It raises the question, however, of what larger monetary environment best suits the functioning of a parapublic credit system.

International Monetary Reform Still to Come

In the final session, the Paris group turned to a discussion of the international monetary system writ large.

The first lesson of international monetary systems in the 20th century, from the gold standard through Bretton Woods and after, is that they do not last forever. For nearly 40 years, since President Nixon closed the gold window, the world has accepted a de facto dollar standard. Reliance on the dollar actually grew stronger in the past decade, as many countries built dollar reserves in order to combat the volatilities the Asian and Russian crises revealed the system to be capable of. But there is no reason for a feeling of confidence that this arrangement will endure.

Some members of the group suspect that the U.S. origins of the present crisis will lead to reconsideration of the dollar's supremacy fairly soon. Others believe that the inertia of the system is strong, and that the absence of a credible alternative—notwithstanding the euro—will keep the dollar at the center of the world system for some time. (All agreed that if an unplanned-for change comes, the transition costs are likely to be high—as they were in the interwar period.) In spite of differences on this question of the medium-term outlook, the group was agreed that the current system has both defects and vulnerabilities, and that a better system could and should be designed.

The principal vulnerability of the dollar-based system lies in the fact that the main justifications for it no longer exist. The dollar anchored the exchange system sanctified at Bretton Woods because of the United States' dominant economic position in the postwar world. In the 1990s, the development of an asymmetric system rooted in dollar reserves was an outgrowth of the power of American financial interests in the world economy, of the Keynesian character of the American system that gave the United States a tendency toward strong demand policies and permanent current account deficits, of the fact that China's opening toward the West initially relied heavily on American markets, and of residual security concerns and the United States' dominant military position through the end of the Cold War. Of these facts, only the second remains a compelling reason for the system to continue—and it amounts to saying that the dollar reserve system depends basically on the United States being the country most willing to run large trade deficits. This cannot be a secure foundation for a permanent system.

The issues of "asymmetry" and "imbalance" were raised and discussed, with some participants arguing that a system based on the financial assets of a single country is inherently unstable. Others were not confident of this conclusion: whether the system is symmetric or asymmetric depends on whether there are economies and advantages to having assets denominated in a single currency serve as the world's reserve. If so, the country favored by reserve status must adapt: its exchange will be bid to the point where imports exceed exports by the amount that the rest of the world wishes to hold in reserve. In a growing world economy this will always be a positive sum, and in a converging world economy (with poorer countries growing more rapidly than the reserve-asset country) it will normally lead to a current account deficit that increases as a share of the reserve-asset supplier's GDP. As Ping Chen put it, the world economy is always asymmetric. The question is, *Does there come a point where considerations in favor of sticking with the single reserve currency are outweighed by reasons to change the system?*

There are three logical alternatives to the dollar-based system. The first is that the dollar might be replaced by another key currency, as the pound sterling was replaced by the dollar (outside the sterling bloc) from the 1920s through the 1940s. The euro is now the key contender for the replacement role. However, for the euro to mount a sustained challenge, several conditions would have to be met. First, the eurozone would have to begin to run substantial current account deficits, creating the net asset outflows that are the counterpart of reserve accumulation. European policy is averse to running demand at that level. Second, the European Union would need to develop a reserve asset enjoying the full faith and credit of the union itself, not merely national bonds denominated in euros. Third, the United States would have to embark on a policy of much greater austerity, basically renouncing recovery from the great crisis—a possibility that the Paris group was not prepared to contemplate for the moment.

The second possibility is the replacement of the dollar by a new international reserve asset—the revival and expansion of the special drawing right (SDR). Note was taken of the G-20 commitment to authorize a major expansion of SDR, evidently in the first instance to help deal with the crisis in Central and Eastern Europe. This initiative raises a serious question as to the role of the IMF.

The group's assessment of the IMF is, essentially, that it is beyond repair. As one participant pointed out, the organization exists outside the framework of law, and routinely violates its own charter, with impunity, particularly in denying to member states the right to impose control over capital flows. Members have the right, under the charter, to demand reduction in terms of repayment—yet the IMF and the World Bank routinely seek to set themselves apart, as creditors preferred above all others. Conditionality and austerity are imposed on the most vulnerable member countries, with the objective of undermining the most basic human economic rights, under conditions that preclude effective economic recovery. Adding funds and power to this organization is an exercise in self-defeat. As one participant put it, "The concept of a reformed IMF is an oxymoron." The prevalent view within the group is that efforts to expand the resources of the IMF should be defeated.

In an ideal world, clearing away the present dysfunctional international monetary institutions would open a path toward a reformed system, in which the function of an international reserve currency would be, not the financing of temporary current account deficits (followed by adjustment), but the provision of resources to support the development of the nontraded and, especially, the nonprofit sectors in countries that cannot sustainably finance their own current account deficits. Thus, an international system would support critical infrastructure, environmental protection and greenhouse gas reduction, public health, education, and research, creating zones of economic stability and supporting development and high employment. Rather than forcing developing countries to find ever more exports in order to invest and expand, the goal would be to free developing countries from a compulsive need to serve the export sector on any terms. However, the emergence of new global institutions governed on progressive and humane principles remains a distant objective.

