

**CENTER FOR
STRATEGIC AND INTERNATIONAL STUDIES (CSIS)**

**CAN THE G-20 SAVE THE WORLD ECONOMY FROM DEEPER CRISIS
AND PROTECTIONISM?**

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STEVEN SCHRAGE: I thank you very much and, again, we apologize. As Senator Brock was saying, some of the discussions on these were very interesting and intriguing and we hope to be able to continue some of those here today.

I'm Steven Schrage, the Scholl Chair in International Business, and this is a forum where we're discussing the G-20 and whether they'll be able to achieve some concrete progress, or even at least a way forward in terms of fighting protectionism and putting that world economy back on track. I think as everyone's recognized, the stakes are incredibly high. Before the first G-20 leaders meeting last November, we said it was kind of like in the middle of a five alarm fire, calling together the fire chiefs to try to restructure the fire department.

But now we're five months later and the fire is still raging, it has spread to much of the world. You've got leaders like President Obama, who's going to be his first time on the world stage under an incredible amount of pressure, as are Gordon Brown, Angela Merkel, several of the EU leaders that are going to be facing elections and intense political pressure from this kind of firestorm that's gripped a lot of the developing world and the developed world. And the question is, will the G-20 be able to meet the immediate challenges?

We've seen a lot of breaks and divides on things like stimulus, whether we can go forward with monetary policy, reviving banks and lending, and most of these seem to have been papered over, a few real concrete actions going forward.

There's a lot of discussion about international regulation, but a real debate about whether this is the right time to do that, given the turmoil that we're seeing in the markets.

And then finally, we're seeing some action to shore up kind of the firewalls and levees in the midst of this unprecedented storm, things like IMF reform. We've also seen statements like the anti-protectionist statements in November that were really toothless and were violated by 17 of the 20 countries according to the World Bank.

So we're really at an inflection point here to figure out are we going to be able to address these challenges or even map a way going forward. So we've got just an incredible panel here today to look at challenges like are these gaps being bridged or they're being deepened between the U.S. and the EU on stimulus, whether China will add more in terms of monetary and leadership to the world system, whether the BRIC countries, which issued their first ever communiqués in the finance ministerial, are going to be going along with the broader implications of whether G-8 and some of the traditional countries want to lead the world, whether this is going to be more than words or whether it's going to be the usual pomp and circumstance that we see at G-8 meetings without any real follow-up mechanisms or real impact.

And finally, given that we've seen this spread from just being an economic issue to being a security issue and potentially a strategic issue with unrest and unemployment spreading from

Latvia to China and risking kind of a repeat of some of the lessons of the Great Depression, where we failed to see that unrest and unemployment led to authoritarian regimes, instability, without any real road map for how to address those. Are we going to tackle those challenges heading forward, and to really grapple with those as we're looking at some of the core economic issues as well?

So as we address these today, we've just got a tremendous group, starting with Senator Brock – a CSIS counselor, trustee, head of the International Policy Roundtable, but who's really been at the cutting edge of many of the world's great developments on trade, including a – (inaudible) – the Uruguay Round that started the WTO, starting the real free trade movement in the United States with the first free trade agreements, but also, we're reminded, as part of the Rio Group bringing trade and finance ministers to get them to address some of these issues. So we're very proud to have him to address this in terms of particularly how it's affecting trade and the political situation going forward.

Clay Lowery, who I've had the chance to work with in many government capacities, was also president of the creation of many of the current financial structures we have going forward, including the G-20, working with Secretary Geithner, and was also intimately involved in launching the G-20 leaders summit last November. So he'll be able to provide an almost unequalled perspective in terms of how these developed and how we got here.

And finally, last but not least, we have David Smick, whose book, "The World Is Curved" was extraordinarily prescient in terms of looking at these challenges. And I think for those of us that have followed his work in the International Economy magazine and elsewhere, he's been ahead of the curve on so many of these different issues and really free to speak his mind and kind of cut through some of the jargon and some of the traditional talking points we're here to address the key challenges we face.

So with that, I'd like to turn briefly to Senator Brock and to all of our panelists to discuss this, then we'll open up to question from you. I look forward to that.

SENATOR WILLIAM BROCK (R-TN): I want to focus on more of the political challenge first, the burden that these face in trying to come up with some solutions in the G-20 and beyond.

Steven mentioned the pledge that was made last fall by the G-20. It was honored more in the breach than the observance. The United States is not least among those that broke the agreement. We passed a Buy-American and we bragged that we did it in a way that doesn't violate the WTO. So what? It is a protectionist act and the rest of the world looks at us to make decisions. We even came down on Mexican trucks as if they were a threat to our security.

And you do have to worry that we're facing a very, very challenging time, not just economic times, but political. The more we move to a global economy, the more we benefit the national and the more we increase pain at the local. That's a hard combination for a member of Congress to face. We're very good at following the old political maxim, "if you've got a problem, find somebody to blame and be sure they can't vote in your district." That's what

protectionism is and it has the potential for doing great violence to our opportunity to crawl back out of this mess.

We don't tell the American people that trade is not the problem, that nine out of 10 jobs are affected by productivity, technology, changing market circumstance, or on occasion incompetent management. We just say, oh, it's somebody else – somebody else that's putting too much pressure on us. The bottom line is this is an extraordinarily dangerous time.

We've compounded this present situation with decades of fiscal irresponsibility. Both parties refusing to deal with deficits, refusing to come to grips with the entitlement challenge we face, refusing to come to grips with some of the expenditures we're making that don't work. We have the highest expenditures per child in education of any country in the world and some of the worst results. We have the highest expenditures per person in the United States for health and some of the worst results, at least among the industrial world. We have the highest corporate taxes and we wonder why we are less competitive than we'd like to be. And we borrow from China in order to buy their product, as if there were an endless opportunity there. We live in denial and we've been doing it for too long.

