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FAULT LINES:
HOW HIDDEN FRACTURES STILL THREATEN THE WORLD ECONOMY

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P R O C E E D I N G S

MR. ELLIOTT: Well, thank you. You're a very, very good audience, I have to say. You seem to pretty much all be here on time, you're quiet, you're ready for us to go, so I think we might as well start in.

So, welcome to the Brookings Institution and thank you all for coming here today. My name is Doug Elliott. I'm a fellow in the economic studies area here and I focus principally on the financial sector and on regulation and legislation surrounding that. And it's an honor to have the opportunity to introduce Dr. Raghuram Rajan and to moderate this panel. I'm sorry, however, that my opportunity comes at the expense of Eswar Prasad, who, unfortunately, had a family emergency and could not be here today, but he sends his deep regrets.

So, Dr. Rajan, who is generally known as Raghu, is one of the preeminent academic thinkers in the intersection between finance and economics. In addition to teaching at the Booth School of Business at the University of Chicago, he was for several years the chief economist of the IMF and he's also been an advisor to the prime minister of India, among other roles. We're here today to discuss his new book called *Fault Lines: How Hidden Fractures Still Threaten the World Economy.* In the book he explains his view of the origins of the financial crisis and some recommendations for how to revise our economic and financial systems to avoid having such severe problems in the future.

Now, his thoughts on this carry added credibility because he was one of the few voices who was arguing against the complacency that held much of the profession enthralled as the crisis was brewing. His book, as you'll see, is well conceived and very well written. And I'd like to add my own personal congratulations to the accolades he's already received.

Now, we're pleased to have two additional discussants as well. The first one on the far end is Charles Dallara. He's managing director of the Institute of International Finance. Charles served with distinction in the U.S. Treasury Department for many years during the administrations of President Reagan and the first George Bush. In addition, he worked a few years at my old employer, J.P. Morgan.

The second discussant is David Wessel. He's economics editor of *The Wall Street Journal*. In addition to his perceptive, long-running column in *The Journal* called "Capital," David is well known for his excellent new book or fairly recently book I should say, *In Fed We Trust,* about the role of Chairman Bernanke and the Fed in the recent crisis.

Now, I don't think I need to tell any of you about the importance of the financial crisis whose effects we are still feeling, nor do I need to emphasize the complexity of its causes. In fact, it reminds me of my favorite mock historical front page from the satirical newspaper, *The Onion*, if you happen to know *The Onion*. This one, supposedly from 1963, screams in big type "Kennedy Slain by CIA, Mafia, Castro, LJB, Freemasons."

Now, unlike the Kennedy assassination, which presumably was in reality the work of only one person or group, the financial crisis truly was the result of many causes. And I'm particularly impressed that Raghu has managed to capture in a single book most of those factors and to show how their confluence created the historic disaster that we're feeling now. So in a moment I'll turn this over to Raghu to explain his thesis. This will be followed by questions from -- sorry, by comments from the two discussants. After that I'll moderate a further discussion among the three of them, and then I'll turn to the audience for your questions.

So, thank you. Raghu?

MR. RAJAN: Thank you, Doug.

So what I thought I'd do is very quickly walk you through the main ideas behind this book. But, of course, given the plethora of books out there you might ask where does this fit in? And, well, certainly the first wave of books, one of which -- I think one of the best books on what happened in the crisis -- was written by one of my discussants, David Wessel. First, a lot of books describe what happened. Right? Some of them went as far as Jimmy Diamond was driving into the driveway of the restaurant and he started thinking about what would happen to J.P. Morgan that evening. I mean, they were that detailed. The fly on the wall accounts, right? You've got -- in fact, fly on the brain accounts. They got into the brain of the participants.

But the second set of books were what Carmen Reinhart discussed at another talk suggested reminded her of the Woody Woodpecker story. And the story goes like this. Woody Woodpecker gorges and gorges and finally he eats an olive and he bursts. And, of course, when asked why Woody Woodpecker burst we point to the olive because that was the proximate cause. But, of course, if we step back we want to think about the feast before.

And so I want to talk about the feast before the crisis. What happened in leading up to it? What were the deeper forces that may have caused this particular chain of events? And the immediate answers are, you know, this was about -- this to some extent is characterizing the olive. It was about greedy bankers with conflicts of interest. As one of my banker friends argues, when there is no conflict there's no interest. But this is a particular viewpoint. So it was greedy bankers with conflicts of interest let loose by pliant regulators.

But we must ask why now? Why in the most sophisticated financial system in the world? After all, the whole point about institutional development is checks and balances that keep conflicts of interest from exploding. And moreover, why subprime? And this is an important question because if you look at the history of the housing crisis in the United States before, much of the action occurs at the top. The richest segments go up the most; the richest segments come down the most. This time it was the poorest segments of housing that went up the most and came down the most.

And the explanation, of course, matters because if it's just the olive, what we make sure is we don't eat anymore olives. So if it's the bankers and the regulators, shoot a few bankers at dawn. That'll give them the discipline to stay away from this kind of activity. Of course, different regulatory backbones, that's what we're in the process of doing by imposing a whole lot of new additional regulations that the bankers who didn't enforce it -- that the regulators will have to enforce going forward.

But what if we can't wash our hands of the problem so easily? What if the problem is, in fact, deeper? And that's really the point of this book, to try to point to deeper causes, not in any way to absolve the financial sector. I mean, some people get the impression the whole point of this is to offer excuses that will let the financial sector off the hook. No. I'm arguing the financial sector was at the center of this and were neither innocent nor victims. Bankers were fully complicit in what happened and there are lots of chapters in the book which talk about that.

But let's not also forget the environment which created the conditions for this perfect storm. And in the environment I want to talk about three issues here in the short time that I have. One, rising income inequality. One of the things I argue in the book is that income inequality has been rising if not in fact certainly in perception in the United States. And it's across the board, but most particularly, most perniciously when you look at, for example, people at the 90th percentile of the income distribution; they're running away from people at the 50th percentile of the income distribution. Most people focus on the very, very top -- on John Paulson, who made 75,000 times the average household income in 2008. That's not my concern. My concern is the fact that the manager at Wal-Mart is now running away in terms of income from the factory worker at the 50th percentile.

Why is this happening? Why is income inequality increasing? Economists who have studied this in great detail say that it's partly because technology requires more and more education to do the jobs that available. But also, the supply of the educated in the United States is not keeping pace. So if you look at the number of high school -- people who are completely high school, that hasn't increased since the 1970s even though the requirement for higher education is increasing. If you look at the people finishing college, amongst males that hasn't increased; females have done much better in the United States. But even while the jobs that are produced require much more skills, the United States is not producing people with those skills. So the middle is remaining stagnant while the upper end is running away.

Well, in this kind of environment, when people have a stagnant paycheck they put pressure on the politicians to do something. They feel that the old jobs are no longer there that enable them to earn a healthy income. And politicians have to respond by doing something. Well, in emerging markets the traditional responses is tax and spend. Redistribute through populist initiators which we dispute was those guys falling behind.

In the United States during this time there was strong pushback against redistributive policies. The next best thing was credit. After all, there were very few people who stand against credit, especially housing credit. And housing credit could be couched as part of the Great American Dream. You could use the instruments of government, the Fannie Mae or Freddie Mac, the Federal Housing Administration, to push housing credit, and it had bipartisan support. From the Clinton administration it was called affordable housing. It meant more money going to national democratic constituencies, the people being left behind. From the Bush administration it was called the ownership society. It meant creating more property owners. Again, the National Constituency of the Republican Party.

So both sides felt housing credit would be an improvement in their fortunes. And together they pushed housing credit on the population in a big way. Home ownership actually expanded considerably to 2004. Since then as a result of what's been happening in the housing sector it's been on a steady decline.

