Jagdish Bhagwati

Thank you very much, Ernesto. This has been one of the most impressive conferences I've attended. I have learnt much and now it is my turn to reciprocate, though the terms of trade will surely be in my favor.

You are starting the Panel discussion with me, an economist, and then we're going to go progressively back into history with Niall Ferguson and Clive James. That reminds me of my great teacher, Charles Kindleberger, who virtually pioneered the study of what he called "panics and manias" leading to financial crises. Every now and then, he would send me a new paper taking financial crises back yet another century. And this kept happening until his death (which deprived him of yet greater glory once the recent crisis has reached iconic status, though he did have the pleasure of having himself profiled by the reporter Jon Hilsenrath in the <u>Wall Street Journal</u> just as the crisis was beginning to hit its stride). So at one stage I told him: "If you keep going back in time in this way, Charlie, you will wind up all the way back in the Garden of Eden. You will certainly find that Adam and Eve had run into a crisis, but it wasn't a financial one."

Now, we have to recognize at the outset that the current crisis is not just a financial one. It started out as one, of course. But it soon became a twin crisis, afflicting both Wall Street and Main Street. And doubtless the interaction between the two has intensified over time. Thus, lack of finance has adversely affected trade which, in turn, has affected the macroeconomic crisis; in turn, that affects the profitability of banks. These interconnections are important, of course, but they have been the subject of the deliberations at the Conference already.

The focus of the Panel is rather on the three questions you have posed for us to think about. They are beautifully crafted; and indeed they are the most important ones for all of us to answer. You remind us that the previous era of globalization during the 19th century can be argued to have ended with the Great Depression. So, you ask us: Will the current era of globalization (1) be a bump in the road; or (2) will end in the same way with the current crisis turning into a major disruption? Or (3) more optimistically, will the crisis be a wake-up call and be a positive influence for reforms that will strengthen and reinforce globalization?

Let me start with the "bump-in-the-road" alternative. In this scenario, the globalization car gets a jolt but keeps going while the passengers get shaken up. If the bump is like the one you can get on what we call kachha (dirt) roads as against the paccka (finished) roads in India, this sounds too optimistic: far too many cars and lorries can be found littering the shoddy roads throughout India, victims of bumps and potholes. But you could always say, and we economists frequently do say, it could have been worse. [This reminds me of a story about "it could have been worse". Two friends are talking about how a third friend of theirs had found his wife in bed with her lover and had shot the lover dead. So, the other guy says, "Well, it could have been worse." The first guy asks: "What do you mean?" The second guy answers: "If it was last week, I would have been the one shot dead."]

Now, we all know that dire forecasts are routinely made when an alarming incident occurs on Wall Street, with many players and pundits spelling the death-knell of Capitalism, or Globalization, as we know it. Many of you must remember the dire forecasts after the Black Monday, October 19, 1987, when Dow Jones Industrial Average dropped by over 22 percent by the end of October and sharper declines occurred elsewhere worldwide; and many were of the view that the "End Had Come". I recall this particularly because I had just reviewed for The New Republic the first book by George Soros, titled The Alchemy of Finance, with a starting line: "This book raises the question: money talks but can it write". His assertion that he had worked out a magic formula to make money on the stock market was funny because he had made money instead by betting on currencies. I was therefore delighted to see --- John Kenneth Galbraith, who had seen and enjoyed my review, dropped me a line on this when Soros's picture appeared in the New York Times with the story about his losses --- that he lost nearly a billion dollars at the time: he had some alchemy indeed!

The 1997 Long Term Capital Management crisis was another fearful event; but that too is now behind us thanks to forceful corrective action. And, if I may permit myself a heretical thought for those who fearfully or (in the case of populists) gleefully, believed that we were in a "free fall", that the fall has been arrested (even as the recovery is still fragile and the job situation is even more so), again by an energetic set of actions, both on the financial and on the macro-stimulus side.

