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Reform of the International Monetary and Financial System

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Introduction

DEVIN STEWART: I'm Devin Stewart from the Carnegie Council.

We have an extremely distinguished panel here today who will talk about the report created from the UN Commission of Experts on Reforms of the International Monetary and Financial System.

We are really happy to have Professor Joseph Stiglitz, who is an advisor to our program here at Carnegie Council.

I'm hoping that we might learn something about where we've come after a year from the Lehman shock, whether this has been a wasted crisis or if we could be more hopeful.

According to a Carnegie Endowment report, the most affected countries from the financial crisis are: 1) Ukraine; 2) Argentina; 3) Hungary; 4) Poland; and 5) Jamaica. Ironically, the least-affected, least-impacted countries from the financial crisis are: 1) China; 2) Japan; and 3) United States.

During the so-called Lehman shock, I was helping to lead a delegation in Beijing with the Carnegie Council. We learned about the financial crisis from somebody's BlackBerry. Our Chinese hosts looked at us in disbelief: "Do you have a plan? Are you going to fix this?"

It was a pretty incredible moment, where we were talking about the public good of working toward energy cooperation and protecting the climate, and then all of a sudden something more immediate occurred. The public good of the global financial system, and with it capital flows and trade flows, quickly contracted, in some ways dispelling what is in a sense the fundamental promise of globalization. Without trade and capital flows, what do you have from globalization?

It's my great pleasure to turn it over to Bert Koenders, who will chair this event. We will hear first from Joseph Stiglitz and Jose Antonio Ocampo. These are the principals of the Commission Report [opens PDF].

Thank you very much.

BERT KOENDERS: I think the release of the Report of the Commission of Experts of the President of the of the United Nations General Assembly on Reforms of the International Monetary and Financial System could not have come at a more important moment. A lot of the experts were working the last couple of weeks to change some of the last details. I was present in two of the discussions of the Stiglitz Commission.

It's an extremely interesting way of looking at how Professor Stiglitz was chairing the meetings. All the subjects were discussed in detail. People could come with propositions. They were discussed in a very serious way. I'm sure that the last couple of weeks have led to intense discussions and an enormously important outcome.

We are faced today, a year after the crisis of Lehman, with a situation in which one thing should be very clear to all of us: that the worst thing we could do is go back, as if nothing has happened, to a situation of "business as usual."

I have been very happy to see that in the last year some positive developments were there. We've had the development of the G-20. There is a new emphasis on multilateral politics. The reform of the international financial institutions is a key point on the agenda of all countries in which effectiveness and legitimacy are now closely related. But there is also risk that we go back to business as it was. The solutions that we have seen so far are not sustainable.

I'd like to acknowledge the vision and leadership of the former president of the General Assembly, Mr. d'Escoto Brockmann, because he decided to organize the UN Conference on the Economic Crisis and its Impact on Development, which was held in June here in New York. I thought that was a major event.

He established a commission, under the leadership of Professor Joseph Stiglitz, to assist Member States like my own to form their views on the origins, the far-reaching implications, and the desired responses to this enormous crisis.

I thought actually before we went into this meeting in June that it wouldn't lead to much, because, frankly—you know how big UN meetings go—sometimes when there are big differences of opinion, you can talk forever, and what actually comes out of it? My enormous compliments to the president of the General Assembly, but also to Joseph Stiglitz, are that the outcome of this conference is probably the most comprehensive statement by any intergovernmental process on the causes and necessary remedies for the present world economic crisis.

That's why I think that what we have in front of us, the new report which is going to be presented in a minute, is something that will remain with us—this week with the G-20 meeting in Pittsburgh, but also in the reforms of the international financial systems, the regulatory systems that we will have to deal with, but especially also on the issues related to the global monetary system.

We know this is a very sensitive issue, and therefore I think it is a major step forward that we have a report in which we are not only talking about the specific consequences of this international economic crisis for different groups of countries, but we are also looking at the root causes of this problem, the issue of global monetary reserves, the discussion about a new reserve currency, and the issue of ensuring that capital flows are more predictable to the poorest countries in the world. That is a crucial aspect of this crisis which we finally have a possibility to discuss.

As a minister for development cooperation in Europe, we are all preparing for Pittsburgh and the upcoming meetings of the International Monetary Fund (IMF) and the World Bank, and obviously also the very important General Assembly this week.

One thing is clear: Everybody is talking correctly now about the issue of bonuses. I think the perverse incentives that were given to many of the bankers are one of the crucial elements in this crisis. It's important that we discuss that and we come to international agreement.

But at the same time, we have to ensure as well that it is not the only thing we discuss. We have to deal also with the capital flows to the poorest countries. Regulatory regimes such as the proposals that we have, or that Professor Stiglitz and his team have presented in this report, which go beyond what is on the agenda right now.

What I find crucial is also that a relationship is being made by the financial crisis, which at some moment will end. But is that the same for the climate and food crises that are so closely interlinked with what we are seeing today in the world?

One word on developing countries, speaking as a Dutch Minister for Development Cooperation. I have been struck by the fact that, although at the G-20 meeting more emphasis than may have been expected was put on the position of the poorest countries, still it is not enough by far.

If I look at how quickly the level playing field is turning against the poorest countries, who are not guilty in any way for this crisis, then we have a severe problem. It is very difficult for countries to support their car industry, to have counter-cyclical policies, to have the same type of expansionary economics that we can have in my country, the Netherlands, or that you have in other countries. So we have to ensure this week—and the Dutch government will do so as a participant in Pittsburgh—that this issue of the $50 billion, which was actually promised to the least developed countries, is actually on the table.