So that's fault line number one, the fact that increasing inequality -- this is not just in the United States, but I want to emphasize the United States here. Increasing inequality pushed consumption and consumption growth as the answer. And the instrument in pushing this was housing credit.

Second, a number of countries around the world have focused on exports like growth strategies. This typically tends to imply -- and I talk a lot about this in the book -- how these countries came upon these strategies. These typically tend to imply that they create surpluses that others have to absorb. And these surpluses tend to be especially problematic in downturns when these countries can't expand demand on their own.

Well, it turns out these surpluses go around the world looking for countries that are following policies that make them overspend. And the United States, on the one side I've already argued, was pushing spending as the answer to some of its own domestic problems. There are other countries that did it. Countries like Greece, for example, which pushed government overspending as an answer to their problems.

But the final fault line I want to talk about right now -- you can read about the details in the book -- is one other element of U.S. policy that tended to push it even more towards it being the spender of last resort. And this is the fact that in the United States the nature of recessions and recoveries have changed. It used to be the case that U.S. recoveries used to be very quick, that eight months from the trough of the recession the jobs that were lost in the recession came back.

Since 1991, things have changed. In '90-'91, it took 23 months for the jobs to come back. Remember, this was the recovery that killed George Bush the Elder's hopes of being re-elected. He was the hero of the first Gulf War, but because he didn't pay attention to economics he was out.

The next recession, 2001, it took 38 months for the jobs to come back, but this time the politicians had learned that if you don't do something it's going to be problematic. So every stop was taken out in terms of both fiscal and monetary stimulus to get the economy back on the road. The current recovery is again proving jobless. Again every stop has been taken out. Why is this a problem? Because the pressure to stimulate in the economy creates enormous forces, sometimes going in the right direction and pushing more jobs, typically going in the wrong direction in the case of 2001-2004 prompting more risk taking, asset price booms, and eventually a problem.

More generally what you see is that -- well, let me come -- given the limited time to why this explains what happened in the financial sector and then end with a broader point. Take low quality, mortgage-backed securities. Why were they created? Well, given the fault lines I've talked about it seems pretty obvious. There's a wall of money going into the housing markets, sent by pricing sensitive institutions such as Fannie and Freddie who had to fulfill a mandate. And so the guy at the front end of the line, Countrywide, seeing that Fannie and Freddie were buying, seeing that foreign institutional investors, the German banks, were buying in order to recycle their surpluses, found that they were willing to buy anything that he produced. So upfront when he started generating the mortgages, he knew that even though the person he was lending to was somebody who could not actually service the loan; somebody else was willing to buy that stuff down the line. So as a result, the incentive to be very careful was lost. Now, this is not to say that the mortgage broker at the front end didn't do anything illegal or bad. There was a lot of activity which today we would frown upon, but the point is the largest systemic activity was driven by this wall of money coming into the financial sector.

The second big question is why did the banks hold onto much of the risk? I talk about that in much greater detail in the book. But the point really is that the fault lines surrounding the financial sector aided and abetted the financial sector in going overboard in the risk taking. So the wall of money to fulfill congressional mandates joined with the foreign money looking for safe securities, financial innovation responded, together the checks and balances and quality were eliminated and the system went over the cliff.

The point I'm trying to make more broadly -- let me skip over the financial sector reform issues and go to the U.S. and political reforms. I am arguing that we need to look beyond the financial sector. Yes, we need to reform the financial sector. That is central to stabilizing the financial sector going forward. And there aren't discussions of the basic reforms we need to do in the book. But we need to go beyond that also because we need to know that checks and balances on the financial system that are in place can be overridden if the political impulse to override them are strong. That's what happened the last time; can happen again.

So we have to reduce the political pressure on the system. What are the things we need to do? For example, improve access to education. People laugh and say how is education connected to the financial system? Well, it creates the inequalities which create the pressure to do something about it and credit was the answer this time around. Something else may be the answer the next time around.

Of course, education and reforming it is a really long-term issue. It involves not just schools, but communities, families, and so on. In the meantime, even if we know that we are successfully on track there, what do we do about the 47-year-old laid-off autoworker? How do we ensure that they don't in some sense find that the system is not working for them? How do we ensure they don't check out? And there is certainly a debate we should have in this country about what we need to do going forward aside from the policies that have been palliatives, the kind of credit policies that have been palliatives that we've used in an attempt to deal with the problem.

Similarly, in terms of the safety net, the U.S. has historically had a very short safety net, six months. Because the safety net is short and because the recoveries have been very long in creating jobs created immense pressure for the politicians to stimulate the economy perhaps excessively and in ways that don't actually add to job creation.

It leads to the question should we sacrifice some of the flexibility and innovation that the short safety net gives us in return for a stronger safety net that reduces the kinds of policy distortions that we see today? Today the Fed, for example, is on hold with strongly negative real interest rates. The argument is it has to be on hold until the jobs come back. At some point will this not engender the same kind of risk taking that we castigated Greenspan for engendering in 2001 to 2004? Should we think of something else to substitute for the fact that firms aren't willing to create jobs?

The Fed and the Treasury together are trying to push consumption again. This is going to be the answer for the U.S. coming out of recession. We're going to push consumption. But isn't this going back to the same old problem that we had before? If we're not going to cut consumption in the middle of one of the worst crises we've had, do we believe the U.S. household would constrain consumption once we get out of this? Doesn't the U.S. need more savings? How do we do that if we don't want to do it now?

Similarly, on the global level, how do we get surplus countries to take more responsibility to reduce their surpluses? We just saw China has agreed to revalue probably very slowly the renminbi, but that's only part of the large number of global policy measures that have to be taken. For example, Germany runs a huge current account surplus. It doesn't have responsibility to some extent to what happened in Greece. Greece overspent, but it overspent buying German goods. Don't both sides have some responsibility for the problem?

Last point and then I'll end. These are important issues. There are no silver bullets. But we have to recognize that the main problem is neither the government nor the financial sector. It's the interaction between the two. And that interaction is getting closer and more problematic over time. And it is leading us from cycle to cycle, which is getting greater in amplitude. And so the question is at what point do we break the cycle? Most people say not now. Not now. Because we don't want people to suffer pain. But if we don't break the cycle at some point it just gets closer and gets exacerbated even more.

Right now we're in the process of having extremely low interest rates which bail out the financial sector yet again. Will this not create incentives to take the same kinds of risks yet again? And next time around will we also again say not now when we push interest rates down to zero? At some point shouldn't policy recognize this?

Let me stop there. (Applause)

MR. WESSEL: It's always a pleasure to be on stage with a prophet. The risk is that because Raghu was right once, that we extend that -- we extrapolate from that and assume that he's right in the future. He might be; I'm not sure.

Let me -- I want to make I think three points. One is I think it's fundamentally interesting and important that Raghu say that there were some conditions in our economy and those of surplus countries that created the conditions that led to the financial bubble. And the reason this is both important I think and disturbing is the following. One is it's important because it means if we just adjust the plumbing at the financial regulatory thing and give the Fed just enough power and alter the Basel capital rules by exactly the right basis points that this will never happen again. And he makes a convincing argument. That's a little hard argument to make when we're on our third asset bubble bursting recession in two decades.

And the second thing is that wow, the things he has identified are really hard to fix. Reducing inequality in the United States or convincing the Germans and the Japanese and the Chinese that they ought to save less and buy more, those are big projects and they're not easily fixed. And I think it's worth thinking a bit about how could we get -- what do we have to do to get to those points.

I think that the -- one, another way to look at the inequality thing, and I think he's right that the pressure on housing credit was a political manifestation of an urge to do something about inequality because the politicians couldn't figure out a way to raise the median wage fast enough so how do you get people to have more ability to spend? If you can't get them more income, you can get them more credit.

