

COLUMBIA UNIVERSITY
IN THE CITY OF NEW YORK
CENTER ON CAPITALISM AND SOCIETY

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Director

15 February 2010

Prime Minister Stephen Harper
80 Wellington Street
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Dear Mr. Prime Minister:

As Director of the Center on Capitalism and Society at Columbia University, I want to report to the G20 on the conference “Post-Crisis Economic Policies” the Center held on 11-12 December 2009 in Berlin. Last year I reported to the G20 on our conference “Emerging from the Financial Crisis” held 20 February 2009 in New York. At this recent conference, as at the previous one, a great many renowned policymakers, bankers, regulators and scholars joined forces with members of the Center to discuss key issues and come up with proposals on how to improve economic performance in the advanced economies in the aftermath of the financial crisis. Paul Volcker, chairman of President Obama’s Economic Recovery Advisory Board, and Josef Ackerman, Chairman of Deutsche Bank, were dinner speakers. Lucas Papademos, Vice-President of the European Central Bank, Sir Howard Davies, Director of the London School of Economics and former Chairman of the Financial Services Authority, Dr. Joachim Faber, Member of the Board of Management of Allianz SE, and two Nobel laureates – Robert Mundell and I – each spoke in a panel as did the chair of the Center’s Advisory Board Peter Jungen.

We convened to discuss ways to raise radically our post-crisis prospects – to boost our nations’ normal prosperity levels and to buttress their prosperity from severe swings brought by speculative forces. A prosperous nation is one with adequately high employment in broadly rewarding jobs – jobs in which not only wages are good (relative to other income) but jobholders are flourishing: learning, exploring, creating and finding stimulation, engagement and self-discovery. For a nation to be *normally* prosperous, not just prospering for awhile thanks to some happenstance, its economy must possess adequate economic *dynamism* – a capacity and propensity for indigenous innovation – and adequate economic *inclusion* – wide access to jobs made rewarding by innovation are widely shared. Though the members of the Center present a range of views on the *ways* to generate prosperity and bolster it in cyclical troughs, we are united in taking a modern perspective on economies: The actors in an economy, particularly a dynamic one, face limitations in their economic knowledge – knowledge of the consequences of departing this way or that from past practice; these limitations create room for speculative excesses (and oversights too); yet such limitations make it possible for the business sector of an economy equipped for dynamism to conceive of plausible innovations without the *deus ex machina* of (exogenous) science; and innovation is the key to normally high prosperity.

This modern perspective is essential to constructing a satisfactory political economy, in particular a conception of the good economy, and it is now crucial to conceiving an

economic policy adequate for the times. It is unfortunate, therefore, that a great many economists and policymakers still take the contrary neoclassical view that businesses are incapable of creativity, that the sole rewards of business are wages and consumption, and that innovation depends instead on the discoveries in basic science. They conclude that the world's innovation requires governments with the wisdom and wherewithal to support science. Schumpeter spelled it out in 1911 and Mussolini tested it in the 1930s.

The evidence is heavily against this old theory. Case studies of enterprises belie the myth that, in the modern age, innovation is still driven by external discoveries in basic science rather than by ideas in companies and markets.¹ Country studies belie the myth that “top-down” economies founded on statism and scientism succeed at innovation better than economies in which ideas bubble up from grassroots businesses. Household survey evidence belies the idea that people care only or predominantly about the money. Respondents report that they look for careers of initiative and exploration. And the job satisfaction they report is pronounced in economies of appreciable dynamism – ones buzzing with the challenges of the new. Apparently ordinary people value the experience it offers: the excitement from involvement in conceiving, developing, marketing and pioneering the use of new products.² (In addition, those who easily gain such participation may well value the inclusion of others. They may see best-effort inclusion as important if they are not to feel ashamed at the deprivations suffered by those left out. And they may see broad inclusion as essential if the institutions and values that nourish economic dynamism are to continue to earn broad-based political support.)³

In this view, the cost of the financial crisis – a crisis centering in the U.S., U.K., Spain, Ireland, and Iceland with fallout in all industrialized nations – is not just the lost output. The loss in economic inclusion is severe, since the healing process is bound to take years. The situation may be even worse. There are reasons for concern about the dynamism of the industrialized economies. In the U.S., there are many signs of a downward trend in economic dynamism over the past decade. Employment in Silicon Valley, far from expanding from its remarkably small level at the start of the last decade, has been contracting. The institutional venture capitalist industry and the rate of new firm formation have also been shrinking over the decade. In Europe, venture capital investment is less than it is in China. Innovation has contracted at established companies as well. Reportedly, investment funds have put stronger pressure on CEOs of business companies to intensify their already strong emphasis on meeting quarterly earnings targets. Business investment levels in the U.S. are, relative to output, at postwar lows. The situation is a Depression, like that of the 1870s, not a Great Recession.

¹ A lengthy empirical study by Richard Nelson and long study by Amar Bhidé, both members of the Center, give evidence supporting the modern view that most of the cumulative advance in techniques, products and productivity are the result of experimentation by producers or trial launch of new products in end-user markets.

² National job satisfaction averages and the international differences among them have been the subject of my research over the past four years in collaboration with Gylfi Zoega, Raicho Bojilov and Luminita Stevens. The findings suggest that higher dynamism tends to produce higher job satisfaction.

³ None of the above denies that an economically advanced nation may gain relatively high productivity simply by copying from industrial leaders; and, with high productivity, a nation can pay high wages and pour out money for social insurance and even wage subsidies.

