U.S. FOREIGN ECONOMIC POLICY IN THE GLOBAL CRISIS

HEARING

BEFORE THE

SUBCOMMITTEE ON TERRORISM, NONPROLIFERATION AND TRADE

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U.S. FOREIGN ECONOMIC POLICY IN THE GLOBAL CRISIS

THURSDAY, MARCH 12, 2009

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON TERRORISM,
NONPROLIFERATION AND TRADE,
COMMITTEE ON FOREIGN AFFAIRS,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:40 a.m. in room 2172, Rayburn House Office Building, Hon. Brad Sherman (chairman of the subcommittee) presiding.

Mr. SHERMAN. We will now bring the subcommittee to order. We will start, of course, with opening statements. I thank the witnesses for being here. But, I especially want to thank President Barack Obama for taking note of the timing of this hearing and coordinating the release of his international economic plan with the timing of this hearing.

I just can't voice my appreciation for that strongly enough. Today's hearing aims to examine the effects of the global economic crisis on how the United States and international trading partners may adjust their economic policies in response.

We know that early next month our President will be attending the G–20 summit in London. The administration has released an international plan, the provisions of which are just now coming into view.

It involves the G–20 countries committing to a stimulus package of 2 percent of GDP, and that the countries should spend significant additional amounts on export promotion through their export credit agencies. In our case that would be the Export-Import Bank.

While we don't have all the details of the President's plan, we have checked with Treasury. They are not going to be seeking budget authority for this effort, and the export financing will be short term, using the existing Ex-Im Bank facilities.

OPIC, over which this subcommittee has legislative jurisdiction, is not anticipated to be involved in this plan. The countries are going to be urged to put in matching amounts to the World Bank, and also in other multilateral banks, to help less-developed countries finance exports.

And, I do want to make a note about the use of the World Bank. The World Bank lends money to Iran. It is helping to keep the Mullahs in power. It is helping indirectly to finance nuclear weapons that will threaten the United States.

The World Bank either needs to adopt a policy, not only of not making additional loans to Iran, but also of not making further disbursements on loans previously approved if it is to be regarded as a healthy agency with which the United States should continue to do business, and to make additional investments.

Also, under the Obama proposal the United States would increase its line of credit to the IMF from $10 billion to $100 billion, with a view to increasing other countries to do likewise, so that the total increase would be $500 billion.

Now obviously we need to see the President's full proposal. I want to work with the administration to ensure an aid package is crafted that maximizes support for American economic and foreign policy goals, and this hearing is the beginning of that process.

I do think that two things need to be more clear. First, how we are going to plan for dealing with the trade deficit. You just can't sweep $.5–.75 trillion under the rug year, after year, after year.

And the second thing that remains unclear is whether our commitment to increase a line of credit to the IMF is contingent upon similar commitments from Europe, Saudi Arabia, and China, or whether it is something that we are going to do in the hopes that it encourages these other nations to act.

I would point out that it appears that Japan is already acting consistent with President Obama's plan. This hearing will also focus on the big brouhaha of the Buy American provisions in the stimulus package, and compare them to the Buy France and Buy China provisions in the stimulus packages of other countries.

The extent of the crisis is well known to all. On March 8, the World Bank announced that the world economy will actually shrink for the first time since the end of World War II.

The International Labor Organization expects global unemployment to increase between 18 million and 30 million workers, and may increase by 50 million workers if the situation continues to deteriorate.

By some estimates as much as 40 percent of the world's wealth has evaporated. Most of those focusing on how we got here focus on the non-regulation of derivatives and absurd mortgage lending standards in the United States.

But we cannot forget that the trade deficit of the United States has spiraled out of control, reaching $800 billion in 2007. This is a symbiotic malignancy in which the rest of the world becomes economically dependent on a malignant trade relationship with the United States, and Americans become dependent upon living a lifestyle where we consume far more than we produce.

Things that cannot go on forever don't, and one would expect that the United States' trade deficit will either be straightened out by the current economic calamity or will result in the next economic calamity.

Our trade deficit expense, I believe, comes from our faith-based trade policy. We have faith that if we open our markets others will do the same, and we have faith that since we are a country that believes in the rule of law, because we believe that the only way government can effect, should effect, or ever does effect private sector and economic decisions is through written regulations that other countries follow the same rule of law.

And, that if we can simply get those countries to adjust their written regulations, we have thereby eliminated any governmental pressure or interference in decisions of private actors seeking to maximize their own utility by in many cases purchasing American goods.

A faith-based trade policy works well as long as one does not look at the results. Now those who became rich and powerful in a system that led to our trade deficit are not going to roll over and move to any other system.

They are using every technique possible to either avoid discussion of our trade deficit or to attack those who dare to mention it. Their favorite tactic is to talk about the Smoot-Hawley Tariff Act of the 1930s, while failing to mention that when that act was adopted the United States had a trade surplus, and continued to have a trade surplus in all the years relevant after it was adopted as well.

So you can't have a less similar circumstance to today, and when comparing today with the days of Smoot-Hawley. Second, Smoot-Hawley involved tariffs on various goods.

It is different from anything that anyone would propose, and accordingly when you mention Smoot-Hawley, therefore you are talking about a proposal radically different from anything that anybody is proposing today.

And you are talking about circumstances radically different from those that pertain today, but aside from those things, it is directly relevant to the discussion of today's trade policy.

When the House set steel and iron procurement standards for Federal funds for mass transit and highway projects, there were cries that we were going to start a trade war. There were a number of ironies in this, the least of which is the fact that the United States specifically exempted several types of projects that were subject to our procurement obligations under the WTO agreement on government procurement.

Who was crying most loudly? It was the Europeans and the Canadians. The EU Ambassador to the United States called the Buy American language a dangerous precedent. The Canadian Ambassador said that the Buy American provisions would fuel the economic crisis.

This is particularly ironic because both Canada and Europe have retained essentially the same or greater procurement restrictions in their WTO commitments. Canada retains restrictive domestic procurement rights for aspects of its transportation sector, including some systems and components, and not just iron and steel.

The EU has retained the right to restrict procurement in its WTO procurement commitments. Now to comfort these critics, the Senate included language that clarified what was already I think well understood, that the provision would be carried out consistent with the United States' trade obligations.

And the Senate simultaneously expanded the Buy American provisions to include United States manufactured goods. So, this expanded version of Buy-America became law. Did the world come to the end? No. In fact, after the bill became law, its critics have been relatively silenced.

The importance of the subject of this hearing is illustrated by the fact that my statement has already gone on too long, but I will use my time during the questioning period to illustrate how the government procurement and stimulus efforts of our trading partners are far more restrictive to United States competition than anything imagined in the United States stimulus bill.

I look forward to hearing from our witnesses, and I look forward with even greater anticipation to the opening statement of our ranking member, Mr. Royce, and our other colleagues.

Mr. ROYCE. Thank you, Mr. Chairman. I look forward to working with you and cooperating as we did last year. I wanted to just make a few observations.

The world is changing ever more rapidly, and unfortunately not for the better. Our Director of National Intelligence calls the global economic and financial crisis, today's subject, our greatest threat. It is certainly near the top.

As the United States economy sinks, so is the world's. All over, growth is down, employment is up, and markets are sagging.

Trade is a big concern. World trade, Mr. Chairman, has quadrupled since 1982. President Obama's USTR-designate, testified last week that the world trading system has "expanded the economic pie." This winning streak, unfortunately, is over. Trade is now declining for the first time since 1982, and it is declining very rapidly. Some have warned that the "golden era of trade" is over. That depends upon whether protectionism gains the upper hand in this argument.

Ideas have consequences. The policies that spark trade's growth were under attack well before this economic crisis began. United States exports were the biggest contributor frankly to economic growth last year. Yet, the last Congress blocked trade deals with Korea, with Colombia, with Panama, and with others. This Congress appears set to do the same. A key House Democrat reportedly warned colleagues this week not to refer to trade agreements as "win-wins." Don't call them that. These agreements though amount to billions in "stimulus" that would not cost a dime.

Now there has been a discussion of blocking trade in the 1930s with the Smoot-Hawley law. Of course Smoot-Hawley, with the 200-percent increases in tariffs, is not identical to some of the initiatives being pushed today.

But what we are talking about when we are talking about Smoot-Hawley is the blow back from our trade partners. The reaction in Europe, in terms of the trade barriers that went up; the reaction in Latin America, in Chile, and in other countries, that then impose trade barriers, and the fact that once that happened, economic decline put a very severe recession into a great national depression worldwide.

I guess one difference is that when President Herbert Hoover signed that bill, reportedly beforehand, he said, you know, I know better. He said that I think the economic consequences of these are great, but to be honest, it was the most popular legislation that Congress probably ever passed. And certainly it was just as easy for the Canadians and the Europeans to follow in the footsteps of Smoot-Hawley, and it is just as easy today for those parliamentarians in Canada, and in France, to push for protectionist measures.

I guarantee you it is a popular argument to make in those countries, but I also guarantee you that if we are successful in undoing liberalized trade, and if those forces in Canada and France, who would like to do the same, are just as successful that some would like to be here, the consequences will most assuredly not be an economic benefit to the people of the world in my opinion. There are very real trends that indicate that we are heading back that way.

The World Bank reports that 17 of the G–20 countries have implemented trade restrictions. As the world's largest exporter, many high-paying United States manufacturing and service jobs are at risk. Protectionism, combined with collapsed commodity prices, threatens to throw hundreds of millions into poverty worldwide. The implications of this for our national security are frankly beyond comprehension.

Protectionism will infect other issues requiring international cooperation. It will be harder to work together on counterterrorism, on financial sector reform, or nuclear nonproliferation, if you are treating trade as a zero sum gain.

One focus of this committee will be foreign aid reform. Nearly everyone agrees that our aid program is dysfunctional, incoherent with its hundreds of goals. The administration's budget aims to double foreign aid. There is no justification for that given our aid program's sorry state. Never mind our dire economy. Many types of aid are simply harmful. I saw that certainly with the impact that it had on Mobutu's Zaire or Congo today. The administration's plan announced yesterday to multiply United States spending through the IMF is ill-conceived. Where did this come from? Many Europeans are right to balk about this.

Calls to increase development aid make no sense while we are denying developing countries market access, the most powerful developmental tool. That is the most powerful thing that can be used for development. The African Growth and Opportunity Act doubles trade between the United States and Africa. Encouraging is the administration's indications that it will move against agricultural subsidies, which punish American consumers and the world's poorest.

Pakistan is a great concern. The country is a powder keg with a nuclear arsenal. Radicalism is spreading, and the economic crisis will weaken the remaining forces of moderation in that country. There is no reason to believe that the very large aid package for Pakistan being proposed will turn this around.

Closer to home some have discussed Mexico as a "failed state." Economic pressures are intensifying there. The Mexican Government's battle with the drug cartels is a death match spilling into the United States. More so than ever, border security is national security. Yesterday I wrote President Obama asking that he resume Operation Jumpstart, which deployed National Guard troops along the Mexican border to great benefit.

Authoritarian governments in Russia, China, Venezuela, and elsewhere already have blamed the United States, deflecting the tension from their own shortcomings. But as Venezuela and others nationalize companies and embrace stateism, their economic demise will intensify.

The idea that a nation's business can be well managed by its government, that politicians and government bureaucrats have the ability or inclination to manage business is a conceit and power grab that has made people poorer again and again. I hope that we understand that at home. Thank you, Mr. Chairman.

Mr. SHERMAN. I thank the ranking member, and just one brief comment. There are, I think, three groups in trade at least that are protectionists associated with Smoot-Hawley. There are those who support generally our present policies, and there are those of us who believe in open markets with a sledge hammer.

And so I am sure when he was talking about Smoot-Hawley, he knew that I was in that third group and not in the first group, and I now yield to our vice chairman, Mr. Scott.

Mr. SCOTT. Thank you, Mr. Chairman. We have five very distinguished guests before us, and I want to move this along so we can get to their comments. It is very important.

I think quite honestly that between you and Mr. Royce, who basically covered the waterfront. However, I do want to say that fear is just not an option for us. The world is in a state of uncertainty with many other countries economies in dire shape.

And we need to be very, very careful how we approach this. We need to do it with a calmness and a confidence, and be very careful about how we view and how we are viewed, in terms of isolationism.

It has not worked in the past. We have been at our greatest as a country. We have shown the way without fear, without trepidation, and we have in many ways set the standards, in terms of using our trade diplomatically, fairly, and understanding that that is the main way that we keep avenues open to countries by having economic relationships with them.

And I come down on the side of wanting to keep those opportunities of trade open and not close our borders. With that, I will reserve for the rest of the questions so we can get to our panelists. Thank you, sir.

Mr. SHERMAN. I now recognize the gentleman from Texas for any opening statement that he may have.

Mr. POE. Thank you, Mr. Chairman, and thank you for being here. I am concerned about four countries: China, Russia, Iran, and Mexico, and our relationship with each of those.

China, are they going to take advantage of this situation worldwide to expand their political influence through their economic programs. I am concerned about the debt that the United States owes China, and that growing interest on that debt.

And Russia, are they going to use their global influence during this crisis to move into more former Soviet states, like they did in Georgia. Is Ukraine next, or who is next.

Is the Russian bear going to come out of hibernation or are they just going to be complacent. I don't know, but maybe you do. And, of course, Iran, with the energy prices being what they are, is that affecting the stability of the Iranian Government or it has no effect.

I am mostly concerned about our neighbor to the south. I think that the United States needs to have a better neighborly relationship with Mexico, and the economic crisis there, and the drug war in Mexico has led some to warn that some of the ungoverned areas in that country may become sanctuaries for terrorists.

Is that a valid concern or is that just some concern or fear. Is it time to renegotiate NAFTA or is it time to reinforce NAFTA.

And, of course, the answer to the question, the question being what should the United States do to stabilize Mexico economically so that it is stabilized politically.

And, lastly, I, too, am concerned about our foreign aid policy. We just write the check every year and maybe we need to figure out why we do that to so many countries all over the world. So, with that, Mr. Chairman, I will yield back my time.

Mr. SHERMAN. I thank the gentleman from Texas. I recognize the Ambassador and Congresswoman from California.

Ms. WATSON. Thank you so much, Mr. Chairman, and thank you for holding today's very important hearing to examine the effects of the United States foreign economic policy and trade effects in this global financial crisis.

It is important that the United States continue to work with our friends around the globe to carefully craft, manage, and redirect this crisis in order to restore confidence in the capital markets, consumers, and developing nations.

As the recession began in December 2007, many foreign leaders around the world believe the economic downturn was isolated to the United States. However, as the situation snowballed into a global financial crisis, the most severe since the great depression, many people around the world began to fall into poverty.

In November 2008, the World Bank reported that with each 1-point percentage drop, 20 million people could be trapped into poverty. We know from past recessions that when people lose their jobs, no matter which country one lives in, that desperation often leads to increase crime rates. We see that here in our country.

In emerging and developing nations desperation among unemployed youth can turn into acts of terrorism and retaliation against their own governments, and in some cases, this activity has spawned uprising and has been the cause of coup d'état in several states.

It is my hope today that we can learn from our most distinguished panelists, and take away some information that will help us as the policymakers so that we can continue to navigate our way through this global financial crisis in a very positive and effective direction.

So, Mr. Chairman, thank you, and I look forward to today's testimony and I yield back my time.

Mr. SHERMAN. I now recognize the gentlemen from New York.

Mr. MCMAHON. Thank you, Chairman Sherman, and to your staff for putting together this very important hearing. Recently I met with the German Ambassador and members of the German Bundestag, and representatives of prominent transatlantic businesses, to celebrate the achievements of the transatlantic community.

But we are faced with the unfortunate fact that the transatlantic community is falling into what could be perhaps its deepest recession since World War II, and has weighed heavily on everyone's mind.

But during our conversation the delegation did not take aim at the United States, and instead proceeded to discuss how the global economic crisis should be credited to the greed that crossed international borders and infiltrated the practices of worldwide businesses.

There are many who blame the United States for initiating this crisis, and many in our own country prefer to look inward for solutions to this crisis, but these seemingly divergent notions are actually one and the same.

Although there can be no recovery in the global economy without recovery in the national economies, the current crisis is not uniquely an American phenomenon, and that is why this discussion today is so important.

The United States must continue to look outward and look for ways to not only maintain, but increase its credibility on the world stage. With that in mind, I would like to hear the suggestions from our distinguished witnesses on how to do just that, while also successfully focusing on our crucial domestic responsibilities, and I look forward to your testimony, and I yield the remainder of my time. Thank you, Mr. Chairman.

Mr. SHERMAN. I thank the gentleman from New York, and I will now introduce our five witnesses. First, I want to welcome Simon Johnson. He is the Kurtz Professor of Entrepreneurship at MIT Sloan School of Management.

He is co-founder of a Web site on global economic and financial crisis, baseline scenario.com. From March 2007 through August 2008, he was the chief economist for the International Monetary Fund.

Second, we are honored to have Lori Wallach, who is the director of Public Citizen's Global Trade Watch. She is also founder of the Citizen's Trade Campaign, a national coalition of consumer, labor, environmental, family farm, religious, and civil rights groups representing over 11 million Americans.

I also welcome Philip Levy, resident scholar at the American Enterprise Institute. Dr. Levy studies international trade and development. Before joining AEI, he was senior economist for trade on the President's Council of Economic Advisors.

Next we have C. Fred Bergsten, who is the director of the Peterson Institute of International Economics since its creation in 1981. He has also served as the assistant secretary for international affairs at the United States Department of Treasury from 1977 through 1981.

I hear that they have some empty space for you there, or for anybody who knows their ways around the halls of the Treasury.

And finally I want to welcome Peter Morici, a professor of international business at the University of Maryland. Prior to joining that university, he served as director of economics at the United States International Trade Commission. With that, let us hear from Mr. Johnson.

STATEMENT OF SIMON JOHNSON, PH.D., RONALD A. KURTZ PROFESSOR OF ENTREPRENEURSHIP, GLOBAL ECONOMICS AND MANAGEMENT (GEM), MIT SLOAN SCHOOL OF MANAGEMENT (FORMER CHIEF ECONOMIST OF THE INTERNATIONAL MONETARY FUND)

Mr. JOHNSON. Thank you, Mr. Chairman, and let me start by saying a few things about the global economic outlook, which was the subject of my written testimony, and then link some of the broader points to the latest statements and policy strategy laid out by Secretary Geithner yesterday.

First of all, in terms of the global outlook, I took note of all your opening statements, and I think that you are right to be concerned about the latest developments around the world.

I would suggest that the situation is actually worst and considerably more dangerous than you currently think, and let me explain that briefly if I can. My view of the global economy in the short term is not very different from what appears to be coming out of the international official organizations that will release their full revised forecasts in April.

I think that globally output will decline as the World Bank said in its March 8 statement for 2009. I am much more worried about 2010 and what happens after that, because I think we are entering not only into a V-shaped recovery, or even a U-shaped slow recovery, but much of an L-shaped situation, where the world economy goes down, and then it stays down for quite a long time.

And I think that is because at the global level again, we face very similar problems to those faced by Japan during the 1990s, the so-called balance sheet recession.

When consumers, firms, and governments around the world have taken on a lot of debt, and when you have the kind of shock to our financial systems that we witnessed over the past 2 years, particularly over the past 6 months, you have problems with consumer confidence almost everywhere.

You have firms that are trying to pay down their debt and save cash, and be very cautious almost everywhere, and you have governments that unfortunately, and quite inappropriate for the moment, find themselves pressed toward austerity rather than being in the position of what we would wish, and what we would try to impress on them, which would be to do some sort of stimulus like in the United States, and I will come back to some specific places in a moment.

I do think in this context the relatively good news is that the United States can recover quicker than most other parts of the world. I think that we have a depth of technology creation and commercialization that will fill the gap left by the decline of financial services.

And I think we also have a financial system, which while it has very deep problems, particularly in and around large banks, and I don't think those can be resolved anytime soon, we also have a variety of sources of finance, and a much broader and deeper system of intermediation than most other countries.

So I think the United States can pull out of this within 3 to 5 years. The rest of the world I think is really going to struggle, and by struggling, I mean the kinds of pressures that I think you were flagging in some of your opening statements.

In the best case, and where you have alternatives, you see increasing pressures toward protectionism, but certainly we see this in Europe, and we will start to see it more and more in emerging markets.

I think we will see instability of governments, and of regimes, and I think what Ms. Watson said about people being pushed down into poverty is absolutely right, and I would emphasize how hard it is to predict the consequences of that.

Mr. Poe raised the questions of what will happen to a number of countries. I think most of these countries will get weaker and be hurt by the economic situation, but exactly how that plays out politically I think is incredibly hard to predict.

The problems particularly that I would stress right now that are evident around Eastern Europe, and East Central Europe, and I will comment on that in just a moment, and I would emphasize the importance obviously of Russia in that dynamic as an incredible wild card.

Let me close by linking this view of the world to the statement issued by Mr. Geithner yesterday in the United States strategy toward the G–20. I will only say three things about that, regulation on Europe and about the fiscal issue.

On regulation, I am sympathetic to the United States administration's position. These are longer term issues that need to be dealt with, but I would also stress that there are bombs in our global financial systems that need to be defused.

I don't think our European partners are focused on that, and I think we need to push them much harder, and that leads into my second point, which is what we are facing now is—some politicians like to say it is a global problem and it needs global solutions, but it is not actually that much of a global problem.

Right now it is a problem in the United States financial system and in Europe, throughout the Europe, and the inability of Western Europe in particular to take care of its weaker members, and weaker members of the Euro zone, and in that context, I support the moves toward greater resources for the IMF, and I will be happy to elaborate on that later.

It is a very serious, dangerous situation in the emerging markets and in the industrial countries of Europe, and this a tsunami of new problems heading our way.

Finally, on the fiscal point, I support the calls for greater fiscal stimulus where appropriate around the world, but I would emphasize that with these kinds of problems mounting, there is very limited room for this, and we should be pushing much harder toward monetary expansion, particularly on the part of the European Central Bank. Thank you.

[The prepared statement of Mr. Johnson follows:]

Testimony to the House Committee on Foreign Affairs, Subcommittee on Terrorism, Nonproliferation, and Trade, Hearing on U.S. Foreign Economic Policy in the Global Crisis, March 12, 2009 (embargoed until 10:30am)

Submitted by Simon Johnson, Ronald Kurtz Professor of Entrepreneurship, MIT Sloan School of Management; Senior Fellow, Peterson Institute for International Economics; and co-founder of http://BaselineScenario.com (a leading source for daily policy analysis on the global crisis.)

Summary

1) The world is heading into a severe slump, with declining output in the near term and no clear turnaround in sight. We forecast a contraction of minus 1 percent in the world economy in 2009 (on a Q4-to-Q4 basis) and no recovery on the horizon, so worldwide 2010 will be at best "flat" relative to 2009. The most likely outcome is not a V-shaped recovery (which is the current official consensus) or a U-shaped recovery (which is closer to the private sector consensus), but rather an L, in which there is a steep fall and then a struggle to recover. A "lost decade" for the world economy is quite possible.
2) Consumers and businesses virtually everywhere are trying to "rebuild their balance sheets," which means they want to save more and spend less. Lower asset prices mean large holes in public and private pension plans; this further strengthens the incentive to save more now.
3) Governments have only a limited ability to offset this decrease in private demand through fiscal stimulus. Even the most prudent governments in industrialized countries did not run sufficiently countercyclical fiscal policy during the boom and now face balance sheet constraints. In the US, the budget deficit is approaching a trajectory that is sustainable only if rapid growth returns in 2010. If the recession persists, the government will face a hard choice between the stimulus needed to aid the economy and the austerity needed to ensure fiscal sustainability. State and local governments risk default, and will either receive more assistance or have to cut back further on their spending.
4) The still-forthcoming policy attempts to deal with banking system problems in the US will be insufficiently forceful. Current indications suggest the Obama Administration currently is unwilling to take on the large banks in anything approach a decisive manner; the prevailing approach will remain one of "muddling through". Large banks will remain "too big to fail," but without a decisive solution lending will remain anemic.
5) Compounding these problems is a serious test for the Eurozone: financial market pressure on Greece, Ireland and Italy is mounting; Portugal and Spain are also likely to be affected. The global financial sector weakness has become a potential fiscal issue of the first order in these countries. This will lead to another round of bailouts in Europe, this time for weaker sovereigns in the Eurozone. As a result, governments will feel the need to attempt precautionary austerity instead of spending on fiscal stimulus.
6) The emerging markets crisis is deepening, particularly as global trade contracts and there are immediate effects on both corporates and the financial system. Currency collapse and debt default will be averted only by fiscal austerity. The current IMF/EU strategy is to protect creditors fully with programs that do not allow for nominal exchange rate depreciation. This approach increases the degree of contraction and social costs faced by domestic residents, while also making economic recovery more difficult. As East-Central Europe slips into deeper recession, there are severe negative consequences for West European banks with a high exposure to the region.