The final alternative to a single-reserve-asset world is to pursue the development of regional monetary authorities, which can, among other things, make dollar reserve assets earned by countries that are successful net exporters available to neighbors who are not. Such authorities have distinct advantages over a global system, because (1) the regional fund has a direct stake in the success of member countries under its authority, (2) a structured system gives small countries some of the advantages and margin for maneuver that are already enjoyed by large economies in both the developed and developing worlds, and (3) regional power can be deployed effectively over regional financial institutions.

In this respect, developments in Europe, Asia, and Latin America in the past decade are encouraging. The euro remains the leading example of international monetary integration; the task before Europe is to extend the protections of membership in the euro system to the rapidly deflating economies of the East; to develop mechanisms to help build demand by transferring resources effectively to the poorer member economies, permitting the quick establishment of employment programs; and to restore effective regulation of finance at the continental level.

Asia and Latin America have the capacity to achieve qualitatively comparable results if they choose to do so. In this way, some of the asymmetries associated with a single reserve asset can be remedied—especially the fact that large parts of the world, unable to earn adequate hard currency, cannot finance development at all.

To put the matter another way, the problem of asymmetry is the problem of assuring sufficient aggregate effective demand in the world economy to permit the full utilization of human resources—while conserving, as much as possible, nonrenewable and environmental resources. The way forward toward this goal is, in the first instance, to put resources at the disposal of countries, regions, and households that have been starved for such resources over the neoliberal era. The United States can (and will) continue to supply the main global reserve asset, running a trade deficit to match. But it would be highly desirable to supply additional reserves, and hence to fund additional activity demand, through an alternative asset, channeled mainly through regional institutions and deployed mainly in the not-for-profit and nontraded-goods sectors.

In brief conclusion, the group of experts convened in Paris in June warns that the crisis is not over, that policies so far set in motion are not sufficient, and that the goals set by the authorities to this point, which amount to a restoration of previous conditions, are neither desirable nor possible. It is time to take account of the irreversible characteristics of recent events, to chart a course of new construction instead of reconstruction, and to build the domestic and financial monetary institutions and safeguards necessary to make it possible to pursue that course.

Notes

1. Participants in the conference included Marshall Auerback, RAB Capital, PLC; William K. Black, University of Missouri–Kansas City; Jack A. Blum, attorney, Washington, D.C.; Jean-Joseph Boillot, Euro-India Group; Luiz Carlos Bresser-Pereira, Fundação Getulio Vargas, São Paulo; Pierre Calame, Fondation Charles Léopold Mayer; Christian Chavagneux, *Alternatives Economiques* and *L'Economie Politique*; Ping Chen, China Center for Economic Research and Virtual Center for Complexity Science, Peking University; Stephen S. Cohen, University of California, Berkeley; Jane D'Arista, Political Economy Research Institute, University of Massachusetts Amherst; Paul Davidson, The University of Tennessee, College of Business Administration; Paul H. Dembinski, Observatoire de la Finance; James K. Galbraith, The Levy Economics Institute of Bard College, The University of Texas at Austin, and EPS; Robert Guttmann, Hofstra University and Université de Paris-Nord; Thea Harvey, EPS; Patrick Hébert, Calyon; Michael D. Intriligator, University of California, Los Angeles; Wojtek Kalinowski, IRE; Jan Kregel, The Levy Economics Institute of Bard College; Aurore Lalucq, IRE; Bernard Lietaer, Access Foundation and University of California, Berkeley; Michael Lind, New America Foundation; Perry Mehrling, Barnard College, Columbia University; Warren Mosler, Valance Co.; Alain Parguez, Université de Franche-Comté, Besançon; Jean-Paul Pollin, Université d'Orléans; Kunibert Raffer, Universität Wien and New Economics Foundation; J. Barkley Rosser, James Madison University; Nicolas Véron, Bruegel; and Lucy Law Webster, EPS and Center for War/Peace Studies.
2. James L. "Jamie" Dimon is the current chairman and CEO of JPMorgan Chase.

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Galbraith is the author, most recently, of *Unbearable Cost: Bush, Greenspan, and the Economics of Empire* (Palgrave Macmillan, 2006) and *The Predator State: How Conservatives Abandoned the Free Market and Why Liberals Should Too* (Free Press, 2008). He is a former executive director of the Joint Economic Committee and was an architect of the modern procedures of congressional monetary policy oversight. From 1993 to 1997 he served as chief technical adviser to China's State Planning Commission as part of a UNDP project on macroeconomic reform. Galbraith studied economics as a Marshall Scholar at King's College, Cambridge, and holds economics degrees from Harvard University (B.A.) and Yale University (Ph.D.).