PANEL DISCUSSION

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I think we live in interesting times, since the world has become global and therefore anything can happen. My definition of globalization is a world where there are no rules, no definite markets and individuals are rational but sometimes ignorant as they do not master all the variables they are subject to. Globalization to me means interdependence of unknown scale. What happens somewhere in the world – you do not know where – can have an impact on your life, on your wealth, on your well-being, etc.

More so, the world is running faster than the laws and authorities can cope with. One can see that the main characteristics of some of the financial instruments which have been partly the cause of the present crisis are precisely due to regulatory arbitrage by intermediaries, i.e., the creation of financial instruments which are not closely regulated by a single authority. The mixture of bank credit, securitized and covered with insurance, and default swaps was done precisely to avoid any single authority being responsible for it. It is what we have been calling, in technical terms, arbitrage among regulations, i.e., zigzagging among the various authorities, none of them being capable of having a complete picture of what is going on, and this has been the market and government failure of the last two to three years.

There has been a long debate in the *Economist* concerning whether you should study market failures and ask governments to take care of them or, according to a famous paper by Joseph Stiglitz, you normally have government failures and hope that the markets will solve the problems.

In fact, what we see is a mixture of government and market failures, and you do not know which is first, which is at the origin of the problem. You remember that Sir Winston Churchill once said that each peace treaty solves the problems of the previous wars and creates the origins of future wars. By the same token, and this is the risk we are experiencing presently, by trying to solve a crisis, you may actually start a new bubble, a new problem developing in the future.

Coming back to the question of markets versus governments and whether in the global economy we tend to have more market failures and then need rules, authorities, governments and policies to cope with such failures, or vice versa, I will now make two points on a broader perspective.

First of all, which countries have been more successful in Europe so far? I have been making a list of features for which to give prizes to the various members of the European Union and, not surprisingly, the countries that have had more growth in the last 20 years are small, open economies. This, by the way, is another definition of what global economy means. In a global world we are all small, open economies, more so than in the past, even America; if you see what is going on in America, it is very difficult to have recession in one single country. We have been discussing the American recession for over a year, and you get the impression that even the US cannot have its own needed recession, precisely because in a world that grows a lot, it is difficult to have a recession. You may succeed in avoiding growth (this is the Italian experience: we are very good at avoiding growth!), but you can't have recession in one single country, if the other 189 are all growing. It is very difficult because we are all small, open economies nowadays.

In this respect, all the debate of Keynesian versus neoclassical models based on closed economy models deals with a world that no longer exists. The big conflict between neoclassical and Keynesian had to do first of all with government sovereignty. It was assumed that when a government says something will occur, it occurs. Normally (and apart from Italy where it is different!) we think that a government statement is followed by a policy and an effect of that policy: in Keynesian terms, a multiplier greater than 0 was the outcome of a policy. Nowadays, all the multipliers have gone down dramatically, because in small open economies the government can influence behavior but cannot guarantee outcomes, because the amount of external influence is overcoming the capacity of the government to deliver on its promises.

In a sense, we are all becoming Italians, i.e., without a government, even after voting one in, which is our experience. We vote more and more often, with the idea of having a government sooner or later. But if you

see, for instance, the line for public spending in Italy, it is a perfect straight line going up continuously and you do not see any change in the inclination of this line. Growth of public spending increases with the age of the population, which is obviously what happens in a normal country if you do not react with policy. The amount of social spending on a person of my age is three times the amount of spending on a person 20 years of age. By the sheer effect of age, public spending goes on, on a straight perfect line. This is what you see in Italy.

But, coming back to more serious problems and leaving aside these comments on Italy: what is my view on the present situation in terms of this mixture of globalization, the dollar, and inflation and the risks associated with the image that central banks are so powerful?

In my view, one of the reasons we have had so much financial fragility accumulating in the last ten years was precisely because the consensus was that central bankers had become so capable of guaranteeing monetary stability forever and very low long-term interest rates that this somehow led us to think that risk was no longer there.

There were no more risks in the world of "Great Moderation" after the paper by Benjamin Shalom Bernanke in 2004. Thanks to the virtues of central bankers, we will have monetary stability, no variance, i.e., no risks, forever. This meant you could borrow without collateral, you could borrow any amount of money without caring about long-term financial risks. The crisis was built on the assumption that there were no longer any risks and therefore you could take any risk; if risk doesn't exist, you can borrow unlimited amounts of money and who cares!