I think the key is that we have a short-term agenda which deals with bonuses, with new regulatory regimes, but also with capital flows to the least developed countries and, second, that we really use the possibilities in the next year to go from economics to the politics of changing and influencing some of the root causes of this international financial crisis.

Everybody who sits here and is interested in this knows that if we look only to some of the United States, European, and Chinese policies on adjusting to this financial and economic crisis, the way it is happening is probably not sustainable in the medium- and long-run.

So we have a big agenda. I would like to thank again the United Nations General Assembly and its former president and the Stiglitz Commission for giving to us as Member States a very comprehensive agenda on seeing how we could move on.

I would like, therefore, to give the floor to Professor Stiglitz. Thank you very much for your work.

Remarks

JOSEPH STIGLITZ: Thank you very much.

When this idea was broached, it was decided that we would construct a commission of experts. That had a big advantage over the G-20 process, which is political. It had a disadvantage, that we are not in the same way politically accountable, but it also meant that we had a freer range in formulating and discussing ideas.

We did have a number of sitting government officials, including the minister of development from Germany and a number of central bankers, but they were all there in their individual capacities.

The head of the Central Bank of Malaysia was there because she had gone through the East Asia crisis—I had been at the World Bank at the time—and had managed it much better than most of the other countries did. So we wanted that kind of expertise. In putting together the members of the commission we were looking for expertise.

We also looked for diversity. It's easy to get agreement among a group of people who, *ex ante*, all agree with each other. But that wouldn't have been meaningful. So we had people in business, in finance, from the private market, central bankers, as I say a development minister—a whole variety of people with different views at the beginning.

What was remarkable is that, after a lot of talking all over the world—we met in Kuala Lumpur, we met in The Hague, we met in Berlin, Geneva, and of course a number of times in New York—I think we reached a broad consensus on all of the issues. I think that says something about the advantage of this kind of approach.

As we went about it, we had a distinct perspective that we wanted to bring to the subject, and that was a view on how the crisis was going to affect the developing countries, but also the poor in developed countries. We thought that that probably wouldn't get as much attention from the finance ministers as it probably deserved.

We also thought we ought to look at this not only in terms of the short-run response, but the longer one. As Minister Koenders pointed out, we wanted to see this in relationship to the climate change problem and the other problems of growing inequality, the Millennium Development Goals, all the other long-term issues that are on the international agenda.

I'm very pleased at your view, because I think it is correct, that the report that came out does provide a deeper analysis of the causes of the crisis and a long-term agenda of what to do about it than, for instance, what has come out of the G-20 communiqués and reports.

We had two tracks. One of them was that we were providing input into the UN process, into this meeting that was held in June. I, too, was actually astounded at the outcome of that meeting. If you read the agreed outcomes at that meeting, it is a very strong statement. Now, of course, like anything else, it has to be implemented and the ideas have to be pushed forward. But in terms of, you might say, standard diplomatic processes, it really was a very strong statement, proving direction going forward.

I want to begin by highlighting a perspective that I think has not gotten adequate attention in discussions in the United States and abroad about the appropriate test of whether you've done the right thing. That is, had these reforms been in place before the crisis, would the crisis have occurred? You might say that's a very simple test.

But to give you an example of something that obviously fails that test, there are proposals, for instance, in the United States to give more power to the Fed. That is the main regulatory reform that is intended to prevent the recurrence of the crisis.

We know that before the crisis the Fed didn't use all the powers that it had and that it had a model of the economy that said that there was no bubble and that allowed the bubble to grow.

If you believe that we have a government of rules, not of men—and it's mostly men, not women—then you want a system that doesn't depend on the chairman of the Fed or the members of the Fed having had their fingers burned and say, "Okay, we won't play with these matches for the next few weeks or a few years." You want a system that works no matter who is in charge.

If you look at many of the reforms that are on the table, they don't meet the test. In fact, many of the things that are on the table had the characteristic of "What can we agree to given that there are some people here not at the table?" We could make agreements about people who aren't here more easily than we could make agreements about the behavior of people who are here.

So if you look at some of the things, I think you might say, "What do they have to do with the crisis?" Nothing. But we have to have some outcome of our document, so that's the agenda.

Let me illustrate, I think, the advantage of having more representation, including more representation from the developing countries, in the process of decision making.

The G-20 is not inclusive. It doesn't have anybody from sub-Saharan Africa, other than South Africa, which is distinctly different from other sub-Saharan countries.

You take the important issue of assistance to developing countries. As was pointed out, they are among the worst hit. They are the innocent victims. Many of them had much better regulatory structures, much better central bankers, than we had, and yet they are being very badly affected. They don't have the resources to cope with it. They don't have the trillions of dollars that the United States and Europe have thrown at the problem.

And, as Minister Koenders pointed out, in some ways the way things have been dealt with in the crisis have made things worse. That's a general theme I want to come back to. Why? Because what we realize now is that companies, finance institutions, autos, and a host of other industries are backstopped by the governments in the advanced industrial countries in a way that the developing countries can't do. That means that even when you're not in a crisis, they can undertake greater risk because they know if that risk fails they'll be rescued.

So we've really changed the face of globalization. We've changed the playing field in a way that is not going to be able to be reversed anytime soon, because no matter what governments say, even if they say, "We won't bail them out in the future," nobody believes that, and the reason they don't believe it is it's not credible. So we really have changed the face of globalization in the last year, and we need to recognize that.

I think it is a testimony to some of the leaders that they did put the concerns about the developing countries so central in the G-20. I think Gordon Brown and a number of other people really need to be commended for the efforts that they made.

But then you look at the solutions. This is so typical. It was going to the existing institutions, the IMF. One has to recognize that the existing institutions did not prevent the crisis. One has to recognize, worse than that, the existing institutions actually pushed the deregulation, capital market and financial market liberalization agenda, which created the crisis and made it spread over the world very rapidly.

