Policy and Security Implications of the Financial Crisis

A Plan for America

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In mid-June 2008, an international group of economists met in Paris to discuss the gravity of the current economic crisis and what the United States should do about it. The meeting was convened by Economists for Peace and Security and the Initiative for Rethinking the Economy. The author presided over the off-the-record discussions, summarized here on his own responsibility. In the process, he provides one of the most comprehensive and compelling assessments of where the United States and the world now stand, and what can be done to ameliorate the situation.

THE DEPTH AND SEVERITY OF THE ONGOING FINANCIAL CRISIS provided the most important common ground at the beginning of the meeting. Participants (listed in the Appendix) considered it to be extraordinary by any standard since the 1930s, including the debt crises of the 1980s and the Asian and Rus-

sian crises of the late 1990s. One called it “epochal” and “history-making.” What distinguishes this crisis from the others are that: (1) it emerges from the United States, that is, from the center and not the periphery of the global system; (2) it reflects the collapse of a bubble in an economy driven by repetitive bubbles; and (3) the bubble has grown into the financial structure in a uniquely complex and intractable way, through securitization -- the bundling of mortgages and derivative products to investors.

The current situation is a global crisis originating in the United States. This fact implies that it calls into question the governance of the global credit economy, long centered in the United States and on its reputation for fair and open dealing. One participant called it a crisis “of the legitimacy of the G1”. Whether a global financial system will continue to be centered in the United States, and on the dollar as a reserve currency, for much longer was already at that time an open question in the minds of the group.

While some in the room chose to interpret the underlying source of the crisis as a matter of macroeconomic imbalances—savings and investment on one side, the trade deficit on the other—most took a darker view. This larger group believes that the country at the center of the world financial system must maintain a current account deficit—otherwise we could not supply the Treasury bills and bonds the rest of the world wishes to hold as reserves. The crisis emerges when the world loses confidence in the system that supports the dollar, because of perceived instability, corruption, and mismanagement, leading to a breakdown of regulatory authority and market order.

Bubbles are endemic to capitalism, but after the early 1930s they did not predominate. Rather, industrialization and technology set the direction. It was only in the late 1990s with the information technology boom that financial considerations—including the rise of venture capital and the influx of capital to the United States following the Asian and Russian crises—again came to dominate the direction of the economy as a whole. The result was capricious and unstable—vast investments in, for instance, dark broadband (un-

used fiber optic cable), followed by a financial collapse. Yet it was not without redeeming social merits. The economy prospered, achieving full employment without inflation. And much of the broadband survived for later use.

The same will not be said of the sequential bubbles of the George W. Bush years, in housing and in commodities. The housing bubble—deliberately fostered by the authorities that should have been regulating it—pushed the long-standing American model of support for homeownership beyond its breaking point. It involved a vast victimization of a vulnerable population. The unraveling has social effects extending far beyond that population, to the large class of Americans with good credit and standard mortgages, whose homes are suffering a serious decline in value. Meanwhile, abandoned houses often become uninhabitable, so that the capital created in the bubble is actually destroyed, to a considerable degree, in the slump, with depressing effects on neighboring homes. This is unlike the experience with broadband.

As the housing bubble collapsed, a commodities bubble succeeded it, notably in oil, food grains, and base metals. This is a speculative bubble, which cannot be explained by fundamentals: oil prices doubled from mid 2007 to mid 2008 before subsiding, while total demand for oil was up only a few percentage points. The simultaneous price rises in energy, food, and metals also tell of a common financial source. Regulatory changes, put into law at the turn of the decade by then-senator Phil Gramm [R-TX] and exacerbated by calculated negligence on the part of the Commodities Futures Trading Commission (the “London loophole”) have fostered financial speculation in commodities. The creation of the London loophole in early 2006, in particular, permitted U.S. oil futures to escape U.S. regulation, just before the explosive phase of the bubble. This is probably not coincidental.