7) A rapid return to growth requires more expansionary monetary policy, and in all likelihood this needs to be led by the United States. But the Federal Reserve has not committed itself to this strategy. The European Central Bank still fails to recognize the seriousness of the economic situation. The Bank of England is embarked on a full-fledged anti-deflation policy, but economic prospects in the UK still remain dire.
8) The European push to re-regulate, which is the focus of the G20 intergovernmental process (with the next summit set for April 2), could lead to a potentially dangerous procyclical set of policies that can exacerbate the downturn and prolong the recovery. There is currently nothing on the G20 agenda that will help slow the global decline and start a recovery. The Obama Administration will have a hard time bringing its G20 partners to a more pro-recovery policy stance; the push for a fiscal stimulus is at odds with the budget realities in a rapidly slowing Europe.
9) Capital will continue to flow into US government securities, primarily due to lack of good alternatives around the world. However, the slowing global economy will reduce the current account surpluses of China, Japan, and oil exporters, and this will further tend to push up interest rates on longer-term US government debt.

Overview

The current official consensus view (e.g., as seen in the World Bank's Global Economic Prospects, the OECD's leading indicators, or the latest IMF World Economic Outlook) is that we are having a serious downturn, with annualized growth for the fourth quarter in the US at minus 6% and a presumed steep decline in the first quarter of 2009. But the consensus is that a recovery will be underway by late 2009 in the US and shortly thereafter in the Eurozone. Fed Chairman Bernanke recently predicted growth of 2.5-3.3% in 2010 and 3.8-5.0% in 2011. This will help bring up growth in emerging markets and developing countries, so by 2010 global growth will be moving back towards its 2006-2007 rates.

Our baseline view is considerably more negative. While we agree that a rapid fall is underway and the speed of this is unusual, we do not yet see the mechanisms through which a turnaround occurs. In fact, in our baseline view there is considerably more decline in global output already in the works and, once the situation stabilizes, it is hard to see how a recovery can easily be sustained.

The consensus view focuses on disruptions to the supply of credit and recognizes official attempts to support this supply. In contrast, we emphasize that the crisis of confidence from mid-September has now had profound effects on the demand for credit and its counterpart, desired savings, everywhere in the world.

To explain our position, we first briefly review the background to today's situation. We then review both the current situation and the likely prognosis for policy in major economies and for key categories of countries. While a great deal remains uncertain about economic outcomes, much of the likely policy mix around the world has become clearer. We conclude by reviewing the prospects for sustained growth and linking the likely vulnerabilities to structural weaknesses in the global system, including both the role played by the financial sector almost everywhere and the way in which countries' financial sectors interact. In the end we come full circle - tomorrow's dangers can be linked directly back to the underlying causes of today's crisis.

Understanding the Crisis

The precipitating cause of today's global recession was a severe "credit crisis," but one that is frequently misunderstood in several ways. While the US housing bubble played a role in the formation of the crisis and continued housing problems remain an issue, the boom was and the bust is much broader. This was a synchronized debt-financed global boom, facilitated by flows of capital around the world.

In particular, while the US boom was at the epicenter of the crisis, regulated European financial institutions played a critical role in facilitating the boom and spreading the adverse consequences worldwide. And, like the US, some European governments ran relatively irresponsible fiscal policies during the boom, making them now unable to bail out their financial systems without creating concerns about sovereign solvency.

The flow of capital from countries with current account surpluses (e.g., China) contributed to the buildup of vulnerabilities. By managing its currency, China effectively suppressed domestic demand, allowing it to build up a large current account surplus. Instead of selling dollars on foreign currency markets (which would have depressed the dollar), it chose to buy large amounts of Treasury and agency securities, increasing the supply of lending to the U.S. economy and pushing down interest rates.

An important role was also played by banks from countries without surpluses, such as the Eurozone as a whole; that is, the gross flow of capital into risky opportunities in the US was just as important as the net flow of capital.

The boom exacerbated financial system vulnerability everywhere. That vulnerability made possible a severe loss of confidence in the credit system when Lehman collapsed in September 2008. The immediate consequence was a fall in the supply of credit, but this rapidly translated into a fall in demand for credit. People and firms want to pay down their debts and increase their precautionary savings; in the U.S., the household savings rate has climbed from almost nothing to 5%.

There is no "right" level of debt, so we don't know where "deleveraging" (i.e., the fall in demand for and supply of credit) will end. Leverage levels are very hard for policy to affect directly, as they result from millions of decentralized decisions about how much people borrow. Anyone with high levels of debt in any market economy is now re-evaluating how much debt is reasonable for the medium-term.

As a result, while attempts to clean up and recapitalize the US and European financial systems make sense – and are needed to support any eventual recovery – this will not immediately stop the process of financial contraction and economic decline. Fiscal stimulus, similarly, can soften the blow of the recession, but will not directly address the underlying problems, and many countries are constrained by high debt levels. A dramatic shift in the stance of monetary policy is required in almost all industrialized countries and emerging markets, but most countries have been slow to recognize this need.

The Global Situation Today

United States

Perhaps the most fundamental barrier to economic recovery in the US is the weakness of balance sheets in the private sector. Households did not save much since the mid-1990s and reduced their savings further this decade, in part because of the increase in house prices; this was the counterpart of the large increase in the US current account deficit. Desired household saving is now increasing, at the same time that the corporate sector is cutting back on investments. The main dynamic is a fall in credit demand rather than constraints on credit supply in the US. Even entities with deep pockets, strong balance sheets and long investment horizons (e.g., universities, private equity) are cutting back on spending and trying to strengthen their balance sheets. This desire to save is creating the economic contraction we see all around us.

There are three major categories of potential policy responses: fiscal, financial, and monetary. However, each of them faces real constraints.

The fiscal stimulus package passed in February is a first step. However, it is too small to close the projected output gap under any scenario; at best, it will shave a couple of percentage points off of unemployment, which will increase further before falling. Further, large portions of the stimulus were diverted into areas that will provide no economic benefit. Most obviously, the decision to "fix" the Alternative Minimum Tax was already assumed, and hence it will have no contribution to economic recovery. If our expectations regarding the overall economy are correct, we will need another large stimulus package later in 2009; unfortunately, it is likely that the political climate will make such a package difficult if not impossible to pass.

Besides politics, the main constraint on fiscal stimulus is the US balance sheet. The US balance sheet is strong relative to most other industrialized countries - private sector holdings of government debt are around 40% of GDP - and US government debt remains the ultimate safe haven. But with increasing Social Security and Medicare payments in the medium term, the national debt will only increase for the foreseeable future. The underlying problem is that fiscal policy was not sufficiently counter-cyclical during the boom. After paying for the economic recovery and cleaning up the financial system (which we expect to cost 10-20% of GDP), government debt could easily be 70% of GDP. The net effect of our financial fiasco is to push us towards European-style government debt levels, and this obviously presses us further to reform (i.e., spend less on) Social Security and Medicare. And we need to make sure we don't have another fiasco of similar magnitude any time in the near future.

Second, financial sector policy has not been encouraging. Despite a series of efforts that were both heroic and chaotic, the banking sector today is roughly in the same state it was in after the collapse of Lehman in September: investors do not trust bank balance sheets, further writedowns are expected, and stock prices are above zero mainly because of the option value of a successful government rescue. The Financial Stability Plan announced by Treasury Secretary Geithner one month ago promises to use stress tests to determine once and for all which banks are solvent; however, as many economists have pointed out, the "worst case" scenario in the stress test is not particularly pessimistic. In addition, comments by administration officials seem to imply that no banks will fail the stress tests, which has reduced the public credibility of the exercise.

In the meantime, the administration's actions imply that the overall plan is to continue providing money to financial institutions on an as-needed basis in their current form. The Citigroup conversion from preferred to common shares, the latest AIG bailout, and the plan to offer future capital in convertible preferred shares are all consistent with an overall intention to keep these institutions in their current form, providing enough capital to keep them afloat, while attempting to minimize government ownership and control. Or, in the more direct words of Paul Krugman, "The actual plan seems to be to keep the banks semi-alive by implicitly guaranteeing their liabilities and dribbling in money as necessary, all the while proclaiming that they're adequately capitalized — and hope that things turn up."

Most economists are agreed that more decisive action is necessary, although we differ on the form of that action. Broadly speaking, the main options being proposed are: (a) overpay for the banks' unwanted assets (or insure them at low cost, which amounts to the same thing), and give them enough cheap capital to ensure their health in their current form; or (b) determine which banks can survive a deep and long recession, declare the others insolvent, take them into government conservatorship, clean them up, and reprivatize them when the market allows. Both of these will be politically difficult.

The Treasury plan to form a public-private partnership to buy banks' toxic assets is simply a version of (a), using non-recourse loans from the Federal Reserve to encourage investors to overpay for assets. But until there is a plan that is sufficiently aggressive and well-funded to inspire confidence, the banking sector will remain in its current state of limbo. And in the meantime, a relatively complex and opaque approach to what is really a simple problem – the chronic lack of capital in the banking system – could well generate the (accurate) impression that the bankers are availing themselves of a nontransparent approach and in effect stealing resources from the state. This is the kind of behavior more commonly seen at such scale in a troubled developing economy, and while it does not preclude episodes of growth, it is usually associated with repeated crises, widening inequality and – eventually – social/political instability.

We expect that the government will follow the "stress tests" with a medium-scale bank recapitalization and launch some form of the public-private asset-buying scheme. This will increase confidence in the banking sector in the short term - as investors feel more confident about bank liabilities - but this effect will fade in a few months as it becomes evident that the banking sector still suffers from the root problems it faces today.

If, by good fortune, the US and global recession ends in the second half of this year, then the difficulties of the banking sector may be manageable. However, we expect to see worse outcomes in 2009 than currently expected by the consensus. Such outcomes are not yet fully reflected in asset prices, and the problems for banks around the world will mount. We will need to readdress the need to fully clean up the banks, but making progress with this depends on a political willingness to take on the powerful banking lobby.

Third, monetary policy can still make a difference. In particular, we still risk entering a deflationary spiral with falling prices and downward pressure on nominal wages. Inflation expectations have become positive once again, and the Federal Reserve has committed to a mild form of inflation targeting (at 2%). However, if the economy continues to deteriorate, inflation will fall short of expectations and the risk of deflation will increase.

We believe a moderate level of inflation would be beneficial in this environment and that generating that inflation should be a goal of monetary policy, perhaps by talking down the dollar, or by engaging in the forms of quantitative easing that Fed Chairman Bernanke has discussed. We expect that the Fed will move toward a more explicitly expansionary monetary policy later this year in the face of a continued recession. This will weaken the dollar and put pressure on other countries to follow suit - expansionary monetary policy is infectious in a way that expansionary fiscal policy is not. The net effect on the dollar, of course, depends on how bad the situation is in other regions.

Western Europe

Major Western European countries, beginning with the UK, have been severely affected by the global recession. The composite of forecasts tracked by Bloomberg predicts a contraction of 3% in GDP not only for the UK, whose housing bubble and degree of dependence on the financial sector were arguably greater than in the US, but even in Germany, whose exports are under severe pressure. The Eurozone as a whole is expected to contract by over 2% during 2009, and grow by 0.7% in 2010. Again, we feel the 2010 forecast is optimistic, because the mechanism for the turnaround is missing.

The UK has already seen a second round of bank nationalization (increases in government ownership), and has adopted an explicitly expansionary monetary policy. The UK is an AAA-rated sovereign with its housing market in a nose dive, overextended (and apparently mismanaged) major banks, and a government on its way to guaranteeing all financial liabilities and directing the flow of credit moving forward. The emerging strategy is based more on depreciating the pound - which is contributing to tensions with other European countries - and surprising people with inflation than on fully-funded bank recapitalization. Additional fiscal stimulus increasingly looks irrelevant and perhaps even destabilizing. The yield on 10-year government bonds is, of course rising - now over 3.5%.

Pressures on individual governments are even greater in some parts of the Eurozone, where individual countries do not have control over monetary policy. Greece faces the most immediate problems, as demonstrated both by widening credit default swap spreads and increasing spreads of Greek bonds over German government bonds, with Ireland in second place. In general, markets are repricing the risk of lending to a wide range of governments.

The need to bail out struggling financial sectors only increases this risk. If the U.S. ever makes a definitive move to protect its banking system (either by recapitalizing existing banks, or by taking them over), this will put pressure on other rich countries to guarantee their banking systems. This effectively converts a private sector solvency crisis into a public sector solvency crisis. Some countries will be able to take on this additional burden; some will not.

The reaction that one hears from senior European officials and richer Eurozone countries is that Greece (and Spain and Italy and others) should deal with their fiscal problems themselves. However, in our baseline view, we expect that in the end Greece will receive a bailout from other Eurozone countries (and probably from the EU). With or without a bailout, however, Greece and other weaker euro sovereigns will need to implement fiscal austerity. The net result is less fiscal stimulus than would otherwise be possible, and in fact there is a move to austerity among stronger euro sovereigns as a signal. Governments will therefore be unable to dissave enough to offset the increase in private sector savings. Germany in particular will do whatever it takes to maintain a reputation for fiscal prudence.

At the same time, however, the deep recession in the Eurozone is putting pressure on the European Central Bank (ECB) to loosen its policies. We expect the ECB will continue to be slow to respond. The ECB's decision-making process seeks consensus and some key members are still more worried about inflation down the road than deflation today. The ECB's benchmark rate is still at 1.5%. Eventually the ECB will catch up, but not before there has been considerable further slowing in the Eurozone.

The current consensus forecast is that the Eurozone will start to recover in mid-2009 and be well on its way to achieving potential growth rates again by early 2010. This seems quite implausible as a baseline.

Japan

Japan, with its export-dependent economy, has been hit harder by the global recession than any other G7 country. Its economy is expected to contract 5.9% in 2009. Exports already fell by 35% from December 2007 to December 2008, hurt not only be weakening global demand but also by the appreciation of the yen. Businesses are likely to want to strengthen their balance sheets further and households with already-high savings rates are unlikely to go on a spending spree. As a result of these factors, the Bank of Japan recently predicted that the country will suffer two years of economic contraction and deflation.

The government's balance sheet is weak, but it is funded domestically (in yen, willingly bought by households), so there is room for further fiscal expansion. However, this is unlikely to come quickly.

The ability of the Japanese central bank to create inflation has proved limited. Once deflationary expectations are established, these are hard to break. Inflation expectations are still negative in both the medium and the long term. This difficulty in creating positive inflation expectations will make it harder for any fiscal stimulus to be successful in restarting the economy. Overall, it is difficult to see Japan being a major contributor to global growth.

China

The current crisis has shown that China's economy is far from invulnerable. The 6.8% year-over-year growth rate in Q4 may have implied that the quarter-over-quarter growth rate was around zero, and forecasts for 2009 are in the 6-8% range - below the level commonly understood as the minimum to avoid growth in unemployment.

The major increase in savings by China over the past 10 years was primarily due to high profits in the corporate sector. Chinese growth now seems likely to slow sharply, and this will reduce savings and the current account. China still does have long-standing scope for a fiscal stimulus. But the Chinese economy is only about 6% of world GDP and their effective additional stimulus per year is likely to be around 3% of GDP. 3% of 6% is essentially a rounding error in the world's economy, and will have little noticeable effect globally - although it might just keep oil prices higher than they would be otherwise.

The Chinese current account surplus is likely to decline as exports fall. This represents the partial unwinding of the Chinese-American economic "alliance" of the past decade. As consumers in the U.S. (and elsewhere) finally start saving more, imports from China are falling. China's trade surplus has been protected in the short term by falling commodity prices (which reduce the value of its imports), but in the longer term commodity prices will stop falling before global demand picks up. This will reduce the available funding for the US budget deficit (which will be partially compensated before by increased U.S. saving) and tend to increase interest rates around the world.

Other emerging markets

Pressure on other emerging markets continues to intensify. East-Central Europe (including Turkey), which spent the last several years borrowing heavily from Western European banks, has been especially hard hit by the contraction of credit as those banks turn to hoarding cash. The IMF is projecting contraction for both East-Central Europe and Russia; in the latter case, this is a severe turnaround from estimated growth of 6.2% in 2008.

The European Union's strategy for East-Central Europe is coming apart at the seams. Supporting exchange rates at overvalued levels does not make sense - unless the goal is to protect West European banks, who have lent heavily to the region - and actually adds to adjustment costs. Consequently, social tension is mounting in Latvia and elsewhere. Fresh waves of financial market pressure are likely to move throughout the region, probably triggered by the timing of external debt rollover needs.

In many emerging markets, the foreign exchange exposure of domestic banks are a major problem. Most governments do not have sufficient reserves to fully cover bank debt in foreign currency. To avoid defaults by either the private or the public sector, most emerging markets will need some form of external support, particularly as both commodity and manufactured exports from these countries will continue to fall.

Worldwide, many emerging market countries will need to borrow from the IMF. Some countries will be willing to go early to the IMF, but for most the fear of a potential stigma will lead them to prefer fiscal austerity (and perhaps even contractionary monetary policy) without IMF involvement. The IMF will be more engaged in smaller emerging markets, such as in East-Central Europe. But even if the IMF doubles its loanable resources to $500bn (as recently announced), it doesn't have enough funding to make a difference for large emerging markets, whose problems are due to their own policy mix, particularly allowing the private sector to take on large debts in dollars. We should expect the IMF to lend another $100bn over the next six months (worldwide), and the G20 will keep talking about providing the Fund with more resources.

Larger emerging markets will not suffer collapse, but will increase (attempted) savings and, as a result, will experience slowdowns. The temptation for competitive devaluation will grow over time. But emerging markets cannot grow out of the recession through exports unless there is a strong recovery in the US or the Eurozone or both, which is unlikely. Many emerging markets are particularly hard hit by the fall in commodity prices. While some commodity prices may have reached their floors, a return to the levels of early 2008 will not happen until significant global growth has resumed, which could take years.

Political risks in China, India and other emerging markets create further downside risks. In our baseline, we assume no serious domestic or international disruptions in this regard.

Global Policy Implications

One leading anti-recession idea for the moment is a global fiscal stimulus amounting to 2% of the planet's GDP. The precise math behind this calculation is somewhat fuzzy, but it obviously assumes a big stimulus in the US and also needs to include a pretty big fiscal expansion in Europe. (Emerging markets will barely be able to make a contribution that registers on the global scale.)

This global policy strategy is already running out of steam.

- Very few countries now find room for a fiscal stimulus; debt levels are too high and fiscal capacity is hard pressed by contingent liabilities in the banking system - particularly with an increasing probability of quasi-nationalization. As a result, the idea of a 2% of GDP global fiscal stimulus seems quite far-fetched at this point.
- Further monetary easing is therefore in the cards, especially as fears of deflation take hold, both for developed countries and emerging markets. There may now be some catching up by central banks - in that regard, see the latest Turkish move as a foreshadowing.
- Commodity prices will likely decline further as the global economic situation turns out to be worst than current consensus forecasts. As a result, official growth forecasts for most low income countries seem far too high.
- The worldwide reduction in credit continues, largely driven by lower demand for credit as households and firms try to strengthen their balance sheets by saving rather than spending.

The crisis and associated slowdown started in the US, but the recession is now global. The US economy is no more than 1/4 of the world economy, so even the largest US fiscal stimulus - say 3% of U.S. GDP per annum - cannot be not large enough to significantly raise the world's growth rate at this stage. If we stabilize our financial system fully and restore consumer credit, this will help. But remember that we are subject to shocks from outside and the outlook there is worse than in the US in many ways. Outside the US the tasks look much harder.

One key principle, stated repeatedly by both the G20 and the IMF, is that policy responses need to be coordinated. This is a basic lesson of the Great Depression, when protectionist trade policies reduced exports across the board without benefiting any nation. The current crisis has not seen a widespread outbreak of higher trade barriers - although some of the bailout programs national governments have offered to domestic industries could amount to protectionist subsidies. Instead, however, we are seeing friction over currency valuations, as countries (who can afford to) try to boost their exports. In terms of recent developments, Switzerland threatened to intervene on foreign exchange markets to suppress the value of the Swiss franc. And the French finance minister criticized the U.K. for letting the pound depreciate.

In addition, fiscal constraints give national governments an incentive to reduce the size of their stimulus packages and attempt to free-ride off of other countries instead. Many countries are probably looking to the United States and hoping that our reasonably large stimulus - 6% of GDP, spread roughly over two years - will help turn around the global economy as a whole.

Looking Forward

The first order of business is clearly to revive the US and global economies. However, it is also imperative that we understand the nature of the global economic order that we live in, with the goal of minimizing the chances of a similar economic crisis in the future and reducing the severity of such a crisis should it occur. As mentioned above, while the government balance sheet can absorb the cost of restoring the economy this time, it is not clear how many times we can add 20% of GDP to the national debt.

We also need to recognize that financial crises, just like bubbles, will recur. Government regulators, no matter how motivated and skilled, are no match for the collective ingenuity of billions of human beings doing things that no regulator envisioned. One way to protect a national economy in the face of systemic financial problems is with a sufficiently strong government balance sheet (i.e., low debt relative to the government's ability to raise taxes). This requires counter-cyclical fiscal policy during a boom, which is always politically difficult. However, this implies less room for fiscal stimulus now, or alternatively the need to put in place measures that will compensate for the stimulus once the economy has recovered.

In order to create the conditions for long-term economic health, we need to identify the real structural problem that created the current situation. The underlying problem was that, after the 1980s, the "Great Moderation" of volatility in industrialized countries created the conditions under which finance became larger relative to GDP and credit could grow rapidly in any boom. A credit-fueled boom adds to the political power of the finance industry, particularly large banks. In addition, globalization allowed banks to become big relative to the countries in which they are based (with Iceland as an extreme example). Financial development, while often beneficial, brings risks as well.

The global economic growth of the last several years was in reality a global, debt-financed boom, with self-fulfilling characteristics - i.e., it could have gone on for many years or it could have collapsed earlier. The US housing bubble was inflated by global capital flows, but bubbles can occur in a closed economy. The European financial bubble, including massive lending to Eastern Europe and Latin America, occurred with zero net capital flows (the Eurozone had a current account roughly in balance). China's export-driven manufacturing sector had a bubble of its own, in its case with net capital outflow (a current account surplus).

But these regional bubbles were amplified and connected by a global financial system that allowed capital to flow easily around the world. Ordinarily, by delivering capital to the places where it is most useful, global capital flows promote economic growth, in particular in the developing world. But the global system also allows bubbles to feed on money raised from anywhere in the world, exacerbating systemic risks. Multinational banking strategies also allow financial sectors to become even more important politically across a wide range of countries. When billions of dollars are flowing from the richest countries in the world to Iceland, a country of 320,000 people, chasing high rates of interest, the risks of a downturn are magnified, for the people of Iceland in particular.

Ideally, global economic growth requires a rebalancing away from the financial sector and toward non-financial industries such as manufacturing, retail, and health care (for an expansion of this argument, see this op-ed). Especially in advanced economies such as the US and the UK, the financial sector has accounted for an unsustainable share of corporate profits and profit growth. The only solution is to invest in the basic ingredients of productivity growth - education, infrastructure, research and development, sound regulatory policy, and so on - so that our economy can develop new engines of growth.

But this change in the allocation of resources is greatly complicated by the increased political power of the financial lobby. During the boom years, large banks and their fellow travelers accumulated ever greater political power. This power is now being used to channel government subsidies into the now outmoded (and actually dangerous) financial structure, and in essence to prevent resources from moving out of finance into technology and manufacturing across the industrialized world.

We have done considerable damage to our economies through a debt-fueled bubble. But it could get worse. If the financial sector can use its political power to generate a higher level of subsidies from the government, we will convert even more of our banking industry into pure rent-seeking activities (i.e., all the bankers will do is lobby, successfully, for more support in various forms). If public policy is captured by banks in the US, Europe and elsewhere, then we face much slower productivity and overall growth rates for the next 20 years.