Whether one believes or doesn't believe that these institutions have learned their lessons and therefore have reformed, the fact is that there is lack of confidence in these institutions in the developing countries as well as in the countries that have surpluses that they might provide for developing countries. That means it is difficult for them to play the central role that the G-20 has turned to them and said they ought to play.

So yes, it is imperative that the reforms that are on the agenda occur. But the speed of those reforms, talking about 2013—we'll be probably in the next crisis before they occur. But even if they did occur, if you look at them, most of them are not deep enough to affect many of the central decisions or economic philosophies of these institutions.

So that's why our commission emphasized the importance of grants rather than just loans, long-term loans rather than just short-term loans at the IMF, concessional loans, and the disbursement through a variety of channels and the creation of new channels.

One of the areas of big debate is the creation of new institutions versus reform of old institutions. In the meeting at The Hague, that was one of the big debates. We came to the consensus you need to do both and you need to push on both of them as fast as you can. We talked about that issue and how we might design new institutions.

Let me just highlight a couple of other examples of where, by being more inclusive, one gets a different perspective on what is going on. I think maybe the result of what we've been pushing is beginning to have some effects, because some of the things we talked about are beginning to show up in the G-20 agenda. So I think we're already, even on that agenda, beginning to have some impact.

For instance, one of the issues that was taken up was what they call the non-cooperative states—tax havens is the less euphemistic way of calling them. Now, we ought to realize the tax havens had nothing to do with the crisis, but they weren't at the meeting, so they were a convenient thing to talk about. On the other hand, they are a problem. Never let a crisis go to waste. If you can talk about something that didn't have anything to do with the crisis and get some progress on something that some of us have been concerned about for a long time, don't complain.

For developing countries the major issue, or at least one of the major issues, is not just tax evasion but also corruption. These secret bank accounts have been places where corrupt dictators take their money and have a safe home after they get thrown out. It's a regular pattern.

The problem is that some of the safe havens for this are not just offshore small countries but major countries onshore, including some of the countries that have been hosts for these meetings, so we understand why it wasn't at the center of their discussion. But we should realize that they haven't even repatriated money when it has been discovered. This is a major problem. It sets up bad incentives.

We can lecture about corruption, but we facilitate it. So this issue was in the outcome document of the UN meeting, and now appears to be on the G-20 agenda.

The reform of the financial regulatory structure is clearly a very big issue. As Minister Koenders pointed out, reforms in the compensation schemes are important. It's not only a moral issue, an outrage issue. It's also the fact that if you have incentive structures that encourage short-sighted behavior and excessive risk taking, incentives matter, and you're going to get that kind of behavior. And so what we've seen happen is not a surprise.

But you need far deeper reforms than that. We need to recognize—and this is something that the finance ministers don't like to focus on—that our financial sector didn't do what it was supposed to do, which is allocate capital, manage risk, and do it at low transaction cost. They did it at a huge transaction cost—40 percent in one year in the United States of all corporate profits were in the financial sector. A competitive financial sector should be a small sector. It's a means to an end, not an end in itself. So we forgot those basic lessons.

But the problems of incentives occur not just at the individual level, but also at the organizational level. If you have banks that are too big to fail, they know that if they gamble and they win, they walk off with the profits. If they lose, the taxpayer picks up the losses.

The problem of too-big-to-fail banks has become much worse since the beginning of the crisis. While we're making some strides in trying to improve things, we've made some things much worse.

It's worse because we have bigger banks, more concentration, but also because we've increased the moral hazard problem. We've introduced in many countries around the world a new concept that never had any role in economics before: banks that are too big to be financially resolved, where you protect the bondholders and shareholders as well as the institution and the depositors.

The G-20 really hasn't done anything adequate to deal with that. They are talking a little bit about more capital adequacy requirements. But if they allow them to continue, even having a little bit more cushion, that is not going to eliminate the asymmetries in their behavior, the incentives that they have for excessive risk taking, particularly when you combine proprietary trading with trading on behalf of others. You have a conflict of interest. So we in our report discuss this issue as just one of the many on the deeper regulatory reform.

Another issue on regulatory reform is capital market liberalization, the agenda that allows rapid flows in and out of a country. Small countries have to be able to manage capital flows. There is a debate about the best way of doing it and what is appropriate for each country. But the agenda that the IMF and the other international institutions had before was really an agenda that exposed developing countries to a lot of volatility. We should have learned that lesson in the East Asia crisis, but evidently we didn't.

The final area I want to talk about has to do with macroeconomic policy and new innovations. If you look at the report, we have four chapters beyond the introduction and conclusion. One is on macroeconomics, one is on regulation, one is on international financial institutions and international cooperation, and the final is on innovations.

There has been a lot of attention to the regulatory issue, but a lot of our concern was with the underlying macroeconomics that led to some of these problems. One way of thinking about it is that what sustained the U.S. economy, and the global economy to a very large extent, in the period before the crisis was a bubble—a housing bubble, the credit/consumption binge.

You have to ask the question: Why was that necessary? What was going on that made it desirable for central banks to encourage bubbles, which is what they were doing? The answer was there was an insufficiency of aggregate demand.

We could diagnose that into two explanations. One is that within most countries around the world there is an increase in inequality. The problem with inequality, besides you might say the societal consequences, the narrow economic consequences, is that you redistribute money from people who would spend it to people who don't, from the poor who spend everything they get to upper-income people who don't.

In the United States, the data that came out just about a week ago showed that in 2008 the median household income was about 4 percent lower than it was in 2000.

We've had a half-percent decline on average per year.

This is the middle, not just the poor. Most Americans are worse off than they were in 2000. All the gains have gone to the top.

