

# Global Economic Prospects: L- or V-shaped Recovery?

## Key speakers:

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## *Introduction*

C. Fred Bergsten: Let me welcome all of you to our Peterson Institute for International Economics today. This is the 15th in our semiannual series of global economic prospects sessions. We are obviously, at all times, assessing the outlook for the global economy, particularly in disturbed times like these; but we formalize that twice a year, as many of you know, because you've been here before, and have programs of this type where we lay out our projections for the course of the world economy over the rest of the current year, and then at least well into next year, 2010 in this case.

Now what we have usually done and again, many of you have been here, is to have a series of two or three complementary presentations—one on the world economy, one on the US economy, one on some other part of the world—and we present those as sort of complementary variants on a theme. This time, we decided to do something different and take advantage of one of the, what we think are rich benefits and advantages of our Peterson Institute, namely our very vigorous internal debates over lots of topics and, on this occasion, to present to you two different views on the outlook for the world economy. I wouldn't say they're antagonistic. I wouldn't say they're fighting each other, but they are alternative views of where the world might go over this next year, or 18 months, and since the truth is, none of us really knows for sure, we thought it would be only the best service we could provide to give you thoughtful presentations on two different prospects.

We thought that to be particularly the case, because the presenters are both former Chief Economists of the International Monetary Fund.

Mike Mussa, who has organized and anchored this entire series of our 15 semiannual projections, was Chief Economist of the IMF from 1991 to 2001, when he joined the Institute. Before that, he had been on President Reagan's Council of Economic Advisers and a professor at the University of Chicago. As I

say, he has organized and anchored this series throughout and he will lead off with his view of where the world economy is going.

The second presentation will be by Simon Johnson, our next but newest senior fellow at the Institute. He joined us last September after spending a year and a half as Chief Economist at the IMF. He's also returned to his teaching at MIT since leaving the IMF, and has been very active, as all of you have seen, in publishing and commenting on the current crisis.

So, what we'll present today is two alternative views of where the world economy is going by two former Chief Economists of the IMF who now can tell the truth and say what they really believe, Mike and then Simon.

### *Presentation by Michael Mussa*

Michael Mussa: Well, thank you very much, Fred. It's a pleasure, once again, to return to this podium. I will not, of course, review my last forecast, which seems to have been overtaken by events. The events of last fall, indeed removed all doubt as to whether the US economy and the world economy would have a recession in 2008 and 2009. The US economy suffered a 6.3 percent annual rate of decline of GDP in the fourth quarter, the steepest quarterly decline since the early 1980s, and the world economy, at least as the IMF measures it, also is estimated to have seen a shrinkage of world GDP at about a 6 percent annual rate in the fourth quarter.

For the world economy, there probably is no other quarter in postwar history when we had such a concentrated decline in output and especially in industrial production and in the volume of world trade. The first quarter of this year is also seeing a continuing decline in output across most of the world economy; and it appears likely that output will continue to contract, at least through the second quarter of this year and many think for a number of quarters after that. So it looks now pretty certain that on a year-over-year basis, global real GDP will have an outright decline, I think probably between one half and 1 percent. And the US economy and the advanced economies, generally, will suffer substantially larger output declines.

Meanwhile, inflation, which a year ago was probably the leading world economic issue, with the global CPI rate having risen to 6 percent on a 12-month basis versus not much above 2 percent in 2003—global inflation has abated dramatically. Three-month figures have hit negative. The 12-month figures have come down to around 4 percent or so and are clearly headed lower. So inflation is really not on the near-term horizon, at least, as a key policy concern.

Well, in these remarks I want to first talk a little bit about what has caused this sudden deterioration in economic conditions worldwide; second, talk about global prospects in countries other than the United States; and finally focus primary attention on the US economy, its recession, and the prospects for a recovery.

First on the causes: What causes recessions? Negative shocks. Economy likes to move forward at some reasonable pace as productive capacity expands and then, whammo, something comes along that knocks it off track.

What causes recoveries? The shocks dissipate and the natural process of economic recovery takes over, often aided by a policy stimulus, at least in the postwar period.

What were the shocks? Well, we had a very large shock through the financial system, hitting the global economy in the autumn of last year, which was set off, at least in terms of timing, around the middle of September with the outright failure of Lehman Brothers, the intervention in AIG, but also significant problems with banks in Europe and elsewhere, and the seizing up of global credit markets where, for the first time since the 1930s, we saw key credit markets nationally and internationally simply stop functioning. And even extremely credit-worthy firms found they could not issue commercial paper and secure funding through that normally reliable short-term mechanism. And major banks were not prepared to lend to each other.

The Libor interest rate's spread over treasuries went up at one point to 400 basis points but it didn't make any difference because nobody was borrowing and lending at those interest rates anyway. That type of credit market disturbance is, as I once described it, like ventricular fibrillation. The heart stops pumping blood around the credit system, stops circulating credit, and the effects on economic activity and trade are very negative, very fast.

That, however, was not the only shock. Earlier in the year, we saw commodity prices escalate, with oil prices reaching \$147 a barrel in the summer. That type of commodity price surge has a big negative economic impact on importing and consuming countries, with a little bit of a lag. That hit us right about the fourth quarter. In addition, earlier, in 2007, many countries, leaving aside the United States, had been tightening their economic policies and their monetary policies because of the concern about rising inflation. That too operates with a lag and began to hit us just exactly when we didn't need it around the end of last year.

So a combination of shocks built upon each other and mutually reinforced across the highly interactive and integrated global economy, and we saw this rapid drop in GDP and an even much larger drop in industrial production and the volume of trade. And that is clearly continuing into the first quarter of this year, which I think is not surprising. There was very substantial negative momentum coming out of those shocks.

So the question is: When is that going to end? And when might we begin to see a turnaround? It was 27 years ago that I first started my career as an economic forecaster at the Graduate School of Business Economic Forecasting Panel and, at that time, I asked my then colleague, Victor Zarnowitz, who sadly died last month and was a great expert on business cycles and business cycle forecasts, what his advice was and he said, "Well, economists have never been able to forecast when expansions will end and recessions will start, or how long recessions will go and when they will stop and expansions will occur. And it's not true that long expansions are followed by deep recessions."

Indeed, there is only one reliable regularity in business cycle history in the United States and elsewhere: Deep recessions are followed by steep recoveries and economic forecasts almost never take account of this regularity. The thinking is always that this thing is going to go on forever and when we start to turnaround, it's going to be sluggish. That is the story of the L-shaped recession and recovery. And let me note now that in the business cycle history of the United States, going back as far as we can, at least with industrial production data to the 1920s, there is only one L-shaped cyclical event.

That was a very special event: In the joyous recession or nonrecession between 1945 and 1946, real GDP dropped 13 percent as federal expenditure on the war effort declined from over 40 percent of GDP to about 9 percent in terms of total federal spending, and even an enormous resurgence of private consumption and investment couldn't quite offset the impact of the decline in the war effort. Indeed, everybody was happy to relax a bit after they had worked so hard to win the war and the recovery of GDP was essentially nil over the next two years. That was truly L-shaped and it was the only occasion when we had an L-shaped event.