Equally ominous, a new and different loss of inclusion has been developing for a couple of decades and may go on worsening: In several industrialized nations, society has been splitting into *two nations*, one a thriving elite and the other a working class struggling in occupations made obsolescent by expanded competition from emerging economies and made redundant by the decline of innovation and thus capital good production – thus increasingly cut off from the experiences of the elite and finding less to engage them in their business life. This damage to inclusion comes at a time when the old deficiencies of inclusion among ethnic and racial minorities are still far from solved.

The conferees shared the belief that post-crisis economic policy should respond by aiming to increase dynamism by restructuring both the *financial system* and the *business system*; and by promoting inclusion of workers by reforming the *labor market* and the *tax/subsidy system*. If societies have a critical need for markedly more innovation, governments should increase economic freedom, create a business and entrepreneurship economy and make it easy to hire and fire, and easy to start up and close down. The recent turmoil in financial markets is not a reason to retrench away from capitalism but to reform and, when necessary, to restructure it so that it generates dynamism in the real economy in preference to short-term speculative gains in financial markets.

One year ago, at the February 20th conference, we made several proposals: putting a tax on the banks' liabilities to limit the level of short-term borrowing; setting up a new class of narrow banks specializing in financing innovative projects; creating an agency with regulatory powers that would be able to intervene when asset prices depart from historical norms; and strengthening collaboration between countries to work together to design and institute a new financial regulatory framework that is internationally consistent. At the Berlin conference we added to this list several new proposals.

Many conference participants at Berlin noted that the policy responses to the current crisis have focused on the “demand side” through fiscal stimuli, liquidity support to banks and very low central bank interest rates.⁴ They agreed that the challenge in the post-crisis era can be primarily found on the supply side. The problem is structural of the economy. The bursting of stock market and housing bubbles has left a void in the real economy that needs to be filled by innovation and entrepreneurship now that so many workers can no longer continue to produce houses or financial service. When this process is completed, a different kind of an economy will have emerged, where the size of the labor-intensive non-tradable service and construction sectors is diminished while the more capital-intensive tradable goods sectors has expanded. Moreover, the bursting of the asset prices bubble will leave a void within firms by making firms in all sectors shed labor since they will no longer put as much emphasis on planning for the future. Labor productivity may gradually rise but the recovery may be to a degree “jobless.”

⁴ Once a structural downturn was evident, uncertainty seized the economy and an excess demand for liquidity arose. Had the central banks not addressed the latter by increasing the supply of liquidity, the economic contraction would have metastasized into a panic and a sense of free fall.

Such an impaired recovery presents problems of inclusion. The workers worst affected are likely to be those who have entered working age when the crisis is at full force. For them a number of years of unemployment or non-participation in the labor force await that may leave scarring effects for the rest of their lives. The Finnish experience of a financial crisis in the early 1990s shows the effect on the labor market outcomes of the young generation, as well as on their state of health. The temptation for policy makers may be to turn again to fiscal stimulus or prolong easy money but, due to the changing structure of the economy, it is doubtful that such measures can be effective or long sustained. As the economy picks up steam, their benefit may come at a rising cost in diverting resources from the avenues of recovery. In any case, the void left in the real economy – principally a newfound structural weakness in business investment – cannot be filled by general fiscal or monetary stimulus. There is a *supply deficiency*, notwithstanding the occurrence early on of a consumer-demand deficiency marked by price weakness – a deficiency driven by balance sheet troubles and an exchange rate weakness caused as the economies tries to substitute export production for capital goods output. Moreover, a mounting level of public debt may lead to bond market difficulties and further exchange rate weaknesses. What is needed is a financial system that promotes innovation in the business sector so as to generate good jobs and a set of targeted fiscal measures that pull the poorer employed workers up from poverty and the unemployed youth into jobs.

Several speakers described how a good real economy should be defined and how a financial system could best be designed to promote such an economy. It was argued that a good financial system was by definition one that supported a good real economy. The nature of such a good financial system was discussed and also the needs and scope for regulation and supervision at the national and the international level.

1. Potential output is diminished

The expansionary fiscal and monetary policies that are being pursued by many countries are premised on the belief that demand has fallen in relation to supply, which has sailed on unperturbed by the crisis. But, as will now be argued, the output that can be produced without triggering rising inflation can be confidently be said to have shifted down to a lower growth-path than the old one (lower and probably flatter too). Because potential output has fallen in this sense, policy makers should be aware of over-expansionary monetary policy and over-sustained fiscal stimuli as recovery starts and the economy gropes its way toward the new potential-output (and potential-employment) path (also identifiable as the medium-term natural unemployment rate).

The credit-driven boom that has so suddenly come to an end in many countries had the consequence that workers enjoyed a larger share of national income, the level of employment was higher and real living standards were higher not just because of a higher purchasing power of wages but also because the inflow of capital from the surplus saving countries elevated real exchange rates, which made goods cheaper, and also allowed households to live beyond their means. Labor intensive sectors expanded and firms across the economy hired workers to prepare for a profitable future. The collapse of

various asset prices, notably housing and commercial structures, made these sectors contract and firms lay off workers who were not essential to current production. (The reduction of wage ratings was reported as an income of “profits”, as if a genuine increase of productivity or decrease of wage rates had occurred.)

An economic boom generated by rising asset prices and increased leverage of businesses and household affects the structure of the economy. The non-traded goods sectors of construction, retail and finance expand at the expense of the traded goods sectors, such as manufacturing. Since the non-traded goods industries – the bubble sector – tend to be intensive in their use of labor, the effect is to raise both real wages and aggregate employment. High asset prices may also induce firms to hire workers to prepare for future expansions; to train new workers in anticipation of higher output; and to slash markups of price over marginal cost to attract more customers. The effect is again to increase the demand for labor, to raise real wages and also to raise the share of labor in national income. The momentary natural rate of unemployment falls and the supply of output – or potential output – goes up.