Securitization is a long-standing practice, created in the United States by the government-sponsored enterprise Ginnie Mae and taken up by Fannie Mae and Freddie Mac. It is a major reason for the success of American homeownership policy since the New

Deal. But the question is, at what point does it go too far? At what point do standards fall too low? It should be clear by now that subprime home loans cannot be safely securitized, because the credit quality and therefore the value of the asset cannot be reliably assessed. Further, in the regulatory climate of recent years (where, as William K. Black pointed out, political appointees brought chainsaws to press conferences), ordinary prudential lending practices were abandoned. The housing crisis was infected by appraisal fraud, a fact overlooked and therefore abetted by the ratings agencies. “No one looked at the loan package.” Now the integrity of every part of the system, from loan origination to underwriting to ratings and insurance, is under a cloud. Fraud is deceit, a betrayal of trust. And it is trust that underlies valuation in a market full of specialized debt instruments, off-books financial entities, and over-the-counter transactions. That trust has, as of now, collapsed.

The result as John Eatwell phrased it is that financial crisis takes the form of *market gridlock*—a systematic unwillingness of institutions to accept the creditworthiness of their counterparties. This is especially grave where a counterparty (such as Lehman Borthers or Bear Stearns) has no direct recourse to a lender of last resort and so the crisis naturally erupts in parts of the system that are outside the direct purview of central banks. In other words, deregulation is a vector for transmission of financial crisis. The economist-physicist Ping Chen tied this situation to a larger theoretical point: the notion of efficient markets and rational agents, which is based on Brownian motion, is based on an erroneous logic. Unregulated financial markets depend on information and social networks that are inherently unstable and may be explosive.

This reality was driven home in September, 2008 as Fannie Mae and Freddie Mac were nationalized, Lehman Brothers went bankrupt, Merrill Lynch was sold and the insurance giant AIG rescued by a massive line of credit. And then there came the spectacular proposal to authorize $700 billion in federal purchases of mortgage-backed securities from the financial system. That proposal, conceived in haste, was superseded in mid-October by actions closely

mirroring proposals developed by members of the working group and presented to the public in the Washington Post on September 25: extension of federal insurance to all bank deposits, direct support for the commercial paper market, and the purchase by the Treasury of preferred equity in the banking system.

To what degree these actions will calm the markets remains uncertain at present time. But even if they meet that objective, the success will be provisional. The underlying issues of financial market structure and function will remain for the next administration to resolve.

The message of these points for the next American president is fairly clear. No one in the group expected the financial crisis to have disappeared, or even to be under control, by January 2009. At that time there will no doubt be immediate priorities: more fiscal expansion, aid to state and local governments, and fast action against the wave of home losses to foreclosures at present appear to head the "to do" list. But the financial problems will not go away. And that means that a benign credit expansion, like the one that began under President Bill Clinton in 1994 and carried him through his presidency, is not in the cards now.

Instead, the next administration will face an internal demand situation similar in some respects to that of the early 1990s under George H.W. Bush, when banks and other lending institutions—deeply damaged by the third world debt crisis of the early 1980s—chose to sit quietly on large portfolios of U.S. Treasury bonds and to rebuild their capital by exploiting a steep yield curve. They did not reenter the business of expanding commercial and industrial loans until 1994—five or six years after credit had dried up. However, it is unclear at this juncture where the steep yield curve will come from this time.

Further, while recession will dampen commodity prices for the time being, the next administration may not enjoy the climate of reliably stable prices that has been the norm since the early 1980s, making possible the noninflationary demand expansion that had created full employment by the end of the 1990s. Every step in that

direction risks being bedeviled by the instability of basic commodity prices and by the precarious state of the dollar itself. Forces hostile to policy initiatives will exploit these vulnerabilities, to discourage and thwart any systematic strategy favoring economic growth or a new direction for economic development under the next president.

Such is, for instance, the obvious implication of the "International Monetary Fund audit" recently announced for the United States, no doubt with the approval of the incumbent Treasury Department. Inflation headlines and tales of deficits and debt will be taken up – are already being taken up -- by the long-standing fiscal doomsday chorus in Washington and on Wall Street. In other words, a problem that has its origin in the deregulation, mismanagement, and corruption of the financial sector may become, in American political discourse, a perceived problem of public fiscal management and irresponsibility. If this happens, it will severely challenge the ability of presidential leadership to place economic growth on a fundamentally new and more constructive course and to deal with critical issues such as the infrastructure shortfall, energy, and climate change.

For these reasons, the group agreed that in the next administration the problems of the financial sector should take a very high priority, as an integral part of broader economic strategy. The financial crisis needs to be addressed at its most fundamental level, which is the purpose, functioning, and governance of financial institutions—and their regulators. Let me add to this conclusion my view that, as a political matter, it will be essential to keep the financial origins of the larger economic problems in plain view, and for this purpose a vigorous program of regulatory oversight and reform, including limits on executive compensation, also will be essential.