In the 2001 recession and recovery, the recession was very shallow and the recovery was very shallow as well. But it was still a V, just a very shallow V. Everything else, as we'll see, has been much more V-shaped.

Well, before turning to the United States, let me say a few words about the prospects for the world economy. So what I foresee for the world is that GDP is going to decline this year but it will have a V-shaped recovery and it will pick up again next year. The industrial countries of the advanced economies are going to drop about 3 percent and then see a 3 percent recovery. I'll return to the United States. Japan has taken a very big hit through, primarily in its exports, but the domestic economy will be affected as well. They're providing substantial stimulus and I think that they will have a turnaround that will begin before the end of this year.

The United Kingdom is having its first recession in 17 years and it will continue for a while. Their economy has a very important financial sector, which has been hard hit and it's going to take a while for that to come around. Manufacturing will improve, ultimately, with a much depreciated pound but that will take a while.

In the euro area, we're also seeing a significant recession. But it's important to keep in mind that the margin of slack that has so far developed in Europe is much less than in the United States. The unemployment rate in Europe is up less than a percentage point from its trough last year, which was itself half a percentage point below the earlier low in unemployment at the beginning of the decade. And even with the output decline this year, the margin of slack in Western Europe will be substantially less than in the United States as we begin to recover from the recession. And I think that that largely accounts for the fact that the policy response has been substantially less vigorous in Europe and came later than in the United States. But I do anticipate that in Europe we will see recovery beginning probably late this year as well as in the United States.

Turning to emerging markets, China had a sharp slowdown in growth at the end of last year. GDP growth on a quarterly basis was probably very close to zero, and that reflected both the tightening of policy and the wind down from the Beijing Olympics. The Chinese government has turned around and is engaging in massive policy stimulus through the budget, but also particularly through the monetary and credit system, and I expect that we'll see a rapid rebound in growth up to the 8 percent level, or a little higher; but the events of late last year will still drag down GDP growth on a year-over-year basis below 8 percent.

The story is similar for India. They are less tied in to the global economy and have not suffered as much from the negative shocks. Also, they've had a fairly good monsoon and the agricultural sector is important, so growth will be reasonably well sustained in India but well down from the 8 percent or higher rates we've seen in recent years.

The rest of Asia is more dependent on trade and has been harder hit. The advanced Asian economies are already up with the advanced economies, and they are suffering very substantial drops in GDP this year.

In Latin America, Brazil had a quite-negative fourth quarter and now it looks like they'll be negative year over year. Mexico, of course, has been pulled down by events in the United States and will be influenced by the continuing US recession, and the rest of Latin America as well, to varying degrees, is being hit, so we'll have a negative year this year in Latin America, but again, I think a recovery is expected next year.

In Central and Eastern Europe, a number of economies are in deep trouble. Some are likely to be more around the zero line, but we'll see an output decline in the 2.5 to 3 percent range in Central and Eastern Europe.

Russia is suffering an output decline linked both to the drop in world oil prices and to the underlying problems in the economy that high oil prices helped to conceal, and there's uncertainty about what the recovery will look like both in Russia and in the rest of the CIS.

The Middle East: The drop in oil prices does not directly affect real GDP but the reduction in oil production volumes does, and there are a number of Middle Eastern states that are dependent on the spending of oil revenues—Dubai is sort of the outstanding example—and they're going to slow down or have outright recessions, so a substantial slowing of growth in that area.

And finally, in Africa, the Fund remains a little more optimistic than I am but I think probably if they manage 2 percent real growth, they will do pretty well.

So that's broadly my view for the world economy, the weakest year in terms of year-over-year growth on record, this year, but reasonable prospects for recovery next year.

Now, an important part of that story is what's going to happen in the US economy and in China as well. I've already mentioned, I think, that the Chinese

economy is going to be recovering and as it recovers it's going to help pull up the rest of Asia. But the Chinese horse is not going to be able to pull the wagon alone. The other big horse, the US economy, also needs to get back moving forward.

Well, we're undoubtedly having a recession in the United States and I thought it was interesting to look at what this recession is likely to look like in comparison with previous postwar recessions. My forecast is that GDP will fall about 4 percent annual rate in the first quarter, fall 2–2.5 percent in the second quarter, bottom out around midyear, have a modestly positive growth in the third quarter, and then the recovery will start to pick up in the fourth quarter and through 2010 and beyond. That forecast says that the decline in GDP for the period from the second quarter of last year through the second quarter of this year, the period in which GDP is falling, will work out at about 3.25 percent which will be close to the largest declines we've seen in previous recessions.

Other measures of the depth of the recession make this recession the deepest in the postwar era, in particular, if we look at how much the unemployment rate is rising. I think we'll get up to 9.5 percent, so we'll have a 5 percent rise in the unemployment rate, which is the biggest of any postwar recession.

In other respects, the recession is similar in some ways and different in others from earlier postwar recessions. Many recessions are dominated by the swing in inventory investment, and in four cases the downswing in inventory investment is more than the total decline in GDP. That is not happening on this occasion. We're getting quite modest decline in inventories, but we'll see, I think, more of a decline this quarter and next.

The other thing that tends to move down in a recession is investment. Housing investment here shows a significant decline. It would be a much larger decline except for the fact that housing began to crash at the end of 2005. So the cumulative decline from the peak in housing to the trough is nearly 50 percent, and only a fraction of that is actually occurring over this one year period. The other components of business fixed investment are declining in the recession and the decline in structures is expected to continue till well after the recession is over.

Finally, consumption spending is falling in this recession. It doesn't do so in every recession. This is going to be the largest decline in consumption spending of any postwar recession. And consumption spending growth is going to be kind of sluggish coming out of the recession.

So that's what the recession is going to look like, what about the recovery? Well, it's hard to say exactly when the recovery starts. I have an early starting point for it and the recession could go on another quarter or so. But I think it's interesting to look at what typically happens in a recovery once it starts and so these are the nine previous postwar recoveries; they're listed in the first column. The second column indicates the depth of the preceding recession in terms of the drop in real GDP. We had two recessions in the early 1980s: in 1980 and then two quarters of growth, and another recession in 1981–82, and so the Reagan recovery is really from the two recessions combined.

The strength of the recovery is measured in terms of the cumulative gain in real GDP during the first six quarters of the recovery, because I'm concerned in my forecast with how much the economy is likely to grow between the middle of this year and the end of 2010. And you can see that those numbers are pretty impressive. The weakest one, of course, is George W. Bush's recovery, when we had a very shallow recession and a very shallow recovery. The other relatively weak recovery was in the first Bush's term and then we also had a two-quarter recession that was actually probably the second mildest of the postwar period. All the others have cumulative output gains in excess of 7 percent. The average for all nine is 7.7 percent in the first six quarters, and the average excluding both the late 1940's recession, which was an odd inventory cycle, and the George W. Bush recovery is 8.8 percent.