But let us go back to the question of today's globalization. We live in an industrial-revolution kind of world. More and more countries are becoming industrial countries, and so you have to go back to the classics, Adam Smith and David Ricardo. We know how Adam Smith explains growth: it is the capacity of a country to benefit from a greater market. Reduction in costs, economies of scale and innovation come from the enlargement of the extent of the market, says the original 1776 Adam Smith book. David Ricardo's idea is that through comparative advantages you can always benefit from more and more countries competing in their own capacities, according to their comparative advantages.

This is exactly what we have seen. Not surprisingly, the most successful countries in the last 20 years have not been the big ones, Germany, France, Italy. We didn't realise how small and open we had become, and we spent time trying to use our bits of remaining sovereignty to maintain our virtues of the past.

We invented "national champions" to protect our defects. We assumed that having had a glorious past—this is typical of France, but also to some extent of Italy and Germany—we could hope to maintain this past and to have it as a model for the emerging countries, which, however, were moving along different lines.

If, however, you see the countries where growth of productivity, innovation, investment in new industries and so on have been higher in the last 20 years or so, you will discover, not surprisingly, that it is small countries, like Switzerland that, having a long experience of being small, were already prepared to become "small and open." I also mention Ireland and Finland—one of the most successful of the last 20 years in terms of productivity, innovation, specializing in few things in which you are number one in the world.

Italy, France and Germany have not been the best in Europe in terms of growth of productivity and so on, precisely because we had this idea of still having a national state, a national champion. And we were not prepared to go through the Thatcher–Reagan recipe of dissolving the past and leaving room for an entirely different future.

In Italy, for instance, we are still having new technology, like the Internet, simply added to the technologies of the past: we have been able to spend millions to protect our Post Office (we are still using stamps!).

These are two lessons we have learned: Small, open economies perform better than large economies; and the success of monetary stability has been effective in leading financial markets to take on excessive risks.

Prof. de Boissieu recommended that "two eyes look at two things." But the central banks' two eyes were meant to look, one, at monetary stability, and two, at financial stability. Most central banks had in their statutes, originally, the idea of having two targets, monetary and financial stability. Then, in the '90s, reforms removed the second eye and we started to have central bankers with one eye only, like Polyphemus. We now have central bankers in Europe who are capable of delivering on one thing, monetary stability. The Bank of England was reduced (by Tony Blair, ten years ago) to a central bank that cares only about monetary stability, and this has been influential in causing the Northern Rock flop.

The ECB is very effective in liquidity management but has no instrument for financial stability — will they simply go to church every morning and pray that no major problem of solvency happens, because we have no authority in charge capable of guaranteeing what the Fed, luckily, still does, i.e., manage its problems in an effective way, perhaps because of the influence of Benjamin Shalom Bernanke.

Most of the problems which Benjamin now has to tackle, of course, were caused by his predecessor. If you go back to the "conundrum testimony" (February 16, 2005), it makes interesting reading, because in that Congress presentation the previous Chairman, Greenspan, said that long-term rates falling when short-term rates were increasing was a conundrum. In the following days everybody went to Google, trying to understand what a "conundrum" is. Conundrum means enigma, something you cannot rationally explain. There is now a huge amount of literature, if you go on Google, hundreds of pages on conundrum now, but no one knew it then in 2005.

It was a kind of mystery. Inflation was starting to rise, the Fed was increasing short-term rates but, notwithstanding the Fed's move, the curve didn't shift, but it twisted: the long-term term rates were declining as much as short-term rates were increasing. Greenspan made a point that intermediaries and authorities should be aware that they should not take this as an indicator of their success. The explanation was that central banks are so effective that when they increase short-term rates, expected inflation disappears and long-term rates already go down. It was thought to be a positive consequence of their success.

Three years later, this year, short-term rates have gone down exactly to where long-term three-year rates were in February, 2005. In other words, after all, it was a perfect explanation by rational people that if central banks increase rates, that will cause problems and therefore rates will come back — not a success indicator but a mess indicator! This is exactly what we have seen. The reaction of the financial market, according to rational expectations, in February, 2005, was, "You are increasing rates to 5 percent and then they will come back to 2 percent in three years' time, because that will cause all the problems you will see in three years' time."

This is my explanation: financial markets knew more and better than the authorities the mess they were making. Do not tell the bankers they are causing problems. They know it. Thank you.

ANTONIO FOGLIA
Banca del Ceresio

First, a disclaimer: we have a roster of professors and central bankers here, and I am the ignorant practitioner from a small local bank, with self inhibiting brakes worn out enough to be able to face them and you this evening.

I think we have first to remember that we are in the midst of a huge fire, a global credit crisis, and we are talking about the central bankers, who are the fire-fighters right now. So, the first thing that you do not do is to badmouth the fire-fighters or try to change the head of the fire department during the fire. Let them do the work!