It is important to emphasize that each reversal of misfortune has been, not because the financial markets did this unaided or that the economy corrected itself without Keynesian stimulus spending. Rather, despite the contentions of Robert Barro, I believe that the economy could not have revived on its own. On the macro side, the Keynesian stimulus helped. And the need for Keynesian spending was something that we had learnt thanks to the Great Crash of 1929.

It has been learning by undoing, basically. We drew lessons from the Great Crash of 1929 and its aftermath; and these lessons helped us to moderate and reverse the current crash. In particular, we know about the liquidity trap, thanks to 1929, and the role of fiscal policy that is embodied in our stimulus package. In fact, Keynes's General Theory grew out of his reflections over the 1929 Crash, and is now at the service of preventing another great crash.

We can confidently say therefore that we have learned from past history: it is hard to imagine anyone except ideologues today arguing for a balanced budget, as Hoover reputedly did. Nor have economists forgotten that a hasty

declaration of victory and reversal of expansionary policies in 1934 contributed to a protracted slump.

We have run into problems of maintaining the Stimulus spending, of course, thanks to the budget deficits which we accumulated through the Bush years – I mean the "Baby Bush", not the "Papa Bush", era. This is a "legacy" effect: we should have allowed for the fact that we may need to run budget deficits in a deep recession even though the possibility was so remote, and we never really gave it a second thought for a variety of reasons which scholars and prominent journalists like David Wessel have written about. This is a real worry because if you have the problem of adding significantly to a very large debt-to-GNP ratio, then your possibility of maneuver is constrained because it would lead, despite the best assurances by the Obama administration that we would go into reverse, to expectations of inflation soon down the road.

Indeed, President Obama is busy trying to tell us that he's going to set the fiscal engine in reverse, that he will take his sports car into fifth gear now in terms of spending and suddenly turn into reverse a few years down the road. Can he however deliver on that? Even as I

support his stimulus spending, I must confess to doubts as to whether he can do this u-turn.

Secondly, once you start spending, we know in the political scene there are entitlements problems. It's very hard to turn it back.

Third, you start building something. If it's just a matter of giving money to us (which I hope he will, certainly to your Center) you're building a school, a bridge, a building. You can't stop it half way. So, how are you going to be able to be sure it's going to be stopped, finished in three years?

I was also in Osaka at the end of the Japanese crisis and there was a big tower that was unfinished, and it was known as the Tower of Bubble, like the Tower of Babel. It had just been stopped in its tracks. Now, this is not going to happen on our political scene in my judgment. So, these are problems which we have to worry about.

Now, leaving the fiscal aspect which we have learned, the learning on trade has been quite profound, in terms of what happened in the 1930s. In 1929 the crash happens. In 1930, the Smoot-Hawley Tariff happens. It has very little to do with the Depression itself because it had been coming in for a variety of log rolling reasons; but it happened to come just one year later. And then, that led in turn to two types of effects. One is tit-for-tat retaliation by others. Second, what I call "monkey see, monkey do" kind of diffusion -- if the U.S. is doing it, I go to my government and say, "Look, these guys are doing it, so we have to do it, too." But between the two reasons, you had a nuclear winter breaking out on trade issues, on trade barriers.

It did not cause the Depression, but it accentuated it. So, I think one thing we definitely learned at the end of that period was that we had to set up rules. You could not run trade policy on the basis of rules that belong to freestyle American wrestling. It had to be more orderly, like the rules of cricket. And that you really had to therefore set up obstacles where people could not just indulge themselves without any rules into what my teacher, John Robinson, called "beggar money" for policies. I try to take demand away from Willem, and Willem does his own thing to take demand away from me. And we agree that both of us get screwed in the process and nobody is ahead. So, the correct answer, which we learned at that time, was to increase demand -- aggregate demand -- not to divert it.

So, that was another aspect which we learned, and I think that has affected the G20 declaration. People realize in terms of ideas which they learned from the 1930s experience, that really this is not the way to go. You should not be indulging in protectionism, particularly as a way out of depression. You have to have stimulus packages, and you can disagree about how exactly or who is going to do what, but that is one important idea.