So if you look at where you break that cycle with whether it's a G-20 or G-2 or G-8, we really do have to understand that you can't borrow your way out of this situation. You can't stimulate people who've been burned by getting so far into debt that they are terrified. You've got to find a way to grow your way out and there's a limit to how much the stimulus can get you to do that. My own judgment is that the only way we can grow is by doing business with others where both of us maximize our efficiencies, and that's called international trade. If you want the only free stimulus available, it's called trade.

But to get from there is hard. The question, then, can we use things like the G-20 to raise the stakes for the conclusions of the Doha round, to raise the price that people have to pay for engaging in protection acts? Maybe we should consider getting much more aggressive with some free trade agreements and maybe we ought to pass things like the Columbian Free Trade Agreement.

Maybe we ought to talk about free trade agreements with Europe or Japan, where we don't have any environmental or labor issues, but somehow we've got to kick start this recovery with something more than is being done now. And somehow we've got to find the leaders that have the capacity, the will, the integrity to do so. And the United States has probably get the most attractive, articulate (candidate ?) for that responsibility. It's going to be very hard because I don't see a lot of support for him to take the hard steps in the Congress. That's my concern.

CLAY LOWERY: First of all, my name's Clay Lowery. I'm responsible for toothless agreements and the G-20. And so I understand kind of unfortunately how we got here and from a historical sense about the G-20.

In the 1990s, we were suffering through a series of financial crises in emerging markets – Mexico, Asia, Russia. It created, in some respects, a lot of bitterness towards the IMF and other international financial institutions, towards the leadership of the G-7. It created a crisis of

legitimacy in international organizations. It revolved around some tricky technical issues – revolving exchange rate regimes and debt workouts. And there was a fear that important countries on this kind of – let's call it our road to globalization – were going to disengage.

And so one of the solutions was to come up with a G-20 process to have emerging market countries and industrialized countries come together to discuss some of these problems. Because of the technicalities involved, it seemed like it made more sense to just stay at the finance ministries level and central bank governor's level. And that was basically the world we were at for 10 years. So we fast forward to 2008 and there's a different crisis that's evolved, this time, though, not coming from emerging markets, coming from developed countries, primarily the United States, but not just the United States. Again there's a lot of bitterness. Some of this bitterness is towards the leaders of the countries, towards the G-7, towards international institutions, not necessarily the IMF, but other types of institutions like the regulatory institutions. There's a crisis of legitimacy and there's a lot of technical tricky issues to talk about – credit defaults swaps, CDOs, and how do you regulate some of these issues.

So the Bush administration, in the late 2008, again, another tricky path on the important road towards globalization, what do you do about it? I think one of the biggest fears within the Bush administration was we don't want to see a return to the 1930s and the dangers that we saw at that time. And how do you do that? And one way to try to prevent it was to create a way of coordinating and to having a real discussion amongst different countries. The G-20 was the approach taken, not because anybody in probably the Bush administration thought the G-20 was a perfect body, because I doubt anyone did, but because it basically was an existing body that was there for a purpose and it could be utilized.

A different reason, which is not as well publicized, is I don't think President Bush – I didn't ask him this personally – but I don't think he felt like he was in a position to figure out do you stay with the G-7, do you go to a G-20, do you go to something in between that, and felt like this was a decision that was more for the next president of the United States, not for him. And at that point, that was neither President Obama or Senator McCain at that time.

So now we're – here we are a few months later and I think that as President Obama goes into, as Steven said, his first real shot at the world stage, there're six over – I would say six themes or topics that are kind of for a discussion in this group. And they're not in any priority order. They're frankly just the way I wrote them down. The first is, how do you stabilize the financial system or the banking system?

This is an area in which almost the whole world agrees that it has to happen somehow. And in fact, actually, if anything probably when Secretary Geithner and governor – Central Bank Chairman Bernanke went to the G-20 Finance Ministers' Process a couple of weeks ago, they probably – this is where they probably got the most criticism. What is your plan for stabilizing your banking system? And since then we've seen Secretary Geithner's rolled out some more initiatives and tried to come up with a plan that he can describe. I think that this is going to be a major area of issue and frankly one where the U.S. government is going to be on its back foot.

Second is how do you stimulate the global economy. Senator Brock referred to that, which is this is where you've seen kind of the arguments internationally. Do the Germans really want another fiscal stimulus package? The United States has a large fiscal stimulus package. Is it going to work? Should others be doing this? I thought that Secretary Geithner tried to come up with this kind of 2-percent rule that the IMF would follow – the 2 percent of GDP. I thought it was – I didn't think it was such a great idea, but I think that that idea's going away mainly because there is clearly disagreement on whether or not large amounts of fiscal stimulus is what is needed at this point in time whether or not it will be effective.

Thirdly is on financial regulation. Financial regulation – one thing that's happened is the Europeans – this has been a major focus. Obviously it's a big focus here in the United States as well. Some would argue is – should it be the focus at this time or do you need to do it at a later stage? What I think that you'll hear is the discussion among some, which is that we need a global regulatory system, which back in November was not really part of the argument. I know it was in the press, but it really wasn't part of the argument I think maybe because nobody exactly knows what the heck that means.

But now, it's basically – it's becoming back again. I don't – I still don't think anybody actually knows what it means, but it's whether or not can you actually have more regulatory convergence on issues. It will be interesting to see whether or not the G-20 can come to agreement on some regulatory issues. The one that we've been hearing about that maybe there is some agreement is something like tax havens. Let me just say, whatever you think of tax havens, they have absolutely nothing to do with the financial crisis we're in right now.