By the way, as a practitioner, I am very surprised by the way they are carrying out their work with fantasy, also in the kind of instruments they are inventing by the day to solve the crisis, and by the way they face problems they had not anticipated and that vex them day after day. I find their behaviour actually quite extraordinary.

We have talked a lot about how good the Fed has been at that. But, in a way, the ECB has been even better, if I may say so, because they did the exact same thing without hitting the front page of the *Wall Street Journal*. They have been throwing hundreds of billions of euros into the market without having any politician cry fool or warn of moral hazard or other similar things such as have been discussed on the other side of the Atlantic but that are just as valid on this side.

Now the question is, "Can central banks alone win the global challenge?" No chance!

First of all, because they do not understand it. The ECB, for one, ten years after its establishment, has not yet sorted out how to deal with its role as lender of last resort. This is amazing and should be a big warning about relying too much on bureaucrats. These guys have had ten years to work out how to operate their most important and critical function and have done nothing about it.

Another indicator that they have no clue of what they are facing is in the 500-page Greenspan autobiography and in the 300-page Rubin autobiography (who was at the Treasury during the 1998 LTCM crisis). You put these two books together and you have 800 pages of biographies of the two leading protagonists of the 1998 big banking crisis. Guess how many pages are dedicated to that crisis out of 800 pages? Less than three! Basically half a page in Rubin's and two-and-a-half in Greenspan's. This is just simply mind-boggling.

Every crisis has a different catalyser, and subprime was the catalyser this time. Last time it was LTCM, but basically what crises uncover is the same thing. What we discovered last time was basically that the banking system was overleveraged and that banks were dealing in extremely opaque markets where nobody had any clue of what risks are being run by them or by the counterparties and so on and so forth.

The fact that nobody did anything about it and, to the contrary, that the rules the banks were operating under then have been relaxed (now Basel II) to give still greater leverage to the banks is totally amazing. Again, this should be a big warning that relying on central bankers is not the safest thing in the world.

Thank God, we do not need to. We do not need to because of how financial intermediation has changed, to a larger degree than what Professor Ertürk has shown. We are used to textbooks describing a world where households save, industries invest and government spends. Well, government spending seems to be pretty classic and does not change over the millennia. But today you have in the US households that invest and companies that save. The kind of financial intermediation that you need in an environment like that is radically different. A lender of last resort that basically guarantees the depositors who themselves cannot know whether a bank is really good or bad is not necessarily needed if the ones who are actually accumulating the savings are sophisticated treasury managers in large corporations. Those guys should know one bank from another and choose the way they invest their money.

Not only that: by and large, credit does not flow through the banking system the way it used to. You have huge financial intermediaries today, insurance companies or hedge funds, which are as important as the banks are. In this respect, I think it is amazing that during this crisis nobody has focused yet on the difference in managing a credit crisis and a debt deflation crisis in an environment dominated by banks versus an environment dominated by a multitude of financial intermediaries.

You remember that in August, 2007, when people began to fear that the crisis was taking a nasty turn, Treasury bill rates fell to very low levels, while the interest that the banks were ready to pay for overnight or three-month deposits shot up greatly. All market participants were very afraid at the time, because the US Treasury bill market had become totally illiquid. It was impossible to find paper. This is in a way pretty silly, because the US Treasury bills are, in today's world, the ultimate risk-free security, and what you should do in a situation of crisis is flood the market with as many risk-free securities as people are willing to buy. So, it makes sense that they should pay no interest or that the interest should fall, but it makes no sense that they should become such a scarce commodity as they did.

Had people been able in August and in the subsequent months to actually decide to sell whatever risky assets they had and buy as many Treasury bills as they wanted or needed to sleep properly, probably after

a couple of nights of good sleep they would have come back and bought back what they had just sold, because they had sold it at a crazy price.

So, we are still focusing on managing a liquidity and credit crisis on the banks' side, and we do not realise that it is actually a much more diversified market where you also need to take a portfolio approach and think about all the other financial intermediaries that are non-bank.

I will now come to other aspects that came up in today's discussion where I think that the perception is somewhat different from what my sense of reality is.

We tend to assume that if a country runs a current account deficit it means that country is in fact spending too much. But as the equations that were presented earlier showed, and I myself had to be convinced to the contrary by professors, this could just as well mean that some other country is saving too much. There is actually no way of telling before or during the fact how much of the deficit is due to the fact that Americans are profligates and have been spending like crazy or how much they were actually pushed into spending like crazy by the fact that the Chinese had decided to accumulate a nonsense amount of foreign reserves.