But I think also that it identifies something that can only be addressed over such a long period of time that it's hard to give people incentive to do it. And one case that was made actually in this very room by Bill Galston was that's why health care reform was so important. Because it was very difficult to do anything about the wage gap in the U.S., to shrink the gap between the 90th percentile and the 50th percentile. But one reason so many people at the 50th percentile were so anxious and so politically assertive was that they knew that if they lost their job they not only lost their income, but they lost their health care. And he argued that health care might be an easier way to fix the safety net than some of the other things which might have worst incentives.

On the Chinese and the Japanese and the Germans, I think -- and this is something that Raghu has told me -- it does suggest an interesting role for the international institutions to get up there and kind of make a public plea to the people of China, Japan, and Germany, about why it is in their interest, as well as the interest of the world economy, that their living standards should go up. They should be able to spend more. I mean, there's something really screwy about a country as poor as China saving so much money so they can buy our treasury bonds so we can have 30-year fixed-rate mortgages and buy bigger houses next year than this year. But convincing them to do that is not going to happen with Tim Geithner giving speeches at the G-20.

Now, I think that Raghu's comments were extremely well modulated and there were lots of caveats, but I am concerned that some people listen to him and have presented a caricature of his argument. And I want to make this so that he can respond to it. And the caricature goes something like see, I knew it. It wasn't the market and it wasn't Wall Street; it was all government. It was Barney Frank's fault because he made Fannie Mae make all those bad loans. And it was Greenspan and Bernanke's fault because they kept interest rates so low so long. And if only they hadn't done those things we wouldn't have a crisis. See, it's all about government. That's not the case he makes, but it is a case that people use his evidence to make. And I think there are a couple of things that are important to think about in those things. And then I'll be quiet.

One is Raghu has not said, though some people do say, that CRA, the Community Reinvestment Act, the notion that banks should have a responsibility to lend to the communities where they do business and that you have to have some kind of affirmative action in banking. Raghu has not said that law which passed in the mid-'70s was responsibility for the housing bubble; some people do.

The second thing is I'm kind of confused about what are we blaming Fannie, Freddie, and FHA for? Are we blaming them for the whole housing bubble which went far beyond subprime? Or are we only blaming them for subprime? And it gets kind of tricky because Fannie Mae and Freddie Mac actually in sheer market share terms did not buy a lot of subprime loans early. They were late to the party. They had exquisite timing.

After all the private sector people decided these were losers, Fannie and Freddie finally got in and decided they needed to preserve market share.

But I think it's actually much more subtle and interesting than that. There are all sorts of things that Fannie and Freddie did that contributed to a housing bubble, some of them which are a little hard to put in an equation. For instance, let me just give you one. Fannie and Freddie, in what seemed like a great technological innovation, came up with this automated underwriting thing which made it possible for mortgage brokers to put numbers into software and decide whether the loan was a good risk or not. That seemed like a good thing. Mae cuts the cost of making mortgages, removes some of the bias that comes if the person who's making the decision knows whether you're black or white. But I think what -- it may have had an unintended consequence which made it easy for people to overlook things that made someone think they shouldn't get a loan because, well, they got a good score on Loan Prospector so we'll do it.

So I think they are an embodiment of a much broader cultural demand that everybody in America should own a house. And I think that Raghu as part of the contribution to something which needs to happen is we need to tell Americans not everybody in America needs to own a house in order to be part of the middle class. Because when you do that it leads us to do all sorts of crazy things to get the last 4 or 5 percent into the houses and that blows up the thing. But I do think it's important to ask were they a necessary condition to the housing bubble? Were they a sufficient condition?

And then finally I'm torn on this question of low interest rates. So Ben Bernanke and Alan Greenspan make the case that it's very difficult to see how it was that had they raised interest rates 1 percentage point all this wouldn't have happened. Would they have had to raise them 2 percentage points? Three percentage points? What was their mistake and what is the counterfactual? It seems intuitive to me that it has to have something to do with the crisis. If you keep interest rates low for a very long time and promise to keep them low for a very long time, people will reach for yield and the subprime became one of the ways they reached for yield.

The former prime minister of Australia, Paul Keating has a wonderful metaphor. His theory of the case is that it's all the IMF's fault, that the IMF screwed Indonesia in the Asian financial crisis. As a result, China decided that it had to save lots of money so it would never have to come to the IMF. And Keating says this created a dark cloud, a storm cloud, floating all over the globe, all that money that had to go somewhere. And what was the U.S.'s response? They put up a copper wire in order to attract all this money to the United States and that's what happened. And although it's a little hard to understand how it is you attract lots of money to your country by keeping interest rates low, there is something intuitively interesting about that, but I'm having a hard time understanding exactly how did the mechanism work. How was it that low interest rates contributed as it were a necessary condition for the bubble?

And finally, so does that mean that the right strategy now is for Ben Bernanke to raise interest rates and the government of the United States to tighten fiscal policy at a time when we have 10 percent unemployment? Is that learning the right lesson? Were there two earlier recessions to which Raghu referred, are they really like this one? Or were they so mild that we could make a mistake by generalizing from them? Might we not be in more like something like 1937 where in order to avoid something terrible happening in the future we raise interest rates now, tighten fiscal policy now, and guarantee that we have something terrible happening in the present?

Thank you.

MR. ELLIOTT: Okay. Charles?

MR. DALLARA: Thank you, Doug. Thank you for inviting me to join you here today. It's always a pleasure to be back at Brookings.

Brookings has a fond place in my heart. Thirty years ago I spent a year in a small cubbyhole. Do you still have cubbyholes here?

MR. ELLIOTT: Oh, yeah.

MR. DALLARA: As a visiting scholar, but it enabled me to do my dissertation research for which I am forever grateful.

I really love this book by Raghu, not because it's one of the few books out that doesn't blame everything on the bankers. It might be tempting for me to think that since I represent an organization full of bankers and other financial institutions. But more seriously, what I love about it is the breadth of perspective. You don't have to agree with every point, every argument, every bit of analysis, but I think what it brings home very forcefully is that this crisis had multiple sources that are complex and intertwined that feed off politics, finance, economics and business, and more broadly, cultural patterns of behavior around the world. It is that complexity of perspective that he brings that I think should cause us all to really reflect on how to find solutions from these problems. It reminds me a little bit of what I call the "magnolia gardens effect" to understanding a problem.

I don't know if any of you have ever visited some very lovely gardens outside Charleston, South Carolina. In the springtime they're absolutely gorgeous. And I visited my first time, it was during a rainy season and the water level was high and all I saw were beautiful bridges, beautiful magnolia trees, and beautiful cypress trees. And I thought what an idyllic place this is. I came back a year later. It was during a drought. The boat would hardly move through the water. And all I saw were ugly, gnarled roots in what looked like a dismal swamp. The same environment, but projecting itself very differently.

The first visit was comparable to the world economy that we saw for the better part of this last decade. And I'm afraid that the vision which we need to have in order to understand this crisis is the vision Raghu's book gives us of those underlying, intertwined nasty roots that we really do need to dig up and try to deal with if we're going to solve the problem going forward and create a more stable system.

Let me talk first a little bit about the bankers because I do think -- actually, Raghu, perhaps you let them off just a bit light in the book. Because in reality there were serious shortcomings in risk management. There were serious inappropriate incentives and compensation. And I think Raghu's suggestions here are well framed to try to tie compensation structures to risk-related performance over time so that if a CEO or a trader makes a huge profit in the short run which turns out to be a source of instability in the medium run, that that individual has to deal with the consequences of the net, not just the system at large or the shareholders.