The fourth area – and I made this separate just because it's becoming – I think it's going to be the areas where you'll see the most agreement – will be on the IMF. The IMF – there's a variety of different parts of it. There are governance issues. Why is it that China has a lower voting share than Belgium? I think that's the one way people always frame that. Why is it that the head of the IMF needs to be a European and the head of the World Bank needs to be an American?

So there're some governance issues about how do emerging market countries become more – get more say.

There is a different issue, which is about resources. The United States is talking about tripling resources. Europeans are talking about doubling resources. China's saying, well, maybe we'll put some more resources in if you give something on the first thing, which is more governance issues.

There is a different piece of talk, which is about the IMF coming up with new types of mechanisms to provide basically something that a lot of people thought was a big problem in the '90s, which is unconditional finance. So liquidity support, this is something that the IMF announced last week. It is something that they talked about back in November. So far, the demand for that unconditional support is still a problem because it is supposed to go towards the good countries and the good countries say, we don't need the IMF. So how are they going to frame that and work on that issue?

A different issue that might start popping up, and you see this with Ukraine, is the IMF having enough conditionality? So they're very scared of this Suharto moment, where Suharto or where – (inaudible) – is standing over Suharto and talking about, you must do this. You must do that, which is probably not what he was actually doing. And now, the IMF doesn't want to have that moment ever happen again, but does now put itself in a position where it's actually not helping countries because they're not helping themselves?

And then finally, there's another tricky issue, which is about what this whole thing about STR allocations, which has gotten all very confused about what is liquidity support, STR allocations, and what is a global currency, which gets into what China was saying this week. And if – I'm happy to deal with questions on that very confusing, ridiculous subject.

The fifth area which I wanted to mention was development. I think that the World Bank has done a service by basically pointing out how many people around the world that are not part of the global financial system in any stretch of imagination are going to become very much poor because of what's happening. And so I think that you'll see the countries trying to figure out how to deal with a few issues. Do we need to provide more resources for the development banks? We've already seen that they want to provide more resources for the Asian Development Bank. We'll hear about the Inter-American Development Bank, the African Development Bank, potentially the World Bank. And secondly, are there ways of providing greater trade finance, especially for the poorest countries because it seems like trade finance has dried up. Is that because there's less trade or is that because there's less finance?

The sixth area and I think Senator Brock hit on it very well, so I will just basically hit on it. You just said, the word is "protectionism." And that will be an area that the countries will have to concern themselves with because frankly it's starting to rise and it's going to get worse, is my view.

So all of those are the topics and I'll let David explain how we're going to solve all these topics.

(Laughter.)

DAVID SMICK: In eight minutes no less. My name is David Smick. It's great to be with you and chat for a little while about the calm, peaceful international financial system we have right now. I feel sorry in a lot of ways for Barack Obama. So many of these problems, they're not of his doing, but he asked for the job and it's very tough.

I mean, when I look at – I don't think taken off, but I think they have – they're going to fly into a summit where less than a week ago, the WTO – World Trade Organization – issued their forecast. They said, for this year, trade will be down between 9 and 10 percent which, by the way, I went back and I looked in the period from 1929 to '32, the three-year period trade was down about 30 percent, so we're on course to – we're on a depressionary course from the standpoint of a decline in trade. And this is just economically related, the negative effects on

trade. We haven't seen the political effects; that is, rising protectionism, that if we're not careful is still to come and I expect it to come.

But I was also – as I read this WTO report, I also picked up the IMF's latest forecast, which they will present again to the G-20 heads of state, and they're projecting for this year GDP growth to be down by 5 percent. But as I began looking at their assumptions, they see that trade is going to increase by 4 percent. So that tells me that the IMF actually believes that they just didn't get around to updating their trade numbers. This is a very, very ugly situation that President Obama is entering.

Where are we today? We are experiencing kind of a global tidal shift, a massive deleveraging of the world economy in which the value of virtually every asset is being reappraised downward. And it is – government efforts are valiant to try to come to terms with what is essentially almost like a force of nature, but it's a little bit like – to mix some metaphors – it's like spitting into a force five hurricane wind. It's very, very tough given what we're experiencing right now.

The conventional wisdom is that we have the bursting of a subprime related mortgage bubble and that has happened, and that's globally speaking. We saw the bursting of a 1.5 trillion bubble, but the conventional wisdom maintains it's just one bubble. But I would argue that we probably face nine bubbles. And you look at, globally speaking, outstanding credit card debt – \$2.5 trillion; emerging market debt – \$5 trillion, some people say it's higher; you have at least \$15 trillion in foreign exchange derivative exposure; the commercial real estate globally and the reinsurance industry at least \$25 trillion; you have the notorious credit default swap bubble everybody talks about. There are whole series of these things.

Now, this – I don't want to be too scary in this scenario, but you can easily on the back of an envelope see why markets are nervous because if you total up, you can get to \$100 trillion very easily. And let's assume that there's a 10 percent haircut on these bubbles, that the bubbles deflate by 10 percent, that's \$10 trillion. To put this in perspective, global GDP is about 60 trillion. So we're talking very, very big numbers, and that's why there's such a – the markets right now are so nervous. It's kind of good and bad. On the positive side, the world has plenty of capital. The downside is it's all sitting on the sidelines, and I think about \$8 trillion in global money market funds alone. In the 1930s we just stuffed money in the mattresses. Now we move in the short-term government debt in global money market funds.

But another conventional wisdom – point of conventional wisdom that I'd like to burst is the notion that we got into this problem because, you know, some banks lent some money to people who couldn't afford mortgages and it was simply a mortgage problem that got out of hand. But I would make the case that the seeds for the current situation were planted long before with the fall of the Berlin Wall, which was a very important event.