Further coverage of the crisis and policy proposals

Background material
Previous editions of Baseline Scenario:

- November: http://baselinescenario.com/2008/11/10/baseline-scenario-111008/
- December: http://baselinescenario.com/2008/12/15/baseline-scenario-121508/

Financial Crisis for Beginners primer, includes recent material on "bad banks" and the Swedish approach to cleaning up the banking system: http://baselinescenario.com/financial-crisis-for-beginners/

Deeper causes of the crisis, an ongoing series: http://baselinescenario.com/category/causes/

More details on current topics
Strategies for bank recapitalization

- Economic ideas: http://baselinescenario.com/2009/01/27/to-save-the-banks-we-must-stand-up-to-the-bankers/
- Guide to evaluating official announcements: http://baselinescenario.com/2009/02/07/ten-questions-for-secretary-geithner/

Global fiscal stimulus: http://baselinescenario.com/2009/01/21/global-fiscal-stimulus-should-it-be-an-obama-priority/

Citigroup bailout (the second round): http://baselinescenario.com/2008/11/27/international-implications-of-the-citigroup-bailout/ and http://baselinescenario.com/2008/11/24/citigroup-bailout-weak-arbitrary-incomprehensible/

As it happened
First edition of Baseline Scenario (September 29, 2008):
http://baselinescenario.com/2008/09/29/the-baseline-scenario-first-edition/

"The Next World War? It Could Be Financial" (October 11, 2008):
http://baselinescenario.com/2008/10/12/next-up-emerging-markets/

Pressure on emerging markets (October 12, 2008): http://baselinescenario.com/2008/10/12/next-up-emerging-markets/

Pressure on the Eurozone (October 24, 2008): http://baselinescenario.com/2008/10/24/Eurozone-default-risk/

Testimony to Joint Economic Committee (October 30, 2008):
http://baselinescenario.com/2008/10/30/testimony-before-joint-economic-committee-today/

Bank recapitalization options (November 25, 2008):
http://baselinescenario.com/2008/11/25/bank-recapitalization-options-and-recommendation-after-citigroup-bailout/

Mr. SHERMAN. I thank the witness. We enjoyed hearing him here, and we will enjoy watching him on the Colbert Report tonight. That will be interesting, and because it is relevant to Dr. Johnson's statement, I will ask unanimous consent to put in the record my op ed for the Christian Science Monitor that urges much larger stimulus now in the United States, but also statutorily required austerity to go into effect when the unemployment rate comes down. With that, let us move on to Lori Wallach, our next witness.

STATEMENT OF LORI WALLACH, ESQ., DIRECTOR, GLOBAL TRADE WATCH, PUBLIC CITIZEN

Ms. WALLACH. On behalf of Public Citizens 100,000 members, I would like to thank the chairman and the committee members for the opportunity to testify. Unlike my co-panelist economists, I am a lawyer, an author of books on the WTO and the global trade regime.

The devastation being caused by the global economic crisis to the lives and livelihoods of millions of people around the world is not merely the result of bad practices by a handful of mega financial service firms, but the foreseeable outcome of one particular system of global governance, or perhaps more accurately anti-governance.

Over the last decade the United States foreign economic policy has been systematically the implementation worldwide of a package of deregulation, liberalization and privatization, and new limits on government policy space often dubbed the Washington consensus, or the neoliberal agenda.

Trade agreements, such as those enforced by the World Trade Organization, and international agencies, such as the IMF and the World Bank, have been the delivery mechanism for this global experiment.

I am no fan of tariffs, but I am a fan of power space. The issue here is not trade rules, but rather the other rules to regulate finance and other elements of our economies.

The current regime of deregulation was put into place with intentionality, and now the evidence is pretty clear that this system is a failure and that it needs to be replaced.

Thus, for instance, while the United States has a responsibility to help those countries that are not responsible for the crisis get out of it, more funds for the IMF must be, for instance, conditioned on changes in that agency's rules.

The right for other countries to be able to stimulate their economies, versus the IMF's typical budget austerity. The ability to do currency controls to avoid raids on currency. The ability, for instance, to regulate foreign investors.

Congress is increasingly becoming aware of the overreach of so-called trade agreements, such as the WTO, when you are being told that auto industry rescues, by America conditions and stimulus packages, the TARP system, unless it is made available also to foreign banks, are all violations of trade agreements.

Some of this is true, and some of it is exaggerated. In the body of my testimony, which I request be put into the record, I go into detail about one little known aspect of the current sale of economic governance system.

That is the radical financial services deregulation program of the WTO's financial service agreement. That aspect of the WTO, which has gotten very little attention, but is at the core of the problem, exports worldwide, the extreme financial service deregulation that triggered this crisis.

And more urgently it imposes barriers on the re-regulation of financial services domestically and globally that many agree is key to remedy the crisis. Agreeing to review and renegotiate these WTO financial service deregulation terms must be a key element of the G–20 process, and in addressing the crisis.

Simply putting more stimulus money into operation under the current rules is not the solution. But even as Congress and the G–20, and other international configuration, are struggling to figure out how to re-regulate finance, many of the same people in governments are currently pushing for expansion of the WTO financial service deregulation regime.

For instance, the G–20 summit in Washington, DC, in November of last year was supposedly convened to lay out a coordinated response and re-regulation. Instead, the communiqué called for completion of the WTO's Doha Round.

Yes, the Doha Round has one of its three pillars further financial service deregulation. Let me repeat. The current Doha Round agenda has as one of its three main elements more financial service deregulation. Calling for completion of that agenda has no place in the G–20 agenda.

Again, I am not discussing passing tariffs. I am not discussing trade, but rather undoing a system that limits Congress's and other legislature's policy space to put into place the array of policies needed.

This is a practical matter. Not an ideological assertion. In addition to these financial service issues, we have the limits that the chairman discussed on Buy America, made more egregious by the fact that the United States, in scheduling its trade commitments, has frequently focused on etiology and not the national interests.

As a result, we have taken on more responsibilities under the current model than other countries. So, the EU and Canada wisely chose to exclude some of their procurement. It has nothing to do with trade, but rather how governments can spend their tax dollars to stimulate their economies.

To conclude, for a few years a few brave economists reviewed the massive persistent United States trade deficit the chairman mentioned as it began to exceed 5 percent of GDP, and they warned that such imbalances were not sustainable, and they called for an array of urgent policy responses so as to avoid a devastating and painful market correction, and massive contraction in trade.

The absence of the policy responses has resulted in the undesirable outcome. Remedying the current prices and avoiding future such crisis, and achieving economic stability at home and abroad, will require a new system of global economic governance that harnesses the benefits of trade, while removing the many non-trade policy constraints that are now obstacles to ensuring markets operate in a stable and productive manner. Thank you.

[The prepared statement of Ms. Wallach follows:]

Public Citizen

Auto Safety • Congress Watch • Energy Program • Global Trade Watch • Health Research Group • Litigation Group

Statement of Lori Wallach
Director, Public Citizen's Global Trade Watch division

U.S. Foreign Economic Policy in the Global Crisis

Subcommittee on Terrorism,
Nonproliferation and Trade
COMMITTEE ON FOREIGN AFFAIRS
U.S. House of Representatives
March 12, 2009

On behalf of Public Citizen's 100,000 members, I thank the Chairman and the Committee for the opportunity to share my organization's views on U.S. foreign economic policy in the global crisis. Public Citizen is a nonprofit citizen research, lobbying and litigation group based in Washington, D.C. Public Citizen, founded in 1971, accepts no government or corporate funds. Global Trade Watch is the division of Public Citizen founded in 1995 that focuses on government and corporate accountability in the globalization and trade arena.

The devastation being caused by the global economic crisis to the lives and livelihoods of hundreds of millions of people around the world is not merely the result of bad practices by certain mega financial service firms, but the foreseeable outcome of one system of global economic governance – or more accurately anti-governance – that has been put into place and now must be replaced.

Over the last several decades, the U.S. foreign economic policy has been the implementation worldwide of a package of deregulation, liberalization, privatization, new property rights and new limits on government policy space, often dubbed the Washington Consensus or the neoliberal agenda. "Trade" agreements, such as those enforced by the World Trade Organization (WTO), and international agencies, such as the International Monetary Fund and the World Bank, have been the delivery mechanism for this radical global experiment.

Congress is increasingly witnessing the WTO's overreach as they are told that auto bailouts, Buy American and certain climate policies are inconsistent with U.S. international trade obligations. Some of this is unfortunately true, while some has been exaggerated. In the body of this testimony, I go into some detail on one little-known aspect of the current failed economic governance: the radical deregulation requirements contained in the WTO's Financial Service Agreement (FSA.) This aspect of the WTO operates to export worldwide the extreme financial service deregulation that has triggered this crisis. Agreeing to review and renegotiate these WTO financial service deregulation terms must be a key element of the G-20 process aimed at addressing the crisis.

Yet, even as national legislatures, the G-20 and other international configurations struggled to create new financial service regulation, many of the same people and governments are currently pushing for *expansion* of the current WTO financial services deregulatory agenda. For instance, President Bush's November 15, 2008 G-20 Summit was supposedly convened to lay out a coordinated regulatory response to the crisis. Instead, the November G-20 summit's communiqué called for completion of an on-going WTO Doha Round negotiation which has as one of its three main planks further financial service deregulation.

Whether such calls by the Bush administration were based on cynicism or ignorance is a matter for the history books. However, to date it appears that the new administration is unaware of the conflict between the Doha Round proposals and its stated re-regulation goals. In late January, President Obama also called for the speedy conclusion of the Doha Round as a step towards remedying the current economic crisis. Obama's statement highlights the need for the work of this Committee in exploring the broad framework of U.S. international economic policy.

While Bush may have been deeply ambivalent about the call for financial service re-regulation, Obama and his economic advisors are not. Thus, the Obama administration must revisit the requests and offers made regarding further financial service deregulation and liberalization made by the Bush administration that now comprise the Doha Round agenda. The continuing G-20 process must take these matters into consideration and undertake as part of its re-regulation agenda the rollback of the WTO's *outrageous usurpation of* domestic non-trade policy space essential to rebuilding our economy and regulatory system to serve the public interest.

Few policymakers at home or abroad are aware of the myriad ways in which today's "trade" pacts constrain their policy space on various non-trade matters. In part, this is because of the relative "newness" of this backdoor channel for domestic deregulation. Prior to the establishment of North American Free Trade Agreement (NAFTA) and the WTO in 1994 and WTO in 1995, the scope of trade agreements was limited to setting the terms of exchange of goods across borders, namely cutting tariffs and lifting quotas. Proponents of the new expansive model of international commercial agreements branded WTO and NAFTA as "trade agreements" and attacked as protectionist all those criticizing these pacts' overreach into non-trade matters. This rhetorical sleight of hand obscured the fact that these pacts were delivery mechanisms for a much broader economic package, of which trade liberalization per se is only one limited aspect.

And now we are living with the consequences of leaving our nation's economic wellbeing to be determined by private interests, who legally must focus on quarterly profit statements while operating under a system they helped devise that removes all obligations and responsibilities to the rest of us.

Remedying the current crisis, avoiding future such crises and achieving economic justice and stability at home and abroad will require a new system of global economic governance that harnesses the benefits of trade while removing the many non-trade policy constraints that are obstacles to ensuring markets operate in a stable and productive manner.

This is a practical matter, not an ideological assertion.

For instance, the WTO's Financial Service Agreement explicitly limits domestic regulation of banks, securities and insurance firms by the United States and over 100 other nations. While many in Congress fume about foreign banks, such as UBS, obtaining U.S. tax-payer bailout funds while simultaneously refusing to reveal information about possible tax evasion by its depositors, few realize that the WTO's FSA sets an array of limits on Congress' regulatory authority over foreign banks operating here. More on that below.

The WTO's procurement agreement and those of the FTAs into which the United States has entered limit how Congress may expend our tax dollars. Given the recent brouhaha attacking Buy American rules in the stimulus package as 'protectionist,' it is worth noting that the terms in question had nothing to do with tariffs or trade or the functioning of private markets. Rather at issue was Congress' right to decide how to best spend U.S. tax dollars in a manner that could stimulate our economy. Yet, "trade" pacts such as WTO and the FTAs set limits on Congress' decisions regarding use of our tax dollars in a manner that provides preferences for U.S.-made goods or U.S. firms.

Thus Congress' stimulus spending of our tax dollars will not fully cycle through the U.S. economy, even though studies show that doing so provides important economic gains. For instance, the $20 billion in funding for electronic medical record keeping in the 2009 Economic Recovery Plan is probably more likely to be spent offshore rather than to employ Americans. Meanwhile, despite the hysteria regarding the Buy American rules relating to infrastructure projects, in reality even though the stimulus package included the much broader Senate version of Buy America rules, only a small share of that money can be directed into the U.S. economy thanks to the limits set in trade agreement procurement rules. For instance, firms operating in 39 countries, including all of Europe, that signed the highly controversial WTO procurement agreement and firms in the additional 13 countries who are signatories to U.S FTAs must be treated as if they were U.S. firms for certain aspects of even the covered spending. While there are some important exceptions listed in the U.S. schedule of commitments in these agreements that safeguard the right to use domestic preferences for some categories of goods, the United States altogether gave up its rights to provide preferences to U.S. firms regarding the construction and other service procurement contracts.

That would be galling enough, but to make matters worse, the U.S. commitments to these constraints on domestic procurement policy demonstrate a consistent trend: the United States made its 'trade' agreement commitments based on ideology rather than economic or other national interests. That is to say that U.S. officials were so intent on selling the expansive model delivered by the WTO and NAFTA to other countries – many of which were wisely opposed to such an overreach – that our commitments are much more expansive than other countries'. This sorry reality provides a different perspective on the hollering by Canada and the European Union (EU) against the stimulus bill's Buy American provisions. Both the EU and Canada wisely excluded considerably broader swaths of their procurement activity from WTO rules and, in the case of Canada, also from NAFTA. Because of this, the EU and Canada have no obligation to provide U.S. firms with access to a wide array of their government contracts. For instance, while the United States safeguards its preferences (only) for domestic iron and steel used in federally funded state transportation projects, Canada carved out steel, motor vehicles and coal altogether (for all provinces, for all sectors), and also carved out all construction contracts issued by the Departments of Transport. The EU carved out of its WTO procurement obligations contracts awarded by federal governments and sub-federal governments in connection with activities in the areas of drinking water, energy, transport or telecommunications.

The United States also made the broadest commitments to comply with the non-trade regulatory strictures of the WTO service-sector agreement regarding non-financial services. These broad obligations pose possible conflicts with President Obama's health-care, affordable pharmaceutical and climate policies. The Clinton administration signed up health insurance, pharmaceutical distribution and hospitals to conform with the strict policy constraints established by the WTO's General Agreement on Trade in Services (GATS.) These rules simply ban certain commonly-used policy tools even if applied to foreign firms on a non-discriminatory basis.

Many of the specific proposals being discussed now in Congress and in legislatures in numerous countries to counter the current economic crisis and avoid future meltdowns violate the WTO's expansive constraints on *domestic* non-trade regulation. These are not 'protectionist' measures, but rather are reasonable non-trade policies needed to address the crisis and rebuild the U.S. and world economies to promote productive, not speculative investment.

For years, a brave few economists have reviewed the massive persistent U.S. trade deficits that have reached six percent of GDP, warned that such imbalances were not sustainable and called for an array of urgent policy actions before a foreseeably devastating "market correction" occurred. Over the past 15 years of WTO and NAFTA, as 4.3 million U.S. manufacturing jobs were lost – 1 in 4 of the entire sector – and U.S. real median wages sat at scarcely above 1973 levels, and income inequality rose to levels not seen since the Robber Baron era, a those same economists and a growing number of policymakers warned about the hollowing out of the U.S. economy and the need for new policies. As the United States became a net importer of food and saw its total agriculture trade surplus plummet and overall our major exports shifted to raw materials rather than value-added goods, a growing number have come to question the global economic system that could result in such outcomes.

Yet, even as the evidence of systemic failure has become overwhelming with the current crisis thoroughly indicting the so-called neoliberal model that wrought these outcomes, a version of global cognitive dissonance seems to have taken hold. That is to say that, while the cries for re-regulation are now issuing forth from many previously unimaginable quarters, many policymakers and scholars have not come to terms with the systemic nature of the needed changes. Thus, many very smart people are clinging to totally inconsistent views: for instance, we must dramatically re-regulate finance to save the world, but we must also finish the WTO Doha Round (which would impose further financial deregulation) to save the world because "free trade" is good.

In part this situation is based on the lack of attention to the systemic manner in which the United States created the current model of economic non-governance. Many people seem to have started to believe the public relations mantra pitched by the beneficiaries of the status quo that the current system is inevitable or some force of nature. In fact, it is an intentional construct. In the 1970s, policymakers dismantled the Bretton Woods system, which was created after the Great Depression to govern capital-flow and exchange-rate policy. Later, starting in the late 1980s, the deregulation drive involved the weakening and eventual repeal of the U.S. "New Deal" system of prudential and pro-consumer banking regulation. In an elegantly effective strategy, the same U.S. corporate interests, "free-market" think tanks and U.S. government officials behind this experiment exported this system of extreme financial service deregulation, constraints on an array of government regulatory policies and new rights and privileges for foreign investors and transnational firms through various international agencies and negotiations. They found a hospitable venue for this offensive in the obscure Uruguay Round negotiations of the General Agreement on Tariffs and Trade (GATT) which established the WTO.

The WTO, and regional pacts such as NAFTA, the Central America Free Trade Agreement (CAFTA) and various other FTAs based on the NAFTA-CAFTA model exploded the past boundaries of trade agreements. Rather than focusing on traditional matters such as tariff cuts and opening quotas, these pacts require signatory countries to adopt an array of non-trade policies. These include limiting service-sector regulation including financial services, providing new foreign investor rights and privileges that incentivize and protect the relocation of production to low-wage venues, constraining domestic import safety and the inspection standards that may be applied, and even limiting how domestic tax dollars may be spent in procurement. Rather than trade agreements, these pacts were a global governance system that dramatically shifted the balance of power away from government oversight of the economy for the public interest.

For instance, the WTO enforces 17 agreements, only several of which have anything to do with trade per se, including the 1947 GATT, which until 1995 was the multilateral trade system. The WTO requires that "[e]ach Member shall ensure the conformity of its laws, regulations and administrative procedures with its obligations as provided in the annexed Agreements."[1] Nations that fail to comply are subject to challenge in foreign tribunals, outside the jurisdiction and due process safeguards of domestic courts. These tribunals are empowered to authorize significant trade sanctions unless and until countries bring their laws into conformity with WTO constraints. The combination of over-reaching, retrograde global rules constraining normal government regulatory activity, and their strong enforcement, poses a very real threat. With nearly 150 WTO challenges to domestic law completed, the laws in question have been ruled against 90 percent of the time, and countries have repealed or altered their laws to comply. The only exception is the EU's refusal to remove its ban on beef treated with artificial growth hormones after being ordered to do so by the WTO. In order to maintain this policy, the EU has made an *annual* payment of the equivalent of $150 million in trade sanctions for the past decade. Given the record of WTO tribunals systematically ruling against domestic laws – many having nothing to do with trade – now the mere threat of a WTO challenge often suffices to derail a proposal before it is ever approved or implemented.

The conflict posed between global calls for re-regulation and the WTO's existing financial service deregulation rules – and the additional deregulation on the Doha Round negotiating table- provides a stark example. Deregulation of the financial service sector – including banking, insurance, asset-management, pension-fund, securities, financial-information, and financial advisory services – has been among the most important, but least discussed, aspects of the WTO's agenda. Few researchers and policymakers now engaged in the debate about the crisis and its remedies are even aware of the WTO's Financial Service Agreement.

How did such expansive non-trade policy constraints end up in a "trade" agreement? The answer is that giant financial service firms – including some now receiving tax-payer bailout funds spent most of the 1990s pushing for an FSA that explicitly limited financial service regulation worldwide. In effect, they locked in domestically and exported worldwide the extreme deregulation model that is a significant cause of the current crisis. This agreement was never even put to a vote in Congress. Rather, under the leadership of then-Treasury Secretary Robert Rubin, the executive branch simply signed the pact and put it into effect.

[1] WTO, Agreement Establishing the World Trade Organization, Article XVI-4.

In recent months, there has been an abundance of violations of the spirit, if not the letter, of the current globalization model and the agreements implementing it. Indeed, governments around the world have discussed – and in some cases, implemented – various measures to counter the crisis that contradict the fundamental precepts of the WTO and other trade pacts. A select few have noticed, as when a foreign bankers association insisted in late 2008 that the U.S. taxpayer funds committed to the "Troubled Assets Recovery Plan" be available for them. But these outcries have been the exception: in the throes of the crisis, with more horrifying economic data emerging daily, the WTO incompatibility of domestic emergency measures has been a muted concern.

This situation will not last. While the outcomes of this model and public and government responses to the resulting crisis have led to press reports declaring the end of the neoliberal era, in fact the very policies that contributed to the crisis remain in place through the WTO, as do 100-plus countries' obligations to comply with them. As more detailed proposals emerge, the financial service firms who helped write the WTO rules will increasingly raise the trade-pact constraints to fight re-regulation at the domestic and international levels.[2] Policymakers and advocates must be ready with a meaningful and factually informed response and proposals to reform the countervailing WTO rules and avoid *further* expand WTO financial service sector deregulation through the current Doha Round agenda.

The WTO Radical Financial Service Deregulation Regime

Few in Congress read the 1994 legislation that implemented the WTO, much less reviewed the actual 900-page trade-pact text or the thousands of additional pages of specific country commitments to comply with these new rules. Various WTO provisions set constraints on how signatory governments may regulate their service sectors. The WTO's General Agreement on Trade in Services, for instance, applies not only to trade in services *between* countries, but also sets limits on how governments may regulate foreign services operating *within* their countries, thus constraining domestic regulation of foreign service-sector firms.

The WTO Secretariat was unusually direct in describing the operation of the GATS: *"Governments are free in principle to pursue any national policy objectives provided the relevant measures are compatible with the GATS."*[3] The regulatory limits imposed by GATS rules cover not only all actions taken by all levels of government – "central, regional, or local governments or authorities" – but also actions of "non-governmental bodies in the exercise of powers delegated by" any level of government.[4] Thus GATS regulatory constraints cover private-sector bodies that have a role delegated or approved by government, such as professional associations or industry bodies whose professional qualifications or voluntary "code of conduct" rules are recognized by government.

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[2] Indeed, the WTO's FSA was the result of a massive push by U.S. and European corporations, who were eager to eliminate the consumer protection and economic stability regulations that constrained their most rapacious behavior. "The sector was truly unique in that respect, and there is little doubt within the trade policy community that financial sector support in the European Union and the United States was a determining force in concluding the FSA," noted scholars Pierre Sauvé and Karsten Steinfatt in "Financial Services and the WTO: What Next?" a study featured on the WTO's own website.

[3] WTO Secretariat, Trade in Services Div, "Everything You Wanted to Know about GATS but Where Afraid to Ask," October 1999, p. 5.

[4] WTO GATS Article I-3-a-i.

As part of its original 1995 WTO commitments, the United States agreed to conform a broad array of financial services, including banking, insurance and others, to comply with GATS' regulatory limits rules and those contained in special GATS annexes on financial services. Some of the U.S. WTO GATS commitments simply locked into place existing policies, given that U.S. financial corporations had already been successful in rolling back much U.S. domestic regulation. In other cases, the WTO was used to push for domestic revocation of existing laws, such as the "firewall" policies established in the 1933 Glass-Steagall Act that forbade bank holding companies from operating other financial services. (More on that below.)

Although the U.S. Congress gave the GATS little scrutiny, it was very controversial in other nations. Developing countries that had suffered financial turmoil – and seen the need to develop new government policies in response – already had experienced the perils posed by such constraints on policy space imposed by the International Monetary Fund and the World Bank. For this reason, while the United States originally sought for GATS rules to apply to all service sectors of all WTO signatory countries, in the end GATS was designed so that it applies only to those service sectors which countries specifically agreed to bind to the rules through country-specific "schedules of commitments."

The United States conditioned its Uruguay Round GATS commitments on other countries subjecting their financial service sectors to similar deregulation and liberalization. Many countries initially rejected the extreme banking and insurance deregulation agenda pushed by U.S. and European governments and corporations and the original WTO included only limited GATS commitments in financial services by most countries. The United States also obtained a commitment, explicitly included in the GATS text, for talks on further financial service liberalization to be automatically continued under the newly-established WTO.