To that extent, if you think they were totally crazy to accumulate that kind of foreign reserves as a percentage of GNP never before seen in history, a falling dollar is their own problem. We shouldn't really care. They created the problem, they suffer from it. It will teach them a lesson next time around. In a way, the same applies to the countries accumulating a huge oil-related surplus.

In part, the subprime crisis has been caused by China and oil-exporting countries in the sense that this huge accumulation of dollar-based reserve has basically bought US Treasury bonds, explaining in a certain sense the "conundrum" of why interest rates of US government securities were so low, but by doing so they have crowded out the local US institutional investors, who are by regulation forced to buy investment-grade securities. Since there were not enough around at an interesting price because foreigners had bought all the government paper available, what did Wall Street do? It invented new securities to which it could attach an AAA rating, make them investment grade and shuffle them off to US pension funds, insurance companies and other regulated US institutions. So, there is always another radically different way of looking at things.

This is also true with respect to the way monetary policy has been used in Europe and in the US in this crisis. We must remember that the effect of interest rates on the two sides of the Atlantic is radically different, particularly when you consider continental Europe versus the US.

In the US, consumers are heavily into debt and very sensitive to interest rates. In Europe, it is actually the reverse. In Italy, for instance, we have seen that when interest rates fell from 12 to 3 percent, thanks to the fact that Italy joined the euro, there was a huge slowdown in consumption because people have savings and they do spend a little bit of the return on their savings. So, the fact that the ECB has kept the rate at the level it has might not have had the same effect in Europe that could be expected on the other side of the Atlantic.

Another point is about Prof. de Boissieu's comments on banking regulations as the only effective international coordinated action. Well, from my point of view, effective is a big word, because they created an amazing mess. The mess was, as Professor Vaciago pointed out, created by the fact that Basel II basically creates a risk-based system to control banks and to determine the amount of capital banks must have. And once the central banks had defined risk as volatility, they went on to suppress volatility in every possible way, without realising that in today's financial world the leverage effect that you get by suppressing volatility is much higher than that of lowering interest rates. The explosion that we saw in banks' balance sheets following the adoption of this risk-based modelling for assessing capital needs is directly related to this effect.

There are a number of other points, but time is running short, so I better stop here. Thank you.

CHRISTIAN DE BOISSIEU

I will comment on three points.

First point, about the conundrum, as discussed by Prof. Vaciago: I also think that the regime of long-term rates has been very important in the dynamics of our economies over the last couple of years. It has to do with excess liquidity and also excess savings at world level. By the way, when Greenspan first talked of the conundrum, he was giving the explanation of the conundrum, and I think that his explanation is still the right one: excessive liquidity, excess savings and the fact that institutional investors are keen to buy bonds and other securities explain why we have been living in this world of low long-term rates and why this has induced many investors to take more risks, in order to get more returns.

From this point of view, when I say that the regime of long-term interest rates has been instrumental in the dynamics, both positive and negative, of our economies, for the past couple of years, I believe that this regime of low long-term rates has also induced many people to take more risks in order to make more returns. This is portfolio theory, as all the students in the room know.

What we have seen since August, 2007, is a dramatic price assessment of the risk and the increase in risk premia. Perhaps in some cases you can say that there is some overshooting of the price assessment of the risk premia. When we talk about long-term rates we are better than ever to make a big distinction between the risk-free long-term rates versus the corporate rates. The risk-free are still very low, if you look at the US and Europe, not speaking of Japan.

Second point, about the ECB: I am somewhat critical of the ECB, but for the sake of the debate I will defend the ECB when Mr. Foglia was talking about ECB as a lender of last resort. It is clear that nothing was put in the Maastricht Treaty about this. But it is also true that empirically I was rather positively impressed by the way the ECB has found a way to provide liquidity to banks, by extending the time horizon, the refinancing of banks, up to six months, and by expanding the collateral that has been and is being accepted. From this point of view, I have a feeling that the ECB is building its own jurisprudence about the way it wants to implement its role as lender of last resort, even if nothing is clear, nothing is explicit in the Maastricht Treaty about this.

To finish on this aspect of Europe, I am interested by the debate which was at the centre of Ecofin and Eurogroup meetings in Slovenia last weekend. The debate is the following. We want to have a single market (because the market is not single yet, even for banking and financial services), and we have implemented three committees at the European level which govern national supervisors and regulators, one for banks, one for financial markets and one for insurance. Do the 27 EU countries agree or not to improve coordination and to give more power to the three committees, which have been put in place according to what is called the Lamfalussy Process? The debate which has been open since the outburst of this crisis is whether the member countries are ready to transfer more power to those sector committees: banks, insurance and financial markets.