What the model keeping the U.S. economy told these people was, "Don't worry. Continue to spend as if your income was going up." That, of course, is debt-financed spending. That is not sustainable and that model is now broken.

At a global level there's a similar problem. One of the consequences of the mismanagement of the East Asia crisis and the other crises in Latin America was that many countries decided to make sure they had enough reserves. You can call that precautionary savings. To put it another way, the prime minister of one of the East Asian countries told me, "We were in the class of '97. We learned what happens if you don't have enough reserves."

The result of that is that they started having huge amounts of reserves—$500 billion in one year. We're talking about amounts that are close to 1 percent of global GDP.

There are some other reasons that we talk about in the report. I don't want to say this is the only reason. But overall there is a variety of reasons.

They increased their level of savings. That's good for their own balance sheet, but the fact is what economists call the paradox of thrift: If you don't spend money, there's a lack of aggregate demand.

In the world of globalization, what matters is global aggregate demand, and this was weakening global aggregate demand. So this, in a way, is part of the overall framework that has weakened global aggregate demand.

Policy responses have to address these underlying problems. So far, there's almost no discussion of that. We therefore try to talk about what are some of the things one might do about it.

One of them is the creation of a global reserve system. This was an old idea. Keynes talked about it. It was his hope that this is what would happen in Bretton Woods, but the United States vetoed it.

We argue that this is probably the most important medium-term reform that ought to be undertaken. I think, partly because of our commission, the topic is on the agenda.

Many people in the United States don't want it to be on the agenda. But when the country that has the largest amount of reserves, China, says it wants to talk about it, it begins to be talked about. China has endorsed the beginning of discussions on this issue. In fact, it was again in the outcomes document.

The final thing is global coordination. The G-20—actually 22, because Netherlands and Spain are there—is a big step forward from the G-8, but there are still 170 countries not represented. You ask: How was the list chosen? Well, it was chosen by President Bush—who [which countries] was going to fly to Washington. That's not a way you want a global system to work.

If you want to have an impassioned statement about this, ask Jose Antonio, who comes from Colombia, and he will give you a strong feeling about why the 170 countries that aren't there feel strongly about this issue. I think it is not just a minor issue. This is a major issue of democracy, democracy at the global level, inclusiveness.

What I've hoped I've convinced you is that making sure that people's voices are heard does have an effect on the outcome, on what comes out of discussion. So what we've supported, and something that a number of governments are now beginning to support, is the creation of a global economic coordinating council.

You can't have 192 countries sitting around a table, but you can have representativeness.

That's how we're democracies. We don't have 350 million people get together in a room to discuss what to do about financial market regulation. We have representativeness, we have constituency principles. We argue that one could do that at the international level, and we talk about how that might be done.

Let me just conclude by observing that it's very important that we not go back to the world as it was before 2008, before the crisis. We can't go back. But to a large extent there are a lot of forces wanting us to go back there.

Just to give you one example, our financial sector, as I said before, was bloated. That means it will have to be downsized. What was striking is it was bloated but not performing its critical functions.

One idea that is being discussed very widely in Europe right now is a financial service tax—widespread agreement in the debates in the German elections that are next week. It's one instrument.

We've been subsidizing the financial sector. We should recognize that. We've been subsidizing it enormously, because this is only the most recent of the bailouts. When you look at the bailouts with names of countries, like Mexico or Korea or Thailand, they're not really bailouts of those countries; they're bailouts of the bad lending of the banks in those countries. So we've been engaged in massive subsidies over the years of the financial sector. And, not surprisingly, with subsidies things get bloated.

This is an attempt to recognize a very simple concept that we use throughout our report, the concept of externalities, how actions of one party have effects on others.

We understand that in the area of environment, that we have to discourage pollution because of the harm it does to others. The financial sector has done a lot of harm to the rest of the economy, and that means it has to be regulated and maybe has to be downsized through a variety of fiscal instruments.

These are the kinds of ideas that need to be on the table and need to be discussed. We view our report not as a report that's being written for action next week, but as trying to lay out an agenda.

Some things that will need to happen very quickly—in our preliminary report we divided them into short-run and long-run—there are some things that need to be done very quickly, but many of the others are things that the international community needs to turn to in the coming years.

BERT KOENDERS: Thank you very much for laying out the report in its essence for us today.

Let me say from the side of one of the governments who somehow has been invited by President Bush—I don't know exactly what happened, but we're happy to be there—I think this bridge-building exercise is absolutely key.

We will try during the United Nations General Assembly this week to organize a follow-up to what the leadership of the General Assembly has done, to ensure that the short-term measures you mentioned that are so key are put on the agenda.

The financial services statutes is a small element, but having it on the agenda could be very key for financing some of the gaps that are, for instance, in serving the Millennium Development Goals, very relevant.

But I think the key for us all is to link this to some of the more fundamental questions regarding deficit and surplus countries, the issue of how we deal with our regulations, and especially also the deeper reforms that are necessary.

I am very much supporting the idea that we also have to look at the issue of inequity and crisis. Growing inequities in countries and between countries is actually having enormous economic implications. I very much support this analysis, which in a way is not a new analysis, but nobody is putting it politically on the table at the moment.

I couldn't raise this issue without mentioning that one of the major persons in the commission and advising the commission is Jose Antonio Ocampo. I would like to give you the floor to talk about your suggestions and your main points for the debate.

JOSE ANTONIO OCAMPO: Thank you, Minister.

I also want to thank Carnegie for this great opportunity to present this report.

Professor Stiglitz presented some of the highlights. Let me re-emphasize two and present a third one, which are among the many other recommendations.

Let me start with the global economic cooperation council, which I think is one of the main ideas in this report. The global economic cooperation council, in a sense, I personally see as an institutionalized G-20 of sorts, except that to guarantee its representativeness we propose that clearly it should be around the United Nations, which is the most representative global institution. I think there are two features that should be emphasized.