The subsequent negotiations on financial services continued for three years after initial WTO talks ended, and culminated in 1997 with the announcement of an additional WTO Financial Service Agreement. This agreement went into effect in 1999 after 105 WTO countries had signed on. Thus, the WTO's limits on domestic financial service regulation are contained not only in the original GATS and its financial service annexes, but in the post-Uruguay Round FSA, its country-specific schedules of commitments, and in an Understanding on Commitments in Financial Services that the Organisation for Economic Co-operation and Development (OECD) countries additionally signed.

The WTO Financial Service Agreement is premised on simultaneous liberalization and deregulation. The agreement functions both to open new markets for foreign financial service firms to establish new operations or acquire existing domestic firms and to ensure that resulting operations will occur in a deregulated environment. The global financial service firms that pushed these WTO talks identified several specific impediments to their globalized operations as unacceptable. First, there were the requirements that foreign financial service firms' market entry be subject to governmental review (and in some instances, constraints). Second, there was the lack of conformity in (and indeed, even existence of) the laws and regulations of WTO signatory countries. They sought both elimination of regulatory constraints, and harmonization (i.e. standardization) of laws, regulations and administrative procedures governing banking, insurance, securities and accounting.

There is a common misunderstanding that the WTO only affects domestic policies that discriminate against foreign service-sector firms. In fact, the rules do much more than curb *discriminatory* laws, such as citizenship and residency requirements. The "market access" rules create certain *absolute* rights for foreign investors who acquire, invest in or establish service-sector operations within a country in sectors covered by that country's GATS commitments. These market-access requirements are extraordinary, as they simply ban certain types of policies – unless a country originally listed them as exceptions in their GATS schedules in the 1990s – even when they are applied equally to foreign and domestic services or suppliers. The following are forbidden:

- *"limits on the number of service suppliers, including through quotas, monopolies, economic needs tests or exclusive service supplier contracts;*
- *limits on the total value of service transactions or assets, including by quotas or economic needs tests;*
- *limits on the total number of service operations or the total quantity of a service;*
- *limits on the total number of natural persons that may be employed in a particular service sector;*
- *policies which restrict or require specific types of legal entity or joint venture through which a service supplier may provide a service."*[5]

There is nothing quite like the GATS market-access rules in any other international commercial treaty. These market-access rules are framed in absolute, rather than relative terms, pre-judging certain types of public policies and practices as WTO-illegal whether they are discriminatory or not.

One cannot overstate the limiting implications of the GATS market-access rules for vital domestic regulatory space. For example, these obligations limit the ability of countries to require "firewalls" between different aspects of financial service businesses, for instance by forbidding consumer banks to gamble with our savings by simultaneously operating investment banking or securities businesses. By making market-access commitments in various banking services, the Clinton administration created a conflict between U.S. WTO obligations and existing U.S. law – namely the Glass-Steagall Act of 1933, which forbid bank-holding companies from operating other financial services. The law had been created so that trouble in one sector would not contaminate the entire system and trigger the sort of financial collapse that occurred during the Great Depression. This firewall policy, which applied to both domestic and foreign banks, had the effect of preventing foreign banks that combined commercial and investment banking services from entering the U.S. market. The administration recognized this conflict and indeed made a formal commitment listed in the U.S. GATS schedule to support changes to Glass-Steagall.[6]

Further, under the GATS National Treatment rules, forms of regulation not outright banned by the market-access requirements must not inadvertently "modify the conditions of competition in favor of [domestic] services or service suppliers," even if they apply identically to foreign and domestic firms. Yet, aspects of the recent U.S. Wall Street bailout and similar programs in other countries may well eventually "change the conditions of competition," and may do so in ways that unintentionally favor domestic firms. Yet, devising the most effective policies – not worrying about how a future WTO tribunal might find their unforeseeable effects to disfavor a foreign bank or insurance firm – should be the goal of policymakers.

[5] WTO GATS Article XVI(2)(a-f).
[6] WTO, *United States of America Schedule of Specific Commitments Supplement 3*, Additional Commitments Paper II, WTO document GATS/SC/90/Suppl.3.

GATS contains a "carve-out" provision that supposedly ensures that the agreement will not undermine domestic laws or regulations – such as those designed to protect investors, depositors, and policyholders, or to ensure the safety and integrity of the financial system.[7] However, several significant loopholes largely eviscerate this ostensible guarantee. First, the putative carve-out contains a classic WTO circumvention clause that negates the ability of countries to actually safeguard a domestic policy that conflicts with WTO obligations. The clause starts by noting that countries shall not be prevented from establishing financial service regulatory policies for "prudential reasons," but then continues by stating: "Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement." That is to say that even if regulatory measures are taken for prudential reasons, they are subject to challenge if they *in effect* undermine the regulatory constraints otherwise established in the agreement.

Moreover, the definition of "prudential" is left undefined in the GATS. Thus the question of what constitutes a "prudential" regulation is subject to interpretation by WTO dispute resolution panels when a domestic law is challenged. Are consumer protections that outlaw unfair and deceptive marketing practices by securities dealers (or insurance companies) "prudential" measures? Are banking laws that cap interest rates or outlaw predatory lending practices "prudential" regulations? Arguably not. The lack of clarity means that an array of laws are subject to WTO threats, which often have a chilling effect on policy initiatives even in the absence of a formal challenge. The financial service industry has been lobbying in the context of ongoing GATS negotiations for a narrow interpretation that would limit "prudential" measures to regulations concerning solvency and financial disclosure.[8]

The United States and other rich countries also committed to *even greater* deregulation and liberalization by signing an additional WTO agreement, called the "Understanding on Commitments in Financial Services." When all was said and done, the United States and the OECD countries were largely bound to extremely broad WTO obligations to stay out of the regulation of "banking," "insurance," and "other financial services." The United States and OECD countries also agreed to a "standstill provision" which requires that "[a]ny conditions, limitations and qualifications to the commitments [made]… shall be limited to existing non-conforming measures." That is to say that these countries have agreed not to create new regulations (or reverse liberalization) for the list of financial services each signatory bound to comply with WTO rules. Translated out of GATSese, this means that, in the countries responsible for regulating many of the world's largest economies, legislators and regulators face specific limits on what they and scholars deem necessary: the creation of new financial service regulations.

The GATS' philosophy runs directly counter to the prevailing call for regulation. For instance, one provision calls for signatories to agree to eliminate domestic financial service regulatory policies that <u>meet</u> GATS rules, but that may still "*adversely affect the ability of financial service suppliers of*

[7] *Annex on Financial Services,* paragraph 2(a) states that "Member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owned by a financial service supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement."
[8] The Commission on the Future of Health Care in Canada, summary report on Globalization and Health, *Putting Health First: Canadian Health Care Reform, Trade Treaties and Foreign Policy* (prepared by the Canadian Centre for Policy Alternatives), October 2002. Available at http://www:healthcarecommission.ca

any other (WTO) Member to operate, compete, or enter" the market. Further, these countries agreed to ensure that foreign financial service suppliers are permitted "to offer in its territory any new financial service," a direct conflict with the various proposals to limit various risky investment instruments, such as certain types of derivatives.

In addition, GATS empowers the WTO to develop "disciplines" (rules) to ensure that domestic licensing, qualification and technical standards are "not more burdensome than necessary to ensure the quality of the service."[9] The financial services sector is affected because regulation of banks, insurance companies and capital markets depends heavily on technical standards such as capital adequacy and financial disclosure rules, and on qualification and licensing requirements for brokers, agents, and dealers. U.S. laws may eventually be subjected to "necessity tests" under GATS disciplines that would put the burden on the United States to ensure that our domestic standards are not unnecessarily trade-restrictive. Such GATS disciplines have already been drafted for the accountancy sector, which indeed mandate that licensing, qualification and technical standards governing accounting and auditing may not be "more trade restrictive than necessary."[10]

For instance, the Sarbanes-Oxley Act of 2002, which limits the type of consulting activities in which auditing firms can engage, could conceivably be challenged within the WTO as an unnecessary barrier to trade.[11] Indeed, various foreign financial service firms have hurled charges of WTO incompatibility at the law. Even without a formal legal challenge, GATS could have a chilling effect on U.S. efforts to regulate financial markets. For instance, foreign companies that list stock on U.S. exchanges have sought exemption from Sarbanes-Oxley on the grounds that the act discourages international trade in securities and violates international treaties.[12] Exemptions for foreign firms would give U.S. firms additional incentives to move offshore, and further undermine U.S. attempts to regulate its capital markets in the wake of the recent accounting and securities scandals.

GATS and the FSA provide powerful incentives for global harmonization of banking, insurance, securities and accounting standards. Harmonization is not as benign as the term implies. International standard-setting moves decision-making out of the hands of state and federal government and into international arenas that are less accessible, accountable, or responsive to the citizens of various nations who will live with the results. Rather than raising standards, international harmonization can precipitate a "rush to the bottom," resulting in lower oversight standards and weaker prudential and investor safeguards. **Rather than creating a minimum threshold that all countries must meet, the WTO deems its international standards to be a ceiling that countries may not exceed**. GATS also empowers private-sector international banking, insurance, securities,

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[9] *GATS*, Article VI:4(b).

[10] WTO, *Disciplines on Domestic Regulation in the Accountancy Sector*, 14 December 1998, WTO document PRESS/118. The accountancy disciplines will become effective at the conclusion of the current GATS round in 2005. The WTO adopted a standstill provision that prevents WTO members from enacting new legislation in the interim that is inconsistent with the disciplines (WTO Council for Trade in Services, *Decision on Disciplines Relating to the Accountancy Sector*, 14 December 1998).

[11] When the accountancy disciplines were being drafted, the issue of whether it is overly burdensome or restrictive to limit the activities or combinations of services performed by accounting firms was raised by the United States (WTO, Working Party of Professional Services, "*Elements to be Addressed in Developing Disciplines for Professional Services: Accountancy Sector*", 20 June 1997, WTO document S/WPPS/W/15).

[12] "Corporate Cleanup Stings Foreigners," *The Wall Street Journal*", Aug. 12, 2002. The *WSJ* reports that the President of the Japanese Institute of Certified Public Accountants, in a letter to his U.S. counterpart, argued that Sarbanes-Oxley "clearly violate international treaties."

and accounting standards to be the yardstick that WTO dispute-resolution panels will use to judge whether a nation's domestic standards are more trade restrictive than necessary.[13] Since it is difficult to defend domestic standards that exceed international standards, the GATS and FSA policy-harmonization requirements often serve as a downward ratchet.

Today, the push for further deregulation of financial services at the WTO continues, despite the calls emerging from all quarters for re-regulation of the sector. The WTO Doha Round negotiations – initiated in 2001 – included GATS talks that are aimed at further liberalizing financial services, among other service sectors. Indeed, further service-sector deregulation and liberalization are one of three central pillars of the Doha Round talks, even though the agriculture and industrial-tariff negotiations have attracted far more media attention.

The Bush administration and EU negotiators led a push to *expand* financial deregulation in the ongoing Doha Round. This is the agenda that remains on the table, although the specifics remain shrouded by the secrecy that permeates WTO processes. This opacity has resulted in widespread ignorance about the Doha Round's agenda of further financial sector deregulation. And, thus the communiqué issuing from the November Washington G-20 Summit convened to establish new financial sector regulation called for the speedy completion of the Doha Round. The G-20 communiqué also committed countries to "refrain from … implementing WTO inconsistent measures" for 12 months. Given the massive overreach of existing WTO rules into domestic financial regulatory matters, the proper response would have been a pledge to alter existing WTO terms to create the needed policy space to implement re-regulation, not to complete the Doha Round's further deregulation.

In the final analysis, the WTO agreements have more to do with governance than with trade. Effectively, the U.S. push for WTO coverage of financial services was a means to export the U.S. deregulatory model worldwide, harmonizing other countries' regulatory systems to the U.S. model. At the time of the WTO Financial Service Agreement negotiations, major EU financial service firms were pushing for similar deregulatory policies in Europe, making the pact a tool to simultaneously accomplish the domestic and global policy changes that the industry sought in order to facilitate worldwide operations unhindered by government regulatory constraints and even differences. Their success in establishing the FSA has facilitated concentration of control of the financial sector in the hands of relatively few players operating worldwide.

Over the past century, U.S. financial regulation has shifted from strict financial controls over banking and capital markets following the Great Depression to periods of deregulation in the 1980s and 1990s. The WTO GATS locks in the U.S. status quo at a time of unprecedented financial liberalization, and exports this model worldwide. Whether this extreme deregulatory model is beneficial to most people – or sustainable – is no longer a contested question. Yet, absent changes to these international commercial agreements, governments worldwide could face daunting difficulties if they seek to reverse the trend toward financial service deregulation.

[13] *GATS*, Article VI:5(b).

Mr. SHERMAN. Thank you. Now we will move on to Philip Levy.

STATEMENT OF PHILIP I. LEVY, PH.D., RESIDENT SCHOLAR, AMERICAN ENTERPRISE INSTITUTE (FORMER SENIOR ECONOMIST FOR TRADE ON THE PRESIDENT'S COUNCIL OF ECONOMIC ADVISORS)

Mr. LEVY. Chairman Sherman, and members of the subcommittee, thank you very much for the opportunity to testify today on the international economic policy challenges facing the United States in this time of global crisis.

You are to be applauded for holding this hearing, and recognizing that in this time of domestic distress our foreign economic policies will have important and long lasting ramifications.

Mr. Chairman, with your permission, I would like to offer just a brief summary of some of the key elements in my testimony, particularly with a focus on international trade, and submit the extended version of the testimony for the record.

I also hope to say a word about some of the important points that you have raised on the trade deficit. The first point that I would like to make is that the trading system is less sturdy than it appears, and it is heavily dependent on United States leadership. It may not survive a sledge hammer.

The propensity to turn inwards at the time of economic crisis is not new. One of the perpetual challenges for trade liberalization is that the benefits tend to be diffuse, lower prices for consumers, market access for exporters; while the costs of import competition tend to be concentrated.

These costs are felt even more acutely in times of economic distress. As you have already mentioned, the misguided attempts to protect domestic producers by raising trade barriers in the 1930s were a major problem, and then served as the motivation for the creation of the post-war trading system.

Despite the creation of the World Trade Organization in the last completed trade round, the global trading system is more feeble than it appears. The WTO has no real enforcement power.

Contrary to some of the testimony today, the WTO does not force anyone to do anything. It cannot. Instead, dispute settlement panels determine whether a member country has reneged on a commitment.

The trading system largely relies upon the willingness of its major members to honor the letter and spirit of agreements. If they do not, there is little to hold the system together.

The United States plays a special role at the WTO. It has pushed for liberalization and it has led by example. Even if the United States continues its vigorous support of liberalization of the WTO, the system faces tremendous challenges.

Without such support, progress is hard to imagine, and the prospect of decay is very real. Even before the recent economic shocks hit, the WTO was suffering a crisis of its own. It repeatedly failed to conclude the last round of talks began in 2001 in Doha.

Which leads me to my next point, which is that litigation without negotiation will do great harm to the global trading system.

A failure of the trade talks threatens to drive members to enforcement actions in lieu of bargaining just at the moment when the willingness to honor past agreements may be at a low ebb.

To the extent the United States forsakes constructive engagement of the WTO in favor of enforcement action, it will be adding strains that the system is ill-equipped to bear.

The leading governments of the world seem to have recognized the twin perils of faltering negotiations and protectionist temptation. At the G–20 meeting in Washington in November, leaders warned against protectionism and called for progress in the trade talks. That progress never came.

My third point: The United States' move toward protectionism, even if they honor existing obligation, can have a devastating impact. You chided critics for being silent on Buy American and so I will follow your lead.

It was against this backdrop that the Buy American provision of the recent American Recovery and Reinvestment Act was so ill-received. I understand that there are any number of arguments that have been made in defense of this provision.

It addresses spending, not trade barriers. There are similar provisions in United States law. It was amended so as to honor United States obligations under international agreements.

Yet the signal that it sent to the world was that the United States was turning toward protectionism. Even in the early days of a much heralded new administration, this provision drew strong complaints from major trading allies, such as Europe and Canada as you mentioned, but also Japan and Australia.

The intent of the provision to divert demand away from foreign producers and protect domestic producers from competition was an old and familiar one. The sentiment is by no means unique to the United States as you note, but by succumbing to it, we seem to be abdicating our long-held position of global leadership in international trade.

If I may also then take a moment. I would applaud your remarks about the trade deficit, and your focus on the trade deficit, the multilateral trade deficit, and in particular I would note the very interesting developments that we have had in recent months, where we have seen major movements in trade balances and current account balances around the world.

Those movements are very, very difficult to explain if we have the hypothesis that it is trade policy that is the primary driver of trade balances. They make much more sense under the widely accepted economic approaches which link trade balances to macroeconomic factors, such as nations' spending and investment.

In that light, I would say that your suggestion that you mentioned about after the crisis turning toward fiscal responsibility and national savings is exactly on point, and I would applaud you for it.

I think that this is the appropriate means to address current account deficits, which as you rightly note are unsustainable.

And as my last point, please let me state that there is no conflict between playing a global leadership role on trade, and helping average Americans. Public concerns about growing inequality are perfectly legitimate.

Economic studies have shown though that the primary drivers of inequality and wage stagnation are different returns to education and the changes brought by new technology.

We do the country a disservice if we ignore the economic evidence and falsely attribute all of these ills to international trade. If the United States leads the way toward open markets and goods and services through its words and its actions, it will help restore confidence in the global economy, and it will help create future prosperity at home. Thank you again for the opportunity to speak. I look forward to answering questions.

[The prepared statement of Mr. Levy follows:]

U.S. Foreign Economic Policy in the Global Crisis

Testimony of
Dr. Philip I. Levy
Resident Scholar
American Enterprise Institute
Washington, DC

Before the
Subcommittee on Terrorism, Nonproliferation and Trade

of the
House Committee on Foreign Affairs

12 March 2009

Chairman Sherman, Ranking Member Royce, and members of the subcommittee, thank you for the opportunity to testify today on the international economic policy challenges facing the United States in this time of global crisis. You are to be applauded for holding this hearing and recognizing that, in this time of domestic distress, our foreign economic policies will have important and long-lasting ramifications.

The crisis began with a drop in housing prices, continued with a crisis in financial markets, and has led to a sharp worldwide downturn in production and trade. We have seen calls for a global response to this global challenge, but there has been strikingly little coordinated action to date.

I hope to describe some of the ways in which the crisis affects our foreign economic policy both directly and indirectly. As significant as the difficulties have been to date, I would also suggest that we must be prepared for additional strains in the near future.

I will place particular emphasis on the importance of maintaining the United States' leadership role in pursuing open markets. If we deviate from this, we risk launching a wave of protectionism around the world. There are difficult choices to be made, but I will argue that the policies that will serve us best on the international stage are also those that we should pursue for domestic prosperity.

1. Direct Effects of the Economic Crisis

The global crisis has significantly weakened both the traditional allies of the United States and those nations with whom we have often disagreed. As just one measure of the impact, the World Bank reported this week that global industrial production declined by 20 percent in the fourth quarter of 2008.[1] Even in relatively prosperous nations, this sort of shock can shake public confidence in governments and economic approaches. In less prosperous nations, it can bring poverty, despair, and can threaten the stability of the country. The crisis thus threatens long-standing goals of U.S. foreign economic policy such as global development and poverty alleviation. At the same time, as allied nations have seen much of their wealth dissipate, they have fewer resources available to attack these global problems of common concern.

The financial nature of this crisis has also had a particularly debilitating effect on Europe, since it has highlighted some of the weaknesses of European monetary integration, a policy that is at the heart of European cooperation. Critics such as Martin Feldstein have long questioned the advisability of a single currency for Europe.[2] Much of this skepticism was based on the argument that economic shocks would affect different countries differently and result in disagreements over how to react. That has happened. We've also discovered new weaknesses in the structure. Whereas there is a European Central Bank to set monetary policy, there is no body that plays a similar broad role in regulating financial institutions or providing fiscal assistance. This lack has led to serious concerns when one nation charged ahead of others in offering support for faltering banks, for example. While European leaders have been at the forefront of calls for a globally

[1] World Bank, "Swimming Against the Tide: How Developing Countries are Coping with the Global Crisis," March, 2009.

[2] For a recent statement, see Martin Feldstein, "Reflections on Americans' views of the euro ex ante," VoxEU, 26 January 2009 at http://www.voxeu.org/index.php?q=node/2867.

coordinated response, Europe has had ample difficulties internally and the perilous finances of some member states promise more difficulties to come.

It might seem to be a silver lining to the cloud of crisis that our adversaries are being weakened as well. However, desperate and impoverished governments can take drastic and unsavory actions to salvage their domestic standing and raise resources. Some nations that flourished under booming commodity prices may be tempted to turn to trade in arms or narcotics when the price of oil falls to roughly one third of its recent highs.[3]

2. Challenges to U.S. International Economic Leadership

Some of the most serious policy effects of the crisis are indirect. They stem from official and private reactions to the economic shock. In the areas of international trade and open markets, developments spurred by the crisis have threatened the leadership role that the United States has played since the Second World War.

The propensity to turn inwards in a time of economic crisis is not new.[4] One of the perpetual challenges for trade liberalization is that the benefits tend to be diffuse – lower prices for consumers, market access for exporters – while the costs of import competition tend to be concentrated. These costs are felt more acutely in times of economic distress. The misguided attempts to protect domestic producers by raising trade barriers in the 1930s were a major motivation for the post-war trading system. Under a succession of negotiating rounds that culminated in the present-day World Trade Organization, that system has offered a rules-based trading environment conducive to growth and increasing prosperity.[5]

Despite the creation of the WTO in the last completed trade round, the global trading system is more feeble than it appears.[6] The WTO sits astride a set of agreements between member countries, but it has no enforcement power. Instead, dispute settlement panels determine when a member country has reneged on a commitment. The complaining party is then authorized to retaliate if the violation is not set right.

These seemingly arcane details of WTO operation mean that the trading system largely relies upon the willingness of its major members to honor the letter and spirit of agreements. If they do not, there is little to hold the system together.

Even before the recent economic shocks hit, the WTO was suffering a crisis of its own. It repeatedly failed to conclude the latest round of talks, begun in 2001 in Doha, Qatar. Those talks demonstrated the difficulties the WTO faces as its membership surpassed 150 countries at all different stages of development. In the postwar era, there has not been a failed round of global trade talks. Such a failure threatens to drive members to litigation in lieu of negotiation at just the moment when the willingness to

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[3] Some of these questions were addressed at an American Enterprise Institute event on "The Future of Hugo Chavez's Petro-Diplomacy" on February 11, 2009. A record of that event can be found at http://www.aei.org/events/filter.all,eventID.1882/event_detail.asp.
[4] See, for example, Jagdish Bhagwati, Protectionism, MIT, 1989.
[5] For a quantification of this, see Scott C. Bradford, Paul L.E. Grieco, and Gary Clyde Hufbauer, "The Payoff to America from Global Integration," Ch. 2 in Fred Bergsten, ed., The United States and the World Economy, Institute for International Economics, 2005.
[6] This argument is developed in Philip I. Levy, "Does Trade Policy Matter?" *International Economic Outlook*, No. 1, American Enterprise Institute, October 2008.

honor agreements may be at low ebb. To the extent the United States forsakes constructive engagement at the WTO in favor of enforcement actions, it will be adding strains that the system is ill-equipped to bear.

The United States plays a special role at the WTO. It has pushed for liberalization and led by example. U.S. trade negotiating authority has set the timetable for the rounds that have structured the trading system's progress. Even if the United States continues its vigorous support of liberalization at the WTO, the system faces tremendous challenges. Without such support, progress is hard to imagine and the prospect of decay is very real.

The leading governments of the world seem to have recognized this peril. At the G20 meeting in Washington in November 2008 and again at the APEC meeting in Peru that December, leaders warned against protectionism and called for progress in trade talks. That progress never came.

It was against this backdrop that the Buy American provision of the American Recovery and Reinvestment Act of 2009 was so ill-received.[7] There are any number of arguments that have been made in defense of this provision: it addresses spending, not trade barriers; there are similar provisions existing in U.S. law; it was amended so as to honor U.S. obligations under international agreements. Yet the signal it sent to the world was that the United States was turning toward protectionism. Even in the early days of a much-heralded new Administration, this provision drew strong complaints from major trading allies such as Europe, Canada, Japan, and Australia.The intent of the provision – to divert demand away from foreign producers and protect domestic producers from competition – was an old and familiar one. The sentiment is by no means unique to the United States, but by succumbing to it, we seemed to be abdicating our long-held position of global leadership in international trade.[8]

This occurred as the crisis called into question the U.S. model of openness. Countries such as Russia and China that have taken distinctly less open approaches in both economics and governance have cited the crisis as evidence of U.S. failure. There is an eagerness to deride a system that relies more on economic liberty and individual initiative.[9]

Such analysis is premature. The United States had a housing bubble. So did others. There was financial malfeasance and some major institutions made some very unwise bets. The financial crisis hit countries with differing levels of regulation and with differing financial structures. None of this should diminish the fact that the United States' open market approach has been an engine of growth, innovation, and employment for many decades. [10]

[7] P.L. 111-5, Section 1605.