So recoveries do indeed tend to be quite powerful, at least in history. So I constructed a scenario that sort of respects that general regularity and that's listed in the third column in this paper where the second column lists the level of real GDP and its components anticipated at the cyclical trough and at the end of the second quarter. And then the forecast is the gain in real GDP and its components over the next six quarters, and in percentage terms in the next column. And then the final two columns are what the scenario would look like if we had an average recovery.

So notably, in a 6.2 percent recovery, my assumption is that consumption spending is indeed going to recover but at a significantly slower rate than GDP. The savings rate is going to go up and it's going to reach about 7 percent in my forecast by the end of 2010. Obviously, durables, which get hard hit in a recession, have a big gain and services keep growing. Gross private domestic investment, as it does in every recovery, has a large gain, 25 percent. Structures, I assume, will continue to shrink a little bit. That may or may not be right, depending upon how much the fiscal stimulus actually boosts private investment in structures.

Equipment and software always has a big cyclical recovery six quarters out. And residential investment has a large gain, but the level of residential investment is still 30 percent below the peak reached at the end of 2007. So this is a modest recovery. New home building is going up in this forecast to a little over a million units per year from about half a million at the bottom. And finally, inventory investment makes a significant contribution but far less than in most cyclical recoveries. Net exports, I assume, will deteriorate in this expansion. The US economy will recover earlier and more strongly than most of its trading partners and we will be exporting demand to the rest of the world, and that will be a drag on our own recovery.

Now, some might say that this is an optimistic forecast. I regard it as conservative and indeed it is below the average of postwar recoveries, and we are recovering from a particularly deep recession when in the past recoveries have tended to be quite strong. So substantial allowance is made here both for the considerable possibility that the recovery might not get started quite as early as I have indicated, but also for the fact that it's likely to restrain a bit the pace of this recovery in comparison with earlier ones. The alternative scenario of the average shows that

one can easily have a substantially stronger cyclical economy without being, by any means, outside the range of what might be regarded as reasonable.

Now, finally, let me say a word about policy, in particular monetary policy. The Federal Reserve has an enormously expansive monetary policy and that's expansive on both sides of the balance sheet. They're buying up assets, lending out money on the asset side in order to restart various financial markets and provide credit directly to support those markets. The liability side has to be expanding as well, and they are just stuffing excess reserves onto the banks. They're holding over \$800 billion of excess reserves now. The Fed's balance sheet goes up on the asset side to three trillion, which I think it will, and may go higher. The level of excess reserves is going to reach a trillion and a half or two trillion.

Now, banks may pay down some of their borrowing, but they're going to have a huge volume of excess reserves on which they're earning a quarter of a percentage point, and I believe at some point they're going to say, "Gee, we could earn another 100, 150, 200, 300 basis points if we actually lent this money to somebody else." So I think there's going to be plenty of credit available for the banking system to lend out and plenty of incentive for them to do so and, in the end, this will work to promote recovery in the private sector.

Now some say, many say, that, "Well, we need to fix the banks first." I have no particular problem with fixing the banks, but I note that that's not the way in which it's usually happened in the past. In the deep recession of the mid-1970s and particularly in the early 1980s, the banks were in terrible shape. We didn't admit it because we didn't mark to market the value of their assets. But they were deeply insolvent in the early 1980s and the Savings and Loan industry never really recovered. They were insolvent throughout the entire expansion. Nevertheless, the expansion came and the housing sector recovered, even though its principal lender, the Savings and Loan industry, was deeply insolvent.

So what has happened typically in the past is the recovery of the economy has helped fix the banks, and it has not been necessary to solve all or most of the problems with bank balance sheets before one stimulates the recovery. And that's been true not only in the United States. If we look at the many countries that had financial crises in the time I was at the Fund, the banks remained in rotten shape as the economies recovered spectacularly, at least from the initial stages of the recession.

So I think that Victor Zarnowitz will be proved right again and that we will see a V-shaped recovery. Whether it will start quite as soon as I have in mind or not is, I think, a reasonable issue to question. But when it starts, I think that it is far more likely than not that the US economy and the world economy will see the V for Victor.

*Presentation by Simon Johnson*

Simon Johnson: Thanks very much for this opportunity and I guess, despite what Fred said, I think there is a very stark contrast between the views of the immediate future that Mike just presented very clearly and articulately, and the view that I'll put forward as my baseline view at least. And I think while I'm not insisting that this be an L, literally speaking a flat L—sometimes my daughters draw Ls that kind of have squiggly lines or point up a little bit—I think the basic point that I would suggest is that it is a sluggish recovery. It's a recovery that really struggles to take hold, both in the United States and globally, and it's not a V in the foreseeable future in 2010, perhaps even in 2011, of the kind that Mike laid out. And I think Mike sort of emphasized the key point here, which is if I'm to be right, then this has to be different from pretty much anything we've seen before in the data. And I'm always suspicious, I'm sure all of you are always suspicious, you should always be suspicious of anyone who stands up before you and says: "The world has changed completely. Disregard all previous observations you thought were relevant and let's think about this differently."

I think that's generally not true, and people say that far too often and I guess I take a little bit of comfort from the fact that I said that at the end of September last year and with some reluctance, and it was met by fairly universal disbelief. And the forecasts we made for 2009 during the fall was that there would be a contraction of about 1 percent in global GDP, which at the time seemed kind of outrageous, and was really a statement that the world had changed, and I think that that turns out to have been more or less in the right ballpark. It doesn't mean we'll be right on the recovery, but we did have a good sense of the downturn.

So how can the world have changed? What happened in the fall? What's happening now? What happened before that? What's the basis of the argument? And I'm going to refer you to a number of pieces that we've done, available through Peterson and through our website that try to articulate this in more detail. And I think that the basic point, which you can either accept or reject or study a little bit further, is that the United States, the heart of the global economy, the United States, and I would include Europe also—I won't spend a lot of time speaking about Europe in these remarks, but we can talk about that in the question and answer—I think that industrialized countries, particularly the United States, have become a lot more like emerging markets than we've ever seen before.

Now we had this idea, I think, previously that development and modern economic growth was about emerging markets trying to become more like industrialized countries, succeeding or failing, hitting various bumps in the road, being subject to capital flow shocks, and so on. I don't question that that can be a useful way to think about it, but I think what we're looking at right now is that the United States has become much more fundamentally unstable because of the way the financial sector developed, and I refer you here to an article that I just published in the *Atlantic* magazine, it's also available online, in which we argue this through and we argue that the financial-sector boom that happened in the United States and in other countries had this characteristic very much like an emerging-market boom where at first it makes sense. At first, you have some efficiency gains, you're generating sensible profits, and then the sector gets more politically powerful. It's

able to take control of its own regulatory destiny, let's say, and particularly as technological innovation occurs and derivatives arrive, but it's not only about derivatives, that the sector has an opportunity to construct its own future profit opportunities and it does that in a way that feeds into further concentration of political power. And I think, to be honest, we have allowed to develop in this country a sector that is dangerous and has caused this extraordinary degree of collapse, unprecedented degree of collapse, speed of collapse, in the United States and in the global economy, unprecedented in the postwar period, certainly, and I think it's a problem for the recovery.