First of all, that it would be based on a constituency system, so that the number of countries sitting at the table will be of course small, like the G-20, although it is expanding. It will be small, but they would represent all the members of the United Nations. I think that is a very important point. So my country—I am a Colombian citizen—which as Professor Stiglitz said may not be on the table, feels strongly that we should be represented, probably by another Latin American country.

So that is the way to have representation of all member countries.

The second feature is that it will guide the UN system. I think this is a very important point. The Bretton Woods institutions are also specialized agencies of the United Nations. They were created in the United Nations in 1944. They are formally a part of the United Nations, but they don't quite recognize themselves as such. I think it is important to bring them into the system.

There is another very important organization, which is the World Trade Organization (WTO), that was not given the status of a UN organization. We proposed that it also be brought into the UN system formally and that the council that we propose should be serviced by the World Bank, the IMF, the WTO, the UN Secretariat, and the International Labour Organization. Those five agencies should be supporting, and also receiving mandates and orders, from the global economic cooperation council.

Those two features are important in the proposal that we put forward in the report.

The other proposal that Professor Stiglitz mentioned that should be emphasized is the global reserve system. In the report there are several proposals for ways we could build that system, which is to have a truly global reserve currency.

By reserve currency what we are mean is that, at least in the first stage of the process, it should be a currency in which central banks deal with each other. It should not be, let's say, a currency that circulates among citizens, although in the future it could probably be something of this sort.

We are thinking essentially of a mechanism of payments among central banks, where central banks can pay each other in that reserve currency, which can, as I say, be given broader uses at some stage.

There are several proposals.

One is to create a new institution, a global reserve bank. The other, which is more or less the Chinese proposal, is to make it evolve out of the special drawing rights of the IMF.

When the special drawing rights were created in the 1960s, the explicit goal was to make them about half of world reserves. It was really meant to be the major reserve currency of the world. Now, it just happened that before the decision of the G-20 it was 0.5 percent of the world reserves. The initial allocations that were made in the early 1970s, and then the other around 1980, put them at 10 percent of global reserves. But then, with time, since the mechanism was not used, they ended up being half a percentage point of global reserves. Even with the $250 billion that has now been approved by the IMF, they will only be about 5 percent. So there is a lot of potential in that.

The third way that we propose is to build around regional processes. We encourage much more regional monetary cooperation. There are some mechanisms that exist in the world today. Of course, the European Central Bank is the most important. The Chiang Mai Initiative of East Asia, which includes the ASEAN countries plus China, Korea, and Japan, is another major mechanism. And in Latin America there is a smaller institution, called the Latin American Reserve Fund. But we would multiply these institutions.

One way is they can build a mechanism of cooperation, recognizing each other's currencies and then pooling them into a global currency.

There are several mechanisms that are suggested in the report to build this.

The final point that I wanted to emphasize is that we also endorse an idea that developing countries strongly pushed for—not all, but many developing countries pushed for—after the Asian crisis, and before in different incarnations, which is the idea of an international debt restructuring court. This is an international mechanism by which countries that have difficulties in paying their debts, their external liabilities, can go and do a formal process of restructuring, such as is done by a bankrupt firm in national bankruptcy regimes.

There is nothing at the global level, which implies that there are lots of inequities—horizontal and vertical—in the way debt crises are resolved. So a formal mechanism that has been suggested several times is also part of the agenda.

I may just add an advertisement for one point that I usually make that is not in the report, which is that the Latin American debt crisis is never recognized as a U.S. banking crisis, which it was. Had Latin America not paid their debt, all the major banks in the United States would have gone bankrupt.

The United States was very skillful in avoiding recognizing this as a U.S. banking crisis, so much so that I always say this is the third banking crisis of the United States in modern times. But the first one, which was the Latin American debt crisis, is not even recognized as a U.S. crisis, even though it was.

The U.S. banks over-exposed themselves in Latin America. Latin America could not pay their debt. The United States was very skillful.

There was a lot of talk at the time of a mechanism to resolve the crisis. It came in very bad, ad hoc ways, through first the Baker Plan and then the Brady Plan. Had Latin America brought their problems to a court, that would have been extremely helpful for resolving that major crisis, which cost Latin America a whole decade of development.

Thank you very much.

BERT KOENDERS: Thank you very much.

Also let me very quickly, as a politician who works right now in these institutions, make three points.

There was a big debate that we had in The Hague on existing and new institutions. In my view, you are very right that the implications of the Stiglitz report, if I may call it that, are actually on the agenda right now. If I look to the voice and accountability discussions that we have at the moment within the IMF and the World Bank, and at the same time the issue of how we make the link between the General Assembly this week and those discussions that are going very quickly right now—they have to be ended by the beginning of next year—I think we have to ensure that in the agenda of the upcoming weeks these ideas are very much part of the debate, to say the least.

It is in my view a possibility because more than ever, as you said, Professor Stiglitz, the relationship between effectiveness and legitimacy is now key. Surplus countries are not easily going to go through the IMF if at the same time it is not changing its nature, so on and so forth.

The second on reserve currency. I think also that is quite key. That is more of a medium-term strategy. But we have to think how the short-term and the medium-term are related to that. This is also controversial in my own country, in Europe.

I think it was interesting that you mentioned we start with central banks. You cannot proclaim a new reserve currency tomorrow in the private markets. There is an interesting relationship also with the alternatives that are being discussed as having a basket of different regional currencies and so on, the pros and cons of that.

The last point on the debt crisis. I think we have to ensure also that we are not getting into a new debt crisis in a couple of years. I think the key idea I get from this, and it's related to what you have in the United States, which is this idea of a court in which you look at debt levels, a way that we look at a common responsibility of debtors and creditors about situations that arise.