The Unstable Macroeconomic Environment

The U.S. economy was driven forward in the 1990s by a credit expansion focused on investment in information technology and in

the mid-2000s mainly by a vast expansion in housing credit, which fueled construction and also sustained, to a large degree, middle-class consumption. These sources of demand expansion are now exhausted and even going in reverse. Meanwhile, large increases in fuel and food prices drain purchasing power, forcing delays in all forms of consumption and investment that can be postponed. This accounts for the massive drop in (say) automotive sales reported early in the summer.

U.S. effective demand in 2008 was supported by fiscal expansion. The tax reductions enacted in January had a large one-time effect on consumer purchases in May—a "sugar shock" to total demand, though part of it did leak to imports. Increased federal government spending—especially on defense—played an important role, as second-quarter data confirmed. So is the effect of lower interest rates on the value of the dollar and on demand for exports. All these sources of demand growth will be absent next year.

Further, starting in midsummer, states and localities began to implement austerity budgets imposed on them by falling revenue projections, which are a function of falling property valuations, shrinking residential tax bases, and stagnant sales tax revenue as well as the collapse of the auction rate securities market which destabilized their funding. Meanwhile, mortgages and home equity loans are drying up pensions invested in mortgage-backed securities are underfunded, and private investment will likely follow the consumer into a slowdown. There is very little chance that any new sources of demand will arise in the private sector. While in technical terms a recession may be avoided in 2008, absent major effective action, 2009 will see stagnation, with recession increasingly likely.

Given the fact that vacated and unsold houses (unless destroyed outright) stay in inventory for a long time, there is little prospect of a housing recovery any time soon. Nor will a new expansion of loans to the broad population be collateralized by home values. A recovery in housing should indeed not be expected within the policy horizon of the next presidential term, no matter what happens to the financial sector. Something good could happen somewhere else in

the economy, for reasons largely unforeseen, as it eventually did in the 1990s in the technology sector. But to rely on such a happy development would be an act of faith. More likely, there will not be good news from private credit markets in 2009, 2010, or 2011. Achieving economic growth in some other way will therefore be an overriding policy goal.

The only other known way is fiscal policy, and this raises two questions: How much fiscal expansion will be needed, and over what time horizon?

Calls are now being heard for a "second stimulus package," reflecting the fact that the first stimulus package, while effective, was necessarily short-lived. But the same will be true of the second stimulus package, if it is designed in a similar way. And after the election is over, will the coalition now supporting a short-term stimulus stay in place? If not, what then?

The political capital of the new president risks being depleted quite quickly in a series of short-term stimulus efforts that will do little more than buoy the economy for a few months. Since they will not lead to a revival of private credit, each of those efforts will ultimately be seen as "too little, too late" and therefore ending in failure. Meanwhile a policy of repetitive tax rebates can only undermine the larger reputation of the country, for it is unlikely that the rest of the world will happily continue to finance a country whose economic policy consists solely of writing checks to consumers.

What is the alternative? It is to embark, from the beginning, on a directed, long-term strategy, based initially on public investment, aimed at the reconstruction of the physical infrastructure of the United States, at reform in its patterns of energy use, and at developing new technologies to deal with climate change and other pressing issues. It is to support those displaced by the unavoidable shrinkage of Bush-era bubbles but to do so gradually and effectively—with unemployment insurance, revenue-sharing to support and expand state and local government public services, job training, adjustment assistance, and jobs programs. It is to foster, over a time frame stretching from five years out through the next generation, a

shift of private investment toward activities complementary to the major public purposes just stated. It is to persuade the rest of the world that this is an activity worthy of financial support.