When asset prices start to decline the effect is to lower real wages, employment and the share of labor in national income. The momentary natural rate of unemployment goes up and the supply of output contracts. The implication is that the natural rate of unemployment falls in a structural boom and potential output increases while a structural slump is characterized by a rising natural rate of unemployment and falling potential output. For this reason the boom tends to be non-inflationary and the recovery relatively jobless in the sense that employment does not reach its previous level. The economic boom that now has come to an end was in a sense too good to be true and the relatively jobless recovery that will follow the current slump will show that to have been the case. If, for a period during the upswing of output, firms are still discharging employees assigned to forward, or advanced, projects, the “recovery” may be absolutely jobless until the reservoir of such employees has run dry.

Monetary and fiscal policy authorities should not make the mistake of attempting to reach the pre-recession level of output and unemployment using low interest rates and fiscal deficits. Keeping interest rates low for too long may create inflation while an expansionary fiscal policy may exhaust the fiscal capacity of the state or give birth to moral hazards such as default or currency debasement. Instead, the state should use targeted fiscal measures such as an earned income tax credit, low wage subsidies or generalized job subsidies to raise employment, especially among the younger, more vulnerable workers who would otherwise be scarred by their experience of unemployment.

2. A good real economy requires a good financial system

Participants agreed that a good real economy is one of innovation and this entails decentralization of judgment and imagination. Coordination through prices is necessary but not sufficient. Makeshift coordination takes place through dialogue between people and is helped greatly by long-term relationships. The financial system should also have

these properties since a banker is also making a judgment about investors' judgment and responsibility in the banking system has to be tied to this judgment. The financial system requires substantial dialog between individuals, ongoing relationships between the providers and recipients of finance, adaptation and well designed organizations. As in the Center's 6th annual conference there was a call for narrow banking. There appears to be a rough consensus within the Center in favor of firewalls around commercial banks.

Solving the practical problems that modern finance has products and processes that are difficult to regulate is not sufficient since modern finance is in conflict with what we need in a modern economy which is that a good financial system ought to be one that supports a good real economy, meaning an innovative real economy. As Paul Volcker pointed out in his dinner speech, if some sector is making 40% of the economy's profits and doubling its share of value added, then you should not have to look very hard for signs of the benefit in the real economy. However, in reality, such signs are very hard to find: it is difficult to find evidence suggesting that innovations in financial engineering have made a sufficient difference to justify the increased financial instability that it has caused. While others pointed out some benefits of recent financial engineering,⁵ most agreed that any potential gain had to be traded off against the effect on financial stability. The discussion tilted toward prohibition of proprietary trading with retail deposits and maybe with borrowed money, at least short-term money.

3. Monitoring fiscal policy

Uncertainty lifts as an economy touches bottom, whereupon a semi-recovery will commence; it retraces the overshooting brought by the uncertainty. What is the right fiscal policy? Participants agreed that even though a short-term fiscal stimulus might always have beneficial effect, temporary stimuli are less and less needed. It comes at some cost in growth, and there is an optimum dose, positive or zero, at any point in the recovery. As employment rises and growth increases, the optimum must fall, perhaps vanishing soon. The current economic situation it was suggested, calls for continuing but falling short-term stimulus in the near-term and a medium-term retrenchment of governments' budgets. One proposal was to combine a temporary employment tax credit with a gradual increase of the standard retirement age; this would increase economic prosperity in both the short run and the long run. Raising the retirement age might even lower long-term interest rates and in that way also have an immediate stimulus effect on the economy.

Under present legislative organization, there can be little conviction that governments will practice fiscal responsibility over the next decade under the best of scenarios. Governments make promises or projections which they will not want to abide by when the time comes. As a result, governments are being held hostage by these international bond markets, which is unsettling. One way to create a credible sustainable medium-term

⁵ Richard Robb argued that securitization was not a principal cause of the current turmoil, since mortgages that banks have kept on their balance sheets have not performed any worse than those they sold off and a country like the Netherlands that relies heavily on securitization has not experienced a mortgage crisis. Moreover, he argued that there was no lack of transparency in subprime mortgage securitizations or CDS.

path for fiscal policy is to establish an independent institute that provides information about the feasibility of the fiscal path. Such independence in the monitoring of fiscal policies is desirable because of its credibility effect. The recent turmoil caused by imprecise recording of the fiscal position of Greece only validates this general point. A good example is the Swedish Fiscal Policy Council. The Council was established in 2007 and has eight members assisted by a secretariat. Its mission is to provide an independent evaluation of the Swedish Government's fiscal policy by assessing to what extent the Government's fiscal policy objectives are being achieved, in particular long-run sustainability, a ceiling on central government expenditures and the consistency of fiscal policy with the economic cycle. The Council publishes an annual report and presents it to the Government.

4. Supranational oversight of financial systems

The participants discussed the architecture of regulatory reform. The key question for policy makers is how regulatory reforms, improved supervision and improved market practices will prevent the reoccurrence of crises in the future while at the same time not impede the provision of credit to the economy or hinder all financial innovation. It was argued that deficiencies in the regulatory framework were not the sole cause of the crisis. However, better regulation could have made the crisis less severe. Sir Howard Davies, former Chairman of the Financial Services Authority in the UK, pointed out five main regulatory failings: Global financial governance was wrongly structured and involved the wrong set of people; there was insufficient discipline in the system with the result that international rules were not evenly applied; there was inadequate discipline on regulators to respond in a timely fashion; capital regulation was flawed and ignored off-balance-sheet vehicles; and there was a flaw in the European single market, as indicated by the collapse of the Icelandic banks. In general, regulators were more focused on form rather than substance and systematic risk was not properly identified, if thought about.