But inadequacies in risk management, inappropriate incentives and compensation, lax underwriting standards, failures to advance transparency as far as you could and should, and inadequate governance, all of which are touched upon in chapters 7 and 8 I think, but in my view could merit some additional elements of stress here because unless the financial industry is prepared to tackle on a sustained basis those weaknesses, I think it may distract us actually if we look in too many other directions.

If, however, the industry is prepared to try to deal with those shortcomings and lift itself up by its own bootstraps, so to speak -- and I think there's considerable reason to believe that that actually is the case among the leading financial institutions of the world -- then I think we have to ask what else do we need to bring into this broader picture of the problems and the solutions?

And I'll only touch upon a few of the areas here. I think Raghu's discussion of the role of education reform in the United States is fascinating, not because most of us in this room are educational experts; some of you may be. But because it helps us understand how deep seated some of the imbalances in the global economy may be and how these structural imbalances and weaknesses can send incentives into the political system which in this case and for many years have actually fed a housing policy in the U.S. which I think regardless of one's politics, regardless of one's economics, regardless of one's ideologies, one cannot help but conclude that the broader policy surrounding housing in the United States are a central part of the problem here. And we must come to grips with that if we're going to find solutions, not just in terms of subprime, but more broadly speaking as David suggested here.

And I think that if you look at other countries, such as Canada and Australia, it really is not rocket science to create a framework for regulating and managing the provision of mortgages that do not actually create the kind of systematically threatening structural weaknesses in the housing market and in the subprime market that we saw this time around. Again, this is no excuse for the lax underwriting standards and the poor risk management, but it is to say that if we want to really find solutions I think this country, and perhaps a few others, including the U.K. and Spain, are going to have to look very seriously at how they frame their policies around housing purchase and housing credit.

Let me touch upon a few other areas here which I think are quite crucial. There's a very interesting chapter in the book on regulatory reform. And I would again underscore the importance of going through that quite carefully because I think it shows the parochialism and the narrowness of the prism that is being used in this country today and Congress to try to advance regulatory reform. We must draw and paint on a fairly large pallet here. We must shrink the capital requirements as Raghu suggested, including there's a role here for contingent capital. We must try to create a countercyclical regulatory framework which is much more difficult than it sounds. We must try to strengthen liquidity management.

One of the fascinating things about Raghu's 2005 speech where he anticipated so presciently many aspects of the crisis to me was the focus on liquidity management because I can tell you this is an area where the industry was significantly at sleep. And I think if there is one resonating message for the industry that emerges from this it's not just that capital matters; it certainly does. And leverage matters; it certainly does. But liquidity management is crucial to the survival of even strong financial institutions. And I think this is something that he pointed toward in the 2005 article and again discusses in the book here.

Additionally, if we look at the broad sweep of regulatory reform, I think the book points out the important role of living wills. We have to move away from a world in which financial institutions are seen as too big to fail. Now, that is an exceptionally difficult problem. It's one of the thorniest problems that I think I've grappled with in my 30 years-plus in global finance. But we must come to grips with it. And it not only involves I think some fundamental changes to the way we view investing in banks; creditors of banks are going to have to be put in the line of fire if a bank gets into trouble, not just equity investors. We're going to have to take the creditors down before we go and hopefully to avoid going to taxpayers because I think we all realize that a repeat of what just happened in the United States, the U.K., and Europe is something that is not politically acceptable, nor economically wise. If we're going to do that we actually have to get serious about creating a framework for cross border resolution of failing financial institutions. And this sounds rather technical and it can be, but today the G-20 support for this is very lukewarm. It is disappointing to me that there is not sufficient recognition by the leaders of the G-20 of just how important this is.

Let me conclude by saying a couple of words on macro coordination because there is a rather pessimistic chapter in the book about the prospects of the current G-20 process being able to overcome some of the obstacles in global policy coordination.

And even though I largely share that skepticism, I think it is incumbent upon all of us to expect more from the G-20, to expect more from the IMF, and to expect more from the leaders of the G-7 as well. Because therein lines one of the keys to ultimately coping with the severe structural imbalances which continue to surround the global economy. Is the G-20 really an instrument that can frame a broad approach toward addressing imbalances globally and over time work with both surplus countries, such as Germany, Japan, and China, as well as reserve center countries, such as the United States and actually influence their policies?

Now, there is reason to be skeptical that the IMF is up to the job, and quite frankly, until the shareholders decide that it must be up to the job then nothing much is going to happen in this terrain. I would have one small quibble with a point that was made in the book. I think Raghu suggests that the world's leaders are not yet prepared to see their important sovereignty to the international bureaucrats.

Now, at face value I completely agree with that statement. I think what we have to realize though is that to a certain extent sovereignty is a diminishing, vanishing breed when it comes to economic policy. I think even the Chinese realize this. The government there, from time to time, would speak boldly over the course of the past year and say the Chinese currency's exchange rate is a sovereign matter. But they knew better and they demonstrated that this weekend when they took a measure to begin to renew flexibility and their exchange rate. The interdependencies we have today on a global economy and in global finance are such that leaders have long seeded significant elements of sovereignty; they just don't realize it yet. And they're not prepared to tell their legislators that. And they're not prepared to tell their people that. That's a very difficult challenge that we all have to face, but ultimately I think we'll have to face it if we're to find some solutions to this.

Thank you very much, Doug.

MR. ELLIOT: Okay. Thank you, Charles. (Applause)

All right. Well, I think those were excellent comments from the discussants. Let me ask you specifically to address two of the points that were raised and then whatever else you thought was most relevant that you'd like to respond to.

The two specific things are the potential characterization -- characterization of your arguments as being it's the government's fault; it wasn't that much the private sector. And another point which is, is this 1937? Is there a danger we might take your arguments too seriously and move too quickly on the macro side?

I just want to say before you answer this, I would agree with what both the discussants said. Raghu has written a very carefully modulated book. Something that's wonderful about it is it's very carefully analyzed and he tries to be balanced. So when I ask questions like passing along the way it could be caricatured, it's not to say that's what you believed, but it does indicate perhaps there was a little bit of a bias in one direction. So how would you respond?

MR. RAJAN: No, it's a very good point and it's something I take fully onboard because I wrote an op-ed in the *Financial Times* a couple of weeks ago and that was taken as a full thwarted defense of bankers, which it wasn't intended to be. So, you know, the atmosphere right now is very polarized. Everybody who is even saying that bankers aren't, you know, the root -- fundamental root of everything and we should just blame them is seen as an apologist for the bankers and therefore, you know, not worth listening to. We have to be careful about that because clearly bankers are to blame. I mean, nobody is saying that bankers aren't part and parcel, and clearly there are many aspects of the financial system -- banker compensation is something I pointed to way back. And I wrote a piece in the *Financial Times* in early 2008 complaining about the one-way nature of bonuses and, of course at that time I was seen as the champion of the anti-banker movement which I wasn't then either.

I think the point, however, is the danger is not the government nor the bankers; it's the interaction between the two which is becoming more and more dangerous over time because the bankers fully well understand what the government is doing and are looking for the edge every time. And the government is giving them the edge by following the policies that it follows saying now is not the time to be cautious; now is the time to make sure the system is back on track. We can't allow our people to face the pain, which ensures the next time around it's worse. It's more hazardous for the bees; it's not something we should worry about. Let's do what it takes. That's the refrain from practical policymakers. But of course, the short-term response ensure things get worse in the long run.

All you have to do is look at the path of public debt for industrial countries. It has been increasingly steadily since the 1970s. And you have to understand that the government is doing more and more in downturns to prevent them from being deep. As a result, we're getting more and more potential for government action going forward. Where this ends we don't know, but the idea that let's just worry about today, in the long run we're dead, at some point comes to an end when we can't afford it anymore. And we have to start thinking about that because public debt in industrial countries is getting pretty close to the point where you have to start worrying about it very, very seriously.