But with that event – and I'm going to simplify a bit – but you saw major economies emerge – China, India, Eastern Europe, large parts of the Pacific Rim – and they wanted to be like us, they wanted to be capitalist. And they were quite good at it. And once you got to the late '90s with the Asian crisis and the Russian default, they became even better. There was a

desire of most of the emerging markets to set up their economies as giant export platforms and to export to the industrialized world with the U.S. consumer being the gluttonous U.S. consumer of massively overleveraged being the favorite target.

And, you know, the story isn't new. You saw the emerging markets building up huge foreign exchange reserves as they exported to the U.S. and to Europe, and that money was recycled back into our Treasury debt, and everything worked beautifully for a while. But I think when we look at the kind of reporting on this the last decade or two decades, there's so much concentration on the gluttonous American consumer and it was a reckless situation where you had people just consuming beyond their wildest imagination, going into debt, credit card debt and all the rest.

But there's also a flipside to that argument, to that situation, and that's the situation that Barack Obama is going to have to confront. And the flipside is that the rest of the world, or at least the emerging markets – and I would throw in Germany and some of the other countries – became dangerously export dependant. And I think the argument was no one ever believed that the U.S. economy or its financial system could ever collapse the way it has. And so the assumption would be that we would continue to prop up the world economy.

So you have this – Obama is going into a situation where the very model under which the global economy's operated for the last two decades – the emerging market export model is what I call it – has just made a crash landing. And even still, we hear the same questions saying, do you think the Chinese are going to buy our debt, or do you think the American consumer once again steps forward to carry the world economy forward?

Well, if I had my way, I would have the president say, we need a new model. We need to rethink this whole system fundamentally not just tinker at the edges. This is separate from the whole financial issue of our complete lack of understanding of our financial paper and our turning over our financial destiny to 5,000 specialists but – that (only ?) know what this paper means and what its value is in a crisis.

But I will end this with a couple of points. You know, if you're watching the summit this week, and you probably need a translator and not to translate the language because everybody will pretty much be speaking in English or at least have a translator there. You need a translator for the meaning.

So when the German chancellor says, we don't feel we need stimulus, fiscal stimulus or any additional fiscal stimulus, what she really means is the emerging market export model has crashed and European banks are massively exposed to the financing, as you pointed out, to emerging market trade debt.

In fact, European banks are at least three times, and some argue six times as exposed to emerging market trade debt as American banks are to subprime debt. It's just that the Europeans aren't talking about it and they don't want to – you know, they're very much hoping that no one notices.

But to give you an example, Austria, member of the European Monetary Union, \$300 billion of bank exposure almost all to Eastern Europe. Of course, Hungary has collapsed next door. The Austrian GDP is only \$370 billion, and so there's a significant exposure and that's why Merkel – the translation is we're going to need every dime potentially to bail out our own banking system.

But if in fact the world, if this trade trend that I'm talking about and trade growth trend is actually a lot worse than the IMF projections – you know, the same thing with China – a very similar type of situation where the Chinese leadership, they need to lecture the U.S. They need to say the Americans and the industrialized world, they got us in here because they've got to deflect attention to the fact that China is a major social and economic bubble potentially about to burst and they have huge expectations in the Chinese economy – the Olympics were supposed to be the coming out party and it may in fact be the going away party because they have their momentum-driven economy.

I'm giving the-glass-is-half-empty side of this, but they are a momentum-driven economy, heavily dependant on exports, and they are trying desperately to stimulate their economy. I think it's very tough to do with an aging society, with no Social Security system, no safety net. The Japanese tried eight packages in the '90s, none of them worked. It's very, very tough to do unless, I guess, you drive around to villages and you knock on the door and say, I want to see you toaster. It's an old toaster. Get in the truck. It's very hard to force the kind of consumption needed.

So anyway, I will end with this that we are talking about – and we can go into it for a couple of minutes – about the financial situation which I specifically haven't gotten into directly, but I would say that we are fixated right now on how to bail out the banks, how to stimulate our domestic economy.

The one thing we're not looking at is with this collapse of the emerging market growth model and with the collapse, potentially, of the European banking system, we are underestimating the potential for political risk. And we haven't figured – we need contingency planning. Barack Obama needs to think through what happens if various things happen, because when the pie is expanding, everybody loves each other; when the pie is shrinking, I think we have all types of scenarios.

And I would say, is there anyone – there might be someone – but is there anyone in this room who predicted that the Russians would march into Georgia? I don't find many people did. So the nature of political risk – the potential there is the thing that I think that we're not looking at very closely right now in this country. And I think I've talked long enough.

MR. SCHRAGE: Thank you.

Before we turn this over to questions, just to build on that last point because I think it is so critical. You mentioned collapsing world growth by the IMF, collapsing trade. How do you see this rippling through the system, you know, the export model? What are the real risks you see to both democracy and stability around the world? And then I guess, Senator Brock and

Clay, if you could address how do you the U.S. political system in both the G-20 and others are going react to this, and what kind of contingency plans or operational structures do they need to put in place to kind of weather the storm?

MR. SMICK: Well, as I said, we already have the collapsing trade scenario. So once you add – I guess if you – political risk then the chances of the market seeing a protectionist shock – that rises significantly. I guess if you want to see a (marker ?) or a window into the potential future with emerging markets, look at Eastern Europe right now.

They've done what other economies do when they're in trouble. They're slashed interest rates so their currencies have dramatically weakened. And in most cases, their debt, borrowed from mostly European Banks, the arrangement is that has to be paid back in hard currencies, either the euro or the Swiss franc. And of course, the local currency is plummeting.

And so, that means that they're going to eventually default on that debt. It's going to be very tough. And the IMF doesn't have enough money to bail out all emerging markets as this process unfolds. That doesn't matter if they increase their – they're talking about the big, big dollars unless the Chinese for some reason step forward and put their massive reserves on the line.