The Function of the Federal Reserve

As noted, the new strategy may have to be developed in a hostile environment of unstable oil and food prices. However, it would be a mistake to interpret that instability as inflationary in the normal sense, a sense normally meant to invoke a monetary policy response. In particular, money wages have not changed or caught up; real wages therefore fell—and quite sharply—as commodity prices jumped. As Ben Bernanke acknowledged in a recent speech, nothing in the present movement of price indices can be attributed to wages. In Bernanke's telling phrase, "the empirical evidence for this linkage is less definitive *than we would like.*" (italics added)

For this reason, practically nothing in the standard formulae governing responsibility for fighting inflation applies. Those formulas were created for a world where Federal Reserve policy acts as a deterrent (through the conduit of "credibility") against excessive wage increases. But excessive wage settlements have been unknown for a quarter-century. What happened in 2008 was instead is a price bubble created precisely in the financial markets! No lender was ever scared of higher interest rates. And no energy trader or oil producer is deterred from pushing up the oil price by the threat that someone else might have to pay a few extra points of interest on a bank loan six months or a year hence.

Federal Reserve policy—caught between a weak economy and unstable commodity prices—is thus faced with a conflict of objectives and a shortage of instruments. It can, in principle, "fight inflation"—mainly by raising interest rates to support the dollar and hold down the cost of imports, including the price of oil. Luiz Carlos Bresser Pereira calls this "exchange rate populism"—a familiar phenomenon in Latin America, attractive to political leaders but cor-

rosive to development. If the Federal Reserve had taken this route, the normal channels of domestic economic recovery would be blocked, and in addition to that, the financial markets would unravel, so that a defense of the dollar as a pure monetary policy strategy is unsustainable, even in the short run.

Or the Fed can continue to deal with the ongoing financial crises, supplying liquidity as a first priority, in which case the dollar will settle wherever the consensus of international reserve holders decides it should go. In a flight to quality, it still appears that the best refuge is US government bills and bonds, and so the dollar may not be strongly affected. Indeed, the unfolding crisis has revealed the fatal fragility of the euro system, which provides neither a credible lender of last resort nor unlimited creditworthiness of sovereign governments. The emergency use of Federal Reserve lending to support the European banks is a potentially explosive development, with consequences that could eventually shake the European monetary union to its roots. But the fact that the eurozone is fragile does not prove that the dollar system is strong.

It is a mantra in some quarters that presidents do not comment on the actions of the Federal Reserve. But in this situation, comment is needed. An appropriate comment on the larger role of monetary policy does not amount to interference in routine decision-making, for example, of the Federal Open Market Committee. Rather, it should reflect the core reality: in the past decade the Federal Reserve and other financial regulatory agencies failed in their responsibilities, and now they must take up those responsibilities again.

The events of September, 2008 dispelled many illusions about the Federal Reserve's role, leaving no doubt that system stabilization trumps price stability in a crisis. But the question remains whether the monetary authorities yet appreciate the full burden that now falls on them. For three decades, a cult of deregulation and "market discipline" has dominated discourse on financial matters. The consequences include a system that is not only unstable and out of control, but also intractably opaque and complex, made so in part deliberately to defeat the prospect of effective prudential regu-

lation. Such a system can survive only so long as no one examines it closely. In a crisis, exposure is inevitable; each wave of scrutiny raises new questions and generates new anxieties and the potential for panic.

The entire point of a regulatory system is to regulate. It is to subordinate the activities of an intrinsically unstable and predatory sector to larger social purposes and thus to prevent a situation in which financial interests dictate policy to governments. That is, however, exactly the situation that has been allowed to develop. The job of the Federal Reserve and of the other responsible agencies must now be, in part, to reestablish who is boss. Specifically, there must be a thoroughgoing revamping of the financial rules of the road, to dampen financial instability, to deflate the commodity bubble, to reduce the enormous monopoly rents in the financial sector, to set new terms for credit management, and to generate productive capital investment where it is most required. This is in large part the Federal Reserve's job, though it has strong interagency and international dimensions. It will remain the Federal Reserve's primary task for the duration, which means that other tools including regulation and supply management must be brought to bear, as needed, to control inflation pressures.

The Future of the International Monetary System

The Paris group included several senior experts on the structure and governance of the international monetary and financial system. Almost all agreed that the present system is in trouble and that major changes are on the horizon if not actually imminent. Whether those changes will come by evolutionary steps or by directed reform was an open question. There was no consensus as to the ideal structure of a new system, but certain lines of the discussion were nevertheless revealing.

