

USAPC Washington Report
Interview with Dr. Anne Krueger
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USAPC: Some analysts have suggested that the financial crisis has undermined the credibility of the United States as an advocate of financial liberalization, particularly in its dealings with China and other emerging Asian economies. How can we restore confidence in the importance of economic liberalism for continued growth and prosperity?

Krueger: I don't think we've lost this confidence completely. But I do think it is far too soon to try and understand what the lessons are from the current crisis. The problems we face now are not because of something the United States did wrong and the rest of the world did right. In fact, the Europeans are discovering that they have more than their share of troubles as do others. To blame everything on the United States is a bit much.

But we hear some Americans arguing the same thing – “the crisis proves that markets don't work.” Well, nobody has ever said that free markets include an unregulated monetary system. There is still a strong association between more liberalized and deeper financial markets and higher per capita income and stronger economic growth. No country has grown without extending its financial markets.

Countries with very narrow financial markets face more painful problems when they occur because there is no other place in the system to absorb the shock, so to speak. The lesson that we should not liberalize is not the right lesson. Rather, the lesson is that we must watch regulation.

The history of the last three centuries is one of enormous prosperity, economic growth, rising living standards, and all good things that accompany that. But we've also been learning as we go how to develop a financial system that works *only* for us. Right now, it works for us but it also has drawbacks.

USAPC: As we speak, President Bush just invited the so-called G-20 nations¹ to participate in a summit on November 15 to address the global financial crisis. Two of the expected attendees – China and India – were held responsible for the collapse of another important multilateral economic initiative, the Doha Round of trade negotiations.

With this G-20 gathering, are we setting ourselves up for another disappointment? Can a summit like this produce meaningful changes in the regulatory framework, particularly in view of the range of economies that will be participating?

Krueger: I don't know of any major international agreement that has ever been produced at a heads-of-state meeting without a lot of preliminary staff work. And we have not seen that sort of preparation in the run-up to the November 15 summit.

¹ The G-20 group is composed of Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, United Kingdom, United States, and the European Union.

The real risk is that the political leaders will not have anything all that constructive on which they can agree. About all the leaders may be able to do is to direct their staff to begin work on developing X, Y, or Z. That is not what a normal summit is about. So the risk lies in the fact that there has not been adequate preparatory work.

By the way, while China and India were blamed for the collapse of the Doha Round, I don't think they bear it single-handedly. There were a number of issues where one could have gone further. On the other side, as well, the United States was the one that insisted on the narrower band before there would be any safeguards in agriculture. Fifteen percent and 40 percent for the Indians is not a very big difference given that they are very marginal importers in the first place.² So I can find blame on both sides for the collapse of the Doha Round.

Deleted: The "package proposal" considered on July 25, 2008 by the trade ministers of Australia, Brazil, China, the EU, India, Japan, and the United States would have allowed a 15 percent tariff increase above the pre-Doha bound rate in response to a 40 percent increase in imports.

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Comment: Regarding the footnote – the highlighted portion is not correct.

USAPC: British Prime Minister Gordon Brown proposed using the upcoming G-20 summit as another opportunity to reach an agreement on the Doha Round. Is that a good idea?

Krueger: The Doha Round is one of the few areas on which there already has been a good deal of work, so it would be possible for the G-20 leaders to agree on something. And if they could conclude a Doha agreement, the leaders would then have something concrete that showed they met in Washington for a purpose. Importantly, a Doha agreement would be good for the world economy, especially at this time. So I am hopeful, although not optimistic, that the G-20 leaders will seize on the Doha Round at the upcoming summit so they can demonstrate that the meeting produced something useful.

USAPC: The U.S. Federal Reserve and U.S. Treasury took some extraordinary actions in a four-to-six week period to contain the financial crisis. But do you think the authorities reacted with sufficient speed and intervened appropriately? Do we have any way of knowing whether the \$700 billion rescue plan will be sufficient to unplug the system and recapitalize banks?

Krueger: Concerning the latter, quite honestly, no one really knows at this stage whether the rescue package will be sufficient. Did the U.S. authorities handle the crisis well? It would have been much better if a more comprehensive package had been announced. It really does look as if U.S. authorities are playing catch-up ball and reacting.

And they still have not made clear how they intend to handle the inter-related problems of increasing non-performing loans and falling housing prices. Until those things are addressed, it's not clear to me where we will be. I think there is a way to go.

USAPC: There is a view that Japan may be less affected by the financial crisis because it was forced to recapitalize its major banks in response to its financial crisis in the 1990s. Is it possible that Japan may weather this storm better than the United States or EU because it already has taken its bitter medicine, or is the "crisis contagion" such that no country is immune?

² An explanation of the agricultural safeguards proposals is available at -- http://www.wto.org/english/tratop_e/agric_e/guide_agric_safeg_e.htm/.

Krueger: There are two parts to this: one, what has happened so far; and two, what happens if, as most people expect, there is a recession following. Recent data indicate that Japan's exports have been weak relatively; earlier data suggested that the Japanese economy was showing signs of weakness. So it is not entirely clear that Japan will fare better than we will. However, it does appear that Japan did not have as much bad paper in their system as other countries so they don't have that particular source of difficulty and that could help them.