Questions and Answers

QUESTION: I couldn't agree more with your point that sometimes grants are much more important than loans to developing countries in solving their problems.

It is reported that the IMF just released $13 billion worth of core reserves to solve the problem, or some problems, of developing countries. Do you think this is a short-run mechanism? In other words, do you think this is loans or grants to developing countries, and how far will the IMF go in helping those developing countries in finally solving their problems?

JOSEPH STIGLITZ: The reason for the global reserves is that they need more finance. This was a problem that was clear in the East Asia crisis, that the international institutions have not been able to keep up in their balance sheet with the growth of the global economy.

The concerns about the IMF are several besides the governance issue. The governance issue is very important because that affects legitimacy and confidence in these institutions.

The problem, though, is that in the past they have often been associated with conditionalities, imposing both structural and macroeconomic conditionalities, which have both political and economic consequences—a loss of economic sovereignty, but also often the conditionalities made the policies counterproductive. That is to say, in this crisis we wanted countries to spend. If you told them, "We're going to give you money but you can't spend it," it doesn't actually help the global economy, and it also causes the country to go down into a weaker economy. That's what happened in East Asia.

The good news is that the IMF says that for some countries they will not have that degree of conditionality. The question is: What does that mean? How many countries, with what conditions?

I was just in Iceland. A year ago they had the largest banking crisis in the world. The IMF had a very non-conventional policy program, where they allowed the country to maintain its deficit and they allowed the country to impose capital controls. But when I was there just a few days ago, the general concern was they were under pressure to reduce their deficit very quickly and to remove the capital controls.

The general view there was very much that this was an intrusion in their economic sovereignty; it was up to them to decide how fast to reduce the deficit. Many people thought this was an example of deficit fetishism. If you are borrowing money to increase investment, then your balance sheet looks just as good as it did before—it can look even better—and it was up to them to decide, depending on what they could finance.

They were particularly resentful of a characteristic that has often marked IMF programs, a focus on repaying the creditors who had made bad loans. In this particular case, depositors in a couple of European countries, where the governments had not protected their citizens from institutions that were not adequately regulated, were under pressure to bail out those depositors. Their view was that they had been strong-armed in a way that put their own citizens' well-being in jeopardy for decades to come.

The point of this is these are debates that should go on within the country, but the way the IMF was doing it had taken this out of their hands. There were certainly a lot of people there who were saying, "Let's repay the money."

The point I want to make goes back to several of the themes of our report. If the IMF is giving money, it shouldn't be done with the conditionality that it has been done with in the past. Because of the legacy of the past, no matter what they do, there is a lack of confidence in many countries, and that is going to impair the effectiveness of this form of assistance.

JOSE ANTONIO OCAMPO: Let me just emphasize that even beyond conditionality, low-income countries may not want to borrow money. Suppose the IMF or the development banks want to offer them money to spend. They may say, "Well, we just went through a debt crisis." The international community is spending a lot of time and a lot of money trying to solve the problem of the indebtedness of the low-income countries. So is the HIPC Initiative, the Heavily Indebted Poor Countries, and the Multilateral Debt Relief Initiative.

So it would not make sense, particularly for low-income countries, to do deficit financing. That is a luxury that of course the industrial countries can do and some middle-income countries can, but not the low-income countries. So that is just to reinforce the point that in that case what the international community should give is grants, because otherwise they will not be able really to spend their way out of a crisis.

QUESTION: I have two brief questions.

One is on the reserve currency. Given several historical assessments, the dollar being the reserve currency enables not just civilians, but gives space for enormous military expenditure by the United States. How realistic is it to assume that the United States would let the dollar cease to be the reserve currency? That's the first question.

The second question is that you mentioned two aspects of backstopping the financial and industrial companies in the West, and both I agree with fully. One is inequity, that you have created a non-level playing field for the developing countries. The second is the question of increasing risk-taking behavior through this backstopping, so you lay the seeds of a new crisis, make it more crisis-prone. But surely the third is also that you increase the overall inefficiency of the economy because of what Kornai used to call the "soft budget constraints." In other words, you are introducing an element of Soviet-type economies into this in order to increase the overall inefficiency of the economy. I wanted your comments on this.

Thank you.

DEVIN STEWART: I'll just follow up on that. How realistic is the coordinating council, and what feedback are you getting on that?

JOSEPH STIGLITZ: On the question of the point you made about the inefficiencies associated with what we're doing, I couldn't agree more. We have distorted our economy within ourselves, within each of the countries. That's very important. That's one of the things that we need to try to rectify.

In the financial sector, where it has been a constant bailout, it's a very important problem. When you see those high profits, they are partly profits that are at the expense of the taxpayers, which we've seen very strongly in this recent crisis. So it is a question of both efficiency and inequity.

On the question of would the United States "allow" this reform, two points. A country's currency can only be a reserve currency if other countries are willing to accept it. The point is that right now the dollar is no longer viewed by most countries as a good store of value. You have to be a good store of value to be a reserve.

Now, that doesn't mean you immediately get out of the dollar, but there will be a move out of the dollar. The reason is right now you have zero return and a lot of risk. People see the magnitude of the deficits, the blowing up of the balance sheet of the Fed, and that's really what has motivated part of China's interest as they have seen their $1.5 trillion of dollar reserves they view as at risk.

So the advantage that the United States has had of being able to borrow at low interest rates is going to be disappearing. It's not going to be overnight, but it's going to be disappearing.

On the other hand, this system costs the United States a great deal. So I don't think it's in the interest of the United States. Let me explain why.