[8] This impression was not due to 'Buy American' alone; the expiration of U.S. trade negotiating authority and the failure to pass trade agreements with Panama, Colombia, and South Korea in 2008 contributed as well.

[9] See Marc Champion and Andrew Batson, "Russia, China Blame Woes on Capitalism," *Wall Street Journal*, January 29, 2009, p. A6.

[10] Globally there is a long history linking openness with growth as well. See Jeffrey D. Sachs and Andrew Warner, "Economic Reform and the Process of Global Integration," *Brookings Papers on Economic Activity*, 1995:1, pp. 1-95.

At the risk of oversimplification, let me suggest an analogy: The United States economy is like a great prizefighter. At a critical moment, it dropped its guard, took a heavy blow, and lost a big fight. Nursing our wounds, we might draw a lesson: "keep your guard up!" Instead, it is as if we are asking whether it makes sense to eat well or pursue a training regimen any more, given that those practices also preceded the loss.

However misguided the analysis, the facile conclusion that U.S. market-oriented policies are to blame for the crisis has served to undermine U.S. global economic leadership. Going forward, if sound policies are rejected along with genuinely flawed approaches, there could be a large future cost to pay for both the United States and our allies in terms of foregone prosperity.

3. Global Economic Strains Still to Come

Countries have only begun to adopt policies in response to the global crisis. These policies are likely to stoke new global tensions in a number of diverse areas. U.S. foreign economic policy will need to contend with this changed landscape.

Borrowing

One of the most striking results of the crisis has been a reshuffling of international capital flows. For a number of years, the United States has been a major borrower on international capital markets while countries in the Middle East, Japan, and China were significant net providers of funds. With plunging oil prices and Japan's economic difficulties, China has been left as the major net creditor. Meanwhile, the dollar rose and Treasury yields dove as investors rushed to the perceived safety of U.S. government debt.

For the time being, this has meant that the United States can contemplate borrowing trillions of dollars without too much concern about its ability to raise the funds. Even so, interest rates on 10-year U.S. debt have risen significantly off their lows and the credit default swap market has begun to show a realistic chance of a future U.S. default.

In the present, there are three things to note about this rapid accumulation of debt. First, it works because the private sector is dormant. When the private sector revives, there will be more competition for funds. Second, it already has the effect of crowding out developing nations, who are eager but unable to borrow. Third, it will require some serious rethinking of our demands on China. The argument that China manipulates its currency has been a mainstay of economic policy criticism for years. China prevents its currency from appreciating in large part by buying foreign debt instruments. If we care about consistency, we cannot simultaneously criticize China for distorting its currency and encourage the Chinese to buy Treasury debt, as Secretary Clinton did on her recent visit to Beijing.

In the longer run, excessive accumulation of debt in the United States raises serious risks. The most worrisome scenario is that other nations would lose faith in the United States' ability to pay off its debt and would sell Treasury debt. This would threaten the value of the dollar, raise interest rates, stifle growth, and raise debt servicing costs. It also poses the risk of large capital losses for countries with large U.S. debt holdings. One impolitic Chinese financial official was recently quoted as saying of the United States:

"We hate you guys... Once you start issuing $1-$2 trillion (in debt) ... we know the dollar is going to depreciate, so we hate you guys, but there is nothing much we can do."[11]

Subsidies

The world trading system has had a difficult time dealing with the effects of subsidies. While explicit export subsidies have been banned, it has been much harder to reach consensus on support that affects trade indirectly. This has led to some very high-profile conflicts in the past, such as the dispute between the United States and the European Union over assistance to large passenger aircraft makers Boeing and Airbus. It also has been a staple of U.S. complaints about China, as U.S. producers have argued that Chinese government policies have unfairly distorted prices.

The current economic crisis response has brought significantly expanded government involvement in new sectors of the economy. Perhaps the most prominent example in the United States was the Bush Administration's decision to provide financial support for General Motors and Chrysler.[12] These companies have global operations and have often performed better in foreign markets than they have domestically. We should not be surprised when foreign governments begin to argue that they are facing unfair competition from government-subsidized American firms.

This problem will not be confined to the auto sector. The U.S. government's involvement in financially supporting alternative energy development has already drawn a trade response. On March 3 the European Council of Ministers approved tariffs on U.S. biodiesel in response to U.S. subsidies.[13] With expanded support for alternative energy, such disputes are likely to proliferate in coming years.

Beyond sectoral support, there will be issues concerning government support of the financial sector. This support has both direct and indirect effects on trade. There is vigorous global competition in financial services. In a time of uncertainty over the viability of financial institutions, government backing can serve as a major advantage in attracting business. This is certain to draw complaints from competitors. Further, an oft-stated goal of financial sector support in the United States is to stimulate new lending. While this is an entirely understandable goal in times of economic crisis, it will raise questions of whether loan recipients who engage in international trade are benefiting from subsidized credit.

Regulation

There is also likely to be conflict over the extent and nature of regulation. In fact, this conflict seems to be on the agenda for the upcoming meeting of the Group of 20 nations in London next month. Some global leaders, particularly in Europe, have long favored expanded regulation of entities such as hedge funds. The crisis has provided an

[11] Henny Sender, "China to Stick with U.S. bonds," *Financial Times*, February 11, 2009.
[12] See Philip I. Levy and Michael O. Moore, "Driving Toward a Trade War," *American.com*, February 19, 2009.
[13] "EU Clears Way for Antidumping, Antisubsidy Duties on U.S. Biodiesel," *Inside U.S. Trade*, March 3, 2009.

opportunity to push this remedy, even in the absence of evidence that these lightly-regulated entities played a role in causing the crisis.[14]

This would seem to be a particularly unpromising area for cooperation. There are important differences among the G20 nations in the configurations of their financial sectors. A solution that works well for a bank-dependent economy may not work for an economy that relies heavily on non-bank financial institutions, such as the United States. There seems to be neither an economic nor a political consensus on the appropriate degree of financial regulation. With too little financial regulation, institutions can run amok. With too much, we can stifle the driving force of economic progress.

Even seemingly innocuous policy planks like a call for increased transparency can be fraught with difficulties. The very announcement that a major financial institution is in a perilous state can precipitate a crisis. This is likely one reason that the Obama Administration is not conducting its bank "stress tests" in the public eye.

4. Policy Options

It is not clear that the G20 is the appropriate forum for reconfiguring the global financial system nor that the time is right for doing so. The crisis today looks quite different than it did six months ago. It may look different six months hence. Before undertaking far-reaching measures, we should begin with a clear diagnosis of the current system's failings. It may not be possible to do that until the crisis has further played itself out.

There is an important need for global coordination, but it is not clear that this need is best met through large-group summitry. The challenges are sufficiently great and the subject matter sufficiently intricate that this requires substantial quiet economic diplomacy. This makes it all the more important that the Administration quickly work to fill the positions in the subcabinet. As to the country grouping, while it is important to maintain an ongoing dialogue with China about economic concerns, it will also prove much easier to work through these issues among a smaller group of like-minded major economies.

The critical U.S. policy measure that surpasses all others in importance is a decisive approach to resolving the difficulties of our financial institutions. Without such a resolution, it is exceedingly unlikely that any package of fiscal stimuli, regulatory measures, or long-run investments will do much good. With such a resolution, we will be able to rely once again upon the most proven stabilization tool in our economic arsenal – monetary policy. There are a number of approaches that could be taken to fixing the financial sector and there are obvious political pitfalls to many of them. As you work your way through these thickets, I would emphasize one distinction that has often been neglected in these discussions. It is *not* essential that existing investors and management on Wall Street be bailed out. It *is* essential that we have a well-functioning financial system. It is possible to have one without the other.

Given the dangers described above, it is also imperative that we pursue fiscally responsible policies as we move beyond the crisis. This is not to argue for budget cuts in the midst of a sharp recession. Rather, we must convince both a domestic and an

[14] For a skeptical view of the role of deregulation in the crisis, see Peter J. Wallison, "The True Origins of this Financial Crisis," *American Spectator*, February 2009.

international audience that the United States will be able to pay its bills as we move beyond the crisis.

Compared to these other policies, the recommendation that the United States continues to push for open markets appears relatively easy. Public concerns about growing inequality are legitimate. Economic studies have shown that the primary drivers of inequality and wage stagnation are differing returns to education and the changes wrought by new technology.[15] We do the country a disservice if we ignore the economic evidence and falsely attribute all of these ills to international trade.

If the United States leads the way toward open markets in goods and services, through its words and its actions, it will help restore confidence in the global economy and it will help create future prosperity at home.

[15] See Robert Z. Lawrence, Blue-Collar Blues: Is Trade to Blame for Rising U.S. Income Inequality?, Peterson Institute, January 2008; and Claudia Goldin and Lawrence F. Katz, The Race Between Education and Technology, Harvard, 2008.

Mr. SHERMAN. Thank you, Mr. Levy. In order to lead by example, when you have a $700-billion trade deficit, it is hard to know how many would follow you, except the country of Lenin, and with the exception of that one country, I don't know of any others that want to follow our trade results. With that, let us go to C. Fred Bergsten.

STATEMENT OF C. FRED BERGSTEN, PH.D., DIRECTOR, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS (FORMER ASSISTANT SECRETARY FOR INTERNATIONAL AFFAIRS OF THE U.S. TREASURY)

Mr. BERGSTEN. Let me start by congratulating you, Mr. Chairman. You are absolutely correct that at the start the administration obviously did lay out its foreign economic policy to preempt your hearing today, and/or to give us something to talk about, and I appreciate the opportunity to do that.

I want to make one conceptual point, which is essential to this debate, and then talk about three operational issues surrounding the upcoming G–20 summit in London in early April.

The conceptual point is to argue that this is a global economic crisis. Virtually every country is being affected by it, some to a greater or lesser degree, but everybody has been hit.

That being the case, we have to conceptualize our response as a global economic strategy. So when we talk about getting others to join the fiscal stimulus program, or avoiding restrictions on trade, or adding trade finance, or helping finance developing countries through the IMF, that is all part of the global macroeconomic strategy.

Only if we think of it in that context will we come to correct answers in terms of individual policy responses. It is not just the United States operating within its own national boundaries. We have to see ourselves as part of a global strategy. I want to stress that at the outset, because it is very important for all the specifics we talk about.

Let me talk about three specifics. First, on fiscal stimulus. There has been a consensus—it has not been agreed to by the countries but has been pushed by the IMF and others—that all the major countries should undertake fiscal stimulus programs equal to about 2 percent of their GDP for each of the next 2 years.

Again, Mr. Chairman, I am with you. That is not enough. That goal was set several months ago, and as my colleague Dr. Johnson laid out, the global outlook is much worse than we thought at that time.

If a 2-percent stimulus was right 3 to 6 months ago, we clearly need more now. My proposal is that the G–20 countries at London in 2 weeks commit to adopting a fiscal stimulus program equal to about 3 percent of each of their GDPs for each of the next 2 years.

There obviously has to be national variance on that theme. Some maybe can't afford it because of their budget situations, but on the whole that should be the strategy. It would require additional stimulus measures even here in the United States and in China, which have so far taken the lead.

It would require lots more in Europe and some of the other key emerging markets, but I think without that, we are not going to get anything like the need of recovery, and we may be in Dr. Johnson's L-shaped problem for a long time.

Second, on trade policy, and the discussion of Buy American and others that you have led, and I won't get into its detail, but I want to make one broad point. I think there is an important distinction between countries legal obligations and proper policy in the face of a global recession or worse.

Lori Wallach, you, and others are correct. There is lots of scope for government procurement preferences within the current rules, but I think to increase our use of those buy national provisions is a policy mistake because it can lead to emulation and retaliation by other countries.

I think the last thing we want to do within my concept of a global recovery strategy is to encourage others to raise barriers to trade, even though lots of other countries can also do it within their legal rights within the WTO.

All of the big emerging markets can double their tariffs from where they are now within the WTO rules, and we don't want to encourage that. It would dampen our exports and hurt our recovery strategy.

On the trade deficit, I am also with you, but I want to make an important point just to make sure that you and your colleagues are aware of it. The United States trade deficit this year will be less than half what it was at its peak in 2006.

A lot of that is the reduction in the world oil price, cutting our oil import costs, but a lot of it is the strong improvement in the United States competitive position. The exchange rate of the dollar came down 25 percent over the last 6 years.

Our exports grew over the year 2008 as Mr. Royce said. It was the main driver of our economic growth, and you are absolutely right. We don't want to let that deficit go back up, but keep in mind that it is now a lot lower than it was even 2 or 3 years ago. We certainly want to keep it there, but it is not the big boogie that it was in the recent past. In order to help keep it there, we do want to expand our export finance capability. We want to expand and straighten the programs of the Export-Import Bank in order to support in any way we can our export opportunity.

Finally, on the IMF. I am delighted that Secretary Geithner adopted my proposal in my testimony to you of seeking expansion of $500 billion for IMF programs.

I think they need to do that in his way through the new arrangements to borrow. They also need to create special drawing rights and they also need to increase their quotas. The point that I want to flag for you is, and you are probably aware of it, that you will face legislation on that this year.

The Treasury has now indicated that it will be submitting legislation to the Congress to authorize increased United States participation in these various IMF programs.

One is obviously going to have to look at the details. You will have to study that carefully. But I think the broad strategic point is that these IMF programs help deal with one-half of the world economy, which is now emerging and developing countries, and have to be viewed as part of the global recovery strategy.

It is critically important for our own economy. It is critically important for this global recovery approach. The international institutions surely are not perfect. I have criticized them lots myself, but they do play an absolutely vital role, and I will hope when you get to that hearing we can talk about that in more detail.

[The prepared statement of Mr. Bergsten follows:]

NEEDED: A GLOBAL RESPONSE TO THE GLOBAL ECONOMIC AND FINANCIAL CRISIS

C. Fred Bergsten[1]
Director, Peterson Institute for International Economics

before the
Subcommittee on Terrorism, Nonproliferation & Trade
Committee on Foreign Affairs
US House of Representatives

March 12, 2009

The financial and economic crisis is a global phenomenon. No country has been spared. The downturn has been, and continues to be, rapidly transmitted across borders through both trade and financial channels[2].

A global policy response is therefore imperative. Unfortunately, the reactions to date have been limited to individual national efforts. Some countries, like China and the United States, have adopted sizable fiscal and monetary stimulus programs that will be extremely helpful. Others, including most of Europe and some of the emerging market economies, have done relatively little. My colleague Simon Johnson has analyzed the causes of the crisis and presented a pessimistic forecast of the outlook in the absence of major new policy measures, and I will suggest what those measures should be.

The upcoming G-20 summit in London on April 2 offers the best (and perhaps last) opportunity to launch the needed global policy package. The G-20 countries account for about 80

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[1] C. Fred Bergsten has been Director of the Peterson Institute for International Economics since its creation in 1981. He was formerly Assistant Secretary of the Treasury for International Affairs (1977-81) and Assistant for International Economic Affairs to the National Security Council (1969-71). His 40 books include *China's Rise: Challenges and Opportunities* (2008), *China: The Balance Sheet - What the World Needs to Know Now about the Emerging Superpower* (2006), *Dollar Adjustment: How Far? Against What?* (2004), *Dollar Overvaluation and the World Economy* (2003) and *The Dilemmas of the Dollar: The Economics and Politics of United States International Monetary Policy* (2nd edition, 1996).

[2] Table 1 (attached) indicates the different degrees of exposure to the crisis among the G-20 countries.

percent of the world economy and could thus have a decisive impact. The summit will be the first multilateral meeting for President Obama, appropriately so in light of the gravity of the economic situation and the priority that he has rightly accorded these issues in the early days of his Administration.

The G-20 should adopt a four-part policy package to arrest the continuing decline of world output and promote recovery over the course of 2009 and into 2010:

- major fiscal stimulus by virtually all member countries;
- a comprehensive political commitment to avoid all new protectionist trade distortions;
- mobilization of large amounts of capital to support beleaguered developing countries, mainly through the International Monetary Fund; and
- initial steps toward reform of financial regulation to reduce the risk of future crises.

Fiscal Stimulus

With private financial markets still largely frozen and consumer confidence at record lows, ambitious new government stimulus will be the only way to restore adequate growth of demand in the world economy for the foreseeable future. Much of this stimulus must be provided by central banks, along with the essential supports for the financial systems themselves, through both injections of massive amounts of liquidity and easing of monetary policies. Fortunately, most central banks have now moved decisively in this direction. In any event, most of the G-20 central banks are independent of their governments; they are thus not participating in the London summit nor would it be propitious for the governments to address the monetary issues overtly and publicly.

This requires governments to use fiscal initiatives to make their needed contribution to recovery. To date, the G-20 countries have adopted stimulus programs amounting to 1.4 – 1.7 percent of their aggregate GDP (see attached table 2). No more than half a dozen of them have adopted expansions equaling two percent of their economies, which has been the notional international target advanced by the IMF and others to this point. The IMF estimates that the real economic impact of the measures to date will be under one percent of global output in 2009 and only a few tenths of one percent in 2010.

In light of the rapid deterioration of the growth outlook, <u>the G-20 in London should adopt more ambitious fiscal stimulus targets of three percent of their economies for each of the next two years</u>. This would inject total new demand of perhaps $1 - 1.5 trillion into the world economy in both 2009 and 2010[3]. Countries that can and should do more clearly include Brazil, Canada, France, Germany, Korea and Mexico[4].

There are at least four reasons why the fiscal stimulus program should be coordinated globally. First, it will probably be much too small unless all major countries contribute to it. Second, it would then be unbalanced geographically and lead to a renewal (or even further increase) in the global imbalances (US deficit, Chinese and Japanese surpluses) that helped bring on the crisis in the first place. Third, "free riding" by non-participants will be widely perceived elsewhere as unfair and add to the risk of protectionist trade reactions (see below). Fourth, and perhaps most important, widespread participation will reduce the risk that any individual country will be penalized by the markets for adding temporarily to its fiscal deficit.

[3] Global output now totals about $60 trillion, of which about $50 trillion is accounted for by the G-20. Additional government stimulus of three percent would thus amount to about $1.5 trillion per year and, with a multiplier effect of something less than 1:1, probably increase world demand by somewhere between $1 – 1.5 trillion.
[4] Truman, Edwin M. February 24, 2009. "Assessing Global Fiscal Stimulus: Is the World Being Short-Changed?" on Peterson Institute for International Economics' Real Time Economic Issues Watch, online. Available at: http://www.petersoninstitute.org/realtime/?p=497

Each country would decide how to shape the details of its fiscal package[5]. "Credit" would be given for programs that were already launched in response to the crisis, such as the recent $787 billion legislation in the United States and the $586 billion effort in China. A couple of the financially more precarious G-20 countries, such as Turkey and perhaps Italy, might be excused from the commitment because of the fragility of their budget positions and shaky credit ratings.

The key conceptual issue is to view each of the national stimulus programs as part of a comprehensive global strategy. In light of the intimate trade and financial linkages among virtually all countries that have now been so clearly revealed, including all G-20 countries, it is essential to spur global demand if any individual nation is to experience an early turn-around. One of the key lessons from the Great Depression is that worldwide expansion policies were a key factor in generating recovery and growth across a wide range of countries in the 1930s[6].

Avoiding Protectionism

It is also imperative that the G-20 countries adopt a firm political commitment to avoid adoption of any additional measures that would distort international trade and financial flows. Their pledge to do so at their previous summit on November 15 has already been violated by at least seventeen members of the group (excepting only Japan, Mexico and Saudi Arabia). This has already led to emulation[7] and retaliation by trading partners. The obvious risk is that world

[5] There have been proposals for international coordination of at least some components of the stimulus packages, such as those aimed at environmental objectives and especially at global warming. There would be no harm in such efforts but they could divert attention from the overriding objective of responding to the economic crisis so should not be emphasized.
[6] Romer, Christina D. March 9, 2009. "Lessons from the Great Depression for Economic Recovery in 2009." Speech at the Brookings Institution, Washington D.C.
[7] Two noteworthy examples are actual or potential emulation of the US bailout of its auto companies by at least half a dozen other countries and Australia's reaction to the EU reintroduction of export subsidies for its dairy industry.

trade, which is declining for the first time in over 25 years, will fall sharply and produce a downward spiral of global growth as it did in the 1930s.

It will not be good enough for the G-20 to reiterate their fealty to their international legal commitments. The rules of the WTO are exceedingly porous and "legal protectionism" is just as dangerous as any other kind. Moreover, there are no rules to effectively cover international investment. The London pledges must be comprehensive.

They also need to cover all types of trade distortions: increased import barriers, higher export subsidies, domestic subsides (e.g., for automobile industries) that discriminate against foreigners, strictures on international lending (e.g., complaints that financial institutions receiving government support have made new loans to foreigners) and other measures that have similar effects. The November 15 pledge should also be extended at least through 2010 (as opposed to "the next 12 months" in the initial G-20 statement). In addition, it should invite non-G-20 countries to "take the pledge."

To promote effective implementation of the new commitment, the G-20 countries (and any other signatories) should agree to notify the World Trade Organization of any steps they take – or that they observe others taking – that might raise questions concerning consistency with the new commitment. On the basis of that information and all other sources available to him, the Director General should publish monthly reports on all violations (by G-20 and other governments, whether or not they have adopted the pledge). The objective is to "name and shame" any deviations from the agreed program in an effort to both deter such behavior and to sanction it in the court of public opinion[8].

[8] This invocation of peer pressure has already worked on at least two occasions: the Congressional modification of the Buy American provision in the stimulus package after the initial House version triggered an international uproar, which was also encouraged by President Obama's strong urging in that direction as he responded to the worldwide

Countries are seeking to export their way out the current crisis through competitive currency depreciation as well as by erecting new trade distortions. The G-20 should therefore also direct the WTO to get together with the IMF to start providing effective sanctions against such behavior. Operating fully within the current charters of both organizations, the Fund would certify that a surplus country was maintaining a competitively undervalued exchange rate, perhaps by intervention in the exchange markets or other forms of manipulation, and the WTO would then authorize its members to bring cases against the offending country. This process could lead to the imposition of retaliatory trade barriers against an offender, both deterring the practice and providing an effective defense against its most pernicious consequences.

The global nature of the problem is again paramount. The fundamental reason for avoiding protectionism, including in domestic stimulus programs like the recent US fiscal package and in the use of financial rescue funds, is that the basic objective is to enhance global demand. Buy-national restrictions, or lend-national requirements, obviously subvert that goal and must therefore be avoided.

The United States has a particular interest in this part of the package. Rapid export growth and sizable reductions in our trade deficit – which has fallen by about half from its peak in 2006 – kept the US economy growing for a full year, from late 2007 through the third quarter of 2008, even though domestic demand was already declining due to the onset of the financial crisis. With the renewed strengthening of the dollar, we should in particular be expanding the activities of our export support programs (especially the Export Import Bank) and pursuing trade policies that seek to further open markets around the world.

reaction, and withdrawal of the "no outsourcing" provision in the original French plan for supporting its auto industry after many of its EU partners lodged angry protests.

Mobilizing Resources for Developing Countries

Developing countries now make up roughly half the global economy[9]. Hence their ability to recover will have a major impact on our own prospects and those of the entire world. The developing countries actually held up remarkably well through the third quarter of last year, lending credence to the "decoupling" concept and even the "reverse coupling" idea that they could sustain the world as a whole. Led by China and India, they are still doing much better as a group than the industrialized countries (see table 1) but many of them have also fallen off a cliff over the past six months.

Any effective global recovery strategy must therefore accord a central role to this group of nations. In addition to rapidly shrinking markets for their exports, they have experienced a huge cutback in private capital inflows. They need offsetting support from public investment, which only the International Monetary Fund can provide in sizable amounts on short notice.

The G-20 should thus direct the IMF to undertake three major new programs. First, it should inject liquidity with little or no conditionality to developing countries who have suffered sharp declines in exports or capital inflows due to the global slowdown rather than any policy errors of their own. This could require as much as $500 billion of additional resources for the Fund, which should mainly be provided by the large surplus countries with excessive foreign exchange reserves (notably China, the major oil exporters and Japan, which has already offered to contribute $100 billion).