I think, again, to follow the European – what have they done? Well, the first thing you do is they do – you can look at what they're doing to the German automobiles. One of the scary scenarios, if you look at the Russians' relationship to Germany, they've done not only the currency devaluation but they've got duties on Germany automobiles that weren't there, all kind of German products. I mean, it's getting rough and I expect that will spread. It could be a very ugly world.

And I would love to – one of the problems is that Obama doesn't have – when looks at it – he doesn't have the kind of strong leaders that he could reach out to that other presidents have had in Europe and elsewhere around the world. Everyone seems to be politically very nervous.

MR. LOWERY: I mean, I think that the politics around the world are – especially geopolitics will become interesting. I look at a country like Ukraine, which is obviously very geopolitically significant and they're in trouble. And the IMF, obviously, has put together a package. It was a pretty significant package. And I don't think it's going to work. And so, what will happen if that doesn't work and the international community cannot rally around to provide more finance because there's going to be a lot of people looking internally as opposed to externally.

In some respects, maybe the more interesting thing is what's going to happen within our own country in terms of the politics, and it's pretty ugly. We were talking upstairs about whether or not the pendulum switch too much from risk taking to absolutely no risk taking, and I would say that that's going to happen. It's going to happen because we're going to over regulate even – no one wants to; we're just going to do it.

And then we're going to – we already have a situation where anybody now is just scared to put their head above the fray because it's going to get slapped down, and I don't just mean the AIG compensation bonuses. I mean just anybody who seems to basically be able to take risks seems to almost get into trouble within the political dynamics here in Washington.

And so, somehow, I think – and I'm glad to see that both President Obama and Secretary Geithner I think have recognized this a little bit and have started to talk about how we need financial institutions to take risks. That is what they need to be doing. They don't need to take the risks maybe that was done three years ago, but they need to take some risks. So I worry that that will create more of a problem within our own country about the politics creating even a worse problem for our financial system in terms of risk issues.

SEN. BROCK: Two thoughts. One, the great American job machine is called small business. Small business has no access to credit right now for IPOs, for growth. And the willingness to extend credit is close to zero unless you've got triple-A rating, in which case you probably don't need it. That poses a real serious challenge to our economic recovery and it's going to be – it's hard to break that cycle right now.

The other half of that – of the equation, though, has to do with trying to borrow our way to success. If you look at the rate of expenditures of our government, we're talking \$3.5 trillion this year, trillion-dollar deficits almost as you can see in the future. Now, money has to come from somewhere. You can borrow a lot of it. How many trillions does China have in the reserve, David?

MR. SMICK: Well, almost two.

SEN. BROCK: Almost two. So we can wipe out their reserves in about six months if they want to lend to us. Why would they lend to us? Because the other way we can expand money is by printing it. When you print money, the old rule of economic rational law says bad money drives out good. The more money you print, the more you devalue your currency. The more you devalue your currency, the more you raise the cost of financing your expansion.

So we face the unholy dilemma of either having to borrow or print. The ability to borrow has a limit because we are increasingly less of a market to the country from which we want to borrow. And the printing will cause the currency to go down in value. Means interest rates go up and inflation goes up.

There really is a horrendous challenge to any member of Congress, much less the administration, to face the fact that we have some very hard things to do in this country and we keep postponing those decisions. It's just a challenge to see how we can turn the country around until we turn our political system around and get some people to take risk politically. That's hard to do. We've got a president with the capacity, and whether he has the support or not, I'm not sure.

MR. SCHRAGE: I'd like to open it up for questions. How about right in the back?

Q: Thank you. (Inaudible) – from Saijing (sp) magazine. Just China's central bank governor, Zhou Xiaochuan, suggesting about this SDR, making SDR to a tradable and reserve currency is rather actually for the longer term, I think. But recently Chinese vice premier, Wang Qishan, suggested, has made it clear that to inject into the IMF he has prioritized the three ways of Chinese injection. First is for China to inject some capital in exchange for the quotas, of course.

Second, you can make the quotas unchanged, but the IMF issues some more SDRs outside that. That's the second way. And the least, but the third is the IMF to issue some debt to China and China will buy it. China has made this clear. And also Mr. Strauss-Kahn of IMF has said that all these three offers is now very possible for China and IMF. So I wonder what do you think of these three options? What are the advantages and difficulties of them? And also for the fourth, the longer-term SDR reform, what's your will on that? Thank you.

MR. LOWERY: Okay, well, first I think that is a very legitimate argument for China to say if you want more money from China, we want more quota, or we want a bigger say in what's going on at the IMF, I think that's a very legitimate request. If you look – I think it was – I thought I saw a newspaper this morning that had kind of who's under-represented at the IMF. It looked, to me at least, if I read it correctly, like besides the United States the most under-represented might be China. Japan I think was fairly under-represented. So I think that that's a fairly legitimate thing. The question will be, in order for that to work, who gives up some power? And that usually means the Europeans. So that becomes a difficult issue.

The second issue in terms of China basically saying that they are willing to buy bonds from the IMF, I think the trick there will be the IMF has never issued bonds in its history, to my knowledge, and so it will be a whole different world for the IMF to get into, to actually issue bonds. So that means the membership is going to have to agree to something that will be significant, given the fact that most of the governments that are part of the IMF are going to also be issuing bonds to pay for all this fiscal stimulus. So at some point there might be a little bit of a crowding out from everybody issuing bonds.

I think there was – I'll skip to the – oh, STR allocation. STR allocation is an interesting idea, which is basically to try to help solve liquidity problems. I think the only hold-up would be is whether the United States agrees to it. I think that there are some within the Obama administration who are very supportive of an STR allocation. There are some that question whether or not an STR allocation is actually all that necessary right now because is really what the problem in the world a liquidity problem, or is there just a counter-party insolvency problem? I think it's an open question. I think that there's different sides of that debate. I'm not sure that right now the biggest problem we have out there is liquidity.