I think this is not just about the banks and it's not just about the recovery. In particular, it's not just about the banks, but I think the banks are at the heart of the matter, and it's the political power of the banks that presents the most substantial problem to this administration in terms of moving forward with sensible policies. I should go further. I would say that most of the administration's policies I support, and some of them I support very strongly, including on our website on a daily basis, but the financial-rescue part of their policies, I think, makes less sense. I think it caters too much to the financial sector in ways that are not good for the growth of the economy or for society as a whole, and we take issue with that and I'm happy to discuss that further.

But if this is right, if the instability, if the collapse, if the decline we've seen so far is something about the United States, the core of the system having become more like what we used to call the periphery and now it's all mushed together, what are the implications for the recovery? Well, partly, you can worry about the banking system, and I do worry about the banking system. If you look at credit default swap spreads on major so-called nonbank holding companies, the holding companies that own banks that aren't banks and aren't subject currently to, as the administration presents it, a resolution authority, and that's why they're seeking a new resolution authority that will allow them to deal with these entities.

If you look at what happened to these swap spreads, the implied probability default in the market, they've actually increased over the past couple of weeks, while other credit risks have, again, according to markets, got better. European sovereign spreads, for example, are down. And of course the equity markets enjoyed a pretty strong rally. Something is still going wrong with the banks and the chance that we get out of this without further collapse, either sudden collapse or a more gradual collapse, I think, is rather limited. So there are problems within the short term in the financial system. There are also problems in terms of the growth potential of the financial sector. These economies, pretty much all the economies represented here today, moved much more of their GDP into finance since 1980, and I would question the degree to which that's sustainable. So if, in addition to the financial disruption, there is also a change in the allocation of talent and the allocation of capital within these economies, that's a long, drawn-out process that's not made any easier by the fact that private credit is largely, or at least partly, still stuck and jammed up.

In addition, of course, we have issues that go far beyond the banking system with regard to balance sheets. The balance sheets of consumers and the balance sheets of businesses are, I think, viewed as being damaged and I think that this is the sense

in which the 1990s Japan scenario strikes me and others as being relevant: if consumers are trying to pay down their debt, globally, and if businesses are trying to be more careful—one of my close colleagues at MIT is from Finland and he tells me stories about how after the Finnish severe recession in the early 1990s, his company and other companies really regarded taking credit as extremely risky because you didn't know if the credit would be there in the future, and they would take every single cent they had to try to pay down their debt and on a precautionary basis.

So I think that this is, to my way of thinking, a global collapse and a difficult recovery, based on the problems of the financial system, based on the fact that the financial system has become so powerful and is so difficult to—that's such a difficult problem to address, perhaps particularly in the United States, but in all industrialized countries, and then also that it spread to confidence, it spread to the debt levels that people want to have. Of course, Fred's right. We have no idea where this goes. I mean that's my point is that we are really in uncharted territory. President Obama has said it's the greatest financial crisis since the Great Depression and I think that's absolutely right. What is the degree of leverage? How much leverage are people willing to have in the corporate sector or in the housing sector going forward? I have no idea. I think they will not want to have the degree of indebtedness that they had to this date, and I think that this will fit very much into a Japan-type sluggish recovery at a global level and remember, most of the bounce backs—of course, Mike's right. The most rapid collapses that we've seen, well if I take Mike's statement and apply that to emerging markets, most rapid collapses in emerging markets, many of them are followed by rapid recoveries. But that typically involves a big real exchange rate depreciation and a rapid increase in exports. Japan's 1990s, if you remember, didn't have that feature. But they did have a strong export performance throughout the decade.

At the global level, what's the equivalent of a big real depreciation and a lot of exports? I'm not sure if Mars is open for business on that level. I think that it's going to be difficult. So it's the negative parts of an emerging-market collapse without the positive, without the ability to grow. My Scandinavian colleagues tell me that they also benefited from a strong, robust world economy when the Scandinavian recoveries began mid-1990s.

Let me conclude with a couple of remarks about policy, and perhaps bring up the G-20, and also make it clear that I'm as critical of European government policy as the US policy, just to be fair and even-handed, which is an important thing for the IMF table. I think that the G-20 summit, to my way of thinking, didn't deal with any of the first order questions. I think there was no additional fiscal stimulus coming out of the summit or the process. I think there is this unfortunate and, to my mind, anachronistic reluctance on the parts of heads of government to discuss monetary policy, which I'll come back to in a moment—I think that is a huge part of the ball game right now; and on this I think I agree with Mike. I also think the regulatory discussion is not really going anywhere in a productive way, and this is all elaborated on my website and you can, by the way—the comments are completely unmoderated there so you can say all kinds of things about me anonymously, even, so it's very satisfying.

And I think there was no serious discussion around the G-20 about how you deal with the banking problems, about this issue of what you're doing to recapitalize the banks. I think that there is no strategy for that yet in the United States, and I question whether the Europeans can actually afford that strategy. And I think that a big part of the problem, in terms of the policy response, is in Europe and particularly in Western Europe, and I have been urging for some time, at least since October, for West European governments to take seriously the fact that Eastern Europe is suffering and will continue to suffer a massive slowdown in the property markets in some Western European countries, most obviously the United Kingdom, Ireland, and Spain, are really deteriorating fast and that has implications for banking. And, of course, exports are coming down in many European countries, also, which has further implications for banking.

Now I do think that the G-20 summit—I do regard it as a success in these terms, partly because my expectations were sufficiently low. I think that the additional support that was given to the IMF, the money that's given to the IMF, both in terms of the additional credits promised and the prospect of new arrangements to borrow arrangement, \$500 billion, reportedly—this is good. I think the Special Drawing Rights allocation has the potential to be excellent. I think, in particular, the idea that I understand the Americans and perhaps some others have insisted on, which provides ready resources or reserves that some European governments, presumably surplus European countries, can lend to European countries with deficits. I think that's an excellent idea and I think that you should regard it as a pilot project.

I understand there are fears of that creating an immediate global inflation and there are fears about this somehow being misused and, obviously, the modes of operation around that have to be worked out. But I think if it makes progress and if the recovery really fails to take hold by September, the next G-20 summit, I think there'll be a discussion of a much larger SDR allocation, which I fully understand would require congressional authorization, as well as many other discussions. But I think that this SDR move, which, of course, I don't know if Ted Truman is here but I don't... There. Okay, Ted Truman is blushing, I think. He should be. I think that this is a terrific idea that Ted has been promoting for a long time and many of us, including myself, didn't think it would ever take hold or win political support, and I don't know how he and others did it, and perhaps you shouldn't tell me. But I think that that really is a very positive step and I think it really creates a potential, I think, for dramatic further action, should that be needed at fairly short notice. And I think that the G-20 should be absolutely applauded for that and I have applauded them repeatedly.

And on a final note, monetary policy; and this is something which I published in an article in the *Washington Post* Outlook section on Sunday saying that I actually—and I'm trying to be very careful and very clear about which parts of the US government policy I support, to what extent, and which parts I oppose—as I said, I'm very skeptical of everything that's happening on the financial reform. That will be in inverted commas “reform” side. The financial rescue, I think, is not at all going well. I'm happy to elaborate on that or you can just read my website. But I think in terms of monetary policy, I would put it like this, and this is what we said in the *Washington Post* article.