[9] With exchange rates converted at purchasing power parity per the standard practices of the IMF and World Bank in calculating global economic totals.

Second, it should resume creating Special Drawing Rights, the international money inaugurated in the late 1960s to deal with reserve shortfalls of precisely the type feared by many developing countries today. An early creation of $250 billion, which could be supported by the United States without new legislation, would ease the financial anxieties afflicting numerous countries and obviate the need for "new mercantilist" measures to build reserves by running large trade surpluses instead. If the crisis and "new mercantilism" pressures persist, a second and larger SDR allocation could be added later.

Third, the Fund should substantially increase its regular quotas to enable it to conduct its traditional, conditional lending programs on the much larger scale required by the current crisis. This would also provide an opportunity, which the richer countries must seize if the emerging markets are to accept the standstill on trade barriers and new IMF-WTO mechanism on currency manipulation described above, to substantially alter the governance structure of both the Fund and the World Bank by providing much larger shares for the newly important emerging markets. The European Union and the United States should also take the occasion to give up their anachronistic holds on the top positions at the IMF and World Bank, respectively, and substitute a merit-based selection system instead. This "grand bargain" has been espoused by Prime Minister Gordon Brown of the United Kingdom, who will chair the London summit, and should be strongly supported by the United States[10].

Financial Regulatory Reform

Some G-20 leaders have attempted to focus the meetings of the group, both last November and upcoming next month, on reform of financial regulation at both the national and

[10] The idea was initially proposed by my colleague Morris Goldstein in "A Grand Bargain for the London G-20 Summit: Insurance and Obeying the Rules." VoxEU.org, February 19, 2009.

international levels. Such a view is fully understandable in light of the substantial contribution of inadequate regulation to bringing on the crisis. Reform is clearly needed to prevent a repetition of the current tragedy.

Such reform is a long-term rather than immediate project, however. This is partly because of the complexity of the issues and the consequent difficulty of addressing them quickly. But it is also because the current need is to promote renewed lending by financial institutions, on as large a scale as possible, and new steps to restrain that lending for prudential reasons would send mixed signals that could derail the recovery strategy. Most important, addressing this set of issues would divert attention from the overriding priority of promoting renewed growth. The G-20 in London should thus continue the process of moving toward reform that they began in Washington, and perhaps provide a bit more guidance to it, but spend most of their time on the first three issues outlined above.

Conclusion

The global economic and financial crisis requires a global policy response. The G-20 summit in London provides a unique opportunity to mobilize the needed cooperation among countries that make up the bulk of the world economy. The United States, and President Obama in particular, must play a decisive role in forging such agreement. I urge the Subcommittee to do everything that it can to promote this outcome.

Table 1: Growth Impact of the Current Crisis

Country	Pre-crisis	Crisis		Dedine in growth 2008-09 (% of 2005-07 growth)	Decline in growth 2009 (% of 2005-07 growth)
	(avg. 2005-07)	(avg.2008-09)	2009		
Italy	1.3	-1.4	-2.1	205.1	263.6
Japan	2.1	-1.5	-2.6	167.6	221.2
United Kingdom	2.6	-1.1	-2.8	139.8	206.0
Germany	2.1	-0.6	-2.5	128.8	220.2
France	2.1	-0.3	-1.9	114.4	191.3
United States	2.6	-0.4	-1.6	113.6	162.0
South Korea	4.8	-0.6	-4.0	111.5	183.9
Canada	2.9	-0.3	-1.2	108.6	141.4
Spain	3.7	-0.3	-1.7	106.7	145.7
Mexico	3.7	0.8	-0.3	80.0	108.0
Russia	7.3	2.8	-0.7	62.3	109.6
India	9.4	6.2	5.1	34.2	45.9
China	11.3	7.9	6.7	30.5	40.7
Brazil	4.1	3.8	1.8	7.5	56.2

Table 2: Estimates of Fiscal Stimulus in 2009, Percent of GDP

			Difference	
Country	IMF	JPMorgan	IMF-JPMorgan	JPMorgan as % of IMF
Argentina	1.3	0.5	0.8	38
Australia	0.8	2.4	-1.6	300
Brazil	0.3	0.3	0.0	100
Canada	1.5	1.1	0.4	73
China	2.0	2.1	-0.1	105
France	0.7	1.0	-0.3	143
Germany	1.5	1.3	0.2	87
India	0.5	5.0	-4.5	1000
Indonesia	1.3	0.0	1.3	0
Italy	0.2	0.1	0.1	50
Japan	1.4	2.0	-0.6	143
Korea	1.5	1.1	0.4	73
Mexico	1.0	1.4	-0.4	140
Russia	1.7	1.1	0.6	65
Saudi Arabia	3.3	n/a	n/a	n/a
South Africa	1.3	1.6	-0.3	123
Spain	1.1	1.9	-0.8	173
Turkey	0.0	0.0	0.0	n/a
United Kingdom	1.4	1.6	-0.2	114
United States	1.9	2.0	-0.1	105
Total-GDP Weighted				
PPP	1.4	1.8	-0.3	124
US$	1.4	1.7	-0.2	115

Mr. SHERMAN. Thank you for your testimony. Without objection, the full opening statements of all witnesses will be put into the record, and the full opening statements of members who submit them for the record will be included in the record of the hearing.

We will now go on to our last, but certainly not least witness, Peter Morici.

STATEMENT OF PETER MORICI, PH.D., PROFESSOR OF LOGISTICS, BUSINESS AND PUBLIC POLICY, ROBERT H. SMITH SCHOOL OF BUSINESS, UNIVERSITY OF MARYLAND (FORMER DIRECTOR OF ECONOMICS AT THE U.S. INTERNATIONAL TRADE COMMISSION)

Mr. MORICI. Well, thank you, Mr. Chairman, and to the members of the committee for the opportunity to be with you today. In my mind the global economic crisis has two origins. One is imbalances in production and consumption, which you heard about.

Mr. SHERMAN. Do you want to turn on our mike? Do you see a green light?

Mr. MORICI. Can I start again?

Mr. SHERMAN. Yes.

Mr. MORICI. Okay. I thank you for the opportunity to be with you today, and in any case, in my view the global economic crisis has two sets of origins.

One is the imbalance in trade, or in production and consumption between China and other countries in Asia and western nations, and also the oil nations, and the banks, which have to do with changes that took place in our banking system over the last several decades, beginning with the end of Regulation Q, and ending with the end of Glass-Steagall, which gave rise to lots of interesting opportunities for creative financial engineers.

In the United States the current trading situation gives rise to a very huge trade deficit when our economy is operating at anywhere near full employment. I don't view the recent reduction in our trade deficit as particularly comforting.

That gives rise to huge capital flows into the United States, which somehow or other have to be accommodated, and they have been accommodated by frankly less than prudent borrowing and lending decisions.

They distort capital markets, and they gave rise to a consumption led expansion that caused us to increase our debt to the rest of the world rather dramatically. There really is no solution to this mess short of fixing those structural problems.

A stimulus package is helpful, and it is nice, but we are going to need ever larger stimulus packages to keep our economy going, because if you stimulate the economy with 2, or 3, or 11 percent, or whatever Fred wants—I mean, you can mortgage the whole universe if you like.

Once you stop spending the money, you will come back down, but while you are spending, your trade deficit will go all the way up again.

Mr. SHERMAN. Would you repeat that last phrase?

Mr. MORICI. Your trade deficit will go all the way up again.

Mr. BERGSTEN. Not if others are spending.

Mr. MORICI. I don't agree with you, Fred. You had your turn. Let me have mine. [Laughter.]

Now in order to fix the problem, we are going to have to fix our domestic energy policy and our trade policy. Domestic oil imports net and our trade with China are 90 to 95 percent of the trade deficit. So you don't have to look far for the problem.

We can and should dramatically reduce our imports of oil by dramatically changing the cars that we drive. We have that within our grasp and have chosen not to do it, and we should.

With regard to trade, we already are in a trade war, gentlemen, and ladies. China's manipulation of its currency, its export subsidiaries—you realize that it has frozen its currency more or less since last July in response to the recession, and it is increasing its exports subsidiaries.

All of us that have studied economics, and those of us who have only been spending time with economists over recent years would know that an export subsidiary is as protectionist as a tariff.

You are in the middle of a trade war, and China is undertaking Smoot-Hawley already, and with the advocates of no protectionism, please, no trade policy, please, are telling you is unilateral disarmament so the Chinese can export their recession to the rest of the world.

If you stimulate the global economy, China's exports will grow unless something fundamental is happening inside of China right now that we are not aware of.

To resolve the problem with China, I simply think we should recognize we are not dealing with a market economy as we know it, and we should basically tell the Chinese you fix your trade surplus so we can fix our trade deficit. If you don't fix it, we will fix it for you.

The current imbalance of trade with China and on oil has created such destabilization in global financial markets as so to eradicate the benefits of free trade. If we are going to go to 10, 11, or 12 percent unemployment, it is hard to imagine that free trade is doing us much good.

However, I don't believe we should repeal 100 years of neoclassical economics if we can get the Chinese trading reasonably, and allow them or to have them adjust their currency so they are not engaged in continuous one-way intervention in times of full employment, then I believe that a program of open trades and competition best serves us, and it would give rise to the most efficient allocation of resources.

With regard to the banks, I will just leave it to you to look at that in my written submission. Essentially, we do need some major restructuring. We don't need a return to the days of Glass-Steagall, but we need something, and I think I have outlined it adequately there, and I will quit at that point with 13 seconds remaining.

[The prepared statement of Peter Morici follows:]

Testimony
House Committee on Foreign Affairs
Subcommittee on Terrorism, Nonproliferation and Trade
Hearings on
U.S. Foreign Economic Policy in the Global Crisis
March 12, 2009

Peter Morici
Economist and Professor
R.H. Smith School of Business
University of Maryland, College Park

My name is Peter Morici. I am an economist and professor at the R.H. Smith School of Business, University of Maryland, College Park. Thank you for the opportunity to testify. I am honored by your invitation.

The United States is beset by the most troubling economic crisis since the Great Depression and perhaps the most complex and difficult to resolve set of economic challenges in the peacetime history of our nation.

This crisis has origins in domestic and international economic policies pursued by the United States and other nations. Often well intentioned and consistent with prescriptions of the consensus of economists, these policies have interacted to create what may prove to be a perfect storm—confounding assumptions about economic policy held dear and championed by enlightened policymakers and economists, including this one, for two generations.

Effective national response that ensures prosperity and a reasonable measure of equity require that we acknowledge our mistakes—both those of well intentioned policymakers from both political parties and the community of analysts and academics that advise them. Also, effective responses require that businesses acknowledge that strategies that have served their interests in the short term have not served the public good over the long haul, and the resulting systemic calamity serves no one's interests and threatens the vibrant market economy that sustains all our wealth and the hope we all share for our children.

What Caused the Crisis?

Most fundamentally, the recession, which may now become a depression without more effective policy responses, has origins in the interaction of changes in our banking and financial systems, energy policies and trade policies, and in the actions of foreign governments.

The U.S. economy enjoyed two long economic expansions, interrupted by a reasonably benign recession in 2001. During the 1990s, the expansion was export led for most of the decade, whereas the expansion of this decade has been characterized by growing trade deficits, averaging more than five percent of GDP from 2004 through 2007 and receding, with the onset of recession, to a still high 4.7 percent in 2008.

Some critics warned of the dangers of such large deficits, while others argued that the resulting inflows of capital represented investments in the United States and confidence in quality of economic policy and future growth of the U.S. economy.

The fact is most of the money was raised by borrowing or selling off fixed assets and was not new productive investments. Much was used to prop up consumption, and some was used to leverage investment schemes that proved more speculative than productive. Much was provided by sovereigns and near sovereigns who were merely looking for hard currency parking places for cash and safe political environments in the event political conditions changed elsewhere in the world.

The largest components of these deficits were net imports of oil, principally to fuel automobiles, and a growing trade deficit with China. In 2008, those components alone totaled 96 percent of the trade deficit.

The trade deficit on oil was the result of domestic policies that neglected domestic oil and gas development and that failed to fully exploit alternatives to conventional fuels and build out energy-conserving technologies.

Those policies maximized dependence on foreign sources of oil. Coupled with rapid growth and fuel subsidies in the developing countries of Asia, U.S. energy policies helped push up global crude oil prices and the U.S. petroleum trade deficit.

China controls foreign exchange transactions and manages the value of its currency. It set the yuan-dollar exchange rate at an artificially low value in 1994 and fixed that rate from 1995 to 2005. From mid-2005 to mid-2008, China permitted some modest revaluation of the yuan; however, this was not nearly enough, and the yuan remains significantly undervalued. Since July 2008, the value of the yuan has not changed much.

The undervalued yuan provides Chinese manufacturers with a huge export subsidy and a hidden tariff on imports. China is using its currency as a development tool, but this victimizes otherwise competitive businesses and their employees in the United States.

In response to the recession, China has again frozen the level of the yuan and laid on additional export subsidies, seeking to export its recession in the worst tradition of Smoot-Hawley.

In addition, China maintains high explicit import tariffs. Through these and other regulations, it essentially requires foreign manufacturers to locate in China to service its market and for their suppliers to relocate to China, further accelerating the decline in U.S.

manufacturing. This creates a pattern of international trade, specialization and production that confounds expectations for trade based on comparative advantage—the kind of trade that was expected to follow from China's accession to the WTO in 2001.

China essentially exports products where its abundant supply of low-skilled labor offers an advantage, and it refuses to import products such as metals and automotive products, where it does not enjoy a comparative advantage. In fact, China exports some products that it would import with free trade based on comparative advantages, instead of managed trade based on its mercantilist policies.

This has deprived the United States of the macroeconomic benefits of free trade with China, driving down U.S. living standards. In recent years, living standards were propped up by borrowing from China and others, creating a false sense of national economic security, but the depth and length of the current recession has now exposed that fallacy.

Along with similar policies elsewhere in Asia, China's mercantilism has given rise to a global imbalance in production and consumption. China, other Asian countries and the Middle East oil states often produce more than they consume, and the United States and other western countries consume more than they produce. Surplus countries amass reserves of dollars, Euros and other hard currencies, and invest those in western capital markets.

Until recently, western banks recycled those savings into the hands of U.S. and western consumers by letting them borrow on their homes and through unsecured or weakly secured credit card and auto loans. Foreign funds were also recycled into the hands of hedge funds and private equity firms, who frequently made foolish investments with cheap capital—consider Cerberus' purchase of Chrysler.

In the United States, rising trade deficits should have caused one of two things to happen. Either the value of the dollar should have fallen to facilitate an increase in exports and decrease in imports, or inadequate aggregate demand would have caused a recession. The foreign exchange value dollar could not adjust to adequately redress the trade deficit; because Middle East and other oil exporters price petroleum in dollars, and China simply intervened in foreign exchange markets, buying more and more dollars, to keep its currency from rising in value as it should have. And foreign borrowing permitted Americans to consume much more than they produced and for the U.S. economic expansion to go on much longer than it should have. Foreign borrowing delayed the recession that should have happened sooner, and if it had, would have been much more benign than the crisis we now confront.

Essentially, a 5 percent trade deficit requires Americans to spend 105 percent of what they produce and earn to sustain aggregate demand for what they produce. Without exchange rate adjustments that rebalances trade or massive foreign borrowing, that deficit in aggregate should have caused inventories to mount and produced a recession.

Foreign private investors should not have been expected to provide such credit, because foreign investors should have expected the bonds and loans of an economy consuming so much beyond its means to eventually default and for the values of its real assets (stocks and real estate) to drop in value. In fact, that is what eventually happened in the United States when the reckoning arrived.

Much of the credit was provided by China and other sovereigns and near sovereigns whose motivations were not merely to obtain safe returns on fixed income assets when they purchased U.S. bonds, bank deposits and property but rather to facilitate export-led growth and park money in politically safe places. That is one important reason why Americans were permitted to borrow so recklessly, and why the recession did not happen sooner and the recession is now so severe.

Role of Banking Policy

Changes in the U.S. banking system permitted American consumers and investors—hedge fund and private equity managers, corporations engaging in leveraged buyouts, and others—to enjoy access to inexpensive financing that would have not been possible three decades ago.

The Savings and Loan Crisis of late 1980s and early 1990s was caused by the deregulation of interest rates (principally, repeal of regulation Q), the growth of nonbank depositories (principally, brokerage depositories and venues for medium-term deposits that compete with bank CDs) and changes in U.S. tax laws that limited deductions on rental property held by private individuals.

In a nutshell, banks were caught with long term mortgages on their books, whose rates reflected lower, regulated deposit rates of years past. They were compelled to compete for deposits and pay higher interest rates than the mortgages on their books were paying.

Correctly, banks concluded that without regulated rates on deposits and those of competing non-bank depositories, banks could no longer, as much, lend long and borrow short. Hence, they could no longer hold on their books as many long-term mortgages financed solely by deposits and CDs.

After the Savings and Loan Crisis, banks turned increasingly to securitizing loans. The banks wrote mortgages, auto and other loans and sold those to money center banks, which in turn bundled those loans into bonds and sold the bonds to fixed income investors, like life insurance companies, pension funds, private investors, and foreign sovereigns.

Those investors could better bear long-term interest rate risk than banks. However, securitization resulted in a disconnection between those who wrote the loans and those that held the loans and bore repayment risk. That created subtle and for a long time unnoticed changes in the incentives for those agents who actually take mortgage applications.

The repeal of Glass Steagall in 1999 made possible the completion of a reorganization of the ownership of banks. Increasingly, large money center banks, which underwrite mortgages and securitize regional bank loans for sale to fixed income investors, combined with brokerages, securities dealers, investment banks, private equity, and even hedge funds. Historically, those nonbank businesses compensated executives at higher salaries than banks—simply, dealmakers and salesmen are paid better than other executives in most branches of the economy.

Unfortunately, folks that performed heretofore conventional banking services began to expect to be compensated by bonus systems that paid much more than traditional banking entities paid. It is simply not possible to pay those in the chain of lending and securitization—from the mortgage broker in Topeka, to the regional aggregator in St Louis, to the New York banker that securitizes loans—the kinds of salaries paid many others in the financial sector by borrowing at 5 percent and lending at 7 percent, without writing irresponsible mortgages and creating derivatives that cannot deliver on their promises. However, that is exactly what happened for at least three sets of reasons.

First, bond rating agencies did not effectively evaluate the collateralized debt obligations (CDOs) and mistook credit default swaps for real, effectively-collateralized insurance. Payment systems for bond ratings contributed importantly to blinders at these institutions, as well as simple moral failure by executives and their economists and finance specialists.

Second, a good deal of the money flowing into U.S. and other credit markets was provided by sovereigns and near sovereigns (Middle East royals and other private actors with easy access to very cheap funds) who often do not look at financial instruments with the same discerning eye as someone who needs to answer to shareholders or private individuals putting up nest eggs to retire, educate children or leave a legacy.

Third, a good deal of the money was put at play by U.S. investment managers incentivized to take big risks—through heads I win, tails you lose bonus schemes—and that created an appetite for credit that should have made banks wary but did not.

At banks, moral failure resulted when the culture of hedge-fund and private equity fund risk taking infected their assessment of risks along with the adoption of bonus based compensation schemes.

The expansion of the U.S. economy and trade deficits through the middle and latter half of this decade should have resulted in a much sharper devaluation of the U.S. dollar than experienced from late 2005 through mid 2008 and in a very different structure of devaluation against other currencies. Such currency realignments would have substantially curtailed imports of oil and goods from China and elsewhere in Asia; *or* a recession would have happened much sooner than it did.

Instead, foreign sovereigns and U.S. banks helped American consumers, businesses and investors become overleveraged. Eventually, the preposterousness of many of the loans became apparent and those loans failed, setting off a chain reaction that has been euphemistically called deleveraging and the negative feedback cycle.

As importantly, the largest and most important U.S. banks got stuck with many of their own poorly written CDOs and loans on their books when the collapse came. The latter were often insured by credit default swaps that lacked adequate collateral, such as those written among major securities dealers and banks and by AIG.

The bad judgment that bankers had recommended their investor customers embrace became the noose that hung them too. In a tragedy of the legal system and manifest inequity, bank stockholders have been ruined, while bank executives have been protected by the indemnity of employment contracts and escaped with their fortunes.

We have heard a lot about the moral hazard that could be created by forgiving mortgage debt. However, the sense of betrayal among ordinary people engendered by the great escape of bankers' fortunes may fray faith in honest work far beyond measure. Economists may not like to talk about this, because they can't reduce it to a number; however, the disruption of national confidence in markets and capitalism propagated by the escape of bankers' fortunes may prove to the worst legacy created by the current Wall Street morass.

Getting Out of this Mess

The evidence mounts daily that the United States is in the greatest economic crisis of our times, and the ultimate place of this crisis in the history of economic disasters is yet to be determined.

The country needs more effective stimulus packages and programs to assist the banks than policymakers have been pursuing—a plan to stabilize conditions and avoid a complete meltdown.

More importantly and lacking from the proposals of the Administration and Congress, the nation—the government, individuals and private business—need to correct the structural problems that created this crisis if it is to resurrect American growth and prosperity.

1. A stimulus package is needed because the demand for goods and services is insufficient. Aggregate demand is insufficient because, near term, consumers and businesses are deleveraging and many banks are dysfunctional.

   Longer term, the economy suffers from a structural shortage of demand for goods and services. As long as the economy has trade deficits that are five percent of GDP or more when it is growing, Americans will have to consume more than they produce to have adequate demand for U.S. goods and services.

   As currently formulated, the stimulus package will give the economy some lift and restore some employment, but once its effects are through, aggregate demand will prove inadequate. Without fundamental changes in the current structure of U.S. trade—massive imports of oil and consumer goods from Asia that are not fully paid for with exports—either Americans will have to borrow as consumers, businesses and investors from the rest of the world and create another credit and asset bubble, *or* the U.S. government will have to borrow on their behalf and run successively larger budget deficits.

Unless the United States resolves the problem of the structural trade deficit, the U.S. economy will require ever larger private borrowing and excessive spending, or ever larger stimulus packages and federal budget deficits, to keep the economy from melting down.

2. The bad assets on the books of the banks are so huge, that no solution short of nationalization—which I oppose—is possible without removing those bad assets through some kind of bad bank or aggregator bank that performs the services provided by the Resolution Trust Corporation during the Savings and Loan Crisis. Without such a vehicle, the amount of preferred shares or noninterest bearing common shares the government will purchase from the banks to help them cover losses will constitute *de facto* nationalization. With the bad assets removed through a bad bank or aggregator bank, the banks could then be recapitalized privately and then pay back their TARP funds.

To resolve the structural trade deficit, the United States will have to have very different approaches to energy and trade policies than in the past.

On the energy front, the nation needs to build out many of the alternative energy sources and embrace many of the conservation measures the environmental community advocates, but the nation must also do many things environmentalists oppose. These include aggressively developing domestic sources of petroleum and gas and building out nuclear power quickly.

Policymakers should not be fooled into believing higher energy prices alone will provide needed results. If higher gas prices would do the trick, then the German automakers would be leaders in hybrid autos and battery powered vehicles, and they clearly are not.

Similarly, a CO_2 tax would disadvantage U.S. industry vis-à-vis foreign rivals in China and elsewhere. It would merely encourage more manufacturing to relocate to these places and raise global CO_2 emissions. Every time a manufacturing job leaves Indiana for Shanghai, global emissions go up, because China uses fossil fuels so much less efficiently than does the United States. That is why with a GDP one-third the size of the United States, China emits more CO_2 than the United States.

A CO_2 tax in the United States without a CO_2 tax in China will make Americans poorer and the problem of global warming worse. Such a tax without absolutely comparable policies in China and other major developing countries is absolute folly.

Regarding nonenergy trade, no solution is possible without addressing the trade deficit with China, and its manipulated exchange rate and other mercantilist practices. And given the role of the trade deficit in the nation's macroeconomic problems and sovereignty problems foreign borrowing creates for the United States, no public policy problem is more urgent.

Americans need to recognize that China is hardly a market economy in a western sense and is still highly state managed. Its financial system may not be able to sustain an unmanaged floating exchange rate; however, China can manage the value of the yuan at 4 as easily as it does 6.8. In fact, it would be a lot easier to manage a value closer to balance of payments equilibrium.