USAPC: What is the most effective way to support emerging Asian economies through this crisis?

Krueger: When countries find themselves in trouble, the IMF [International Monetary Fund] certainly can provide support. The main thing that can be done to help everyone, of course, is to develop policies that, indeed, will offer a shallower recession and a quicker turnaround than would otherwise happen. That would help everyone, both developed and emerging economies.

USAPC: Within the context of this G-20 summit, what can we reasonably ask or expect China to do to help stabilize the global financial system? There are reports that the Chinese government is developing an economic stimulus package. Would that be step in the right direction?

Krueger: China must look out for China. And as far as I know, China has not particularly contributed to the problem except in the sense that large liquidity helped to lower interest rates.

But for several years, most observers have argued, I think correctly, that China needs to rebalance its economic growth toward greater emphasis on domestic economic activity and domestic demand and less on foreign demand. Obviously, to the extent that China manages to offset the downward pressure in the external sector with greater domestic demand that will be support for the international economy as well as China.

USAPC: President Bush has warned that any re-write of regulations governing global finance should not undermine capitalism and free trade. Is this a valid concern or an overreaction?

Krueger: Certainly, people who argue that the financial crisis proves that capitalism is all wrong lend credence to President Bush's concerns. I don't think their argument is right in the sense that proponents of economic liberalism never did say that a totally free and unregulated financial market was the way to go. There always has been recognition that banks must have adequate capital and they must be regulated to ensure that they don't just accept deposits and then run off with the money. That's clear.

However, some people have been saying that the crisis shows there is something wrong with American-style capitalism. I'm not convinced that it does, but there is a risk.

USAPC: Congress has been trending populist for some time. Particularly in the current economic climate, some newly elected lawmakers may favor policies that serve to

constrain the forces of globalization through restrictions on trade and foreign direct investment.

Examples might be the re-emergence of proposals similar in spirit to that of Senator Charles Schumer (D., New York), which would have imposed punitive tariffs on Chinese imports as a way of forcing China to re-value its currency, or the negative hoopla concerning the planned investment by Dubai Ports World. What would your advice to lawmakers be about the need to avoid such extreme approaches to economic adversity?

Krueger: I think it would be difficult to pass proposals of that nature. I hope it won't happen because that is not the best way to address our economic problems. The gains from integration in the international economy are huge, and the costs of trying to pull back would be enormous.

Fortunately, I think there are strong market pressures to keep us integrated. The fact that many more industries now have various components produced in different countries instead of having production all in one place helps to discourage extreme approaches because there will be enough people who would lose from that. So I believe that such approaches are less likely to be regarded as a good thing than might have been the case several decades ago.

USAPC: U.S. Federal Reserve Chairman Ben Bernanke has called for additional fiscal stimulus to help stave off a recession. Even before the November 4 election, there was growing support on Capitol Hill for a stimulus package, although the two parties differed on elements of the package. What are your thoughts?

Krueger: We can't stave off the recession. If, as most people think, we're going to see either flat growth or a downturn in the third and fourth quarters of 2008, by the time we get the fiscal stimulus package through Congress we will be in recession. So it's not a question of staving off the recession, rather it's a question of how deep and how long it will be.

In that regard, I think the key question is how quickly or how soon the real estate market bottoms out. Anything that is fiscal stimulus will probably make it bottom out sooner, but there are some proposals that could make that happen faster.

For example, some proposals call for giving direct tax credits for a certain fraction of mortgage payments. That would help to keep more homeowners in their homes. There are some big problems with this proposal, too, but you can target to some extent more effectively that way.

There is even a proposal, which I don't think is a good one, which would give a total tax credit for any new homebuyer for whatever they paid in the first two years. That would have huge fiscal implications.

USAPC: Martin Wolf of the *Financial Times* has argued that the current crisis is an outgrowth of huge global imbalances that have been building for the past decade. Do you agree, and how do we rectify these imbalances as part of the solution to the financial crisis?

Krueger: Over the longer term, there always have been cycles of economic activity. I think a lot of people felt two or three years ago that the pace of growth was not sustainable and there would have to be a slowdown. Part of that pace, of course, was relatively liquid conditions and easy monetary policy. And part of that, in turn, came from the global imbalances, which

could have been offset by tightening up monetary policy sooner. So you could sort of say, yes, the imbalances were a contributing factor.

But in the normal course of events, there always are some periods in which growth is more rapid than in other periods. We were due for a slowdown. If there hadn't been the sub-prime mortgage problem, we might be saying that it was the oil price increase that did it. Certainly oil price increases contributed to our current problems, but they were not the main causative factor.

It's certainly true that global imbalances were a factor and they needed correction. For years, many people argued that the correction would be a very sharp depreciation of the dollar. Now they are worried that it is something else.

USAPC: As a result of this crisis, do you think we are headed toward some sort of global oversight of financial regulation and currency valuation?

Krueger: The key words are "some sort of." Until people can agree "what sort of," they will argue that global oversight is a good thing or bad thing depending on what kind of regulation they think it will provide. Money is the most fungible thing there is. Finding anything that could be done nationally and internationally is going to be very hard.

USAPC: Are you generally optimistic that we will see the light of day?

Krueger: Of course, we will. The only question is how soon.