Because supervisors did not see the problem as a whole, the question of the appropriate regulatory structure at the country level has arisen but in fact there is very little relationship between regulatory structure in different countries and performance. It was agreed that central banks should be responsible for macro-prudential regulation and stability concerns should influence monetary policy and vice versa. However, central banks should not be institutional supervisors; this should be left to an independent regulator. This does not mean that central banks should be held accountable for shifts in the relative price of housing, let alone relative prices of assets generally. Relative prices are better assigned to another agency with corresponding expertise and tools. There was also an agreement that the Financial Stability Board has been improved with the broadening of membership to include China. But the Board still has no authority over the individual regulatory groupings and it has an uncomfortable relationship with the International Monetary Fund. In spite of its imperfections it is the best way to impose discipline, which is needed so as to prevent de-globalization from occurring. In the European Union good progress has been made towards the establishment of an appropriate institutional framework for macro-prudential oversight with the European Systemic Risk Board. The proposal to strengthen the Financial Stability Board is

consistent with our proposal from the Center's 6th annual conference to design a new international financial regulatory framework.

Better regulation and supervision that promoted financial stability would not impair efficiency and block innovation in the financial system. The current economic financial crisis provides very convincing evidence that regulatory reforms and macro prudential oversights will support sustainable growth because the benefits from reduced probability of a banking crisis more than offset the effect of higher lending standards on growth.

5. Improved corporate governance

The conference participants were not of the view that corporate governance was to blame for the crisis. Yet, if it is agreed that a decline of dynamism over the past decade is discernible and some of this decline is attributable to a rise of short-termism in the business sector, we have to agree that short-termism is one of the obstacles standing in the way of a return to high prosperity. In any case, the view was expressed that the role of the board of directors had to be revised. The board typically has independent members with a day job. It follows that they have to be part time to be independent of the company. A typical member on the board of a FT100 company now spends around 20-25 days on this task and this should go up to 30-36 days according to the Walker report. However, the Walker report also recommends that they prepare an annual risk management report and it would give them only ten days per year to take on the risk management task. The structure of part-time directors will fail if we keep adding tasks that force them to do things superficially. It is this superficiality which is the weakness of the current system of corporate governance. We propose that a third of members should be full-time professionals and should be made responsible to shareholders instead of management. In this case of level of expertise would be added while at the same time these professionals would need to convince the rest of the board to accomplish anything.

6. A need for job subsidies

The current recession has caused very large job losses in industrialized nations. The OECD members currently have around 18 million more unemployed people than at the end of 2007, an unprecedented increase of unemployment to an average level of 8.8%. There are differences in the mode of adjustment across countries; some countries have experienced higher unemployment while in others the number of hours worked per employed worker has fallen. There have been major job losses in the US, Spain, Ireland, the UK and some Nordic countries. In contrast, there have been only reductions in hours worked in Germany and almost no change in unemployment; in Singapore little decline in employment or hours. In some part this is due to differences in the shocks experienced.⁶ But a huge part is due to the state interventions undertaken promptly and swiftly to moderate employers' desire to fire. Many countries – Germany the prime

⁶ Some countries saw a burst of their house price bubble with a subsequent collapse of construction activity while others, such as Germany and Singapore, saw mainly a drop of export demand. In Germany the shock affected the skilled tradable sector and firms decided to avoid dismissal costs and hiring costs by hoarding labor, which is helped by job subsidies.

example – provided resources to encourage the retention of workers. Singapore went for a program of wage subsidies to companies that serves to encourage employment of workers toward the bottom of the wage distribution. Several participants thought that such wage subsidization is important for running modern societies because they both help in recessions and lower the level of structural unemployment. At least one participant was of the view that if the private sector does not pay low-wage people enough to accord with social preferences, then the country has to subsidize low-wage employment in that sector. Most participants thought that wage subsidies create employment and a socially acceptable wage distribution, thus fostering economic inclusion.

Income support for the unemployed is also important. Coverage differs between countries and in some countries those on temporary jobs are not eligible. It is important to combine benefits with reemployment services and incentives to search in order to mobilize workers back into work, especially the young who may otherwise suffer persistent unemployment due to scarring effects.

Let me take the opportunity to send my good wishes for the G-20 meeting in June. I hope that ministers, their advisors and aides preparing for the meeting will find this report helpful both in canvassing and in weighing policy ideas.

Sincerely,

A handwritten signature in black ink, appearing to read 'Edmund S. Phelps' followed by a stylized flourish.

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Condensed record of the speeches at the December 12 sessions of the Berlin conference of the Center on Capitalism and Society. A video of the proceedings is available on the Center's website at www.capitalism.columbia.edu

***Introductory Remarks from CCS Director
Edmund Phelps***

We are meeting today to discuss ways to raise the prospective prosperity in the post-crisis decade of the economies of the western world and to safeguard it from the more extreme speculative excesses. Although the Center on Capitalism and Society offers a variety of views in this regard, most members tend to take the modern perspective on market economies that actors face limitations in their economic knowledge of the economy whenever they depart from (or revert to) past practice. The tenacious forces behind the current downturn were on the supply side: the fall of asset prices lowered, the amount of capital goods produced and this depressed output, notwithstanding the central banks rush to counteract an increase in the demand for liquidity. The modern approach of the center offers a way to recover to the “old normal” – that of 1995 and 1996 – by describing how in a modern economy the degree of prosperity depends on the degree of economic dynamism. The roles of imperfect knowledge, innovation, and uncertainty are important in this regard. There is reason for concern about the future because the venture capitalist industry has shrunk, new firm formations have been far weaker in the present decade than in the previous decade and, reportedly, the business sector has never been so hamstrung by short-termism as it has in recent years.

