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Stephen C. Freidheim Symposium on Global Economics: Financial Turbulence and U.S. Power

Symposium Rapporteur Report
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9:00 a.m. to 2:00 p.m.
Hosted by the Council on Foreign Relations

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The Council on Foreign Relations held a symposium recently on “Financial Turbulence and U.S. Power.” With all the talk of “green shoots,” this was an ideal time to look over the horizon and discuss the challenges ahead. The Stephen C. Freidheim Symposium on Global Economics, organized by **Sebastian Mallaby**, director of the Maurice R. Greenberg Center for Geoeconomic Studies, consisted of three meetings: the first on the geopolitical consequences of the crisis, the second on financial regulation, and the third on the macroeconomic outlook.

In the first session, **Joseph S. Nye, Jr.**, professor of international relations at Harvard University, warned of the risks of geopolitical extrapolations from short-run trends. Nye believes that U.S. power is holding up better than expected. **Philip D. Zelikow**, professor of history at the University of Virginia, was more pessimistic and warned that the big tests of the crisis lay ahead.

The second session discussed the desirable shape of financial regulation. **Peter R. Fisher**, Managing Director of BlackRock, emphasized the limited benefits of capital requirements and argued for more disciplined credit underwriting. **David S. Scharfstein**, professor of finance and banking at Harvard Business School, pointed to the need for better resolution mechanisms for non-bank financial institutions and described the work of the Squam Lake Group on financial regulation. And Council Senior Fellow **Benn Steil** drew on his recent Council Special Report, *Lessons of the Financial Crisis*, recommending reforms to reverse the debt financing bias built into the financial system.

In the last meeting, keynote speaker **Dr. Christina Romer**, Chair of the Council of Economic Advisers, discussed her expectations for America’s future economic trajectory. Dr. Romer argued that long-run growth without bubbles is achievable. This growth is likely to come primarily from non-housing business investment and net exports. She is cautiously optimistic about a robust recovery and believes that the United States can come out of this crisis stronger.

Session 1: "The Global Consequences of the Crisis"

-Joseph Nye believes that it is a mistake to draw long run geopolitical conclusions from short run trends. Many recent short-run predictions have proven wrong. For example, the dollar has not crashed and the "decoupling" between the United States and emerging economies has proved to be a myth. Just as talk of American decline has been overdone, so too it would be a mistake to discount the continuing weight of Japan and Europe. So talk of a "G2" or "Chimerica" is wrong-headed.

-Instead, Nye says that the geopolitical order is actually holding up better than one might have expected. For example, there has been much less protectionism than predicted. It is also important to remember that power is relative. So even though the United States has been hit hard by the crisis, the rest of the world has been hit too. In fact, the United States may recover faster than most other countries.

-Although Philip Zelikow agrees that the international economic order has shown a remarkable amount of cohesiveness so far, he warns that the big tests are still to come. He reminds the audience that in May 1931 people were beginning to see "green shoots." Bank failures had not yet hit Europe and Japan was still part of the Western order. A reasonable observer might have been optimistic that better times were coming. But by 1933 the world economy had cratered and the international system had all but collapsed. This story demonstrates the need for humility when making geopolitical predictions.

-Zelikow says that U.S. hard power still looks relatively robust, and its soft power has strengthened, so it would be mistaken to declare the decline of American power. But many dangers lie ahead. U.S. fiscal policy creates risks for the dollar, the German social market economy is being tested, and China may prove reticent about taking its place in the economic system.

-The speakers agree that there are multiple possibilities for the future of U.S. power. As Nye emphasized, if the recovery proves to be V or W-shaped, we can expect U.S. power to hold. But if the recovery is L-shaped—that is the economy stagnates or deteriorates further—then we must reanalyze our expectations for U.S. power. There remains a high degree of uncertainty surrounding the geopolitical consequences of this crisis.