So that said, it's the interaction between the two that I keep focusing on in the book because that's where the danger lies. And of course we know the problems within the banking sector. They've been documented widely. I talked about it in the 2005 speech; I've been talking about it for some time. It's the other side that is less well recognized. The contribution from the government and the Fed, which I focused more on in this book, but clearly for an appropriate balance you want to look at both sides and most important the interaction between the two.

So this is not meant to blame Greenspan or Bernanke. In fact, I'm arguing that in many ways everyone, every actor is doing what comes naturally, what comes naturally given the incentives, given how they see the picture. But in doing what comes naturally, even the export-led economies are doing what comes naturally. They want to take the people out of poverty. But in doing what comes naturally there are adverse (inaudible) for the rest of the world which create problems, which we have to worry about. And so looking at the whole is probably useful.

Fannie and Freddie, their contribution to the housing bubble is sort of completely, you know, I think lost in the ambiguity of data. What is clear is in 2004 they stepped up tremendously the purchase of mortgage-backed -- private label, mortgage-backed securities. Enormous flows of money there suggesting that that may have encouraged the process of creation, especially it was the end. But they also had an increased affordable housing mandate through the '90s and into the 2000s, which they fulfilled on by directly financing and packaging mortgages to (inaudible) subprime entities in the market. How much that was is something we're still trying to figure out and how much that increased is something that we're still trying to get data on.

So I think it will be very hard to deny the role that Fannie and Freddie played, including the role that David pointed out in setting standards and in sometimes pointing to the kind of data that would be needed in order for them to buy the mortgages. One of my colleagues at Chicago has described how over time when people understood that Fannie and Freddie were looking only at FICO scores and loan-to-value ratios, people understood how to manipulate this. If you want a better FICO score I'll tell you what loans to pay off so that their FICO score goes up, no matter that you don't have an income, that you are a tree surgeon, an euphemism for a gardener, and that you actually, you know, I mean --

loan-to-value ratios. Loan-to-value ratios. I know what loan I'm giving you. All I need to do is fix the denominator. Get you an appropriate appraisal. Everybody knew which appraisers to go to to get the right appraisal.

So once you focus on a couple of data points everybody knows what to manipulate. Who is to blame? I think all sides are to blame in this. The blame game. What I keep pointing out in the book is the blame game is not a politically useful way to get ahead if we want to make sure this doesn't happen again.

David asks a very good question which Doug echoes. What do we do now? And of course the easy answer is I wouldn't start here. I mean, yes, we are in a situation where we are a prisoner of what we've done. The Fed has set expectations that interest rates will remain low, so people have adjusted. And if the Fed now raises interest rates, even to a normal zero real level, interest rates right now at the short end are negative real. If the Fed even moves it to zero real it will be taken as a significant signal by the market of tightening down the line. It could upset the market, and people keep re-echoing 1937. Right?

Of course, remember that in Greenspan's time, in 2001-2002, we were saying remember Japan. Remember Japan. We don't want to start deflation. Let's not raise interest rates. Now, of course, we blame poor Alan Greenspan. I say poor because Alan Greenspan, in my view, was doing exactly what Ben Bernanke is doing right now, staying the course while the jobs didn't come back.

Now, at some point we have to think of whether this is appropriate policy. Maybe we don't want to discuss it right when we're recovering, but at some point we have to think about it. And I think that setting expectations that we won't go down to negative real every time this happens and we'll move quickly back to positive territory so that we don't penalize savers, we don't favor banks, but more important we don't make sure that people understanding this take the kinds of risks that make this happen again. That's to my mind central.

On fiscal policy, I think we've done what we needed to do. Going forward I think if the jobless recovery persists, judicious extensions of unemployment insurance are probably relevant. But going again on a massive spending spree without quite having the kinds of ways to spend it that are appropriate may, in fact, tax the exchequer much more than it has.

So broadly speaking I think the real question that David asked is about monetary policy today. And my sense is if I were Ben Bernanke, which I'm not, thankfully, I would start preparing the way, especially once the anxiety in Europe dies down, to move towards low, but not zero interest rates. I would move it back to 1-1/2 percent and wait and see what happens. I'd prepare the ground. I'd move it very slowly. I'd do it in a judicious way, but I'd start moving back to normal interest. Not so much from an inflation perspective, but from the risk management perspective.

MR. ELLIOTT: Okay. Thank you.

I let all of you talk longer in each case than originally planned, so unless there are some things you really want to jump on now I'll turn to the audience for Q&A. Fair enough?

So, and while they're bringing up the mics let me just say please let us know who you are, don't ask too long a question, and please have it be a question. And so let's start in.

MR. CHEN: Yeah. Chow Chen, freelance correspondent, (inaudible) Maryland.

I would like to pose a question to all three wise men there. How about we raise the interest and devalue the dollar? This will help the load on the consumption and also increase the export. American (inaudible) just not sustainable. We should not grow the American (inaudible). We should not ask Germany, Japan, China, to consume more. How about that? Thank you.

MR. RAJAN: I mean, I think when the U.S. was running a large current account deficit leading up to this crisis the view was always that if problems arose that exactly that would happen. The dollar would depreciate, the U.S. would export its way out of trouble, and there would be no problem for the U.S. The problem would be elsewhere.

What we've seen is no country is an island. You know, in a sense when the rest of the world is dead, where is the U.S. going to export to? And in some sense the U.S., unfortunately, is still the engine of world growth.

So, even if the U.S. could depreciate the dollar today, which it's not, and in part that's because there is this tremendous flight to quality that's happening the world over. Whenever anything happens, everybody runs to buy dollar assets. It really doesn't have the exchange rate as a reasonable policy instrument. In fact, the monetary policy is the way that you are trying to depreciate the exchange rate, but it's not working in that way because people are all too eager to hold U.S. assets.

So I really think you need to focus on not trying to manipulate the exchange rate, but do the underlying sort of economic changes that would promote more savings and allow other countries to increase their demand. And this is the kind of thing that David Wessel was very -- I mean, I think I've expressed a little more pessimism about whether countries are ready for this. In fact, what I'm proposing is rather than just have the dialogue at the top, have a more bottom-up dialogue on this.

MR. ELLIOT: David or Charles, do you want to --

MR. WESSEL: Well, the only thing I might add is that I do think that as Raghu points out very clearly: these are problems that need to be addressed in a globally coordinated way. If we want to sustain growth in a global economy and at the same time we want to move toward a higher savings rate in the United States, which I think we all would agree is essential over a period of time, people are going to have to rebalance the sources of growth in countries like China, Japan, and Germany. This is a difficult challenge and is probably not going to be achieved solely through exchange rates. Over time there may well be an expectation that further depreciation of the dollar may be part of the solution, but right now we've got another weak currency sitting in Europe which is the focal point of concerns and the dollar continues to serve as a safe haven in time of global financial stress.

So this comes back, I think as Raghu suggested, not so much to exchange rate, but to underlying fundamental and whether or not governments are prepared to sit around the table and try to work through some of their differences about how they may over a period of time structurally realign the sources of growth.

MR. ELLIOT: Okay. Other questions? One over there.

MR. ROTHSCHILD: Hi. My name is Kenneth Rothschild. I'm independent.

The strange thing is I agree with everybody. However, I don't think this discussion is profound enough for what the real problem is. It's as though we're talking about a patient and we're asking whether the patient can distinguish between blue and purple and is actually going blind. I don't think we've experienced the crisis yet.

The question I have is this. We have a terrible structural problem, both within our country and throughout the world. And a lot of it revolves around decision-making. How decisions are made and the incestuous relationship between the government and business. Government, for the most part, is a safety net for the big corporations. How are we going to make the move towards the type of economic and governing system that we need in the future before the real crisis, which we haven't hit yet, hits us? How are we going to -- how are we going to start to make that? Because it's very politically uncomfortable to come out and make those kinds of criticisms of what's going on. And yet without doing that we're leaving ourselves open to a really horrible crisis.