The second is we set up the GATT, which now is the WTO since 1995. We set up an institution, which then throws sand into the engine, and prevents you from freely raising trade barriers. We also have interests now, meaning the lobbies, because today in the interdependent world economy, which is very considerable, you don't have the freedom even if you want to say "I'm doing something in a WTO legal fashion," it will invite WTO legal retaliation. There are lots of ways in which you can actually play this game. And today when Buy America policies were being instituted by the President, whom I voted for right from the beginning because I have no political aspiration and there is no demand for my services, either, by the politicians. So, I was for Obama from the beginning because I didn't really think I wanted to go the other route, meaning the Clintons. I was one person who was somewhat disappointed when the Clintons began to despair of being able to win and started going for Obama. Lord Acton said "absolute power corrupts absolutely," and looking at the Clintons getting very nervous and behaving in ways which was really not their standard behavior, I said "lack of absolute power corrupts absolutely as well."

But when Obama was doing the Buy America, it was GM, Caterpillar, Boeing -- huge numbers of exporting interests -- who said, "Our markets will be in trouble." So, you may win something by putting on tariffs now in the import competing end, but, by God, when you go beyond that, you know, you go into X affecting Y and Y affecting Zed, and so on and so forth. Then it all adds up to a very substantial adverse impact.

So, on all three dimensions which we distinguish in terms of policy making, ideas, institutional interest, we have held. And I think a lot of it came out after the 1930s experience in my view. And this is why I think we learned from the earlier crisis.

Now, if we look ahead and ask what will we learn from the current crisis, because each crisis is a learning experience. And what changes will we be able to institute in terms of being able to create the institutions which will in fact support and strengthen the globalizations, which is in fact at the heart of post war prosperity. It's a pity President Obama is so straight-jacketed on everything relating to globalization, particularly trade, that he can't bring his eloquence to bear on the subject. But if he did, he would be able to sing the praises of the prosperity and the impact on poverty in India, China, etc., which the post war embrace of the open economy has brought to people, except for two decades which were exogenous to globalization -- the oil price increases in the seventies and then the eighties, Paul Volcker taking recession. But you have to adjust for that and say, "Look, this is nothing to do with it." So, we go into a J curve, and we get back to prosperity. That is something which I think is at the heart of what we have learned.

Now the question is how do we strengthen it in light of the crisis that has happened. If you look at [Hatriama's?] statement, Kevin Rudd, and the first reaction when they come in is to make beautiful statements, where they say virtually everything is gone. So, it's not crazy economists or NGO activists who don't probe these things further. We really have our work cut out for us in that sense.

What have we learned in terms of what we can actually do. What are the weaknesses and how do we need to support it? In the financial sector where we have had a lot of discussion, certainly that's where major problems arose. And therefore, that's where you're going to have to shore up. There are any number of experts here and I teach comparative advantage -- and

I'm forced to practice it -- so I won't be able to give you very much. But I'll just say a couple of things which I think are important.

One is, of course, there are multiple courses, and there are also multiple solutions in consequences as to where you want to intervene. First, looking at it from the perspective of a non-specialist, I think that the financial instruments -- the innovation in financial instruments -- I think nobody has been looking at their downside except for occasional people, once in a while. It is assumed because it's called innovation that therefore it must be like non-financial innovation. If Bill Gates invents something, like let's assume he invents a PC, the only problem, as Tom Peters said, was that all the guys like Olivetti, IBM, who are making the electric typewriters -- they have to go through creative destruction and adjustments.

Now, with financial innovation, you have the possibility of enormous downsides which we see from time to time. It occurred to me when I was listening to Andrew Crockett at Basel right after the crisis, and an LTCM crisis. And he said Basel had invited the top central bankers and the commercial bankers to discuss what had happened in LTCM, and he said the vast majority of them didn't even know what the hell a derivative was. So, I said, "You should have put down DY by DX and cancelled the D's and seen what the reaction was." This is a calculus joke, for those who don't know.

