

Event Summary

US and European Response to the Global Financial Crisis

Giuliano Amato, Former Prime Minister of Italy

Peterson Institute for International Economics, Washington, DC
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Giuliano Amato began his talk at an event at the Peterson Institute on February 13, 2009, by saying that policy decisions are being taken primarily with in view of domestic issues, domestic demand in particular, and that it is easy to forget the global dimensions of the crisis, which are very important. “Putting your own house in order” is typically both the problem and the whole solution. This time it is the problem, but not the whole solution: International cooperation is an essential part of the solution.

His talk focused on remedying the crisis, which depends on the type of diagnosis one makes of its causes, and the responsibility of the United States and Europe.

The causes of the crisis are clear:

1. There were real shortcomings in both the real economy and the financial sector, with much more responsibility in the latter.
2. Large surpluses in China and currency undervaluation in Asia resulted in a global imbalance, which need to be corrected.
3. The crisis broke out in and spread from the United States. Why? Because much of the so-called financial innovation actually resulted from a decision to raise debt if it proved impossible to raise income. This was done in violation of Basel II or outside Basel II, primarily with mortgage-back securities.
4. Central banks and finance ministries have been too complicit; they allowed prices to be opaque and be set without a market mechanism.
5. Rating agencies are also responsible, especially for giving triple-A ratings to assets whose value could not be determined.
6. The globalization of finance made a contribution.

Therapy for the crisis must proceed piece by piece in addressing all these problems:

1. The real economy problem: We cannot go back to the world where one economy, the United States, drives everybody else. The single-driver world economic model must be abandoned in favor of more drivers who produce and consume more. China has to be the first to step up, especially given that millions are now going back to rural areas in search of jobs. This can provide immense political pressure and lead to social unrest. China needs to increase domestic demand.
2. Africa needs to produce and consume more anyway.
3. For the United States, there is a formidable challenge to integrating its social goals into the economic rebalancing. Much of disposable income in the United States goes to basic

needs that are provided for differently in Europe. The United States needs to reduce costs such as education and healthcare, and thus raise the real disposable income.

4. Europe needs to produce and consume more. One particular difficulty Europe is facing is the threat of protectionism. This problem is partially enhanced by the latest round of EU enlargement, which slowed down economic convergence among members, and thus allowed the asymmetric impact of the present shock. This causes internal imbalances and thus a temptation to be protectionist inside the European community. Mr. Sarkozy is calling for relocation of production back to France, the British are calling for “British jobs,” and so on. But, although these moves may bring some benefits in the short run, it has been shown that the long-term costs outweigh those benefits, and the recession will be prolonged. Also, without the defense of the common market, member countries’ productivity and capacity will not rise sufficiently to raise demand and production.
5. Regulation of financial activity: Self-regulation and restraint by the regulators proved to be nonsense. Most derivatives are Ponzi schemes multiplied by the number of pieces they are made of. Such markets have to be regulated, but the systemic effect must be kept in mind, given the globalization of finance. Crucial are governance standards on the global level. Good regulation does not need to be invasive.
6. International Monetary Architecture: The market-led monetary system does not work, as there are too many incentives for instability. There has to be a reform, which includes reforming the international organizations, primarily the IMF and the World Bank Group. Although Amato is skeptical of the “New Bretton Woods,” the IMF needs to be reformed. Amato wonders why there has been little reform in the past 20 years despite all the talk. It is perhaps because the standards of decision-makers were too low, or perhaps because the task at hand is so complicated and large that it makes the standards inadequate. The IMF has been focusing on new topics, but it has crucially neglected the big countries, most notably China and the United States, which is like showing “Hamlet without the Prince of Denmark.” The IMF should go back to its core mission—tough and broad surveillance, in close coordination with countries’ central banks. The governance structure of the IMF also to be changed: depoliticize the board and eliminate individual seats for EU members.

Amato concluded by observing that there are few opportunities like this in history to make sweeping and needed reforms. However, he worries that the governments will not have the time and energy to engage in needed coordination and cooperation to bring them about, since they will be exhausted by the mounting problems at home. Enormous attention needs to be given to global matters. “Let us be the lobby for it,” he concluded.

Q&A Session

Richard Gardner, former US Ambassador to Italy, mentioned a *Financial Times* article Amato wrote with Emo Bonino arguing that state aid to the banking sector or the auto sector that distorts or threatens to distort competition is in conflict with the common market and that a committee

should be formed to evaluate such aid before it is granted. He asked how French President Nicholas Sarkozy or Italian Prime Minister Silvio Berlusconi could be persuaded to accept such a proposal. He also asked whether there should be global coordination of state aid, perhaps through the WTO.

Amato believes it is possible to persuade Sarkozy and Berlusconi because the European Commission has already been granted the power to block any aid that is distortive. Proposals like the committee would help preempt problems in other sectors that can lead to future calls for distortive aid and can help set a precedent. In the auto industry, for example, there is a need for greener cars, and production needs to be scaled down because the market is already saturated. The committee could thus help set guidelines for aid that recognizes this and that would not distort competition, discriminate, or breach the principle of proportionality.

Barry Wood of Voice of America asked what the G-7 and G-20 should do.

Amato does not have high expectations, since such summits are often not followed up with action. However, it is extremely useful to use the opportunity to make a pledge against protectionism: A sound denunciation of protectionism alone would be a successful outcome. The G-20 is more useful than the G-7, because less-developed countries are heavily involved in the current crisis.

C. Fred Bergsten of the Peterson Institute for International Economics agreed with Amato. Around 30 countries have enacted protectionist measures already. The G-20 made one crucial mistake at its summit in November: While they pledged against protectionism, this referred only to the WTO-illegal forms of protectionism. This time, however, they should make a more comprehensive call, referring also to those measures that are allowed under the WTO but are still protectionist.

Bergsten asked whether Amato agrees with calls in the United States for other countries to step up their fiscal stimulus programs, with statements in the United States that the European Union is lagging behind, and with proposals that these issues be highlighted in international fora.

Amato agreed in principle, but said he doubted that commitments made internationally would be honored, even if stated. This is because of fiscal constraints, particularly vis-à-vis the Stability and Growth Pact. What puzzles Amato more regarding international coordination is the complete absence of attempts to price the “toxic” assets. Value has to be estimated; otherwise the credit crunch will persist. This is where coordination is most needed.

Andreas Bilmeier of Ziff Brothers Investments asked about the prospects for a breakdown of the eurozone. What would happen if an opposition party in a member state builds a platform around blaming the euro for the current troubles? How would the euro be defended against such a platform?

Amato said that it is not possible to blame the euro for the crisis, “no more than my wife.” The main causes are the US-Asian imbalance, excessive risk taking, and policymakers’ complicity. But the euro is completely innocent, and Europe is not center-stage in this problem.

Edwin M. Truman of the Peterson Institute asked two questions: If the innovation came primarily from the United States, has it been transferred globally through a competitive race to the bottom (a “competition in laxity”)? And should the United States lead the response with everybody else following? Or, should the United States and Europe pursue stringent regulation and let everybody else go their own way?

Amato said that regulation has to be coordinated and fairly uniform, and letting everyone decide on their own is nonsense. He also stressed that it is further nonsense to say that regulation was lax because the regulators could not understand the complexity of the derivatives, etc. This must not be an excuse for failing to push for tighter regulation going forward.