It costs the United States a great deal partly because it contributes to global instability. We argue it's one of the main factors that contributed to global financial instability, particularly in this interim where confidence in the dollar as a reserve currency is eroding. But also, the flip side of people demanding your dollars to put in reserves is that you have a trade deficit. You are exporting T-bills [Treasury bills], I say jokingly, rather than automobiles, and when you export T-bills it doesn't generate jobs. That contributes to the weak U.S. economy and almost forces us to have large fiscal deficits, and the fiscal deficits are a mounting problem.

So I actually think that it's not in the interest of the United States.

Now, from a global perspective there's a further inequity that we talk about in our report, that in effect poor countries are lending the United States trillions of dollars at zero interest rate. It's a form of foreign aid. When you look at it that way, you should say, "Why should poor countries be giving foreign aid to the United States?" The magnitude of this when you calculate it is greater than all the foreign aid the United States gives to poor countries. So it's a reverse flow.

On the question of the likelihood of the global economic coordinating council, let me first answer that in the following way. I've talked to a number of heads of states and others involved in the G-20. I think that there is a broad awareness of the problem of lack of political legitimacy of the G-20. The countries that are at the table are very much enjoying being at the table, so they don't want to say, "We shouldn't be at the table." We can understand that. But they realize the lack of political legitimacy of the process.

Some of them want to approach the problem of thinking of the G-20 as a caucus reporting to the United Nations. That's one framework, saying, "We are a discussion group within the UN that will get our legitimacy by providing consensus that will be presented to the UN and then discussed within the UN."

I think in many ways an easier approach is the global economic coordinating council, where you get legitimacy out of the constituency principle that Jose Antonio talked about, where the country in Africa views itself as having a responsibility of assessing the views of all the other countries in Africa, so it's not only speaking for itself but it's speaking for the other African countries. That will increase the force and weight of that country's view.

So I'm very hopeful that this will eventually lead to an institutional evolution of the G-20 into the global economic coordinating council.

QUESTION: You raised the very important question of conditionalities, and this has been one of the important developments over the last year. For example, the IMF is now saying, "We wouldn't require you to do conditionalities."

But take the case of Jamaica, the fifth-worst affected. Jamaica is now talking to the IMF quietly. We had a tax budget passed in April. They had no requirement to do so, not by the IMF. This tax budget cuts the current expenditures in that by 20 percent and the capital by 10 percent. It will never be said it was an IMF requirement because they are in silent discussions, but clearly it was a requirement. So what do we mean when we say that the conditionalities have been reduced or have not been required?

Let me just make one other point in terms of the question of global reserve and the insurance. In a real sense, the global reserve becomes a question of global insurance, which is really what the IMF was supposed to have done in the first instance. What has happened is, as you have said, countries have had to self-insure, and we all know that self-insurance is the most ineffective and most costly form of insurance.

So could you elaborate a little bit more on these two issues?

JOSEPH STIGLITZ: Let me talk about the second point first.

The way we've structured our global financial system has exposed particularly poor countries to a lot of volatility, a lot of risk. The underlying problem, in a sense, is risk mitigation.

We have to understand the private financial markets haven't done what they are supposed to do. Well-functioning financial markets would transfer risk from those less able to bear risk to those more able. They would transfer risk from the developing countries to developed.

We have in the last chapter of our report a number of proposals of how we can catalyze the private sector to do more of what it should have done. It really has failed to do a good job of risk management.

It's true at the micro-level the mortgages that were created actually increased risk. There were other products out there, like the Danish mortgage bonds, which would have reduced risk—they didn't work. At the macro-level it's also true.

One of the proposals that Jose Antonio talked about, the mechanisms for restructuring debt, is a risk-mitigation mechanism. It's a way of handling large losses. So we argue very strongly that this is a very important failure in the global financial system.

We also argue that some of the rules of the game have exacerbated the degree of volatility to which developing countries are exposed—that's capital market liberalization, financial market liberalization—and we argue that you need new regulatory frameworks to help manage those risks.

Again, this is something that has not been on the G-20 agenda, partly because some of the major countries pushed the agenda of capital and financial market liberalization that led to greater volatility. So it's very difficult for them to say, "Boy, did we make a mistake." Part of our proposal is to be quite up-front about saying, "Look, there were some mistakes in the past and we have to change it."

The global reserve system is one way of helping mitigate risk. It doesn't solve everything. I think it is an important step forward, but it needs to be seen in this broader perspective of managing risk.

On the issue of conditionality, every bank when it lends money puts conditions. When you lend money, you want to make sure the money that you lent is well used and you're going to get your money back.

But many of the conditions that the IMF has imposed in the past actually have reduced the likelihood of getting repaid and go well beyond those conditions that a banker would normally impose. They're not just making sure the money is well used. And that's part of the problem. It's not only the extent of conditionality, it's the conditions that are imposed. So we now recognize that many of the conditions that the IMF imposed in the past actually led to more volatility, led to greater risk being borne by the country, and have contributed to the crisis.

So there is one set of political issues, the interference in the economic sovereignty of a country. But there's another one where you impose conditions that make your country's economic performance even worse and expose the country to more risk. Again, this is a topic that is not obviously being discussed at the G-20, which has given the IMF more and more responsibility for handling the crisis.

So, for instance, one of the big issues on the table in Pittsburgh is what they call the global imbalances and how to correct them. They want to turn over to the IMF oversight for making sure that the appropriate actions are undertaken.

Well, the concern is: Do they have the right economic models to make sure that what is right is done? The best you can say is they have a particular model that didn't work in the past, and maybe they've learned. But the worst you can say is there are disagreements and you have to be very careful about what models you impose.