***Panel I: Fiscal Policy, Currency Depreciation and Cost Inflation
Robert Mundell.***

The subprime mortgage crisis in 2007 came to a head in August 2007 when central banks pumped liquidity of 300 billion dollars. This managed the subprime crisis. Thirteen months later the collapse of Lehman Brothers in September 2008 resulted from mistakes by the Fed, which stepped on the break in 2008 fearing rising inflation and made the dollar appreciate by 30% from June to October. The Fed tipped the weakest bank, which was Lehman, and then decided not to pick him up again because of a concern of moral hazard which made more banks fail. This was the biggest mistake made by the Fed ever, at least since 1982. You cannot have an international monetary system when the dollar-euro exchange rate swings by 30-40% within a year. Stabilizing the dollar-euro rate is the key to stability – one should put up bands – and then gradually narrow the bands down. This is a necessary foundation for the SDR to be used as an anchor currency. A new international monetary order once exchange rates have been fixed, SDR based on the dollar, euro, yen, renminbi, and pound. This will be a new international monetary order.

Alan Auerbach

What are the right types of fiscal policies for countries to follow and where might the political will come from to adopt these policies? Some types of stimulative fiscal policies do not require large commitments in the longer term; temporary reductions in VAT or temporary employment tax credits. When it comes to the credible initiation of longer term fiscal consolidations, the challenge is to adopt policies that set us on a feasible path without affecting the economy in the short run. Starting to increase consumption taxes gradually could help aggregate demand in the short run by lowering interest rates; also increasing the standard retirement age, less negative impact on current spending than lowering benefits. Where does the political will come from to do this? There is not much evidence on courage by politicians. One step in the right direction is more

independence on the fiscal side, not fiscal authority, fiscal independence similar to monetary independence is not possible, instead provision of requirements to provide more information about the feasibility of the current fiscal path. Independence in the monitoring of fiscal policies is desirable as in the case of the Swedish Fiscal Policy Council. It is important to look at longer term trajectories.

Stephen Roach

Monetary policy is the most critical element of the exit strategy and monetary policy is what got us into this mess. Looking at the last equity bubble in 2001, there is a striking asymmetry to monetary policy, quick to slash in the aftermath of a burst bubble, very slow to exit. This provides a breeding ground for house price bubbles. We may make the same mistake now and there we will be more bubbles and even greater crashes to come. What needs to be done is to add financial stability to the dual mandate of the Fed. The time for a financial stability mandate is now. The financial stability mandate would force central banks to lean against the wind to prevent damage, rather than doing post damage cleaning. Growth may be sacrificed, and central banks would have to be early in their exit strategies. Central banks would have to monitor the rate of growth of debt, the rate of growth of asset prices, and asset driven distortions on the real side of asset dependent economies. The distortion in asset dependent economies are enormous, bubble distorted sectors in the US were 80% of the economy, so a blunt instrument is needed.

Gylfi Zoega

The economic model used by many macroeconomist to study the effects of an inflow of capital is inappropriate. A capital inflow makes the currency appreciate, asset prices rise, investment increase, employment and real wages go up, and labor's share of national income increase – there is a non-inflationary boom. When the capital stops flowing in, there is a reversal and the contraction may last years. The mistake is not to realize that it is on the supply side of the economy where big changes occur. Which sector is booming affects the real wage and the unemployment rate. During the boom you have the labor intensive non-tradable goods sectors doing well, after the crash the capital intensive tradable goods sector does well. The typical pattern is that the boom is non-inflationary, the recovery jobless. After the crash, central banks may keep interest rates low for too long, hence risking rising inflation, since they do not realize that the natural rate of unemployment is increased. Also the slump is going to last too long for a big package fiscal policy to be viable, so you need to target the spending on the groups that are most affected by the slump, and based on the Finish experience, these are people in the late teens, early twenties when the shock hits.

Robert Aliber

We have had four waves of crisis in the last 30 years; the Mexico, Brazil and Argentina crisis, then Sweden, Finland and Norway in the 1990s, the third set was in the Asian countries at the end of the 1990s, then the current one is in the Anglo-Saxon countries. Each crisis following a credit expansion driven asset bubble, real estate bubbles can only occur if there is an expansion of credit. The rate of growth of indebtedness in each of these cases was 2-3 times the interest rate, unsustainable. The Fed economists apparently had never heard of Ponzi, were distracted from looking at cash flows. The IMF also frequently fails to warn of unsustainable credit expansions. We should focus on where to put the watchdogs – we need to rethink where to put people with the whistles. We should also reconsider the financial structure; there has been massive concentration in the financial industry. We should limit the size of each financial institution, fracture Deutsche Bank and separate Morgan from Stanley and see how we can get a more competitive financial system.