The present international monetary system suffers broadly from two critical flaws. First, it has failed to provide stability, hence pre-

dictability, for ordinary business activity. Financial flows determine almost entirely the ups and downs of exchange-rate movements, with the result that these are largely haphazard, unpredictable, and subject to manipulation. Meanwhile the underlying financial networks are opaque and subject to large systemic risks. Second, it does not provide a framework within which individual countries can pursue coherent development, growth, and full employment strategies. On the contrary, it subjects them to harsh discipline and erratic performance. It is no accident that the major success stories in the developing world—China and India since 1980—were precisely the two countries that did not use foreign bank credit and so remained insulated from financial shocks. Since the late 1990s, these two have been joined by others (notably Argentina) that have realized that the most effective financial strategy is sometimes to withdraw from the international system.

Within this unstable and capricious context, the United States has enjoyed a highly favored position, especially since the early 1980s, as the provider of the sole major reserve currency. How long the dollar can hold this position is a grave uncertainty facing the United States. But the same uncertainty also faces the world, much of which is well served by having a single reserve currency, especially by having it be that of the United States. It is precisely because the United States has been willing to maintain a high level of effective demand despite violating every imaginable balance-of-payments constraint that the world economy has been able to grow, and largely to flourish, since 2001. The United States could do this because its debts are in its own currency and at low rates of interest.

A shift to a multipolar system would remove this feature. It would therefore be extremely risky, because such a system has no consumer-of-last-resort. If no country or region is willing (or able) to run up debts, the others cannot pursue export-led growth toward full employment. Most of the world understands this, and as a practical matter most of the world supports the United States in its role. The real danger of a collapse is thus not a challenge to U.S. leadership

from the outside, but decay and disorder arising from within.

The Bretton Woods system tried to deal with instability through capital control. The idea was to keep private international financial players in check, with global money and a clearing union to settle international accounts, and a system of adjustment that favored expansion by surplus rather than contraction by deficit countries—thus pushing all players toward full employment. The Havana Charter of the International Trade Organization, which was never implemented, stressed the need for this type of asymmetric adjustment, along with exemptions for developing countries from the rigors of free trade. Some in the group favor returning to that vision as the starting point for the design of a new system. Most regard that ideal as unattainable and seek instead the narrower objectives of better control over instability and a greater tendency toward growth and high employment—that is, to cure the flaws of the dollar-reserve system rather than to replace it.

All participants understand that the ultimate survivability of the dollar system cannot be separated from the reputation of the United States, especially in three areas. The first of these is geopolitical: The United States gained financial preeminence after World War II because it was the recognized and accepted leader of the non-communist world. The United States provided security to that world and received financial privileges in return. In the years since the cold war ended, it has become increasingly clear that the United States is not providing very much security to others and in many eyes has instead become itself a source of instability. The financial position of the country cannot fail to pay the price for this.

The second area where reputation is important is that of financial governance: The United States owed its financial preeminence in part to a widely shared conviction that U.S. financial markets were comparatively clean, stable, and transparent. Obviously that reputation has come under great strain in recent years. The resulting uncertainties do not affect the liquidity of Treasury notes, but they do affect the valuation of the dollar and the attractiveness of dollar-denominated securities as reserve assets.

Third, the United States has enjoyed financial preeminence because of its technological leadership. Investors go where things happen. This fact was prominently on display in the late 1990s—the United States got the capital inflow because it was the only country that could generate the technology boom. This asset, too, has been partly squandered, but it can be repaired. Doing so will be a major part of the challenge facing the next administration.

These fundamental issues are obscured by a superficial international regulatory discourse, according to which the central issues facing the financial system are transparency, disclosure, and better risk management by firms—the Basel II agenda. This agenda ignores systemic risk. Yet systemic risk in a changing world is the central and unavoidable question. Meanwhile the International Monetary Fund (IMF), as an organ of world financial governance, is a spent force, discredited by its rigid ideology and asymmetric service to the creditor states. It is no surprise that developing countries do not want to work with the IMF anymore.

Participants from China, India, and Brazil emphasized that regional financial agreements and, in certain cases, new institutions are already developing. (Of these, of course, the euro is a major example.) Outside Europe these agreements will aim not at fixing exchange rates, but at providing zones of managed change, through a combination of swap networks and capital control, especially inflow control. Regional currencies or clearing units, in Asia and Latin America, seem increasingly possible. These will improve regional economic stability and reduce the demand for dollar reserves, but with adverse effects on U.S. economic stability unless something is done. Many of these developments have already, to a large extent, escaped direct control by the United States.

What Should the United States Therefore Seek?