And then finally is whether or not the kind of the reserve currency aspect – I mean, I think the IMF would be the first to say that STRs are not a currency. I mean, they don't serve as a medium of exchange. But I think I understand if you're the Chinese government why you're basically trying to figure out, how do I move off of the dollar? But how do I move off of the dollar without driving the dollar down? And the reason is, it's because our aid – (inaudible) – so let's take David's \$2 trillion of debt. Not all of it's in dollars obviously, but if so China says I

want to move 10 percent of my allocation to some other currency, okay, well, that's selling \$100 billion of U.S. Treasury bills. That's significant. That significance could drive down the dollar, which China doesn't want to see happen because that would hurt the rest of their portfolio.

So I think that what they're trying to figure out is how do you actually eventually move off of it. I find the STR proposal a little bizarre, but at the same time I think that they're trying to signal – I probably should never, ever try to guess what China is thinking – is how do I move off of it in a way without harming the dollar in the short term? I think that this is part of that idea, and this is maybe just kicking around some ideas.

MR. SMICK: Well, I guess I would look at the broader implications of the way the world economy is going, separate from the currency situation. If you look at the history, particularly in the '30s, the countries that were the surplus countries, which included the U.S., hit much harder than the deficit countries. If that is true today then you look at the deficit countries, probably with the exception of China, Europe, other parts of Asia, Japan are going to suffer much more ironically than the U.S.

If that's the case, we could end up in a situation where we have this U.S. – there's kind of two poles of the world, China and the U.S., with vastly different economic systems. We're going to need to come to terms with that trade relationship. I mean, people worry about – continue to worry about the Chinese appreciating their currency, you know. My concern is – or they're worried about the Chinese not appreciating their currency.

My concern would be at some point the Chinese trying to engage in currency depreciation. I mean, the beggar-thy-neighbor currency depreciation, along with disguised forms of protectionism is, I think, the global fear. I mean, you see it in Eastern Europe. As I say, you're going to see it expand. So I would worry that we end up with a world where everybody wants a weak currency because everybody wants to expand their way out of using the export platform. It puts the United States in a tough position. That's why – there was a guy, David Rothkopf, who wrote a piece in the Sunday Washington Post Outlook section on "Where Are the Leaders?" It was I thought a very clever piece. It was a fun read, too. But he's right. We're going to hold this together if we have leaders that kind of have a vision about what the dangers are. I see the danger as beggar-thy-neighbor currency depreciation, protectionism, and then, just as we saw in the '30s, you know, you see capital controls in one form or another, efforts to restrict capital as the great fear.

Now, my general view of the economy right now is I think that we're putting so much faith in the Obama stimulus plan, but I'm worried that we're moving – that so much, you know 70 percent of the economy is the consumer, and so much of whether the economy succeeds or not depends on psychology. We have an – Americans collectively have just taken a \$15 trillion hit to their wealth, and so we've gone – it wasn't that long ago we were spending collectively \$1.20 for every \$1 we earned. That was insanity, but we were the consumer of last resort for the world and now we're spending probably less than 50 cents.

So what do we – do we return to the 70- or 80-cent level, or do we return to something more like the '70s? And if in fact our propensity to consume as a nation is – never returns to

even kind of the situation of the '90s, then Obama's fiscal stimulus plan is far too small. Even if you buy – looking for kind of a Keynesian stimulus kick, it's small because the American consumer has this kind of psychological – is in a retrenchment mode. I'm concerned with that.

Just to repeat a little bit of Bill's point, if you are – my line is if you're Warren Buffett, but I had to remind myself, Warren Buffett no longer has a triple-A rated company. But say Warren Buffett and a handful of highly respected companies. Because I think the insurance industry is one of those bubbles, and the reinsurance that's coming. It's going to be a big problem and his company is big.

But let's say Buffett and your friends who have triple rated companies, it's got to be frustrating. You're sitting there, you look over and you see this idiot banker who's totally lost control of his balance sheet, he's getting a subsidize – he can borrow money for 2.9 percent. And then you have next to him kind of, you know, the politically plugged-in banker. I didn't say Goldman Sachs. You know, but – (laughter) – he's getting money for 2.9 percent.

But here you are, you've done everything right. You know what your balance sheet – it's an accurate reflection. You pay a minimum 6 percent for money. But you have this – you're running this company, you're a CEO. Your son or daughter is sitting out in Silicon Valley and has a brilliant idea, would be the next Steve Jobs. But if they're lucky, they're going to pay 12 to 14 percent for money. And as Bill said, they probably can get the money because a venture capitalist would say, they'll never get an IPO. I'm just throwing money at a great idea in this kind of environment. This is not a great way to have a financial system.

One of my concerns about – I mean, I think Geithner, our Treasury secretary, has been unfairly maligned. Watch the re-runs of "Saturday Night Live" and it's like he's an idiot child, and he's a smart guy. But you know, it's unfortunate right now that there's so much distrust of Wall Street that I think no matter what Geithner comes up with, it's going to be a complication because the public now assumes there are inside deals. And to tell you the truth, there are inside deals, but – and I would recommend there be much more transparency. I mean, you can call it whatever you want.

Call it a Bretton Woods II or call it a Manhattan Project, which I guess has some connotations that are not great, but there needs to be the pulling together of the world specialists in financial paper, and the chairman should be someone who's not from Wall Street. I mean, I once said it was Jim Baker, Baker is the one to do that. But someone who's a proven problem-solver but not from Wall Street, puts these guys in a room and he says, look, we cannot bankrupt this country based on our fear of paper. We essentially have a web of paper that insures the mortgage-backed security, or asset-backed security market with another derivative pyramiding on top of that. We are paralyzed because we're so afraid of having to devalue this paper.