Panel 2: Dynamism I- Financial Reform and Regulation Reform

Richard Robb

Securitization is going to get some blame here, it plays a role, but if you look at mortgages that banks have kept on their balance sheets they have not performed any worse than those they sold off. A country like the Netherlands that relies heavily on securitization but has not experienced a mortgage crisis. People investing with their own money did things that in retrospect look foolish. There was no lack of transparency, the subprime mortgages, the CDS, are transparent as are asset backed mortgages. An insight about what happened: the prevailing theory should think of traders as Hayekian entrepreneurs, who have sequential relationships to the capital they control. All the things happening behind the scenes that can create extreme events are interesting. You have an investor who takes a loan, a mortgage, he is a specialist, understands the security, and the price falls from 100 to 75, it looks attractive and the price falls to 50 and it looks more attractive, and the price drops to 10, this is the “wrong price” and the wrong model and the specialist investor leaves the market and a new investor, non-specialist investor comes in, and they come in with a different model, the first investor has to explain why they need more but no one wants to listen, a story fatigue kicks in, it takes time to the persuasion to play out. Then things become correlated in a crisis.

Howard Davies

Regulatory reform, architecture of regulatory reform. Monetary policy was the most important factor behind this crisis. Regulators could not have created this mess on their own but could have put enough speed bumps in the way. Five main problems of regulatory failings: Global financial governance was wrongly structured and involved the wrong set of people; There was no discipline in the system, international rules unevenly applied, no discipline on regulators to respond in a timely fashion; Capital regulation flawed, pro-cyclical and too light and ignored off-balance-sheet vehicles; A flaw in the European single market – Icelandic banks. Regulators more focused on form rather than substance, systematic risks not properly identified – this is the most important point.

The Financial Stability Board is an improvement, broader membership and China is now in. But the FSB still has no authority over the individual regulatory groupings and it has an uncomfortable relationship with the IMF, needs to be strengthened further, it is imperfect but it is the best horse in this race. Many competing ideas in the marketplace, too many and discipline is needed, driven by the FSB or de-globalization will occur. In Europe we have a halfway house, with the European Systemic Risk Board, which is a good idea, and three authorities on banking securities and insurance. Supervisors did not see the problem as a whole, and this has reignited debate about the regulatory structure, which is surprising because it is very difficult to see a relationship between regulatory structure and performance. The central bank needs to focus on financial stability and should have a statutory responsibility because stability concerns should influence monetary policy and vice versa. This is macro-prudential policy. The central bank does not need to be an institutional supervisor; the Fed should not retain this level of supervision.

Lucas Papademos

The key question for policy makers is how regulatory reforms, improved supervision and improved market practices will prevent the reoccurrence of crisis in the future while at the same time not impede the provision of credit to the economy or hinder the process of financial innovation. In the European Union we are making good progress towards the establishment of an appropriate institutional framework for macro prudential oversight with the European Systemic Risk Board. There is no tradeoff between better regulation and strengthened supervision aimed at promoting financial stability and the other hand market processes and policies that can force the efficiency and innovation in the financial system. The current economic financial crisis provides

very convincing evidence that regulatory reforms and macro prudential oversights will support sustainable growth. There are interesting findings such that overall net effect of regulatory tightening on growth performance is positive because the benefits from reduced probability of a banking crisis more than offset the effect of higher lending standards on growth. A timely and consistent implementation of the regulatory reforms underway and the establishment in parallel of a new framework of a macro prudential oversight are necessary steps which will reduce systemic risk and strengthen the resilience of the system. Moreover, better regulation and improved prudential oversight will not hinder efficiency and growth.

Amar Bhide

Banks should be old fashioned banks, there should be narrow banking. We should shut down money market funds and let others do what they please. It has been proven that the referees are incapable of overseeing the complex financial instruments that have been developed. Adding more referees is not going to solve this. Even if we could solve this practical problem that modern finance has products and processes that are difficult to regulate, modern finance is in conflict with what we need in a modern economy which is that a good financial system ought to be one that supports a good real economy. What is a good real economy? A good real economy is one of innovation, decentralization of judgment and imagination. Coordination though prices are necessary but not sufficient, coordination takes place through dialogue, and requires long-term relationships. The financial system should also have these properties. A banker is also making a judgment about investors' judgement, responsibility in the banking system has to be tied to this judgment. The financial system requires substantial dialog, ongoing relationships between the providers and recipients of finance, adaptation and well designed organizations.

Andrzej Rapaczynski

The regulation that we are going to get will be much more a matter of politics than economics. There is a political cycle, which is a longer cycle than the economic cycle. Following the great depression the belief in markets faded while the belief in governmental intervention started to break down in the 1960s. There was a more liberal phase in the 70s, 80s and the 90s. The political left adjusted to this change by adding a market philosophy to their commitment to social justice. But for many people the commitment to social justice remained more important than the commitment to the market. For those people, recent events provide the ultimate proof that the system is immoral and unsound. In addition, for the past couple of decades, the very extensive political system that was built on assuring stability in Europe was under attack from this American risk loving system. There is a feeling now that the world has been victimized by the U.S and a greater movement to social stability is in order, away from risk taking and innovation. However, it would probably not be a good thing to eliminate booms and busts, in retrospect each boom brings a significant addition to economic life and we may go too far in valuing stability as opposed to development.

Joachim Faber

Allianz is one of the largest insurers and one of the world's largest asset managers with about two trillion dollars under management. It is a long-term investor; you will be hard pressed to find any short term investments on its balance sheet. I am scared about the rising short term volatility in our capital markets, pensions systems are affected, pension values are down 20-30% in the US and the public budget suddenly no longer has money to finance pension liabilities. Pension funds are scared of putting money into stock markets as a long-term investment because of the volatility. I am also scared about the equity culture in the world, in particular in Europe, as a consequence of the crisis, private investors are no longer buying equity, regulators impose more and more risk capital requirements on insurance companies, and in Europe you have very few asset gathering institutions other than insurance companies. The financing functions of long term investors are

being undermined. We are very clear that famous self regulation is not going to make it. We have to live with state regulation and we are asked to give as much input as possible in order not to have excessive regulation replace excessive risk taking.