MR. RAJAN: That's a difficult question. I mean, as a quick answer, a little too shallow for your big question. I mean, remember the right and left see the same problem, which is Mark's thought that, you know, the government was in the pockets of big business. And his solution was eliminate the government. Eliminate business, I'm sorry, and keep the government.

Stigler thought that, you know, government was in the pockets of big business and his solution was eliminate the government. So both sides want to eliminate the other. But, of course, what we really need is both sides to work with each other. We need business. We can't eliminate business. And we need government. We can't eliminate government. But how to make sure that one doesn't take advantage of the other?

And I think in some sense things are weighted towards business because it has more bar to extract from the government and to take advantage of the government. But, of course, government can react as occasionally it does. And we've seen in the last few days and force big business to its knees also. How to keep a dangle under appropriate constraints and to make sure that they don't influence each other too much in the wrong direction has always been the problem of the capitalist system. And I think we've sort of managed in muddling through, and that's the way it's going to happen. We're going to muddle through, but the best way to muddle through is to sort of find the places where the interaction is most dangerous and to try to separate them at that point. And in a sense, all the debate right now on financial sector reform, is really about separating the places where they've gotten too intertwined and to make sure that big business doesn't rely on government to the extent it did.

But I don't think there are magic bullets here. It's a slow process and I don't think there will ever be a complete answer to the big problem you've asked.

MR. ELLIOTT: Okay. Next one. How about the gentleman there on the aisle.

MR. RISCARDO: My name is Al Riscardo. One of the discussants mentioned, the different regulatory reform -- regarding the G-20 and how they're coordinating to different interests such as the resolution of financial institutions and so on.

My comment would be that even though this is a big step from the G-8 to the G-20 and encompasses a lot more nations and thus, more -- a larger part of the world economy, this still excludes the vast majority of countries. So my question would be how would you envision a system where most of the world has an input into how to reform the regulations regarding financial institutions so that it reflects not most of the 20 largest countries, but most of the world.

MR. RAJAN: You ask a very good question. What is the optimized size of national gatherings? Twenty is already too big. One of the things we've discovered at the Farm is that when you have 20 -- usually when you have 20 at the table it means actually 40. When you have 40 at the table, they don't talk to each other. They give speeches. And when people give speeches, you've heard those speeches before. It doesn't advance any discussion.

And so you really need the group to be smaller, but more sort of legitimate. You're talking about the legitimacy of the group that's formed and also appropriately representative. That's difficult because typically, you know, you may have read C. Northrop Parkinson, this famous management guru from the U.K. His books are out of print in the U.S., but they're fascinating. If you ever get the chance, go read them. But he talks about the optimal size of the group being five to seven. Okay? So the G-7 was an appropriate size only it was totally unrepresentative.

My sense is we need to find a way to bring together the right group for each problem so that they can actually talk to each other in a group setting. The IMF tried to do that with what it called the multilateral consultation, which is bringing a group of the right size to the table to discuss an issue. I think we need to think about something like that where the broadest group of nations decides that this is an issue, here are the people we think should participate in this discussion so it gets legitimacy, but then the small group actually meets to thrash out the issue.

Now, there are some issues on which everybody has to meet, but typically when everybody meets they break up into much smaller groups and then, you know, eventually get together. So my sense is the point you raise is very important, but the answer is not to create a United Nations that will ensure that nothing actually happens. The answer is to create the relevant small size groups to address the problem and that will be I think the way to go forward.

MR. ELLIOTT: Charles?

MR. DALLARA: You know, I might just add two or three brief points. I do think that in a way one needs multiple groupings here. I think the G-20 is a step forward. It's an important step forward because it has brought into the leadership of global policy framing key emerging markets who in the past had been in the backdrop. And it's not just important because it gives them more voice, which is what we typically talk about. They deserve a seat at the table, et cetera. It's important because it begins to help them see that with voice comes greater responsibility for how the system as a whole works. And I think this is crucial because I think as the major emerging markets, such as China, India, and Brazil, realize that the seat at the table comes with a price. It comes with a growing capacity to see the broader interests in a world economy. Then I think we're on the right track.

At the same time I agree with Raghu in a way that the G-7 was the right size. It was just the wrong G-7. You should have had India, China, Brazil in there and invited a few of our smaller European friends who wants to stay home from time to time. The IMF structure actually has a legal structure which brings to the table in a very meaningful way, but perhaps too bureaucratic a way all the voices of their smaller countries because each director on the board represents a constituency of large and small countries. However, the board at the Fund maybe has become part of the problem. And as having served on the board for five years representing the U.S., I believe that the governance structure there probably needs to be changed with a new type of board structure so that you don't have such bureaucratic interference in management, but you have senior political leadership over the board which can bring to bear the views of the smaller emerging market economies to the global regulatory debate.

MR. ELLIOTT: David? Do you -- okay. Fair enough. How about the other gentleman just down the aisle there. The one, yes.

MR. KIKUCHI: Hello. My name is Kunio Kikuchi and I'm with Masaoka & Associates.

Commenting about China, Japan, and Germany, I would say that China is where Japan was 25 years ago as far as per capital income is concerned, so they have a long way to go on consumption. But I think it's wrong today to say that Germany and Japan should be concerning more. They're up to their ears in consumption.

But my question is to Professor Rajan. Talking about the mortgages, I'm worried about the individual responsibility. One is, of course, about the greed of the executives of these mortgage companies. But what about the responsibility of all these people who took the mortgages knowing that they couldn't pay? And we seem not to pursue their responsibility. Is that because we think that our education system is not adequate to teach them that they shouldn't get loans that they can't pay back? Thank you.

MR. RAJAN: It's a very good point. And I think that this is why I say responsibility lies everywhere. In fact, in the book I talk about the people who took loans without being able to afford them. Yes, some of them were fooled, but I think the majority were not fooled. They knew exactly what they were doing. And the sense that we need -- I mean, I think we need consumer responsibility. We need consumer protection for different reasons, but we seem to argue that that would have solved our problem. No. People wanted those loans and they were looking for creative ways in which the broker would help them. We always seem to think the broker was against the customer. No, the customer and the broker got together to find ways to beat the system. Both had responsibility here. So I agree with you there.

On the Germany and Japan, I don't think the answer is consumer more, but I would say that the answer has to be the revitalized -- the domestic sector to create more growth. So in Japan, for example, retail -- improving productivity in retain, improving productivity in services. Barber shops, that's one example I give in the book. If you could improve productivity there, I think that could help Japan grow. And growth is what Japan needs to contribute at this point to the world economy. So consumption, you're absolutely right. With the aging population it's probably the wrong idea to say consumer more right now, but create more growth, consumption will follow. That seems to be the right answer. And similarly for Germany.

MR. WESSEL: Can I just respond on the housing thing because I think that I agree with you, but only 50 percent. Here's the part I agree with you on, which is something really bad has happened in the United States. We have taught a generation of people that it's okay to walk away from your mortgage. The problem with a system where fully one quarter of all the mortgage holders in the United States have a mortgage that's greater than then value of their house is it has it become socially acceptable to walk away from your mortgage and it might make economic sense. You know, you default on your mortgage, your neighbor defaults on his mortgage, and you just rent each other's house from the bank or buy the house from the bank. So we set up a situation where the incentives to do that are very strong and the social stigma of defaulting as it goes down, you can see where that leads you.