There is no agreement, and I am not astonished by the fact that the UK government does not want to transfer more power to those committees. But what is surprising is that the Germans do not want to transfer what remains of their national sovereignty in those fields, or part of what remains of their national sovereignty. Despite the fact that Merkel and Sarkozy are writing to each other every two weeks, they did not agree on this in Ljubljana, Slovenia, and I think that from this point of view the meeting which took place last weekend was a failure.

Now they are going to Washington, D.C., to discuss with the US, the Japanese and the emerging countries. If we do not agree among ourselves in Europe, how can we be credible vis-à-vis the rest of the world? How can we push our own ideas? When you look at the debate concerning governance, the articulation between world-wide governance and European governance could be important. As a European—and I am a European – I must acknowledge that Europe as such has been very weak facing these financial crises.

In a meeting in Paris in November, Mr. Almunia, the European Commissioner for Economic and Monetary Affairs, was asked, "What is Europe doing to face this crisis?" He said, "We are organising committees." The

answer was purely based on committology. But we have enough committees, and we need action, we need recommendations and we need convergence.

One last point, following up on Prof. Vaciago's comment on market versus government, when he said it is not "versus," it is both, market and government failures. There is one aspect of this problem which we have not been explicit about this afternoon but which is important in the current debate.

We are implementing new accounting standards, new prudential rules. Those standards in many aspects represent progress. I would say for me the fair value is better than historical accounting, in general terms. I would say to have risk-based prudential ratios like Basel II could be better than growth estimates, which were in Basel I. And in general I think that Basel II, despite all its drawbacks, is progress compared to Basel I. But the problem that we are facing is that it is difficult to reap only the benefits of these progresses. We also have the drawbacks. And all the debate about the pro-cyclicality of the new standards is a very important debate, because if you look at fair value, market to market, if you look at Basel II the new accounting and prudential rules are introducing some pro-cyclicality into the system; that is, they increase the natural fluctuation of the economy. We do not have very precise answers to those challenges, how to keep the benefits of the new accounting standards, how to keep some of the benefits of Basel II without being exposed to so much pro-cyclicality.

In order to reduce the pro-cyclicality of Basel II, some people are saying we must pass to a new regime of provisioning, like dynamic provisioning. I do not know how this problem is felt in the US: the US is rather far from Basel II, they will join next year, and they will apply Basel II to only 20-25 international banks. In contrast, in Europe we are applying Basel II to all our banks in the 27 EU countries, and this is a big difference.

In conclusion, we know that it is difficult to have, as we say in French, "le beurre et l'argent du beurre," the butter and the money from the butter. How to keep the benefits of the innovation, of the new regime, the new standards, without being exposed to those big drawbacks? Thank you.

QUESTIONS FROM THE FLOOR

Benoît Mojon:
There is so much interesting material that it is difficult to react on all the things I would like to react on. But there are two main points in Prof. de Boissieu's presentation I would like to come back to.

About asset price inflation: The Bank of Spain did require that banks wanting to securitize some of their mortgage debt should put aside some capital. In the end they did not do it. When it comes to asset prices, most of the bubbles that we have seen and which are likely to have a bad impact on the economy, either in the ascending phase or the descending phase, have been fed by credit. A collapse is a possibility and this puts the banking system in danger. In my view, it is a supervision task to impose on banks that when they embark in this kind of credit, on a large scale, they would increase provisions accordingly. This is a personal point of view and I am not expressing the views of the ECB or the Federal Reserve system, but I think it should be put into debate.

Another point about relative prices: We do see oil and food prices increase; I do not see only bad news in this and I believe, as an economist, that it creates incentives for the economy to adapt. We are going to see cars that consume less oil, as we did after the first oil shock. OECD countries have effectively decreased their consumption of oil following the increase of oil prices in 2006. So, the volume of oil consumed has declined a lot. What we have seen is a surge of the consumption of coal in China, which is actually a very bad thing for global warming. But demand reacts to prices, and so does supply. And the price of food is also good news for those parts of the world that are not as effective as China in boosting the manufacturing sector, and I am thinking for example of Africa. We see growth in Africa and this is a good thing for the world. So, I am slightly more optimistic on this front than Prof. de Boissieu. Thank you.

Korkut Ertürk
Two quick comments in connection with Prof. de Boissieu's comments. I fully agree that it has to get much worse before something happens. Political pain has to be much worse, especially in the United States. I think