I think that the steps being taken by Mr. Bernanke and his colleagues, and the risks that they're taking are extraordinary and unprecedented; but I support them fully. I do agree with Mr. Trichet, the Head of the European Central Bank that there are risks of inflation in this situation. I am not of the view, and we've explained it there, and we've explained it also in slightly more technical detail on Monday on our website. I do not agree that there's no risk of inflation in this situation.

I think, again, because the dynamics of this economy have changed, because we've become more like an emerging market, standard, conventional, US-type macro models of inflation based around some notion of an output gap don't necessarily apply. I don't know that they don't apply, but my prior is quite weighted towards this having other features of emerging markets, and one of those would be the kind of monetary policy being undertaken, the kind of credit support that Mike nicely summarized, could well lead to inflation, even while unemployment, for example, is still rising, which will be, I agree, extraordinary, unprecedented, and you'd put that in the ever-growing list of extraordinary and unprecedented developments in this country over the past six months.

So I think there is a risk of inflation. I think there's very little—I think that the Fed doesn't have much option and I think that the risks that Mr. Bernanke's taking, in terms of economic outcomes, and in terms of the future independence of the Fed are very real. I think it shows great courage. I respect fully the view of the European Central Bank that inflation is a risk in this situation, and I think they're wrong in their policy. I don't think they are reading the risks right. I think the risks are, on both sides, quite severe and I'm on the side of Mr. Bernanke in thinking that he's reading this one right.

### *Question and Answer Session*

C. Fred Bergsten: Okay, lots of food for thought. Speakers have both invited questions on lots of aspects of what they said, so the floor is open. Joe Kennedy. Go ahead and introduce yourself and say where you're from.

Joe Kennedy: Thanks. Joe Kennedy, Pew Charitable Trusts, and I guess my question is to what extent do you think the current difficulties are fundamentally caused by significant economic imbalances, say, between consumption and savings, between exports and imports, and between the Federal government's willingness to spend and its willingness to tax, that we seem to be unable to deal with, and following up on that, can we have a sustainable recovery until we deal with those fundamental imbalances? Thanks.

Michael Mussa: No and yes.

Well, I mean, in terms of the impact of the imbalances, many of these imbalances have been existing for a considerable period of time and they didn't create steep recessions before, and I don't think it's necessary to get rid of all of them in order to have a recovery. We do have some very important long-run problems for the US

economy and society and the President has spoken about them. We face a major fiscal challenge and I think a societal challenge in dealing with the healthcare issue, which I think is going to be far more difficult to resolve in the present recession and I could go on, on that score.

Undoubtedly, we had an unsustainable build up in residential investment, which has happened before, and in house prices, which is more uncommon in the recent history of the United States, and the unwinding of that situation is playing a major role in the recession. But I think that problem is actually being corrected very rapidly. The Case-Schiller index of home prices is now back down to where it was in 2003. We're down nearly 30 percent from the peak and we're still falling 1.5 percent per month. So I think we're going to get house prices down to reasonable levels at which we can have a recovery in the housing market by sometime this year, probably around the middle of the year.

In contrast, it took Japan 12 years to grind down its real estate prices to reasonable levels. That adjustment is happening very rapidly. It's painful but it's necessary and, once we've achieved it, then the prospects, I think, for a substantial recovery in homebuilding, which is down 75 percent from the peak and probably 60 percent below the sustainable level determined by new household formation and removal of existing homes from the stock, can begin and it's a long way to come back.

Similarly, I think, on the trade side, one of the things that sheltered us from a recession for about a year and a half was that, as the housing industry shrunk, our real trade balance improved. So we had sort of offsetting corrections of those imbalances. Now, I think we'll probably regenerate some of the imbalance on the trade deficit side because we will have a more powerful and earlier recovery than some of our trading partners. That will be a problem down the road for us and for them, but I think in getting the world economy back up and running at a more sustainable pace, having the United States lead is not such a bad thing. So I don't believe that it's the imbalances that were the principal source of difficulty.

Now, what Simon talked about in terms of excessive risk taking and inappropriate asset and liability creation on the financial sector, and the unwinding of that, that clearly has been an important part of the story of this downturn. What I insist is that that has happened many times around the world and in the United States, and we could go through the history of them. I simply point out that 50 years ago, when I was a high school student and before I knew anything about economics, I wrote a term paper on a subject I was interested in, which was "Andrew Jackson, Nicholas Biddle, and the Controversy over the Rechartering of the Second Bank of the United States." It's very interesting to study the many episodes in US economic history in which there have been big financial bubbles, and their subsequent collapse has played an important role in the economic recessions of those times but the recessions have not lasted forever.

C. Fred Bergsten: Simon?

Simon Johnson: Well, nothing lasts forever. I think that's what Voltaire said about the Roman Empire and of course, no recession, no collapse lasts forever. But if we can agree,

and I absolutely agree with everything Mike said, including the point that we should think of the dynamics of the situation as being more 19th century, more about massive prolonged financial and other related but finance-driven bubbles collapsing, so in that sense, you can have your own version of how that bubble's created. I don't mind that. You can tell that story of some imbalance playing a role there.

To me, though, the key driver is the way that feeds into the profits of the financial sector, feeds back into their political influence, allows them to shape the playing field to create more profits over 30 years. It's a 30-year bubble—boom that became a bubble if you like—that we have to undo, rather than any of the conventional macroeconomic imbalances. Perhaps we argue some of the symptoms, we might argue some of those are relatively minor contributing factors, but it's the growth of the economic power, and the political power of the financial sector that creates a structural issue. And I think the spirit of the question is: Is there a deeper structural problem here, or is there just sort of transitory short-run stuff that we get out of?

There's a deeper structural problem and, even if we recover, by the way, even if we get the V-shape, I'm still going to insist that we think really hard about the political economy of banking because, if you started this with say, 10 or 12 major financial players, you end up with three. Those three have an even more compelling put option than before. They have an even—down the road, I'm not saying they do it right away, but down the road it's even easier or more tempting for them to take on massive amounts of risk that threaten the system. And I would suggest that the contrast between the United States and Europe is that we may well have financial institutions that are too big to fail. I think in some European countries—for example, I think about the United Kingdom, the Royal Bank of Scotland. I think about the size of bank assets and liabilities relative to UK GDP. It's an order of magnitude bigger than in the United States. I think in Europe, they have banks that are too big to rescue. We have too big to fail. They are too big to rescue.

C. Fred Bergsten: I would just add one word on the international dimension of the imbalances that Joe asked about, citing none other than Chairman Volker who has talked about this quite eloquently. It's quite true that the Chinese and the oil exporters and others who were pumping huge amounts of foreign lending into the US economy did not force us to make stupid subprime loans. On the other hand, that big infusion of foreign capital certainly eased monetary conditions, pushed interest rates down, and helped create the environment within which it was much easier to make the financial mistakes that were made here and, indeed, one might even say, created some of the incentives to make those mistakes. And so, as one looks to the next round, and trying to avoid repetition of the problem, I would add to the list for policy initiatives: trying to limit the big international imbalances of the type we have seen in the past.