But the problem -- I want to disagree a little bit -- is that I probably would -- I think that it made a lot of sense to take a loan you couldn't afford as long as house prices kept going up. And everybody knew that house prices in the United States would keep going up. So if you got a little behind you could always refinance. And we set up a gigantic system that was fueled by this assumption which turned out to be flawed. It doesn't mean that the people -- we told them to do that. George Bush said buy a house. Fannie Mae and Freddie Mac took out ads, "Buy a House." And the logic, the economic logic was indisputable. As long as house prices go up you can always keep refinancing. And you can always -- so it wasn't -- it wasn't only a moral issue for these people. They were led to believe that it was in their interest. I'm not talking about the person that bought four houses or five houses and speculated and all that or the people who lied on their mortgage applications. God knows there's a lot of fraud here.

But what made this so big was it wasn't all fraud. It was a whole bunch of people doing something that seemed totally logical and legitimate and it blew up. And that's what's so frightening about the thing. If it were just a few rotten applies we wouldn't have such a big problem.

MR. RAJAN: That is exactly what happened in Japan in 1985.

MR. WESSEL: Well, I think one of the lessons of this crisis is that all those people in the 1990s who said the Japanese are stupid and they should just do what the

American economists tell them and everything will be wonderful, those economists are slightly more -- slightly, only slightly more humble today. It turns out it's not quite as easy to pick up after one of these messes as we thought it was when we were telling the Japanese how to do it.

MR. DALLARA: Actually, if I can interject a question of my own, Raghu, because some of these points have been touching on something that's in your book, but you didn't have time to talk about it much. Which is can you elaborate a little bit on your belief that -- you didn't put it in percentage terms, but that the large majority of the bad actions that were taken were perfectly rational given the constraints and opportunities that people faced that most of the problems resulted from how we had the rules set rather than from irrationality or stupidity.

MR. RAJAN: Yeah, well, I think I want to pick up on David's last point that when you have a systemic problem like this, trying to point to a few bad apples is probably the wrong idea, especially when you have so many checks and balances. So, I mean, just to give an example of that, I mean, I fully agree with the structure of incentives which the homeowner faced. You didn't have to be somebody who wanted to default. The whole story that was being told to you is that you could ride up on the house price appreciation and that would be enough to keep you going. And, in fact, for a little while that is exactly what many people experienced. But, you know, take all the actors in this. Politicians pushing housing. They were helping their constituency. I mean, I'm not saying put Barney Frank out there and say he's the guy responsible for the crisis. He was doing what comes naturally and fulfilling a mandate. He's out there in Washington to represent his constituency. They were pushing him in that direction and he responded I think appropriately for a politicians given the incentive structure.

Similarly, the Fed. I mean, John Taylor has Greenspan fingered as the guy who kept interest rates too low, well below the Taylor rule. But I would say that given that the Taylor rule doesn't directly have employment in it, but has output, what Greenspan was focused on was employment. And the Fed has an employment mandate, is required to set interest rates so as to generate maximum employment. In fact, it's maximum without any conditions. It's maximum employment. And he was fulfilling that mandate. So I think the point you make is we were all doing what comes naturally, but what comes naturally didn't add up. And when it doesn't add up it can take the system a long way.

I mean, again, bankers. Some of them were doing what comes naturally; some of them, again, there were rotten apples everywhere. But Lehman, it was taking risks. Those risks had paid off every time before. Lehman -- why was Dick Fuld sitting on a billion dollars? People keep saying Dick Fuld and his billion dollars. Why was he sitting on a billion dollars? Because Lehman had made tons of profits in the 10 years before. Its shareholders were cheering them on. You've taken the right risks. Dick Fuld thought he could control the risks. There are various chapters in various books which suggest that in fact there was a certain amount of hubris. We've done it before. We've escaped. Let's take those risks again. We've made money. We'll make money again. So I think just nobody was, I mean, none of these big actors were doing it because they wanted to "get the system." They were doing what comes naturally.

MR. ELLIOTT: Thank you. Okay. How about in the back on the aisle.

MR. MONDERER: Mike Monderer from Medley Global Advisors.

We all agree that cooperation and consultation are to be desired, to work towards, but politicians are loathe to get together and consult without having a result. Sunday afternoon what results should we fear?

MR. RAJAN: Are you talking about the G-20?

MR. MONDERER: Yes.

MR. RAJAN: Very little. I'm actually very pessimistic and this goes back to Charles has already talked about my pessimism. My sense is there are very few things that we require these countries to do that they can do even at a meeting of heads of state. I think one of the few things that they could do is moving the exchange rate, which China has already done over the weekend or at least talked about doing. And that involved a whole process of consultation amongst Chinese authorities, which they've finally come to some conclusion on.

But take, for example, the strategies of growth that countries are following, the U.S. emphasis on consumption, that's a much broader dialogue. That's a dialogue that has to take place over the next few years within the country amongst the people, amongst the interagency, amongst politicians. It's not something that, you know, Barrack Obama can go into that room and say we, the U.S., have decided to, you know, straighten out our act over time and stop the consumption, that growth that we've been guilty of in the past. It's not going to happen.

I think export-led policies. Germany is not going to stand up and say we're going to move off export-led growth. We're going to do all the reforms you've been telling us to do on the domestic side. I mean, what needs to be done is well known. The political impetus to do it is not at the heads of state level and is never going to be there. It's going to be at the grassroots level or the political level lower down. And that's why I argue in the book that perhaps we should start taking some of the resources away from the heads of state level to work more at the middle or lower levels.

In other words, I find a successful example of international policy coordination is Mothers Against Landmines. That to my mind is one place where we made countries actually do something that they wouldn't have done on their own. And we need to take from that kind of stuff, from the Live Aid kids of -- the project for debt forgiveness, for example -- to try to get some bottom-up support for global coordination. Because without that, to my mind, it's not going to happen as easily at the top. But this is --

MR. ELLIOTT: Raghu is actually leaving the University of Chicago to lead street demonstrations in favor of cutting Social Security and Medicare. (Laughter)

I want to say two brief words about the G-20 -- or three. One is, so, they seem to have low ambitions this time so not much to worry about.

The second thing is, look, what is this thing good for? It's hard to do what Charles said. It's hard to tell countries that you don't have as much sovereignty so this is where we get together and we have to surrender our national priorities. But it seems to me there are a couple of things we do. One is they're great action forcing events. Right? What happens at the G-20 is what happened in China last week. It wasn't an accident it happened now. If Congress finishes the Financial Regulatory Conference on Thursday, it will be because Obama pleaded with them so he could come and say we did something. So they are action forcing events.

But I think we could overdue this criticism. We did not relive the 1920s. We did not relive the story that Liaquat Ahamed told so well in the *Lords of Finance* where the heads of the central banks of the four major powers conceded in shooting each other in every part of their body. We had a reasonable amount of global coordination when the world economy was on fire. And we should not forget that. It wasn't sufficient, but it could have been a lot worse.

MR. WESSEL: You know, if I could add just two brief points. I mean, I think that we would not have gotten through the crisis without crucial G-20 leadership last March in London. But now I think there's a serious risk that the G-20 may become more a part of the problem than the solution in two respects. One is they set themselves up with a clear commitment for global coordination of regulatory reform in Pittsburg, and ever since then they've done very little serious global coordination of regulatory reform. Instead, many of the individual countries, led by the United States, have gone off in their own particular parochial directions, largely reflecting domestic political considerations, and I think raising the risk that global regulatory reform will be fractured, which is not exactly what the confidence factors in requirements in the market need.

Secondly, if the U.S. goes to the G-20 and says to the Europeans and to the other members, not too fast on fiscal consolidation, guys. We still have a recovery to stimulate. And if the Europeans show up and say we are in the business of fiscal consolidation, make no bones about it, because that's what the market requires. And I think there's a risk that if both of these groups come in with this vantage point, then I think we could be in for some real trouble in the market unless authorities realize they really need to sit down and try to find some common threads of harmony. In the long run I think Raghu's suggestions are very valuable that we try to reach out at the grassroots level. But we still need to hold leaders and heads of states accountable just as we need to hold CEOs of banks accountable.