This group should know the counter-party risk, the second and third level, so that the American people can know, we know the whole story. So we know, for instance, if the credit default swap market is so bad that the taxpayer money is going to help Deutschebank, or help a French bank, we should have a much more – a better understanding of the full nature of the problem. And I will daresay it's going to be, my guess is, highly international, so there should

be burden-sharing. This should be part of the G-20, a discussion of how we unwind this paper. And if there needs to be burden-sharing internationally, then we ought to all be in there and say, look, we cannot go down because we're worshipping at the shrine of the derivative market.

We need to say, to what part of this market, for instance, was purely speculative. You can see I'm on a soap box here. Purely speculative, just for trading profits, which was a legitimate part of a kind of a hedging or insuring operation for a company. We just can't – this notion that we can work behind the scenes and the public's just going to give us a pass on that, I'm not so sure in the long run it's wise policy.

SEN. BROCK: I'm sorry, I'm just jumping here. Here's the problem. Obama has got to walk the tightest line known to man. He's got to keep our confidence high enough to get things done, but he can't raise expectations to the point where we're going to get disappointed. You do that a few times and he's lost credibility and we've lost the ability to act.

A lot of this is psychological and you've got to just accept that fact. And with all respect to David's point, the reason we're here is because we don't know how to measure risk in a world with derivatives and collateralized net obligations and all the rest. We've lost the connection between that local banker and the local homeowner. If you break that tie, and again slice and dice these obligations to the point where you don't even know what's in there, and then you have to go to AIG and get insurance on it, there's no way to measure these things. That's where we are and it's a really hard thing to change.

The second complication is that if you want to deal with some of these issues, and David's right, you're going to have to bail out some institutions we haven't even talked about yet, tell me how we do it when we can't even get a majority of the American people to support GM. How do you think they're going to feel if we want to bail out Deutschebank? Or UBS? It's not an easy sell.

Then you've got to lay down the foundation of all this, which is that as individuals, as families, as people, as communities, as a country, we have been spending way beyond our means, we've had negative savings in the United States, certainly for the last 10 years. If you're going to shift back to the normal rate of savings, which is somewhere between 6 and 10 percent, that's going to take a significant whack out of our ability to consume. If you're going to do that, you're going to hammer China, unless China is able to stimulate its consumption. China can't do it as fast as we would hope because their GDP is so much smaller than ours, so the leverage factor, or the mathematical model doesn't allow them to move fast enough to solve our problem.

All this says that each piece of this puzzle is connected, and you can't do one without doing the others. If you try to do it that way, you're never going to get home.

MR. SMICK: Let me just add this one more little point. I feel for our Treasury secretary because he was there when Lehman Brothers went down, and the Treasury and the Fed and entire Washington establishment completely under-estimated the contagion effect. So there is a feeling now to be very, very careful about systemic risk to the international system, having experienced Lehman.

But I wonder if in fact that fear is keeping us from thinking big and thinking about – I hate this cliché – but outside the box at finding solutions to dealing with the paper. If this were just any old other company, the bad stuff would be in separate vehicle amortized over 40 years with some type of tax advantage and it would be all over. But we're not thinking big, I believe, just because that Lehman experience was so traumatic as they saw the credit markets just seize up and nobody wants to go through that again.

So it's made us very risk-averse, and it's made us also intellectually we're frozen. We can't think about anything that's outside a very, very incremental in our handling of this problem.

Q: Thank you very much. Norman Bailey, Institute for Global Economic Growth. I have a question for David Smick, but first I would like to say that Mr. Lowrey's question about whether we're in a situation of insolvency or liquidity was answered by your colleague. Bill Brock said you can't borrow your way out of a situation of over-indebtedness. David Smick said there's plenty of liquidity in the world. I would say that it's the solvency, stupid. I don't mean that personally.

(Laughter.)

MR. LOWERY: I've had worse said to me.

Q: David, now that the U.S. government has in effect nationalized a good part of the economy and is telling private corporations – formerly private corporations what to do and what not to do, and who to hire and who to fire and who to merge with and so on and so forth, are we moving toward a corporate state, which in the 1920s, 1930s was sometimes referred to as fascism?

MR. SMICK: Well, I'm not thrilled about the direction we're moving in. I think we have a lot of confidence in the ability of government to handle this. But I will also – so philosophically it's against everything I believe in. But I do think that if you take the taxpayer money, I think it does make you different. And you know, I think you have to think long and hard about when you put a cap on the salary because you don't know if you're essentially draining the financial institution of its talent. I frankly think that you're going to end up with mediocrity.

But on the other hand, you are different when you take the money. You're then suddenly in the political arena, and you know, I don't blame people for being angry. I mean, you can say it's a retention bonus. You take the money, then you're a different animal. I just hope it doesn't go beyond that, where we think for political reasons to – I mean, I hear from hedge funds and private equity firms that – I say are you going to be involved in public-private, Geithner's plan? They're nervous because they say, we'd like to be but what happens if you make a couple hundred million dollars? Then next thing you know you're dragged to the basement of the capital into a torture chamber. And somebody said, and Dick Cheney's doing the water-boarding. (Laughter.)

And you're saying to the Treasury and to the administration – but you said you'd protect me. I don't think they can, when you're talking about this kind of populist political outrage. So I think there are real dangers. I can understand you're different if you take the taxpayer money, but it's very hard to stop when you play the populist game. It's hard to stop at any particular line. I think the administration finally caught on to that last week.

Q: Thank you very much. I'm John Ithroth (sp). I'm with Interaction, which is a group of NGOs. Clay, that's an excellent list of your themes. I would like you or anyone there to give elements – there's no solutions at this point exactly, but the stabilization of the banking and financial system and stimulus of the global economy both seem to be almost impossible. Europe's saying they have a safety net, they don't have to do stimulations.