I think that's particularly important because of one other feature of the crisis that neither Mike nor Simon referred to here, although they have many other times. When you look to previous crises over the last decade or two or three decades, the countries that fell into them were often able to export their way out of the crisis,

because the rest of the world was doing okay. Simon did mention, I think, that was true for Japan through the 1990s. It was true for the Asians as a whole coming out of the Asian crisis a decade ago. They were able to export to the rest of the world. You did not have to rely on Mars. This time, the countries that might try competitive undervaluations, or efforts to get out through exploiting foreign demand, rather than domestic demand, might only have one place to look and that's the United States.

If the United States were both able and willing to move back into very large, perhaps even larger external deficit than before, that would reconcile the desire of a number of other countries including the Europeans, incidentally, to exploit foreign demand, rather than domestic demand, rather than generating the domestic demand that's needed to come out of a truly global crisis. And, I think, as we forecast recovery scenarios, and try to design policies to make them successful and sustainable, that element's got to be factored in.

Kadosh: Kadosh with the Carnegie Endowment. This is a very important discussion because if you believe Mike, we don't have to do much more. It's going to happen. If you believe Simon, we've got a big policy deficit. I want to ask Mike why, in his presentation, taking a suite of various recessions, he stops in 1945 and why he doesn't go back further to the Great Depression? The reason I'm asking is yesterday, Barry Eichengreen published a paper on a website called *VoxEU* that shows that the decline in global industrial production and in trade over the last year is greater than the first year that followed the crash of 1929. And the question, really, is you're assuming that somehow the mechanisms are there for the recovery to happen and that is, to me, the heart of the question, which really separates the two of you, in that the argument is that if the financial system is as severely impaired as many of the estimates suggest, given in particular the incredible housing boom and bust that we've had and if, at the same time, world economic activity is declining, there's no external support. Where is actually this recovery going to come from? Not at all clear to me.

Michael Mussa: Well, of course, I don't go back to the 1930s because US quarterly GDP data starts in 1947, so I don't have a very good basis for drawing the comparisons if I want to use that type of information. But obviously, I've looked at that data and we have industrial production data and a variety of other indicators that we can use that are more frequent than annual GDP to get an idea of what's happening in these earlier business cycles. I would say going back to the First World War—to go beyond the First World War becomes even more difficult, though you can go back to about the Civil War and still get some useful information, though it is a quite different economy back then: The agricultural sector was much larger, manufacturing was much larger, the service sector was much smaller, and so forth.

This question really, I think, deals with Simon's point: It's different this time because of the nature of the crisis, and the shock and the financial system are different from all of the earlier postwar recessions. Well, each recession is different and the question is: Is there sufficient commonality that we can say something useful? I mean, if there is no commonality, then we can just babble on forever without any constraint, and I don't find that particularly useful. So GDP is consumption plus investment, plus government spending, plus exports minus

imports. And, if GDP is going to rise or going to fall, it's got to somehow come through those things, so I like to have a story that at least adds up in terms of the numbers, and where the numbers behave in a manner that is respectful of the regularities that we've observed in the data going back not only over the postwar period, but considerably longer. And we know in business cycles that consumption of services doesn't move very much. It's durables that have the big action in consumer behavior and, to some extent, nondurables. Investment is a big mover and it's often inventories, but housing is also very big and so forth. Those are things that I think you need to take account of in talking about the business cycle.

So the question is: When and under what conditions might we expect that the housing sector, which has suffered an enormous decline, might bottom out and recover? Well, I insist that one needs to take account of the fact that new household formation is about 1.2 million per year and we remove about half a million units from the housing stock each year, which gives us sort of a trend demand of about 1.7 million units, and we're producing new units at about half a million a year, so we're well below trend.

Now, there are good reasons why, given the shocks, that we are in that situation today, and part of the problem is, of course, housing prices have been falling and people either are fearful that if they buy now, that the price will fall out from under them or they're hopeful that if they wait, the price will fall further. Well, we need to get the price down to a point where we've dissipated some of that and where there's adequate financing for people of reasonable credit worthiness to be able to buy a new home, move out of their existing home, and sell it at a price that they don't think, if they buy a new one, they aren't going to be able to sell the old one.

Well, I think we're actually getting nearer that point with the enormous decline that we've seen in house prices and the big reduction we've seen in mortgage costs, at least for credit-worthy borrowers. And I note a lot of discussion of the financial sector—the Savings and Loan industry was a total mess, not only in the early 1980s but throughout the 1980s—so much of what was the mechanism of housing finance before we went into the 1980s recession was blown away in terms of its solvency.

Nevertheless, we had a spectacular recovery in the housing sector in the 1980s, and all those people who were mailing 2x4s to Paul Volker at the time, well, they stopped mailing them because they needed the 2x4s to build the houses that they started to build as the economy recovered. So yes, there are reasons why this cycle is going to look different and already has looked different from earlier ones, but that does not repeal all of the regularities of macroeconomic behavior that we've been able to observe and document over the past 50 to 100 years, and I could go on and on about that but let me stop the answer to the question.

C. Fred Bergsten: Mike, I heard you make a similar point about auto demand that you just made for housing demand. Does your argument—I'm just trying to summarize for the group—does your argument focus heavily on pent-up demand developing over this period of downturn, slack in consumer spending, the saving rate rises to some new level, maybe 5 percent like it is now, and then levels off there, maybe, and

then consumer demand resumes its growth? Is that basically the mechanism you have in mind?

Michael Mussa: Fundamentally, yes, but I have the savings rate going up to 7 percent, so it's not that I think that households aren't going to adjust to what looks like a relatively permanent decline in their wealth. I think the wealth will come back some, but I don't think we're headed back with home prices to where we were in 2006, so I think consumers are going to want to save more because they're getting less of the gain from their wealth from other forms.

The question is how large a factor should we assume, and I'm assuming we're going to push the savings rate up from roughly zero to around 7 percent, and I think that that's a quite sizeable adjustment. Now, could it be bigger? Of course, it could be bigger. It could also be smaller.

Simon Johnson: Yes, so I agree to the reasons Mike nicely articulated. It's not the Great Depression in terms of the size of the decline. Services are a bigger part of the economy. The government's a bigger part of the economy than back then. What I haven't found compelling, and we do track this on a daily basis on our website, is evidence of the recovery, what's driving the recovery, and I guess I'm just less willing to rely on these past patterns applying because much of what we've seen over the past six months in particular has been so far outside what we've observed over the last 100 years. Perhaps we could agree if we'd taken the last 200 years that there may be something we could discern from those dynamics, but we don't have the data.