MR. RAJAN: Just on that, I think Charles made a very important point. I think the problem with this G-20 was the first actions were very easy to coordinate. When you want governments to spend, it doesn't require a huge amount of outside questioning. You don't have to ask. I mean, governments have a mandate to establish budgets and so on. So they could spend in the wake of the crisis. Yes, it required some, but there was consensus there. Now, as countries move at different paces and as you need to move towards real reform, they're recognizing that initial coordination was much easier. And now they really have to do something very hard. And this is where I think the point that maybe the G-20 has overpromised is actually a very real, serious one.

MR. ELLIOTT: Martin?

MR. BAILY: I'm Martin Baily at Brookings. And congratulations on your book and all the contributions you've made. But I'm going to quibble with one issue.

There's a bit of your flavor in your book that misguided attempts to help poor people get houses was a big factor in this crisis. And I'm wondering if that's really true and if you have the facts that support that. My interpretation would be that it was mostly middle and upper middle class people buying bigger houses, taking money out of their houses, and that, yes, Barney Frank did encourage too much of the subprime lending, but it was a lot of (inaudible) which is another form of subprime. And that was probably the bigger part. And actually, Fannie and Freddie, their prime mortgages right now are costing them more than subprime mortgages. So I think this is important because people look at this crisis and say see what happens when you try to help poor people? I'm not sure that's what happened here.

MR. RAJAN: Look, I don't -- I'm all for helping poor people so I don't want this to be taken as an anti-poor point. It's more the issue of what happens -- what are the unintended consequences sometimes of government action.

Second, unfortunately, I mean, it seems to be about the poor. I'm not talking about the bottom end of the distribution. Those typically don't own houses anyway. You know, home ownership is about 65 percent now in the United States. That means 35 percent are left out of it. Let's assume they are the bottom 35 percent. So we're reaching into the lower middle class, but not much beyond that. So, I mean, the point is well taken. This seems to be about the poor. No, it's the people left behind. Often the middle to upper middle class. Sometimes in California. The upper-upper middle class because those are the guys who couldn't afford the houses.

So take the point more generally as not about so much the poor as the people being left behind. And the vocal people left behind, if you will, because the very poor also don't have much of a voice. And none of this is intended to be anti-poor in any sense. I think we should figure out how to help them. The whole point is how do we do it in sensible ways. And this is where I think the short term is that we need to do it quickly sometimes comes in the way. We've set people who are being helped further behind now than if we had done the right thing.

MR. ELLIOTT: Okay. The fellow in the purple shirt there, I guess. I'm not great with colors so sorry if I got the wrong color there.

MR. DESAI: Hi. My name is Renell Desai, just an interested college student. My question is regarding an issue that both Dr. -- is it Dr. Wessel and Dr. Rajan brought up, and that's the issue of lower interest rates being used to encourage growth while at the same time encouraging risk. And my question is that isn't there a way we can have an expansionary monetary or fiscal policy while at the same time reducing risks? You know, from what I've seen we've had interest rates at an all time low, but lending has decreased and the lending rate has increased. So we're giving more money to banks, but they're not giving money back to us. And to me, you know, correct me if I'm wrong, but I feel like we're saving finance at the expense -- at the expense of the taxpayer. And in reality a situation like this should be the other way around.

So is there a way that the U.S. Government or policy in general can be directed in a way to reverse the situation we're in to restrict banks, restrict risk, but at the same time improve the status quo or the general standard of how the average person or the lower middle class can obtain money?

MR. RAJAN: Stuff. David has probably a better answer, but -- (Laughter)

MR. WESSEL: Here's what I would say to that. I think there's a little bit of -- you have to decide what you're worried about. You can't be worried about too much lending now and too much risk taking at the same time. So let's take the case that Rajan --

Dr. Rajan makes, which is if they hold interest rates too low too long, people do stupid things that lead to a blow up later. And we've got lots of anecdotal evidence that that happened. So, what the current Fed thinking on that is that requires a much different approach to regulation than we had before. And that's why you hear all this talk about macro prudential regulation, all this stuff. And where the Bernanke-Greenspan disagreement is, is it's okay to have low interest rates at a time like this and you know that people will eventually lend some of that money out, so Bernanke says you have to have much tougher regulation. The Greenspan case is, well, he didn't much like regulation so we didn't have very much under his regime. And so the question is we're going to run that experiment now because, as Raghu said, he's not at the Fed, Bernanke is.

It's pretty clear they're going to hold interest rates low for a long time. Eventually that's going to lead some people to do stupid things. We're going to find out whether this macro prudential regulation where the Fed looks across the whole system and says some of you are lending too much money. Don't lend so much. Whether they actually have the smarts and the will to clamp down while they're still holding a foot to the accelerator.

MR. DALLARA: I think if I may just say that I think Doug made the point earlier that this book, *Fault Lines*, is remarkably balanced analysis. And I think this is a key ingredient of what we need right now in regulatory reform is balance. There's no doubt that in order to prevent future crises the key ingredients will need to be higher capital and liquidity requirements. But if the regulators overcompensate and go too far in this direction it's going to make it more difficult to restore growth, to create jobs, and to get the right balance and credit flowing in the economy. So I think that it's so crucial that as we look at regulatory reform that we neither miss some of the lessons that we should have learned from the past crisis, but at the same time not overreact and impose capital and liquidity requirements which may actually make it more difficult for banks to extend credit.

MR. ELLIOTT: Okay. I apologize, Dr. Rajan is going to have to catch a plane so let me give each of them a couple minutes if they want to make some final comments. And I'm sorry I'm going to have to cut audience questions here.

MR. RAJAN: No, I think we had a very full set of questions. Again, I would say that this book is in some sense saying we need to think about the future. We need to think about a society which has -- where, you know, these two sides, the government and the financial sector have got so entwined and that we're going from one cycle to another and we've got to figure out how to break that link. Sometimes the link is broken by the government doing more. One of the things I'm talking about in this book is the government doing more on things like education so that it can reduce the political pressure to do something about people falling behind. The government doing more. Health care was one example of creating a better safety net so that there would be less pressure and downturn to just expand policies so as to bring the jobs back.

At the same time, you know, we have to be careful about doing too much. And there are areas where the government is doing too much. I think government in housing is an old American, you know, residue of old American policies which we need to start rethinking. Do we really in such a sophisticated financial sector need such a large government presence in housing? Right now the government essentially owns and supports the housing market. Should it pull back? And how much should it pull back?

The whole point of the book is about getting that balance right. And, of course, maybe I haven't got the balance right, but I'm trying to say going forward if we don't get the balance right we're going to go deeper and deeper into this kind of mess.

MR. WESSEL: I'm going to make two short points. One is it's not very satisfying to say that this crisis was the fault of a lot of people, maybe everybody. I think that it was, and that's what's so frightening about it, that every check on the financial system failed. And I think Raghu does a good job in the book of enumerating all the parts of the system that failed. And the second thing, as I said earlier, beware those who caricature authors and make them say things that they didn't really say. So read the book yourself. (Laughter)

MR. DALLARA: My only closing comment will be really to underscore that same point. This book brings a remarkably broad perspective to what are complex issues that do not lend themselves too easily to superficial political sound bites or superficial efforts by bankers or any party in all this to explain away the problems with one or two small fixes. There are deep seated problems here and I think Raghu's book shows ups a window into how we should think about finding the solutions over the longer term.

MR. ELLIOTT: Okay. Please thank our --

SPEAKER: Good questions. (Applause)

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