Special Guest Speech by Dr. Günter Oettinger

Do not judge the day before it is night! You may wonder whether this is appropriate in economic matters, we should be careful and keep our eyes open. The tremors sent out by the Dubai crisis shows how fragile the economic recovery is. The banks have to write off immense sums in the face of a demand for new loans. Chancellor Merkel had a conference on credit supply a few days ago and the positive aspect for us Germans is the fact that the world economy seems to be recovering at a rapid pace. The consequences of the crisis were serious for Germany. The recession was bad but it did not become a deep recession because of well-coordinated policy responses that reestablished confidence. However, the medication has side effects, the price of stabilization is greater government control and overwhelming national debt, the political resistance to protection is reduced. The great increase of the money supply has to be stopped to prevent the emergence of another bubble, and we have to reign in government deficits, otherwise the next crisis will be a public debt crisis. When the balance sheets of banks exceed GDP of whole nations, the collapse of these banks is not a national but an international issue. Better management of globalization is needed. In Europe there is the common umbrella of the EU for this purpose; energy policy is a good example. No member state is capable of completing a centralized energy system. We need a better infrastructure because liberalization does not work on its own.

Panel 3: Dynamism II – Corporate Governance Reform and Public Sector Reform

Roman Frydman

American economists represent history by an exact model with an exact probability distribution. These models say that rational people behave according to a fixed mechanical rule, every rational person forecast the future according to the economists' model, but the problem is that there are many models in the profession. Another problem is that rational people do not behave like that – technical arguments, no rational person will do that. You define rationality ala Chicago and then you call what you observe irrationality and you model that using the same mechanical rules. Two models, rationality and irrationality, with mechanical rules. To replace these extremes, we start with the premise that no one has perfect knowledge of the right model that portends to the future. The theory will say that markets are superior so that ex-ante fixed policy rules are not useful, but due to imperfect knowledge markets cannot be perfect. Markets do better than any single agent in allocating capital but markets have a tendency to overshoot because knowledge is not perfect. The state should attempt to ascertain the right values and then use instruments to intervene. How is the state going to figure out the non-excessive range? Natural point to study when markets have self corrected in the past, assigning a range of 5% at both ends of the stock market we find that the market crossed that band in 1996. You penalize the bulls and encourage the bears when you exceed the upper limit and vice versa.

Ronald Gilson

We are now back to the drawing board about how we redesign the institutions we have. Irony in that we turn to institutional economics when the Nobel Prize was given to someone in that field. My topic is corporate governance. The history of corporate governance is a pattern of spikes of reforms coming on the heels of crises. The first question is whether corporate governance contributed to the crisis, first or second order, my answer is no. The second question is if corporate governance created a systematic risk. My answer is no. The last question is whether

there is something we can do to corporate governance, the answer is yes; we need to think about what managers do. The role of the board of directors has to be revised. Each time there is a crisis a task is added to the board of directors. We want independent board members who have a day job. They have to be part time to be independent of the company. The minimum time (FT100) should go from 20-25 days to 30-36 days (Walker report) but then they have to prepare annual risk management report. Ten days a year to take on risk management, 7 hours a month! This is not going to work. The structure of part-time directors will fail if we keep adding tasks forcing them to do things superficially. Proposal: A third of members should be full-time professionals, responsible to shareholders, not management. They need to convince the rest of the board to accomplish anything. Current arrangement practices forces board members to be superficial.

Janusz Ordovery

Competition policy has been useful, no need for thorough revisions. No meltdown in this field, the success of competition policies are quite visible. Gains from deregulating airlines, railroads, electricity, telecoms and so forth has increased GDP by about 7-10% in the U.S. alone. Should regulations be changed to deal with the post crisis tasks? The prevailing view is that no changes have to be made to competition policies. For example, should we approve of mergers that generate cash for R&D? This is one reason why we should relax strict rules about mergers. Answers are complicated. How should we model the relationship between the real sector and the financial sector? Access to financing is quite important for pro-competitive R&D, the absence of financing is going to decrease the powers of rival firms to unseat the incumbent firm, financing is thus critical for competition. There is a need to review whether or not the financial sector is competitive.

Peter Jungen

We currently find ourselves in an Austrian situation with overinvestment and overcapacity. In some industries we have a 20-30% overcapacity. China now has an excess capacity in steel of the size of the whole European steel industry. Maybe the crisis was needed to prevent the creation of an even greater excess capacity. Capitalism is heavily criticized. Alternatives: half-way collectivism like new deal or fascism; democratic socialism and welfare state; Keynes and Beveridge; totalitarianism like communism and central planning, or a renewal of capitalism. My proposal is that we need more capitalism. Capitalism is about dynamism and growth and in capitalism one can get rich without making anyone else poorer. Capitalism is about ownership, competition, innovations, new firms, and new owners with framework conditions in place. Schumpeter wrote about the instability of capitalism. Innovation produces growth. Question about new entrepreneurship, where is the next google? In China last year more venture capital invested than in the whole of Europe. The government needs the entrepreneur more than the entrepreneur needs the government. Governments should increase economic freedom, create a business and entrepreneurship economy, make it easy to hire and fire.