I guess George Soros today said, he thought the shape of the recession would be an inverted square root sign. I've been drawing those all day and I think I know what he means. It's just way too complicated for me. I'm just calling it an L until I understand where this recovery is coming from in the United States and globally. Are we going down a ways and we're going to stay? Are you getting it? I guess he means you've got some sort of bounce off the bottom as people rebuild inventories and so on, but then I think he's expressing similar skepticism about what really drives growth back to the kinds of levels that we wish, that we hope we'll see, and that official forecasts definitely, definitely see, and the G-20 communiqué, I think, was predicated on and emphasized that the IMF is forecasting a return to rapid growth in the second half of 2010. I just don't see that yet.

C. Fred Bergsten: And Simon, let me, before I go to this next question, Simon, let me push you on one point that you made in your remarks, this provocative point, very important point. You suggested that it was anachronistic that governments were not intervening more in Central Bank activities.

Simon Johnson: No, what I said was it's an anachronism that heads of government don't feel comfortable discussing Central Bank policy at a G-20-type meeting. I can assure you, heads of government discuss monetary policy all the time, including—the governing council of the European Central Bank is comprised of representatives of the governments. They don't like to talk about these in these international forums. Somehow, the independent Central Bank mantra precludes that, but to my mind, what Ben Bernanke's doing with his expansion monetary policy is actually—it will create an infectious expansion, infectious in a good way, for my European

colleagues, in the sense that the dollar is going to tend to depreciate. That puts upward pressure on the euro, and I think that that will be contagious in a way that a fiscal stimulus is not contagious. Why not discuss that a bit more explicitly at a G-20-type forum? Why pretend, or why keep it as a taboo subject is my point.

C. Fred Bergsten: Okay, next question.

Lea: Lea from VOA. The Chinese Central Governor, Zhou Xiaochuan, recently proposed a global currency. I am interested in knowing the panelists' take on that. Is it time for a global currency? Thank you.

C. Fred Bergsten: I might respond on that since I've got an op-ed appearing on it in the *Financial Times* on Thursday. I think Governor Zhou and others in China who have made that suggestion recognize it's a very long-term idea and not very practical to think about the SDR, or any other asset, replacing the dollar in the system any time soon, and his colleagues have made clear that it was an intellectual presentation meant for discussion, not for any early negotiation or serious reform.

However, there is a part of Governor Zhou's statement that I think does call for early attention. The very last paragraph of his speech or paper suggests creating at the IMF something that used to be called a substitution account, where countries' central banks, official holders who are anxious about the stability of their dollar holdings, could convert them into SDRs in a new account at the IMF in a totally off-market way. That would enable countries that wanted to diversify their reserve holdings to do so without having adverse market effects. The United States would prefer that because it would avoid the shortfall of the dollar. The Europeans would much prefer it because it would prevent a sharp appreciation of the euro, which is what the conversions would take place into. The Chinese and others would get their diversification and the global system would remove one potentially important source of instability. So it's a win-win-win-win proposition, and I think that piece of it could profitably be hived off, addressed separately and pursued.

I think it's encouraging, in fact, that the Chinese have made at least that one proposal for modification of the international monetary system that would be quite positive, at least in my view, in the short to medium run. It could lead to longer-term changes as well, but that I think is the operational part of it.

C. Fred Bergsten: Okay, Ron.

Ron Blackwell: Yeah, thanks Fred. Ron Blackwell, AFL-CIO. This is a very interesting conversation, Fred, and I congratulate you for doing this. This is very helpful. You obviously have different interpretations of the nature of this recession but I wanted to ask you a policy question. Mike said very clearly that he did not think that cleaning up the blockages in the credit markets was necessary to get a recovery going, that that might be a more complicated relationship than is often alleged here. I just would ask each one of you to describe what role you see the credit market problem playing in the recovery, and Simon you had mentioned that you noticed, but didn't describe, the kind of reservations that you have with regard to the proposal for moving the banks forward here under the Treasury's plan. What role does recovering the banks play in the recovery prospects that you see, and how

do you evaluate the steps that are being taken by our Treasury and Fed to accomplish that?

C. Fred Bergsten: Yes, Simon, why don't you elaborate on your doubts about the Treasury plan?

Simon Johnson: Okay, well first of all, let me answer the sort of central part of the question, which is: What's the role of credit in the recovery? And Mike is, of course, right that in many instances you can—it's the recovery that helps improve the balance sheets of the banks, rather than the other way around. It's not always the case but that is certainly one way to do it, and you can also have some inflation, and the Bernanke scenario, of which I'm supportive, is one in which there's more inflation than the Fed believes in its heart of hearts is likely and that a moderate degree of inflation would also help reduce real indebtedness and, depending on exactly how it played out, could be most helpful to the banking system.

I think the banking system plays a facilitating role in the recovery, and I think if you have further banking-system collapses, if you have further repeated crises of confidence around the banking system, if you have repeated runs on the government, basically—and I think that there have been already and there continue to be pressures in which the financial markets are running on the government's ability to support the banking system, very much like you see runs in fixed exchange rate systems. And there are questions about the government's ability to either come up with the cash, given its relationship with Congress, or to have the requisite political will to support the banks in a way that speculators would actually lose.

So I think my worry is, in this current situation, is that they've created and they continue to create, and it's a very hard to avoid a situation in which speculators can run on the government's authority, if you like, vis-à-vis the banks, and I would emphasize that the more you ease credit in the economy, for example, through the kinds of measures Mr. Bernanke is doing, which I support—one of the unfortunate side effects could well be that you make it easier for people to take short positions in the credits of major banks. So I think that there's potential. What worries me about the banking system is its potential to get worse and, of course, it's potential to spread globally.

I think discussion has naturally centered around the United States, as this is where many of the problems remain and all the great deal of uncertainty is. But I would emphasize, or remind you of what I alluded to very briefly, but we talk about a lot more on the website, which is the extent to which European governments have a potential fiscal problem because their banks are so big relative to their economies, and we don't yet know the full degree of losses that they have already incurred and may incur through additional financial disruptions, for example, originating in the United States. And presumably none of this is good for emerging-market growth and so that's going to hurt our exports.

In terms of the government's plans on the banking system, I have written about this extensively and I don't want to bore the audience on it, but the very brief summary is that I think some form of government-managed prepackaged bankruptcy is a plausible way forward. It needs to be on the table. The

government—I think the administration recognizes it needs a different extension of its legal authority in order to handle the largest holding companies, and I respect that and I hope that they get that quickly and I’m supporting it in my conversations with Congress on the subject, I’m fully supporting that.

I don’t think that’s the end of the matter and the issue is obviously recapitalization of the banks, and I would rather do that with government money and receive an appropriate amount of common stock, which could then be sold off quickly, but which many people balk at, because they feel that’s a form of nationalization. I’m absolutely opposed to government takeover, control, the government trying to run the banking system. If the money’s not on the table, and I feel that it’s not on the table now, because of the history of what’s happened, then you’re looking at some form of debt to equity conversion, for example, the level of the holding company, and there are issues about how you treat derivatives, transactions, obligations in that context.