Our discussions pointed at three major lessons for the next administration:

- First, the key-currency role of the U.S. dollar should be preserved as much as possible, as long as possible, even if it cannot be preserved indefinitely. This can best be achieved by explicit coordination among the major players, including the United States and its largest creditors in the developed and developing worlds. Here the status of China is central. Since the two countries are bound by the force of circumstance to prosper or fail together, the United States should seek a constructive partnership with China in the interest of preserving—for as long as possible—an economic relationship that has greatly advantaged both countries.
- More broadly, the United States should accept both the inevitability and the benefits of regional stabilization blocs, which have the potential to mitigate the risk of financial crisis in large parts of the developing world, permitting sustained economic development. But in return, the emerging regions and their institutions should agree to support the dollar, by stabilizing reserve holdings and fostering investment in the United States.
- Ultimately, excess holdings of U.S. reserves can be reduced through the gradual revival of U.S. technology leadership, especially in the area of energy transformation. It is by selling what it produces that the United States can ultimately make the transition—if a transition is unavoidable—from financial hegemon to "normal country." It is in everyone's interest that this transition, if it cannot be avoided, be as smooth, and as slow, as possible.

Policy Priorities for the United States

As a final exercise, the group was asked to consider what the major policy priorities should be for the United States in the economic and financial conditions likely to face the next administration. This discussion produced considerable consensus on major points.

The next administration will face an acute situation in housing. It

is clear that efforts to stem the foreclosure crisis and the massive deflation of house prices now under way are constantly being overtaken by rapid growth in the scale of the crisis. Estimates range up to 10 million households "below water" and a notional loss of household wealth on the order of $6 trillion. And the matter is extremely time-sensitive: after houses are foreclosed and abandoned, blight settles over the landscape, darkening and deepening the problems for many who were not foreclosed as well as for those who were. An effective policy to halt foreclosures and to keep families in their homes is a most urgent priority. If the next president cannot forestall a rising tide of home loss, no other problems are likely to seem solvable. For these reasons, a new Homeowners Loan Corporation (HOLC) and Resolution Trust Corporation (RTC) should be put in place urgently.

Just as the S&L crisis in the 1980s brought re-regulation to the savings and loans, so the commodity bubble must bring re-regulation to the futures markets. Certain technical steps take priority, especially closing the Enron and London loopholes (as is now being done) and bringing credit default swaps back under regulation as financial rather than commercial positions. More broadly, as Paul Davidson has recommended, the new administration can sell oil from the SPR (as was done during the first Gulf War and after Hurricane Katrina in 2005), if required to help manage the price and to deflate any return of the summer 2008 commodities bubble. As oil prices come down, they should also be stabilized over a reasonable floor: the policy should not be cheap oil but oil sensibly priced to promote conservation without beggaring the middle class.

The new administration can also work with food-producing countries to reduce export restrictions and hoarding. But, as with oil, the price of this concession should be a commitment to new global policies aimed at stabilizing the supply and price of staple foods. After these measures take effect, the Federal Reserve will be under less pressure to defend the dollar or, worse, produce the deep recession that would be required to reduce demand for food and fuel.

These measures will tend to burn speculators and force financial

institutions holding speculative assets to recognize their losses. But this must be done, and for the sake of an economic recovery it should be done sooner rather than later. The view of the group is that the major losses from an unraveling of the commodities bubble would be felt by hedge funds, private equity funds, and other speculative pools, rather than banks—losses that the larger system can tolerate. There is no need for panic. It will be far easier to rebuild the financial system than to cure the urban and suburban blight that an unattended housing crisis will leave behind, let alone to undo the damage of conditions approaching famine in some countries.

Regulatory powers require political will and determination as much as new laws. A will to act can put an end to the self-fulfilling prophecy that governments are (in this area) intrinsically overwhelmed by the complexity of markets. The next administration should therefore move swiftly to repair the vast damage done to regulatory capacity in recent years. It should emphasize the acquisition of authority—filling in the regulatory black holes that have been allowed to develop. It should appoint strong regulators to vacancies on the Federal Reserve Board and elsewhere. It should rebuild the staffs of the regulatory agencies, paying adequately to tap and retain top talent, including senior experts. It should hire enough people to have systemic competence, and it should eschew zealots. It should insist on a clearing house for OTC derivatives and that dealers guarantee liquidity, if and as these markets are rebuilt, by making the markets in their securities.