Simply, the United States should give China the opportunity, with a hard deadline, to manage down its trade surplus with the United States, either through meaningful and complete currency revaluation—complete means raising the dollar value for the yuan to a level that reduces China's trade surplus with the United States by one third each year and to zero after three—or through other domestic means of Beijing's choosing.

If China declines, the United States should simply tax dollar-yuan conversion in proportion to its official and surrogate currency market interventions. The United States should impose a tax equal to the quarterly value of China's intervention divided by its exports of goods and services. China would then have a strong incentive to reduce and then stop intervening.

If China does not reduce and eliminate intervention and chooses for the United States to tax currency conversion, then the benefits from a revalued yuan of higher prices for Chinese imports that should go to Chinese businesses would instead go into the U.S. Treasury. If China reduces and then eliminates one-way intervention and lets its currency rise to a value that balances trade, Chinese businesses would capture those benefits in the form of higher dollar prices for their goods.

Eliminating the trade deficit with China by eliminating or at least redressing currency manipulation would have a much greater stimulus effect on the economy than the package just approved by Congress. It would inspire a renaissance in manufacturing and restore American growth and wages in a manner and magnitude no public policy this Congress could implement could ever achieve. Simply, it would permanently increase aggregate demand for U.S. goods and services, while raising revenue for positive public purposes; it would restore incentives for the efficient use of labor and capital that free trade should normally provide.

Redressing the trade deficit with China in this manner would not be protectionist. China's actions now are protectionist, and constitute a modern day Smoot-Hawley. China's policies are about as protectionist and predatory as could ever be conceived by the most skilled Seventeenth Century mercantilist, and are an absolute threat to U.S. prosperity and sovereignty.

I am not advocating protectionism—let China stop rigging its currency and trade and the United States can and should compete. I am advocating the United States abandon a policy of appeasement in commerce and embrace self defense and self preservation.

All countries practice the equivalent of Buy American and in most cases more aggressively than does the United States. The WTO Procurement Code provides for exchange of national treatment for certain purchases, and that is the extent of U.S. international obligations. It does not apply to developing countries, like China, that have declined to sign the code.

Americans should not expect much of China's stimulus package to be spent in the United States owing to its protectionist policies, and given China's contribution to the current mess here, it would be folly not to apply Buy American to U.S. purchases that might otherwise go to China and other countries that have not signed the Code, or whose actions in the current crisis do not warrant national treatment.

Regarding the banks, the Treasury needs to take the following steps: initially, it needs to organize a bad bank or aggregator bank to sweep all the questionable mortgage-backed securities from the books of the banks and require the largest banks, including securities companies with bank status, to undertake aggressive and sweeping management reforms and changes in compensation schemes for professionals engaged in commercial banking and securitization activities. Such changes should be required for any institution enjoying bank status under the TARP, at the Federal Reserve discount window or FDIC insurance.

With these in place, the banks should be able to raise private capital and repay TARP funds, and the Congress should reconsider the segregation in ownership of banks and near banks, meeting the above criteria, from other financial institutions.

The bad bank or aggregator bank could be capitalized with $250 billion from the TARP, and it could raise additional capital by selling $250 billion in shares to private investors and another $500 billion to $1.5 trillion by issuing bonds. The commercial banks could be paid for their securities with 25 percent in special common shares and the rest in cash. These special shares could only be redeemed after TARP financed shares, private shares and bond holders were paid.

This entity could purchase all of the questionable mortgage-backed securities from commercial banks at their current market-to-market values on the books of the banks and purchase those in the hands of other investors too. If 2 trillion in TARP and private money is not enough, then the above dollar figures could be scaled up proportionately and even doubled.

The bad bank or aggregator bank could determine the number of defaults by performing triage on mortgages—deciding which homeowners if left alone will pay their mortgages, which if offered lower interest rates and moderate principal write downs could reasonably service new loans, and which must be left to fail.

Implementing those standards and necessary mortgage modifications across the entire market would, at once, limit the number of defaults and determine how much housing prices will ultimately fall. That is something the individual banks cannot accomplish acting independently.

By sweeping all the mortgage-backed securities off the books of the banks and limiting losses on those securities, the bad bank or aggregator bank would earn money by collecting payments on the majority of mortgages that ultimately pay out and sell off repossessed properties at a measured pace. Like the Savings and Loan Crisis Resolution Trust, and the Depression-era Home Owners' Loan Corporation, it would likely make a profit.

Relieved of the mortgage backed securities, the banks would not be trouble free—they still have auto loans and credit card debt to repent. However, having huge deposits and vast networks of branches, they would be worth a lot to investors again, and could raise new capital, repay their TARP contributions and write new mortgages.

Mr. SHERMAN. Amazing. Let us see if I can be equally brief in my questions. First is kind of a question for the whole panel. I would like you to—and it is a simple yes/no question. I will ask you to raise your hands.

China has an economic stimulus package of close to $600 billion in progress now. Raise your hands if you think that the United States workers will get 1 percent of that money.

Mr. BERGSTEN. 1 percent?

Mr. SHERMAN. 1 percent.

Mr. BERGSTEN. $6 billion?

Mr. SHERMAN. $6 billion.

Mr. BERGSTEN. Over 2 years?

Mr. SHERMAN. Yes. Now I am not talking about United States firms, and I see Dr. Levy as well. So you think that—and I am not talking about the secondary economic impact. I am saying the government buys—well, apples and oranges.

You could have a 100-percent Buy America stimulus, and say not 1 penny could be spent on anything built abroad, no matter what it is, and the foreign countries would still benefit because my sister would get a job, and she would buy a flat-screen TV.

But we are going to spend $800 billion, and some of it will go abroad and some of it stays here. The Chinese Government is going to spend $600 billion. In terms of contracts to be performed by American workers of that $600 billion, and not multiplier effect, does anybody think we are going to get 1 percent?

Mr. BERGSTEN. I honestly don't know because—I honestly don't know and no one can, because they have not announced how they are going to spend the money. But I really think——

Mr. SHERMAN. Come on. China is not going to give us—if they give us a penny, it will be a mistake. Every billion people are entitled to one or two mistakes, but clearly the Chinese stimulus package is designed to go exclusively to Chinese workers and not to go to American workers.

Mr. BERGSTEN. The important point, Mr. Chairman, is your premise. They are trying to stimulate their overall growth rate by 2 to 4 percentage points per year.

It is up to 5 or 6 percent, and they want to get it back to at least 8 percent, and they might do better. Out of that increased Chinese growth, we will clearly get much more than $6 billion of exports.

Mr. SHERMAN. Doctor, I am trying to compare apples to apples. You didn't have the European Union Ambassador praising the American stimulus package on the theory that it would increase our growth rate, and thereby benefit the entire world.

Instead, we had Dr. Levy particularly attacking the Buy America provisions. My question is to illustrate that if you compare apples to apples, they have got a Buy China 100 percent stimulus package. We have some Buy America provisions. Let me go to Dr. Morici.

Mr. MORICI. I want to encourage you not to take Canadian Ambassadors too seriously. Having been the director of Canadian Studies at the University of Maine in my prior life, and before that the director of the Canadian-American Committee, and having written accounts on foreign relations book on the Canada-United States Free Trade Agreement, I have some credentials.

And I would say to you that the Canadians read the same book of economics that the French do, and that is that the Americans cause all of the economic problems, and forgive me for saying this to you, but when the Republicans are in, then they cause nothing but problems.

So right now you have only caused 80 percent of the problems of the world. So I really wouldn't take that very seriously. It is quite disingenuous for them to say things like that, and I think you have raised a valid point.

I would not have phrased the question as 1 percent. We probably or we might get 1 percent, but who cares. The point of the matter is that we are not going to get very much out of their stimulus package, and it is absolutely absurd in a world where the Chinese are so manipulating trade and causing so many disruptions in the world financially to not pursue a policy that requires them to give us some measure of reciprocity.

Mr. SHERMAN. I am going to go on to one more question. That is that Warren Buffett has suggested a cap and trade system. That is to say if you want to import $1 dollar's worth of goods, you need a voucher from somebody who has exported $1 dollar's worth of goods.

That would be a result oriented free trade system. Instead, we have a process oriented system, where we negotiate with other countries as to what they put in their written regulations on the basis that anybody in China feels that the sole influence on decision makers is what is in the written regulations.

And we spend endless discussions about what is or is not in the written regulations and laws of a country that is not a rule of law society. Dr. Morici, what do you think of the idea—and I am going to apply it just to China—that we can reach if we choose to, and we want to phase this in, a balanced trade relationship, a nonmalignant trade relationship with China, with a cap and trade system?

Mr. MORICI. I don't believe that we can. I think it is ludicrous for the United States either to have cap and trade or a CO2 tax in the absence of——

Mr. SHERMAN. No, no, this is cap—I am talking cap and trade for exports. This has nothing to do with carbon.

Mr. MORICI. I think it is—wait, I am sorry. When you say cap and trade——

Mr. SHERMAN. What I mean by cap and trade is a voucher system where if you want to import $1 million worth of tennis shoes from China, you have to go to somebody who exported $1 million worth of goods to China, get their vouchers, and then, and only then, you are allowed to bring in the goods.

Mr. MORICI. I would prefer an alternative approach to China which is equally radical, and that is that if the Chinese don't want to find a way to balance the trade on their own because of its highly managed economy, then we put a tax on their exports equal to the value of their currency market, intervention, divided by the value of their exports, and we see how that works out for a while.

And if they want to reduce their intervention, then we will reduce the tax.

Mr. SHERMAN. I think your approach is slightly less radical, but perhaps better than Warren Buffett's. It is interesting to see at least two radical ideas out there.

Mr. MORICI. Well, the thing about it is that if you think about it, if we were to do that—you know, you have stimulus, and you get the economy going, and then you spend 11 percent of GDP, or whatever it takes, to get yourself there.

And your deficit goes up and the Chinese are intervening, then by us taxing that intervention the benefit of higher prices on Chinese exports to the United States, or our imports would go to the United States Treasury.

Whereas, if they stopped their intervention, then the benefits of a higher price for Chinese exports would go to their businesses. So they would have a strong incentive to capture that rent.

So my feeling is while that might violate half-a-dozen laws—and I don't know that it would, but people argue that it does, and have called me a protectionist for recommending that, I think it might help China reconsider its regime and move in a direction that was more oriented toward free trade.

Mr. SHERMAN. I have gone a little bit over, but I do want to hear from Ms. Wallach.

Ms. WALLACH. I think that one benefit of that Warren Buffett proposal, which would create a secondary market for those permits, is it lets the market decide, versus picking out winners and losers, and what is worth importing and what value in that secondary market is worth obtaining that certificate.

And the way he does it is to phase it in over 5–10 years so that it is not an abrupt disaster in supply chains, but rather that it forces a balance, and also creates incentives for exporting, while simultaneously creating a balance.

Mr. SHERMAN. I think my time has expired. We will go on to our ranking member, Mr. Royce. It is my intention to do a second round, and I know that a number of the other witnesses are anxious to make theirs.

Mr. ROYCE. Thank you, Mr. Chairman. Ms. Wallach, I would ask you, you strongly reject the "CAFTA model." Some might say that it has shown itself to be a pretty good deal for the American worker in the sense that since its implementation in 2005, I think then the United States trade deficit, where the region was over 1.2 billion.

Since its implementation the United States has swung to a surplus, and it has grown every year, and I would just add that an analysis by the USITC says passing the three pending FTAs would spur at least 12 billion in new exports.

Let me ask you another question here in concert with that. You severely criticized the World Bank and the IMF, which have distributed trillions of dollars made over the years.

If these institutions can't be reformed as you recommended should they be closed? And because if your answer to that is yes, then you might have an ally here, in terms of what I have seen in a lot of that spending.

I assume that you oppose the plan announced yesterday by the Obama administration to funnel some $.5 trillion through the IMF, and the United States contribution to that would be another $100 billion. Let me ask you about that proposal.

Ms. WALLACH. I will try to answer all three questions. On the CAFTA issue, the matter that I find most concerning is when you look across all of our FTAs and look at export growth—and the balance I will get to, but the export growth issue, if you look across all of our FTAs, which are premised largely on the same model of NAFTA and CAFTA, our export growth with our FTA partners is 6 percent.

But export growth with our non-FTA trade partners is 14.4 percent. There is something deeply wrong——

Mr. ROYCE. That is China, I guess, principally.

Ms. WALLACH. Not exclusively.

Mr. ROYCE. Our non-FTA partner.

Ms. WALLACH. To everyone else.

Mr. ROYCE. Yes, and that is the weighted balance.

Ms. WALLACH. It is all 153 WTO partners.

Mr. ROYCE. Right.

Ms. WALLACH. Minus the 14 FTA countries.

Mr. ROYCE. Right, the lion's share of it though, in terms of the weight of it.

Ms. WALLACH. No, export wise actually, we have larger exports obviously to other parts of the world. So if you do a weighted share, it is our exports to countries such as the European Union countries, et cetera.

Our export growth is doing better to countries we haven't made special FTA arrangements with, than with the countries with whom we have, which is a serious indictment of the underlying model.

Now the fact that we have gone from a $1.2-billion deficit with all the CAFTA countries to a $3-billion surplus is more or less a rounding area in the trade deficit that we have.

Though it is a trend in the right direction, our export growth to those countries still lags behind the countries with whom we don't have FTAs. So it will be interesting to see over time what happens with the CAFTA balances, but the trend of export growth, and then when you look at the larger FTAs, such as NAFTA, or if you look at our trade balancing with Israel, we have enormous deficits with all of our large FTA trade partners.

So that overall the entire body of the 14 FTAs, we have about a $60-billion deficit net with the whole package of them, not exactly in the right direction.

Mr. ROYCE. And let us go to the issue of the World Bank and IMF, and your thoughts on that that I asked.

Ms. WALLACH. My expertise is in the structures and operations of the WTO from the scholars who I have read regarding the IMF and World Bank reform. My support is with various scholars who have noted that absent major reforms those organizations should be shut down.

But I think where we might differ is that other institutions to play similar functions in global governance are needed, and that the rules of the current regime of IMF and World Bank are so off that that is the issue, and not the existence of global economic governance.

Mr. SHERMAN. Let me ask you. You reject trade agreements with allied countries of Colombia, South Korea. How will this impact other areas in which we might want international cooperation should we reject——

Ms. WALLACH. Well, I think there are a lot of different ways to cooperate with countries. For instance, I am a supporter of the Indian Trade Preference Drug Eradication Act.

So to the extent that we want to actually have relationships with some of the countries that we are having troubled relationships with in the region, including Bolivia and Ecuador, I think that is an interesting piece of leverage and partnership to offer them.

The free trade agreements were set up as sort of foreign investor rights that allow the right of new privileges and rights by companies operating in those countries, so that the model of those agreements is extremely problematic and needs to be altered.

It is the same model question that I was discussing vis-a-vis the WTO.

Mr. ROYCE. Colombians though want the agreement, and let me ask you can trade have national security implications? You know, for example, further opening United States textile markets with respect to Pakistan to fight an economic collapse in that country, which is rather critical.

I mean, there are ties between trade liberalization where it occurs, and the economic growth that is a consequence of that in stabilizing some of these countries. Colombia comes to mind.

Ms. WALLACH. I think trade agreements can have economic security implications, and so I was extremely worried by the report by the Department of Agriculture of Colombia that described the Colombia free trade agreement agriculture provision as destablizing the rural society by displacing so many farmers, and thus resulting in three options, and only three options.

The theme, growth of paramilitary, more undocumented immigration to the United States. You will note that after NAFTA immigration from Mexico has increased 60 percent because of this displacement.

And, three, more cultivation of illegal crops, i.e., narcotics. So, yes, having a free trade agreement like the one posed with Colombia can be extremely hazardous to our national security.

Mr. ROYCE. And trade liberalization with Pakistan, which is rather critical in terms of some of our concerns on the committee right now, allowing textile imports, and creating more employment, let us say, as a result of the synergy between trade between the United States and Pakistan?

Ms. WALLACH. I think the model there, for instance, the Cambodia-United States Textile Agreement, is a very promising one. That was an agreement that set out various democratic governance requirements, and helped set up labor unions, and had a role for the International Labor Organization to make sure that the benefits actually went broadly to the people, which is the goal in this case, to bill people who have some wealth and security in a democratic market system.

And so that kind of a model for other countries, including Pakistan, I think is a promising one.

Mr. ROYCE. Let me ask Dr. Morici a question. You testified that 96 percent of the trade deficit is oil imports and imbalanced trade with China, which you find very problematic, as we do.

Does this observation suggest that you find our trading relationship with other countries than China and oil producers generally satisfactory?

Mr. MORICI. That is the sort of thing that you view on a continuum from one to——

Mr. ROYCE. Well, yes, but you said 96 percent.

Mr. MORICI. No, no, I understand, but whether our trading relationship with Canada is satisfactory, or with Europe is satisfactory, or with Uruguay, or Panama, or whatever, just because we don't have a trade surplus—well, we have trade surpluses and deficits around the world.

That doesn't mean that our trading relationships are satisfactory or unsatisfactory. Our trade problem with oil is largely something we have done to ourselves. We have pursued a flawed energy policy.

With regard to China, that is something that China has done to us. We have opened our markets to them, and they have not done the same in reverse, and we have this problem on our hands.

With regard to other countries in the world, I think that by and large, we can work those problems through the normal processes that we have. Not all, but many. I don't know that we can work them through, for example, with India through normal processes, but I think we can with the Canadians as much as they blame even their cold weather on us. I think that we can always work with——

Mr. SHERMAN. I think the time of the gentleman has expired. We will move on to our vice chairman, Mr. Scott.

Mr. SCOTT. Thank you, Mr. Chairman. I would like for us to focus for a moment if we may on this issue of Buy American, and it is especially timely because next month the President will attend a G–20 summit.

It will be his first global opportunity on the world stage to set the vision for the United States position as well, and there has been some thought that the Buy America and Buy American provisions fall out of the normal scope of our international trade, and there has been some thoughts that it could trigger a trade war.

And I would like to get each of your thoughts on that right quick, please. Yes, Mr. Bergsten.

Mr. BERGSTEN. There is a distinction between our legal obligations and what I would think is correct policy. In terms of legal obligations, there is a government procurement agreement as part of the World Trade Organization.

That is not adhered to by all members of the World Trade Organization. Only about 40 member countries have participated. So we as a signatory, and in fact the proponent of it, have obligations in our Government procurement policies only toward other countries that are a part of that agreement.

China is not part of that agreement. India is not. We have no legal obligation under our Government procurement rules to a China, India, or other countries that are not members of that agreement. I repeat, no obligation.

Likewise, and that is what the chairman said, they have no legal obligations to us. China does not have to give us a penny of procurement under its government procurement rules because it is not a signatory to that agreement.

The only add-on to what I just said is where we have particular trade agreements with countries, like NAFTA, where then our obligations, and theirs to us, go beyond the general procurement agreements in the WTO.

So that is the legality of it. We can do anything that we want to China and India. We are constrained to some extent with Canada, Mexico, and other trade agreement partners.

But even where there are those agreements, there are lots of exceptions. Somebody mentioned earlier that China has exempted all sorts of things, and Europe has exempted. The United States has exempted lots of sectors of our own Government, including lots of State and local government spending, that are not subject to those legal requirements.

So there are lots of areas where we can prefer American producers. That is the legality of it. If you want to do that, you can do it. My argument, if you just add one sentence, is that for us to increase our buy national preferences at this point in time would be a policy mistake, because it would for sure encourage others to do the same thing.

Not only incidentally under their government procurement apples to apples, but in their trade policies more broadly, where there is lots of pressure to move that direction, and I think it would be a mistake to encourage global movement in that direction at this time.

But under the law of the land and the law of the universe, there is lots you can do.

Mr. SCOTT. Okay. Let me just follow up that with do you feel that Congress should require that no additional procurement commitments be offered in future trade negotiations?

Mr. BERGSTEN. No, our interests are in maximizing the commitments we can get from other countries in those kinds of negotiations. We should do it on a fully reciprocal basis. We should offer to open up additional parts of United States procurement only where we can get them to open up under theirs.

But if we could get back to what the chairman said, if we could get China to commit to open to us under its $600-billion procurement program, I assure you that we would gain lots more that we would lose to them by opening up to them.

Mr. SCOTT. Yes, Mr. Morici.

Mr. MORICI. I am sorry, I didn't want to interrupt your train of thought at this time.

Mr. SCOTT. You may.

Mr. SHERMAN. Microphone, please.

Mr. MORICI. All right. The procurement codes list those entities for which there will be national treatment, and not the exceptions, would be correct; and second, is given the current tenor of international trade, I don't see a particular problem with the Buy America provisions that were included in the stimulus package.

If we expect to ever obtain reciprocity from the bad actors in the system, unilateral free trade has been shown by practical experience doesn't work. So my feeling is that I guess while I support free trade as much as Fred does, in the present context of policy, we have to deal with the world as we find it, and not what we think it should be on our blackboards.

Mr. BERGSTEN. Just to be clear, a factual point. We now give Buy American preferences under all of our Government procurement programs. There is nothing new. And as Peter said, we commit under the WTO agreement only to components of government procurement that we explicitly specify.

We have exempted mass transit and a lot of other things. So there is nothing new about this. The policy question is whether you increase protection in the teeth of a global recession headed toward a depression, which can encourage others to go down the route and spiral the whole thing downward.

Mr. MORICI. I take exception. It is not increasing protection. It is whether you liberalize further without an adequate response from your trading partners. I am perfectly happy to increase our commitments under the procurement code as soon as China signs up and actually lives with those commitments.

But I am not willing to give them access to our procurement as long as they behave as they do. Fred, you are not talking about increasing protection. You are talking about liberalizing further.

We are already in a trade war. Do you now deny that China's mercantilism policies are a source of disruption in the global trading system? And one of the reasons that we are seeing the reactions that we are having——

Mr. BERGSTEN. Mr. Chairman——

Mr. SHERMAN. Usually the question and answer—you know, you have got to work hard to get elected to Congress to be allowed to ask questions to panelists here.

Mr. MORICI. But could I say one thing here?

Mr. SHERMAN. But I will let the gentleman from Georgia allocate as he will the next 40 seconds, and then we will move on to the next gentleman.

Mr. SCOTT. All right. I will give 20 to you and 20 to you. [Laughter.]

Mr. BERGSTEN. I was one of the first people in 2003 to call attention to China's currency manipulation as the substantial undervaluation of its currency, and the need to react strongly to it, and I continue to take that view. I am delighted that Secretary Geithner did so in his confirmation hearing.

Mr. SCOTT. All right. Ms. Wallach.

Ms. WALLACH. Congressman, in regards to your question about the procurement provisions being in future agreements, and also relating back to what you said about isolationism and the United States relationship with countries. Most of the world's governments do not consider procurement to be an appropriate topic in a trade agreement.

So originally the Doha round had procurement in it, and the developing countries—but also some of the developed countries walked away from that provision, and that was one of the main causes of the breakup of the entire round in Cancun. It got chucked off the wagon. It is so objectionable.

It is also procurement being in the free trade agreement is the reason that South Africa and Malaysia explicitly walked away from our free trade negotiations. We said basically it is either the NAFTA–CAFTA model or nothing, and they said if it has the procurement rules, forget it, because those governments see procurement as a matter of government appropriations policy, a government stimulus policy totally separate from trade.

Mr. SCOTT. Thank you very much.

Mr. SHERMAN. Thank you. We will now move on to the gentleman from Virginia, and I promise you, Dr. Johnson, if my colleagues don't ask you questions, we haven't forgotten that you are here. If they don't, I will.

Mr. CONNOLLY. Well, you took the words right out of my mouth, Mr. Chairman. I have a limited amount of time, so I am going to ask a question and ask you each to try to be concise, and I am putting two questions to the entire panel.

The first one is as Mr. Scott indicated, this is in a sense President Obama's first stepping out on to the international stage in a major way in attending the G–20 meeting. What is a success for him? What do we come out of G–20 with? Dr. Johnson.

Mr. JOHNSON. I think he needs, and I think he is aiming to, reestablish American leadership in terms of fighting the recession. Immediate policy responses, and I think Secretary Geithner wants to pursue a fiscal stimulus.

I would suggest that also be framed in terms of the Europeans putting together a stabilization fund for their weaker members. That is really very important. And as a backup to that, I think Mr. Geithner is outlining $500 billion to the IMF.

That is a huge amount of money if you think the IMF is only going to lend to emerging markets. If you think the IMF is going to have to step in to lend to weaker European countries, because the Europeans are going to drop the ball, then $500 billion makes a lot of sense.