Here was an innovation which nobody understood. So, where was the question of regulators being able to understand and therefore deciding what to do about it? Here was innovation which could actually take you on the downside, which it did at that time. It was Mr. Corrigan who managed to intervene and kind of rescue us.

Now, you go down all the different innovations, and you run into this problem of what I've called destructive creation. Some people like the phrase, like Tom Friedman, and it has come into a little parlance because it's symmetric to Schumpeter's. So, that's one thing.

I’ve suggested that people who are independent of Wall Street but understand Wall Street and understand the financial sector like you, Willem, and Ken Rogoff and others, and Ben Bernanke, should be able to become a set of experts whose job it is to look at the downside.

Now, of course, we know that the future is unknowable. I quoted in one of my *Financial Times* articles a beautiful statement from Keynes. He was writing to Kingsley Martin about it, and he said the expected never happens. It is always the unexpected -- meaning the future is not knowable. And this is really where the job of such a group of people would be -- to look at and try and narrow the range of possible downsides. For example, we play war game scenarios. When we went in the current war in Iraq, nobody looked at it beyond the scenario where it could finish in six weeks, like the first Iraq war. That it would go on for six years, nobody had thought about, and we were caught by surprise. So, that’s one thing which is really important.

Second, I think what I've called Wall Street treasury complex way back about 15 years ago in *Foreign Affairs* which Simon Johnson has sort of taken over. I don't believe in IP protection, but I must say he takes it over, and calls it Wall Street treasury corridor. That's a nice variation, but he gives it a touch of conspiracy. I was simply saying people talking to each other, wearing the same school tie, going to the same places, they share the same euphoria about the instruments and so on, and any strange voice like yours would not be allowed to intrude. I called it a complex in that sense – non-conspiratorial sense. That again is another thing which we need to worry about a little bit.

Ideology also helps because I think what happened, aside from the ideology of Greenspan which we are all aware of, there was also ideology at a slightly lower level. People often ask why our good friend -- one of the most brilliant economists of our time in my view -- Larry Summers, why did he go over and suspend everything he knows about how the financial sector is volatile? Everybody knows that. It's an ages old

thing. Why did he forget that and start liberalizing it, and capital flows and so on?

My suspicion is that the huge success of trade liberalization, of direct activity investment and so on, made people like him have an unwarranted carryover into the financial area. So, you suspend your guard.

It's not partly maybe in listening to Rubin - that's where the Wall Street treasury complex comes in. But basically I think there was an unwarranted spillover. And today it's virtually impossible that anybody would be able to do that, thanks to the current crisis. There's no way to justify the current crisis. It just explains it.

These are different things we could do. I think that will shore it up, but you're never going to get rid of crises, in my opinion. We have to live with them and work largely with what we call adjustment or accommodation. How do you deal with them rather than with the pretension that somehow we are going to rule out something which is essential to that sector? It's a bit like saying, can we think of a capitalist system

which will grow forever without any oscillation at all?

The only system that grows like that but negatively is the Soviet one where nothing changes, where everything goes downhill, like watching one of the films where the Roman battalion goes down steadily, all in lock step. It just doesn't happen that way, so it's part of what you've got to live with. On balance, you come out much more ahead. All we can do is try and devise institutional ways in which we live with it. And this is the way to go. We are not going to be able to remove volatility completely from our system, and there are other reasons why we have it also in the real sector. And we've got to learn how to cope with it. Otherwise, we will have shut door -- that I'm convinced about.

At the same time, I think to support globalization there are several things. We were discussing remittances today and how Mexico has lost out, as have many other people. Some of us have been talking about having some kind of international organization on immigration, which I think we will do. So, a number of

areas where we need institutional support structures will come in, and that will strengthen the globalization. I think globalization is good. We will need these institutional support structures, and the fact that we've had the crisis is going to make us increase our efforts and increase our success also in being able to institute these support systems. So, I'm optimistic on your last question.