Any way you look at it, it’s a mess and, any way you look at it, it’s potentially damaging to consumer confidence and business confidence, and you know you understand more and more where the Finnish business people were coming from in 1991, 92 when they were saying, “Credit’s there now. We could recover. We could invest, but I don’t know if the credit’s going to be there in three months.” That is not exactly encouraging you to plow ahead with those projects that you previously thought made sense, and I think it’s not just in the United States, that’s also globally. Ordinarily, I would completely agree with Mike, you could just leave banking alone and get on with trying to stimulate the real economy through other means, but I worry there’s still a degree of precariousness and instability and so fulfilling credit runs are something I would not yet be willing to allow.

C. Fred Bergsten: Mike?

Michael Mussa: It’s important to understand that, on the issue of what we’re doing about the banks and the financial system, well, to paraphrase Sir Winston Churchill, “Never have governments done so much about such a problem in so short a time.” The actions that have been taken to stabilize the financial system and to restart credit flows have been without precedent in the history of the United States or, indeed, of the world. The Federal Reserve has, of course, driven the interest rate to zero. It’s nearly tripled now the size of its balance sheet. We had five major independent brokerage outfits a year, 15 months ago. Two of them survive as independent entities.

One of the five largest banks, Wachovia, has been merged into its previous smaller rival, Wells Fargo. WaMu has been merged and so forth. Fannie Mae and Freddie Mac have been taken over by the government. \$250 billion of government funds have been injected in capital into major and smaller banks, and the list goes on and on and on.

I’m not arguing that nothing needs to be done to deal with the problems in the financial system. What I think is a mistake is to believe that we cannot get a very substantial recovery unless we fix essentially everything in the financial system. There are a lot of questionable assets that sit on the balance sheets of financial

institutions. Many argue, well, their distressed prices are below what they will ultimately be able to produce, and that's the argument for offering more attractive prices for them.

My view is that if that's really true, leave them where they are. After all, the banks need to recover. If they've got these assets that are going to be substantially more valuable in a year or two when the economy recovers, then they can sit perfectly comfortably where they are in many instances, if not in all instances. Now, if you get a bank that's in such serious trouble that it can no longer meet the official standards for its capital, then you need to intervene in that bank, and that has indeed happened more rapidly, and to larger institutions than has previously been the case in US history. I don't think we should stop that.

If the stress tests reveal that there are additional institutions that are too weakly capitalized to continue safely in operation, then there's going to need to be not only capital injection, but some injection of government control to get those institutions back into shape and to limit the risk to which the taxpayer is exposed. But I think the history of past financial crises is that you don't need to solve all of those problems at the depth of the recession. An important part of them will solve themselves as the economy recovers.

C. Fred Bergsten: Final question, Colin.

Colin Bradford: Thank you. Colin Bradford from Brookings. An important part of sorting out this debate about whether it's a V or an L coming out of this is knowing what the size of the stimulus package is of the major countries. Simon and I talked about this before lunch, but I wanted to raise it here. The storyline coming out of the G-20 summit is that there was no incremental fiscal stimulus among the G-20 countries. That is true, but Paragraph 6 of the G-20 summit communiqué states that the concerted expansionary response of the 20 countries, by the end of 2010, will be to the size of \$5 trillion. That includes automatic stabilizers; that is social expenditures that kick in during recessions. That includes the fiscal stimulus that each of them is making, and it includes some of the bail-out money that's just been discussed. But it's \$5 trillion. It's not mentioned in the media and in the public image, or the market communications that have happened in the wake of the summit. My question to you is does that \$5 trillion affect whether it's a V or an L coming out of this recession?

Simon Johnson: It obviously has an effect and that's obviously, I think, in both our views. There was no surprise and no news last week so we didn't revise on that basis. I think that the question speaks to this broader issue, which Mike was also raising, which is we've done a lot. Governments have done a lot. Policy has changed a lot on many dimensions. But the question is, is it a lot relative to the scale of the problem? And I think that that's exactly what we were discussing over lunch. To my mind, it's not enough and to my mind there's actually a limit to how far you can go with a fiscal stimulus because of problems of how much debt you're willing to take on in the United States and other industrialized countries. I think that's why more of the weight falls on monetary policy. That's why I support very radically what I regard as very radical action on monetary policy while recognizing, consistent with my overall view I hope, that if we have a more emerging market-

type financial/political structure, we will also probably have a more emerging-market dynamic around inflation. And inflation in emerging markets, obviously, can go up when you have a big monetary stimulus even in a situation where the economy is not booming.

C. Fred Bergsten: Simon, just to nail this down. You say more radical monetary action. I know you mean in Europe. You made the clear. Do you mean also in the United States? I thought you said you had supported pretty much...

Simon Johnson: I'm supporting, and we said in the post on Sunday that we're supporting where Bernanke is now. In fact, we've been pushing them to get to this point three months ago. Fine, we are where we are, okay? Given where they are now, I think this is moving in the right direction, and I think they will and should press ahead with that. I think that the Fed...

C. Fred Bergsten: You think that the Fed should do more now?

Simon Johnson: I think we're broadly comfortable with what they're doing at this moment, the Fed. The Europeans, not so much.

C. Fred Bergsten: So the additional radical financial action you're calling for is in Europe?

Simon Johnson: No, on the monetary side.

C. Fred Bergsten: On the monetary side.

Simon Johnson: On the financial reform side, I'm worried for the reasons I've articulated.

C. Fred Bergsten: Mike, you get the last word.

Michael Mussa: Well, I certainly think that one of the reasons why the Reagan recovery was as powerful as it was, was that not only did we have the natural forces of recovery, but the Reagan tax cuts, which were quite substantial, and the defense buildup on the expenditure side provided additional impetus to the recovery. In contrast, the Ford recovery in 1975–76 was not as strong as the Reagan recovery I think, in part, because there really was no fiscal stimulus to help boost the recovery from that recession and, perhaps, the easing of monetary policy was not quite as dramatic in that episode as it was beginning in July of 1982. So I think stimulus, both monetary and fiscal, helps both to limit the recession and to produce a more vigorous recovery.

What I maintain is that for the United States, especially, but also for other countries, we are getting an enormous amount of policy stimulus, certainly on the monetary side in the United States, beyond anything that has previously been done. I mean, the criticism of the Fed in the early 1930s was they sat back as the money supply declined by 40 percent and the banking system was wiped out. That's certainly not our Fed at present and, as I indicated, I mean, they're pumping in huge quantities of reserves, simply flooding the banks with liquidity in addition to operating directly in key credit markets.

So a great deal is being done. Now, the big stimulus package just passed in February. I mean it was not short-term tax cuts where the checks have already been sent out, so we felt no impact from it yet; and it will be pretty limited in the second quarter. By the third quarter, though, we're going to be getting more bang out of that fiscal stimulus package and I think that is going to work to boost aggregate demand in the United States, and the Fed is building more and more the asset side of its balance sheet and the liability side of its balance sheet, and we'll see more effects of that as we move forward.

So I'm not just optimistic that the economy will recover on its own. I think eventually that would happen, but there's no reason to sit back and just say, well, we're going to let it happen and that's not what is being done. We're having an enormous amount of fiscal stimulus and an unprecedented degree of monetary intervention to boost the economy and as I say, I think that that will work.