Session 2: "Fixing Finance: Reactions and Over-Reactions"

- The moderator opens by asking how we could have gotten financial regulation so wrong. Peter Fisher is not so sure that financial regulation was the problem. He argues that monetary policy was too easy and warns that we risk "fixing" a lot of things that weren't broken. Benn Steil agrees that monetary policy was too easy, but also emphasizes the importance of taxation policy, which created incentives for taking on debt.

-David Scharfstein says that capital requirements did not sufficiently account for systemic risk. Capital requirements should be higher for larger institutions and banks that hold a lot of illiquid assets. Benn Steil argues that capital requirements proved to be pro-cyclical—when asset prices fell, financial institutions were forced to raise capital quickly, further depressing asset prices. Capital requirements must be made countercyclical. But Fisher believes that capital requirements are irrelevant if you don't have more disciplined credit underwriting to begin with.

-Scharfstein agrees that there are limits to the benefits of capital requirements and says that perhaps the penalties for failure should be greater. He points out the need for a better resolution mechanism so that creditors and counterparties are not bailed out. This points to the need for an FDIC-like resolution mechanism for non-bank financial institutions.

-Benn Steil thinks that one of the biggest problems, particularly in the credit default swaps market, was counterparty risk management. Steil argues that certain over-the-counter contracts that are highly standardized and traded in high volume should be moved onto central clearing houses to reduce counterparty risk.

-On the need for a systemic regulator, Scharfstein argues that the Federal Reserve is best positioned to address systemic risk. Fisher worries about conflicts between a systemic regulator and other regulators, such as the SEC and CFTC. And Benn Steil says that we must disabuse ourselves of the idea that there is an institutional fix to this crisis or future crises. He argues that we must fix the incentives created by monetary policy, the taxation system, and regulation of capital standards.

Session 3: "Keynote: Growth Without Bubbles"

-In the last two decades, there have been two periods of robust economic growth: one in 1992 to 2000, the other in 2002 to 2007. But in both cases, growth was accompanied by asset price bubbles that eventually burst, in the tech sector in the 90s and in housing in the 2000s. Dr. Christina Romer asks how we can achieve the good without the bad—that is how can we achieve robust growth without bubbles?

-First, Romer says that history demonstrates that we can achieve growth without bubbles. She cites U.S. economic growth in the period from 1962 to 1967 as evidence. Other examples include the United States from the end of World War II to the 1950s, and Japan, Canada, and Western Europe from the end of World War II to the 1960s. Romer also argues that bubbles are not a natural consequence of growth. In fact, a well-functioning market economy is the best first-line of defense against bubbles since competition creates incentives not to overpay for assets.

-Nonetheless, the crisis has demonstrated that we cannot rely on market forces alone to prevent bubbles. Romer believes that we must reform our financial regulatory structure. A systemic regulator could be responsible for ensuring that financial institutions that pose systemic threats be properly monitored and regulated.

-So what will non-bubble driven growth look like? Where will demand come from? Housing investment and consumption almost surely will not be the source of growth. And in the long run, government spending is likely to be roughly constant rather than serving as a source of increased demand. Instead, Romer suggests that long-run growth is likely to come from net exports and non-housing business investment. The lower cost of borrowing resulting from higher household savings should encourage investments. Figuring out these investments will be the job of the private sector

-Romer argues that government policies do have a role in promoting private investment. Public investments in renewable energy and a smarter electricity grid included in the American Recovery and Reinvestment Act can pave the way for investment in private energy sources. A market-based system designed to limit greenhouse gas emissions would incentivize clean domestic energy investments. And public investment in human capital—education and research and development—could spur private investment as well.

-But even if growth without bubbles is possible in the long-run, we still face a deep recession right now, as demonstrated by the unemployment rate reaching 8.9% in April. Romer says that the short-run boost will come from the government. The $787 billion American Recovery and Reinvestment Act will provide stimulus to demand over the next two years. In addition, we could get a temporary surge in spending from an investment rebound and pent-up demand after households and firms cutback consumption and investment more than was proportional to falls in their income. The result could be a virtuous circle of recovery.

-Romer concludes that there is a path to sustainable, bubble-free growth. The economy can come through this crisis stronger.