What would be the elements? Not a total solution but what would be the elements that would be useful in trying to address one or both of those issues?

MR. LOWERY: Well, I think that it is – I guess if we had a solution we would have tried to come up with it. I think that right now the – I mean, the reason I asked about liquidity over solvency is I think there – well, I was called stupid. Is that I think that people aren't sure. I actually believe it's more solvency, but I think that a lot of people keep believing it's liquidity, and including people that are talking about STR allocations and so forth.

Fiscal stimulus, which is what obviously this administration, the Obama administration thinks is what is needed, I think it is something the Japanese, the Chinese, I would guesstimate that the Brazilians, the Mexicans, most of the other non-European G-20 would also say is exactly what needs to happen because they are most concerned right now not about their banking systems, they're most concerned about economic growth and job creation. The Europeans, I think David's translation is a good one. I think that the Europeans would also say, we've already done a lot and we are concerned not just for saving money for a rainy day, so to speak, but – which could be a huge hurricane – but because there is some concern that we're overdoing some of this fiscal stimulus, and it goes to Senator Brock's point about when does your debt start becoming a little less – becomes more worthless? And then your dollar stops dropping.

So I guess that if I had a solution – I don't know if anyone has a solution. I think that basically the Obama administration is trying to put together a plan in which they have a stimulus package, they have some way of trying to stabilize the financial system, including try to figure out how to deal with the toxic assets. And by the way, I've noticed that they're running into the exact same problems that the Bush administration ran into. And they're trying to make sure that they address the international problems by doing more on emerging markets by boosting IMF.

The area I actually think that they're not doing nearly a good enough job on is the area that Senator Brock and David Smick both – and actually Steve Schrage both hit on, which is protectionism. Let me just give you another one. The fact that in the stimulus package, talk about being scared, if you come in and help out on the public-private partnership, does that mean you have to get rid of or you can't hire people that have H1-b visas in this country? It is just a ludicrous bill – and this, by the way, was passed with bipartisan support. But it's just ridiculous

that basically that's how we're going to help solve this problem because we're going to hire more qualified American than somebody that comes from India. It's just a crazy way of doing things.

So I think that there are things that they can do. And the G-20 hopefully – I mean, this was the overall discussion piece – helps us do a coordination to stay away from David's doomsday scenario of beggar-thy-neighbor currency policies, and beggar-thy-neighbor regulatory policies.

SEN. BROCK: I want to go to the specific positive that I would suggest, but before I do, let's admit that economic illiteracy is a contagious disease in Washington and it's spread wide, particularly in a place called the Hill. That's worrisome because you really do have to think out of the box. David said it, Clay also. What have we not talked about? Anybody? Doha? The World Trading Round has been going on and on and on. We got close but we never got to the point where we could reach an agreement.

If you want to change the psychology of not just the United States but of the world, how about committing to a significant reduction in trade barriers that now impede our recovery? Do that as a beginning?

Now, where did we get caught up last time? A few countries. Mostly one called India. Okay, it's about time for a leader of the United States and the country, and maybe our friends elsewhere, to play some hardball. Doggone it, one country should not be able to bring the trading system to a crashing halt, or refuse to allow the growth that will allow us to claw our way out of this mess.

So it seems to me that if we want to have some serious movement to reduce the burden on the stimulus package and put the burden back on the economic genius of a trading system, tell the Indians to play or get off. Tell the Chinese, we need you and we're not going to take no for an answer because your stakes are bigger than anybody's. If you do that, maybe we can shake the world up and quit whining about the fact that it's always somebody else's fault.

MR. SMICK: Let me just make one more point. We've been talking about China, we're talking about how we finance our debt and all this. Let me just try to close the loop here a little bit. I'm a big admirer of Federal Reserve Chairman Ben Bernanke. I think he's a perfect guy, that you want someone who's been a student of the '30s in charge when you're going through a period that has some resemblance to the '30s.

I think he loaded the Fed's balance sheet with a lot of dubious paper, but it was all short-term maturity. I have no problem with that, but I think there was a development that happened at the last meeting of the Fed or the FOMC, in which – that was a huge issue was barely mentioned in the press, and it relates to the Chinese and it relates to how we finance our debt. The Fed announced that it was going to buy Treasury securities, long-term Treasury securities. I think the message of that to the Chinese and to others was, that's the crack open of the door for the monetizing of the debt.

I think that the Fed always, you know, to be smart about it, always wanted to keep that option in case there's a doomsday scenario, but had no intention of moving on that this soon except that they saw that the whole political base for bailing out the banks on Capitol Hill had totally collapsed. And so when it collapsed, they immediately said, we've got to do this or we're going to have a steeply sloped yield curve. In other words, we're going to have long-term rates continue upwards, and short-term rates, even though we keep short-term rates the same.

And to just tell you where things have been, you had just before Christmas, you know, the long-term rate go from slightly more than 2 to almost 3, and then the Fed has tried to bring it down. It's about 2.7. But that was a very important, under-reported point. The market doesn't think that Bernanke wants inflation, but they don't know who's coming on, who are the future Fed chairman. Maybe it's a political appointee from someone they don't know. And look at history of back during the Nixon administration with Arthur Burns, the pressure that can happen.

So I do think that that – I wanted to close the loop because I do think that that is going to be a problem and the Fed's going to have to show that it has great credibility in the future and is not – doesn't consider – it seems absurd to think about inflation now except people who buy bonds think about that all the time.

MR. SCHRAGE: Well, I think this has been a fascinating discussion. Out of respect for our panelists, I think we could go on all day on many of these issues even though it's not the most optimistic outlook out there. But thank you all for coming, and thank you for participating. I think some very critical and important notes going forward that we have to address. Thank you.

(Applause.)

(END)