One short-term fiscal stimulus package may be inevitable, given economic distress and the need for an early political victory in this area. But it should be pursued without illusions. The economy will not resume normal growth on the basis of a single such package. Fiscal expansion in the next administration therefore needs to be a long-term proposition, and it should focus on building institutions needed for the long run. Thus, general revenue sharing to support state and local public services, a national infrastructure bank, new educational initiatives including universal pre-kindergarten, an

energy and environmental program—all must be conceived of as part of a long-term strategy to stabilize demand, provide jobs, and reestablish the technical basis for U.S. global leadership and eventual reemergence as a dominant exporter in advanced markets.

In addition, since the financial crisis will inevitably bleed into the value of private pensions, the next administration should consider steps to expand social security benefits, so as to put a more secure floor under the incomes of the elderly and the financial position of near-retirees. Long-term capital commitments are appropriately financed with long-term debts. Thus, the pay-as-you-go provisions of the budget process should not serve as a bar to action along these lines. However, there is no harm in programming progressive tax increases for future years, in order to keep budget-deficit projections under control. If circumstances warrant, those tax increases can always be deferred before they take effect.

It was a central tenet of our conversations that these measures cannot be viewed, or undertaken, in isolation from the international financial position of the United States. Obviously, a successful speculative attack on the dollar would severely disrupt the orderly implementation of this or any other strategy. Equally obviously, a unilateral defense of the dollar via a campaign of high interest rates would severely aggravate the problems of the real economy.

The way out of this dilemma—the only way out—lies in multilateral coordination and collaboration: a joint effort by the United States and its creditors. And this means that the next administration must return, rapidly and with a credible commitment, to the world of collective security and shared decision-making that the Bush administration has been at pains to abandon. An orderly disengagement from Iraq would send a major signal of the intention of the U.S. government to play, in the future, by a different set of rules.

Collective security, in short, is not merely a slogan. It is the linchpin of our future financial and economic security—security that cannot be ensured by any unilateral means. Only a collective effort will keep America's creditors committed to the stability of the dollar-reserve system, long enough to effect the next round of economic

transformation in the United States. Conversely, continued failure to appreciate the financial and economic dimensions of unilateral militarism is one certain route toward the failure of the next administration's economic and financial strategies. The two largest issues we face—how to maintain American economic leadership in much of the world and how to manage U.S. military power—cannot be separated.

Collective security is, however, also more than simply a way of reducing risks and instabilities. It is the foundation stone for many physical transformations of the economy to come. In particular, it is obvious that the military basis of international power on which the United States continues to rely is completely outdated, and has been for decades. As the U.S. invasion of Iraq has made clear (not least to the professional military), military power alone cannot deliver stability and security—let alone at an acceptable human and social cost. Yet parts of the military establishment continue to develop, and to harbor, the technological talent and capacity for problem-solving that every aspect of our energy problem now needs. Shifting the basis of our security system away from one based on military equipment is a key step toward making those resources available.

And the same is true for other countries. China, for example, has long made energy choices favoring coal partly because the resulting power plants are diffuse and militarily expendable. In a secure world, that country would be far more willing to develop its vast hydroelectric potential, as the then-invulnerable United States did in the 1930s. Hydropower is carbon-clean but militarily exposed. A stable reduction of military fears is a key step toward opening up markets that have the potential to permit resolution of collective problems on the grand scale.

In conclusion: From the beginning, the next U.S. president will face acute situations requiring immediate action, especially in housing. He should aim for early victories in these areas as the foundation for intermediate- and long-term programs. For the medium term, institution-building and the restoration of competent and effec-

tive regulatory power over the financial system—both national and international—will be key.

For the long term, the goal should be the transformation of our energy base and the solution of our environmental challenges—nothing less than the rebuilding of the country. And that can be done only in an international financial climate made possible by a return to multilateral decision-making and a commitment to collective security. The American people are ready for this.

The new president should be prepared to explain that leadership in a world community—leadership of collective action on the grand scale—is the true destiny of the United States. It is not in futile warfare but in great endeavors that a great nation finds its future, its purpose, its place in history, and prosperity as well as security, for its people.

Appendix. Participants in the Economists for Peace and Security–Initiatives for Rethinking the Economy Seminar on Finance and Security, Paris, June 16–17, 2008

Americans

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