For instance, one of the issues as they look at this is the usual mantra. When you get these international meetings, you always have to have shared responsibility. So the United States has too big of a deficit, China has too big of a surplus, and Europe now has to say: "How do we bring Europe into the table?" Well, Europe treats its workers too well. They don't call it that. They say they have too much social protection; they need more labor market flexibility.

There is no evidence that labor market flexibility has played any role in the crisis. As an economist, I think that if they had had more labor market flexibility, wages would have gone down and the downturn would have been much worse in Europe. Now, that may be a controversial position. But certainly, looking at the crisis, in many ways they've been protected because of some of the labor market issues.

Whether you agree with that view or not, that, I would say, is an internal affair for the European governments to decide for themselves. It isn't really related to the issue of global imbalances, which are the issues on the table. So that's why I get very nervous as soon as they start talking about conditionalities.

Now, the final point I want to make is they say that they aren't going to impose the same conditionalities that they did in the past. I think in the case of a couple countries that has been true, and very strikingly so.

But, as I gave in the example of Iceland, it appears that they're beginning to put pressure to change. And if you talk to many other countries, as I have, they all have the sense that you do, that they're being told, "If you want the money, you better do what we would ask you to do, but we don't want to ask you because that would be conditionality. So if you want the money, you propose it, and in fact if you propose too stringent cuts, we'll tell you 'be a little bit looser,' and we'll get credit for putting pressure on you to loosen it up."

But you and I all know that the condition for opening up the discussion is being very tough. If a finance minister isn't tough enough, they'll put pressure for a change in the finance minister. I know that this has happened at least in one country.

So the issue is very much on the table.

QUESTION: Professor Stiglitz, on the matter of the reserve currency, do you think there's any way the United States could achieve financial discipline while it remains a reserve currency?

Second question: The Chinese have not only been talking but also acting. So international commerce is beginning to change, given the yuan-won and yuan-yen swaps to conciliate their trade. And now they have done swaps with Argentina, Paraguay, Uruguay, and most significantly Brazil. So if the Brazilian-Chinese trade this year is like last year, that means at the end of the year the Chinese will give $11 billion equivalent in yuan to the Brazilian Central Bank, which forthwith will give it to Brazilian importers, because they want to keep that, and they will be importing Chinese goods first to get rid of the yuan before anything else. Do you think that changes in world commerce could bring the United States out of denial on the reserve currency issue?

And finally, the third and last question is: Ecuador last month abolished the independence of its central bank, because it had been independent from the government and Ecuadorian congress but not from the IMF and the World Bank, which controlled it very tightly. So now the central bank will be under congressional oversight.

Given the nature of the U.S. Federal Reserve system and the composition of the district banks and the well-known revolving door with Wall Street, do you think a similar measure in the United States might be the mega-regulatory measure?

JOSEPH STIGLITZ: Let me first say the issue of independent central banks has really come under examination in this crisis for a number of reasons.

First, the countries without independent central banks have typically done better than those with. India and China and Brazil have central banks that are not independent. All three of these had very good central bankers.

Independent means that you can be subject to a lot more political pressure from the investment community, who want a bubble. And so, while they were independent of oversight from Congress, they were not independent from pressure from the financial markets and they served their clients well. But even more, the fact is that the central bank in the United States and many other countries has acted in ways to circumvent the congressional appropriation process.

Some people go as far as the Constitution, which says that appropriations originate in Congress. The fact is that they have put at risk taxpayer money, because they have taken on bad collateral, and we know that we've lost on some of that, but we don't know how much we've lost. So they have in fact put the taxpayer at risk by a very large amount. This has really changed the nature of what they do.

This has really highlighted the questions about independent central banks. It has also highlighted democratic accountability. They didn't want to disclose what they were doing.

Fortunately, at least one judge has now ruled that they are accountable to the public and that they have to disclose. I don't think they have yet decided whether to appeal that decision. It was a very important decision, because, for example, we didn't know where the money from AIG was going, and when we found out, we discovered that it wasn't going to systemically significant institutions in the United States, which was the argument for the $180 billion AIG bailout. So that kind of transparency that we demand of public institutions they've said that they don't need to have, and at least that's a minimum.

The final point that you raised is exposed particularly in the context of the New York Fed, a raft of conflicts of interest. It's a form of self-regulation. When you go beyond self-regulation to make a bailout, concerns about those conflicts of interest become extraordinarily acute.

On the first question, I think that while having the ability to borrow in an unbridled way probably makes a softer budget constraint, and therefore leads to, as you say, less discipline, the fact that there is still confidence in the dollar, though it may eventually erode, means that in fact that's not the operative constraint, that it is only a part of the lack of discipline.

To put it in economic terms, we face a fairly horizontal supply curve of funds from the private market, and this would probably be true even if we weren't a reserve currency. We may eventually—and we are increasingly—facing constraints that other countries haven't faced.

But when we had a debt-to-GDP ratio of 30 percent, then we clearly had a lot of borrowing capacity. As our debt-to-GDP ratio goes up, those constraints become more binding.

In a global economy it is very peculiar for the currency of one country to be the basis of reserves. You don't want the stability of the whole global economic system to depend on the vagaries of the political and economic processes in that one country.

Globalization means that we not only have to democratize our institutional decision making—that's the idea of the global economic coordinating council—but we also have to, you might say, democratize or multilateralize the foundations. In a way, that's what the global reserve system does: It's multilateralizing the economic foundations underlying the global economic system.

I think it *will* happen. My view is very much that it will either happen in a smooth way—and that's what we hope—through this kind of discussion and a movement to a global reserve currency, or it will happen in a chaotic way, in a move from a single-currency to a two-reserve-currency system, which could be even more unstable.

I'm afraid that right now we're headed into a frame of the dollar reserve system, a movement into a multiple, unstructured reserve system that is likely to confront the world with more problems than the current system.