Panel 4: Policies towards Employment and Inclusion

Edmund Phelps

We are in a midst of a downturn that that has caused a large decline of employment, a lot of it falling on lower wage people. Inclusion is important. As I see it, the Anglo-Saxon countries have done better in terms of inclusion than the corporatist countries on the continent, such as France, which has an abysmal record on inclusion. By inclusion I mean bringing in to the formal economy a high proportion of able bodied people and paying them not too badly relative to the median wage. It was the view of John Rawls that social policy should maximize the net wage of those earning the lowest wages. This was too neoclassical. I began arguing in the 1990s that most healthy people need the experience of employment, particularly the kind of employment offered

in an economy of dynamism. There is also the sense of excitement from inventing novel methods of production. Finally, people also like to feel that they belong. One of the main benefits of capitalism is its ability to create jobs, meaningful jobs on a massive scale. Countries differ in terms of how inclusive they are. Now inclusion has suffered a fall for various reasons. It is therefore important once again to think of policies that can increase inclusion in the short term and in the long term.

Stefano Scarpetta

In October we had 8.8 per cent in the OECD, 18 million more unemployment people now than at the end of 2007, an unprecedented increase of unemployment. There are differences in adjustment across countries. Major job losses in the US, Spain, Ireland, the UK and some Nordic countries. In contrast, only reductions in hours worked in Germany and almost no change in unemployment. Differences in the nature of shocks – house bubble bursting versus a fall in the demand for manufacturing – and also institutions affecting incentives to fire. Some countries, such as the US and Ireland, had a burst of the house price bubble with subsequent declines in the level of construction. In Germany, the shock affected the skilled tradable sector and firms decided to avoid dismissal costs and hiring costs by hoarding labor, being helped by state subsidies. A shallow recovery is projected. In response to the crisis, apart from the stimulus packages, many countries – Germany being the prime example – have also provided resources to encourage the retention of workers. Income support for the unemployed is also important. Coverage differs between countries and in some countries those on temporary jobs are not eligible. Benefits have to be combined with reemployment services and incentives to search in order to mobilize workers back into work, especially the young who may otherwise suffer persistent unemployment due to scarring effects.

Jean-Paul Fitoussi

There are deep causes of the crisis, which is considered to be a financial crisis. Why has the financial sector suddenly become so foolish? This crisis can be traced to rising inequality in the world. During the last 25 years there has been a universal increase of inequality. This has caused weak demand due to differences in MPC. Normal reaction is to be expansionary, long period of expansionary monetary policy without inflation. Monetary policy raises private indebtedness, which is the mechanism through which monetary policy affects aggregate demand. The other consequence is that the rich wanted to have a fair return on their savings and they bought assets, causing an asset price bubble in all asset markets, including the housing market. There occurred an increase in private debt and the value of assets and nothing appeared to be wrong in the balance sheets. We did not realize that there was a problem. This increased inequalities, which have been made worse by the crisis due to higher unemployment and increased poverty. We need now an unemployment policy aimed at inclusion. The distance between the lowest and the highest wages has increased. Two solutions, first, to change social conventions to lower CEO pay so that the low productivity worker has a higher relative wage or, if this does not work, tax the high productivity worker to subsidize the low productivity worker so as to favor inclusion.

Hans Werner Sinn

The first 11 months from April 2008 to March 2009 were similar to the first months of the Great Depression but this is now changed due to huge rescue packages. One year ago we were close to the collapse of the financial system. The welfare state has helped to keep up aggregate demand. The stability of Western Europe due to the welfare state has helped the whole world. Trade balances have changed such that the German one has deteriorated by 160 billion dollars, while the US deficit was reduced by 400 billion dollars on an annual basis. US biggest shock producer, the welfare states the biggest shock absorber, Germany has been the largest shock absorber in the world. Short term unemployment scheme helped Germany be a shock absorber. The German

labor market has also benefited from the Schroeder reforms in 2004, Wage subsidization is the clue for running modern societies. It helps in recessions and also in the long run, better than minimum wages. If jobs people get in the private sector do not pay enough to be compatible with social preferences, then you have to subsidize their employment.

Hian Teck Hoon

Singapore adopted a subsidy scheme in 2007 as a structural policy that promoted the employment of low wage workers. For this reason it has recovered from a steep drop in GDP in later 2008. The government decided at the beginning of 2009 to bring forward announcing its budget to January and then announced a major plank of a package to deal with the credit crunch. The government proposed a resilient package following the collapse of aggregate demand and a job credit scheme was implemented in January 2009, retrospectively. This was a laboratory experiment at dealing with the structural problem of the less advantaged. This creates problems for the less advantaged, now that the low skilled jobs have moved out. Singapore looked how to help these workers during the 2000s and went for a scheme that boosts inclusion; it went for a scheme that boosts the pay of the people in the bottom decile by 10% if you hold a job, split between employers and employees. There is also a strong effect on structural unemployment, apart from lowering unemployment cycles.

Dinner speech

Paul Volcker

The idea of efficient markets came into fashion in the 1990s, market fundamentalism. Profits in the financial world reached almost 40% of all profits, the contribution to GDP doubled and young people were pulled into the financial sector. Now we have a wakeup call after a period of good performance. Some people say that we have had a bit of a bump here and that high unemployment is a tolerable cost. Full speed ahead, don't think of regulating too much. This is a view that we have to fight a bit. If some sector is making 40% of total profits and doubling its share of value added, it should be easy to find signs in the "real" economy. However, such signs are very hard to find. It is difficult to find evidence suggesting that innovations in financial engineering have made a real difference in producing economic results. Meanwhile, what if any lesson should we draw from the current recession? Some say we put too much faith in mathematics and not sufficient in practical judgment. We also have to look at banking regulation in the U.S. and the rest of the world. It was very comfortable for the U.S. to overspend and for China to export, and no force stopped this before it became a problem. It is time to start thinking about reforming the international monetary system.