So I think that both of these measures, particularly the $500 billion, and certainly the administration is taking this very seriously, and they are going to, I think, shake up the Europeans, and tell them that they have to really act to deal with their own problems.

And if they don't, then it will fall to the IMF, and that is not a good outcome for anyone. I don't advise any country ever go to the IMF if they have an option.

Mr. CONNOLLY. Ms. Wallach, what is a success for the United States coming out of the G–20 meeting?

Ms. WALLACH. To have a commitment amongst the countries to review and repair the existing WTO and other international economic governance rules so that we, for instance, have the policy space to be able to re-regulate financial services.

That the WTO is not promoting further financial service deregulation given there are 105 countries now signed up to an agreement that requires that, and then finally to figure out what structural changes are needed in an institution such as the IMF and the World Bank to allow for those policy flexibilities.

That we are able to re-establish domestically, but also internationally, global governance rules that actually promote productive investment and stability, as compared to promote this casino economy that we are living with.

Mr. CONNOLLY. Dr. Levy.

Mr. LEVY. Congressman, I think a success would be for the United States to persuade the rest of the world that we are committed to taking our traditional leadership role, and that we are committed to fixing our financial sector, and working with others to do the same, and to preserving open markets.

If I may beg your indulgence for one point, and this is on the repeated attacks on the financial services agreement. Let me just note that the WTO financial services agreement has an unusually strong carve-out for prudential regulation.

Now this can be done for all manner of excuses, including to ensure the integrity and stability of the financial system, regardless of any other provisions of the GATS, and that is the General Agreement on Trade and Services, and I am citing paragraph two there.

And so I know that time is short, and I won't beg further, but I wanted to put that on the record.

Mr. CONNOLLY. Thank you. Dr. Bergsten.

Mr. BERGSTEN. It is a pleasure to see you again here today, and in your previous incarnations, as well as your——

Mr. CONNOLLY. And, Fred, it is good to see you again, because if you remember, over 30 years ago, I was on the other side of the capital, and it was great to see you again here today.

Mr. BERGSTEN. Absolutely. I think the big win for President Obama will be if he can get the rest of the G–20 to get with his program, which is stimulating an economic recovery and creating jobs—getting that done in a way that will inspire confidence in markets around the world rather than undermine it.

It is unfortunate that central banks are independent and are not participating in this meeting. So you can't really do much in terms of monetary policy or increasing their support for financial restructuring in this context.

That being the case, fiscal stimulus is it. I suggest in my statement upping the ante, seeking countries to commit to stand by a 3-percent of their respective GDPs each year.

That would require additional stimulus here. I think we are going to need it. I think if we can get the rest of the world to join, we could get a compelling and confidence-inspiring global recovery strategy, without which this situation may continue to spiral.

Mr. CONNOLLY. Dr. Morici.

Mr. MORICI. Well, I am hoping that we can get——

Mr. CONNOLLY. Can you press your button?

Mr. MORICI. I did. I am sorry, there we go. I am hoping that we get something on stimulus. I think that Fred is correct that we need more of that. We need the Europeans to pull along, and I think we can get that.

However, that is really a big Band-Aid. I would like to see recognition of the fact that the imbalances in production and consumption between the Asian nations and the oil nations, versus the west, are a source of instability and must be corrected if we are going to permanently pull out.

And I would like to see more reasonable expectations about the notion of global financial regulation. I think those solutions still lie predominantly in domestic solutions with cooperation.

And the Europeans continue to obfuscate issues in that matter. We are not going to regulate our banks through some sort of international entity.

Mr. CONNOLLY. Thank you. Mr. Chairman, my time is up, but I just want to note that what struck me about the answers here is that there is a real opportunity for the United States at the G–20 to reinstill some confidence in the global system, and I hope that we will take advantage of it. Thank you, Mr. Chairman.

Mr. SHERMAN. I thank you, and I thank you for your excellent questions, and for sticking to the time limit as a few of us have not. And I now recognize the gentlewoman from California.

Ms. WATSON. Thank you so much, Mr. Chairman, and this is a question for all of you. While the first world countries have been hit hard by the crises, poor countries and poor people are suffering as much or more.

And according to the IMF's most recent forecast, low income country growth in 2009 is projected at just over 4 percent, more than 2 percentage points lower than expected a year ago, with high risk that the situation could get worse.

In per capita terms, this means that many of the world's poorest countries will at best see income stagnate this year, and possibly even contract, and this is of critical importance to us here in America.

The National Intelligence Director, Admiral Blair, has told Congress that the primary near-term security concern of the United States is the global economic crisis, and its geopolitical implications.

Yet, we are stuck confronting this 21st century poverty challenge with a foreign assistance apparatus that was designed for the Cold War. So to all of you, what do you think are some of the key challenges to the United States Government being able to address how this crisis impacts the poorest countries, and people around the world? And let us start over with Dr. Johnson.

Mr. JOHNSON. Thank you, Ms. Watson. I think you are putting your finger on an incredibly important and difficult issue. I absolutely agree that this is going to impact the poorest people in a terrible way, and I think you are right that our mechanisms for dealing with this are outmoded and probably far too small in scale.

But first and foremost, I think we have to get the global economy back on some reasonable trajectory, and so that is why that should be the emphasis, the right emphasis of the G–20 meeting, and I think, and I believe that President Obama and Secretary Geithner are going to focus on that, and that has big effects everywhere else.

In terms of additional assistance for the poorest people, as you know that is a complicated question. It is not an easy thing to provide additional financing in a way that is effective, and that it really reaches poor people. Too much of it can get siphoned off one way or another.

But I think that is something that is worth a considerable amount of attention, and hopefully further resources from rich countries to the extent that it is possible in this difficult environment, because it will come back to haunt us one way or another if we neglect these people.

Ms. WATSON. Ms. Wallach.

Ms. WALLACH. Thank you for your question. The crisis is exacerbating what are already very troubling trends, in that the countries in the developing world who most closely followed the package of policies of the IMF World Bank and World Trade Organization have actually seen their growth rates declining.

And the countries who haven't, like for instance, China and Vietnam, have seen their growth rates expand much more quickly. So in a variety of regions, you have seen since the adoption of the current global economic governance regime drops in per capita income growth in sub-Saharan in Africa, also with other issues, such as the AIDS epidemic.

You have actually seen literally net declines, versus in Latin America, slowdowns in growth rates relative to the period before these policies were adopted. So now with the crisis exacerbating that, the policy states having been removed for those countries to respond, part of the overall remedy is to fix the underlying rules.

The majority of the developing countries were against the Doha round agenda. It was cynically dubbed the development agenda by then USTR Wallach. Actually, the developing countries had a different agenda. It was called the Implementation Agenda, and it was a review and repair agenda for the existing WTO rules.

And that is where I am arguing is also part of the response that is needed and appropriate in this crisis, and I apologize for having no expertise in foreign aid issues.

Ms. WATSON. Dr. Levy.

Mr. LEVY. Thank you, Congresswoman. I would agree with Dr. Johnson that first and foremost it is going to be very difficult for these countries to prosper in a world economy that is having the kind of difficulties that it is. So there are those measures.

I think we can do far better than we do with foreign assistance. This is an issue that I spent 1½ years working on when I was at the State Department. I think it is important to work through multilateral organizations, despite some of their failings.

But I think we can also be much more focused and effective in our foreign assistance policy by trying to set goals and be very clear in what we are doing, and try to get better management implementation from the executive branch.

Mr. BERGSTEN. Let me give you a slightly dissonant answer. You mentioned the developing countries are looking at 4 percent growth this year. In today's global economy, 4 percent growth looks very good. There is no industrial country, and I repeat, no industrial country that is expecting positive growth of any number this year.

We have done an analysis in my institute that looks at each of the G–20 countries to see what is their relative decline, and it may surprise you that the smallest relative declines by far are in the developing countries in the G–20: Brazil, China, and India.

They have all suffered substantial reductions in growth in absolute terms, but relative to where they started, it is not so bad. This is important for your question, because remember the largest cohorts of poor people in the world are still in China, India, Brazil, and Mexico—big developing countries that we think of as advancing, and indeed they are.

They are in the G–20 but still house by far the biggest cohorts of poor people, and since they are doing less badly, their situation relatively speaking is not so dire.

Having said that, I fully agree with my colleague that poor people in those countries are going to be hurt badly by the global downturn. The answer is to get global economic growth back up and keep global trade open, as a couple of your colleagues on the panel have said, because it is still true that no country has achieved sustained economic development without integrating into the world economy.

Ms. WATSON. Thank you. Dr. Morici.

Mr. MORICI. I would like to build on and align myself with what Fred has just said. Most of the poor people are in countries that are doing relatively well, and they don't require any particular special assistance from us.

That said, I think it is important for us to remember that many of the poorest people are in very small countries, who are really swept up by the events of the heavyweights, and I think we need to be cautious about how we deal with those very small countries, who are caught in the great sea of combat between the United States and China, and the intellectual combat between the United States and the EU, and all the rest of that stuff.

So I do believe that if we could find some way to assist them that would be appropriate, but I am skeptical of how you get that done without just getting the engine going again.

Ms. WATSON. Thank you.

Mr. SHERMAN. Thank you. The time of the gentlelady from California has expired, and we will now recognize the gentlelady from Texas.

Ms. JACKSON LEE. Mr. Chairman, thank you very much for this hearing, and particularly I am delighted to be on a committee that gets it, terrorism, nonproliferation, and trade, and I think there was some mindset that understood that these are all interrelated.

It seems that I am following this track today. I started out with a border security hearing on the crisis of drug cartels at the southern border, and the enormity, and the fearlessness of what I think really has slipped the minds of Members of Congress.

And obviously we are just beginning in the new leadership, but it is a wakeup call, and the reason why I mention that, of course, is that we are in the question of trade, but also the falling economy lends itself to the crisis in the social fabric.

And so my questions will be along those lines, and I want to go to Dr. Bergsten and Dr. Morici. Those huge numbers of impoverished, and I have just come back from Pakistan and India, are there.

I think the question that we have to ask is are they doing anything about it, even though they have certainly a much sizeable poverty in India, even though they may have the resources.

So I want us to continue to believe that it is important to fight against world poverty, and to even in this economic crisis be part of the warriors to extinguish some of the huge depths of poverty that really fuel terrorism and dissent. So that should not be off the table for the G–20.

But what I would like to ask both is as we move to the G–20, I think Dr. Morici has mentioned, and forgive me for not hearing all of your testimony, but the awkwardness of our relationship with China, I would like you to comment on that further.

But, Dr. Bergsten, I would like you to tell us how pushy our President should be at the G–20. My understanding is that we are making our own sacrifices and our heads are getting battered on the stimulus.

All the talk shows that build up their credits on bashing Washington is all about how much money we are wasting. Maybe the G–20 is listening to Rush Limbaugh, and has indicated that they don't want us to go any stimulus. So where does that put us?

So if I could ask the question to Dr. Bergsten, and I am glad that Ms. Wallach is here. I just want her to be satisfied that what her organization has spoken about maybe years ago, deregulation is now falling on top of our heads, and we are smothered up, and she might just want to comment on how we get out of that, if you will, debris of deregulation. So let me go to Dr. Bergsten.

Mr. BERGSTEN. President Obama should be very aggressive at the London summit. I think he comes with a strong hand, because you and the Congress have voted for a major stimulus program.

I hope that nobody is listening to Rush Limbaugh's appraisal of it. There sure are flaws. You all know it. But it has put the United States out front in leading the concerted policy effort to get the world economy back on track.

We may need another stimulus. I think we probably will have to do more, but right now we are out front. Now it may shock you when I tell you the other country that I think is out front and that we should join arms with in leading the effort at London is China, because China has also taken a huge stimulus program.

The chairman and I had a little debate about how you count it, in terms of United States effects. I think it is going to help the United States, as well as help the world economy. I think the United States and China on that front, the fiscal stimulus, the macroeconomic impulse, lead the league.

And President Obama should certainly be aggressive in pushing particularly the Europeans, but also some of the other emerging markets who have not yet gotten with the program. The Germans and the French, for all their talk, have done very little. They in fact have tried to deflect the agenda. They say we should worry about financial regulation. It is very important, but at a time when we are trying to get the banks to lend more money and unfreeze the financial system, it is unhelpful, to put it mildly, to talk about increased financial regulation.

It confuses the public and the banks, and it is a bad idea. The focus has to be on avoiding a global depression, and on that the President needs to be quite aggressive and is in a strong position to assert leadership.

Ms. JACKSON LEE. Dr. Morici, Dr. Bergsten has just put my hair on fire. He has some good points, but he has talked about China——

Mr. SHERMAN. If he put your hair on fire, you may end up looking like me. [Laughter.]

Ms. JACKSON LEE. Chairman, I am going to ask for your indulgence. I would ask for unanimous consent for a minute so that Ms. Wallach could finish her answer, and Dr. Morici, on his response on the China issue.

But I would also say that if our President is not aggressive, it impacts trade. Americans are not interested in a sort of trading situation if they can't get their pocketbooks back together. Dr. Morici, what about China and what about some of the ills and problems that they have?

Mr. MORICI. Well, I think there is a tendency with regard to China for policymakers to view it as a tactical problem. You know, if we get them to reform their financial markets, then everything will be fine.

In reality, this is an issue of systemic competition. We offer the world the notion that democracy and markets best serve the progress of mankind, and best can help people fulfill their dreams.

The Chinese offer the world a very different model, and are pursuing tactics which abuse the international trading system and their opportunities within it to make us look foolish.

It is very difficult for us to tell the world that they should adopt our prescriptions. Rather, they offer people order and stability with an autocratic government. So I think we need to start to see China for what it is, and to start to craft our trade policy in an appropriate way, rather than one that views them with as sympathetic an eye as we have.

That doesn't mean at the G–20 that we can't pursue what Fred just described. We want to get the Europeans to stimulate their economies, but I think at some point, we are going to have to reckon with what China really means for the west, and I don't believe that this administration or the last administration has been ready for that question, except when they are trying to get confirmed in the Senate, or running for President in Ohio.

Once those goals are accomplished, they seem to fall back. Vice President Biden quickly said right after Mr. Geithner was confirmed, that we need to determine whether China is manipulating its currency.

I don't want to say in this chamber what I thought of that statement, but I will say it on the Lou Dobbs Show tonight if I am given the opportunity. If Lou——

Ms. JACKSON LEE. But you will say that we are all interested in working through your issues, and we are, too, concerned.

Mr. SHERMAN. The time of the gentlelady from Texas has expired.

Ms. JACKSON LEE. Does Ms. Wallach have a simple answer?

Mr. SHERMAN. If she has a simple answer, out of respect for her, we will give her some time.

Ms. JACKSON LEE. And, Mr. Chairman, thank you, and I will yield back as Ms. Wallach answers the questions. Thank you, witnesses, very much for your answers.

Ms. WALLACH. Thank you, Congresswoman. The short term answer is regarding the G–20 communiqué next month, one, it should not include a commitment to push for the completion of the current WTO Doha round agenda, because that explicitly contains as one of its three main pillars financial service deregulation.

Number two, it should contain a commitment for the G–20 countries to review the existing constraints imposed worldwide through the WTO on an array of different regulatory and non-trade policies that undermine the policy space that Congress and other legislatures, and different world configurations need to create the policies of global governance to restabilize our economy.

And given the WTO is strongly enforced, and given that there have been 150 cases, in 90 percent of the cases the domestic laws have been ruled against, and every single one has been changed but for one, where Europe is paying $100 million in sanctions a year. We need to strongly enforce global governance of a balanced sort, and not the current system. Thank you.

Ms. JACKSON LEE. Thank you.

Mr. SHERMAN. At this point, I will start the second round. I will have to leave for a few minutes after my questioning, and our vice chair will take over. I will try to return before the end of the hearing.

Dr. Bergsten, you are correct to point out that even if not one penny of China's stimulus money goes to a United States contractor, that Americans will benefit to some degree by the general acceleration of the Chinese economy.

Just as I would point out that if we had provided that not one penny of our stimulus package had gone to China, that they would get an enormous benefit because the goal here is to get people back in the malls, and whose products are sold in those malls.

The fact though is that China will get both the direct and the indirect benefit of our stimulus package because a lot of the money that we spend on manufactured goods as part of that will come from China.

I think that we have made the case that most of you agree with that we need more stimulus worldwide, and the President goes to London leading by example, leading by force of personality, leading with great oratorical skill.

What can he do other than encourage? What can he do in terms of bargaining, in terms of demanding, in terms of saying we are not going to do this unless you do that, top encourage other countries to have a stimulus package hopefully above, but at least at a 2-percent level? Dr. Johnson, our forgotten, but very eloquent, witness.

Mr. JOHNSON. This is a problem, the fiscal stimulus. It encourages free riding. If you do a bigger fiscal stimulus, maybe I will just sit back and you build the roads, and I will sell you the BMWs, and the construction equipment to build those roads.

Honestly, this is the problem. The main answer, in terms of global policy coordination, is to push harder with easy monetary policy, which of course is limited in terms of cutting interest rates.

But moving toward quantitative easing and expressing support for the kinds of policies now being used by the Bank of England, for example, which is trying to expand the money supply in a way that Mr. Bernanke has talked about in the past, but hasn't actually gotten to.

That will focus the Europeans attention, because if they have the prospect before them, with the dollar potentially depreciating, and therefore you can't sell BMWs to the United States because the Euro is appreciating, they will be much more likely to take the cause of the fiscal stimulus seriously.

Mr. SHERMAN. So we should seek stimulus measures that coincidentally bring the dollar down in value, versus other currencies. I know that is an anathema to many Americans, of course.

Can you name a single country in the world that doesn't—a major industrialized country in the world that doesn't try often to have a lower currency so that it can compete?

I mean, we live in this world where testosterone and the strong dollar are our pride, and I know that we run up the biggest trade deficit. What do other countries think of having a strong versus weak currency?

Mr. JOHNSON. Well, every country has the same sort of testosterone issues that you are discussing. No one else goes quite as far as the United States, and it is interesting right now in Europe, in the Euro zone, where the interest rate and the monetary policies are controlled by the European Central Bank, they are rather turning toward a tighter monetary policy than many people would suggest is appropriate given the economic circumstances.

And that would tend to push the Euro toward appreciating. So you are right. Most other industrial countries, many industrial countries, for example, the United Kingdom, and for example, the Canadians, for example, the Australians, have a tendency to depreciate——

Mr. SHERMAN. And the Asian giants, Japan and China, I think work very explicitly to lower their currencies don't they?

Mr. JOHNSON. Well, as has already been discussed, China manages its exchange rate and that is a particular issue, and that absolutely needs to be addressed. I couldn't agree more with that topic.

Japan's exchange rate obviously has been undervalued for a considerable period of time, and there it is a little bit more complex with the aftermath of their—the fact that they had this massive bubble burst 20 years ago, and they never properly dealt with it, has caused all kinds of other pathologies.

Mr. SHERMAN. One last question, and I don't know who will indicate an interest to answer it. In October 2008, we helped the Swiss with a relatively routine currency swap. Now we find out that the Swiss are hiding 50,000 American tax evaders.

What can we do to make the Swiss uncomfortable enough that they tell us who these 50,000 tax evaders are? Does anybody have a strategy? Dr. Bergsten.

Mr. BERGSTEN. What makes the Swiss uncomfortable would be the threat of abrogating the bilateral tax treaty between the United States and Switzerland.

Mr. SHERMAN. So that would be interesting, having a policy toward our tax treaties that was relevant to collecting tax revenue. Good idea. Finally, Ms. Wallach, we have had this idea that we will lead by example, that our markets will be open, more open than any other countries.

And more importantly perhaps that we will be a rule of law society so that the degree to which our markets are open or closed can be read in the statute books that we won't have Commissars call business people and tell them to buy domestic goods.

How is that working out for us, and have other countries looked at the results of our trading policy and said, by god, we want to do it just like Uncle Sam?

Ms. WALLACH. Well, I think you have answered your own question. It is rather evident that in fact the countries that are doing well under the current regime are not following the current rules, and in fact are baffled probably by why we have so unilaterally signed up by example on an ideological basis, versus maybe negotiations on the basis of national interests.

And I think that in the procurement area is one of the most stark examples, and I know that it is an issue of special interest to the chairman, and in fact there are not many carve outs that the United States has.

There are now of the U.S. States, 12 States that haven't signed on to the agreement, but otherwise the United States has signed on its entire service sector, and all goods, but for some of which are taken for exceptions, such as iron and steel in transit projects.

We didn't carve out all transit projects. So, for instance, right now while the rest of the world, and not just Europe and the EU, but all of the countries of the WTO, but for the 39 who signed on to that extremely controversial agreement that most countries wanted nothing to do with, have the right to set their procurement policies and their stimulus policies according to their best needs.

The United States, for instance, we just put $20 billion into the electronic medical recordkeeping business. Almost all of that certainly is going to go offshore. We are not allowed to have contracts on services that have Buy America because of our crazed, expansive, no one else did it like this, and the WTOs lack of exception for services.

That is a service contract, and it is the transcription of medical records. We can't say that work must be done by United States workers.

Mr. SHERMAN. I thank you for your answer.

Mr. MORICI. May I give a fact?

Mr. SHERMAN. My time has expired, and when facts don't fit our theory, by god, we have got to change the facts. My time is so expired that I am going to see whether one of my colleagues allows you to bring up your fact. We will now yield to our ranking member, Mr. Royce.

Mr. ROYCE. Thank you, Mr. Chairman. I want to go to Dr. Johnson. You commented about the Japanese troubles and probably half of that equation or more is not dealing with those toxic assets.

But part of it might be the eight separate stimulus bills passed, which doubled the GDP here, or doubled that to GDP in the country over that lost decade. Also, you warned of the danger of the European push to re-regulate, suggesting that it could lead to potentially dangerous procyclical policies that can exacerbate the downturn and prolong the recovery.

I would just like your commentary on that, and would you elaborate on your observation that governments have only a limited ability to offset increased private demand through a fiscal stimulus. I think that is what we are hearing from the Europeans, and I would like your view on that as well.

Mr. JOHNSON. I am happy to take those points in order. I think on the experience, my reading of experience from Japan is that you need—and not that fiscal stimulus is irrelevant or unhelpful, and not that the fiscal stimulus is the entire story, but you need to address both problems together.

And if you have as the root of the issue is in housing, as it was for them in commercial real estate and housing obviously here, then you need to have some direct measures to take that on.

And to my way of looking at it, if you just pursue fiscal stimulus, or if you overweight the strategy toward physical stimulus, you will end up running up more debt, and it will take you longer to get out of it.

Mr. ROYCE. Until you get rid of the toxic assets.

Mr. JOHNSON. Well, you have to address the problems of the financial system, which involve a strategy for recapitalization, and that enables you to keep the financial sector private, and I would say privatize it given the extent of state control you now have over United States banks.

And also clean up the balance sheets one way or another. It is an inexpensive proposition. It is not politically popular, and major bankers, powerful bankers in Japan, opposed it. They have opposed it in every single country where these kinds of issues have come up.

They always want a way of dealing with it that is better for them, and much more expensive for the taxpayer, and perhaps it is no surprise that the United States finds itself in a remarkably similar position.

On the procylicality of regulation, I do think this is an important point which has been lost in the broader discussion. If you go to banks, or you go to regulators, and you say you have really got to tighten up on credit standards, you will get a great depression.

You will further have contractions in credit. This is a very tough problem. We want banks to be careful in their lending. We have to recognize that it was excessive credit, and so some deleveraging or reduction in credit around the world should be expected.

And also many creditworthy people, both individuals, families, and firms, don't particularly want to borrow right now because it is too darn scary. We should save cash, and we should hunger down, and spend less, and see what happens, and that is happening globally. That is happening in a very synchronized way.

So I don't think piling on in terms of the kinds of regulations that Europeans have in mind is particularly helpful. I do think defusing the bombs in the financial systems, which is the point about the toxic assets and the lack of capital, that is absolutely and critically important.

And I do think down the road to forestall the next bubble, we have to think hard about a proper regulated structure, and in particular I would emphasize any big bank that is too big to fail, is too big to exist.

We have a problem in the United States with banks that are 10 or 20 percent of GDP. In Europe, they have banks that are two times GDP, in terms of bank assets to GDP.

That is an automatic bigger problem than we have here, and if we don't fix our problems, we are going to be looking at the kinds of issues that Europe is going to grapple with this year, which are absolutely terrible and terrifying.

Some of their banks are too big to rescue, let alone left to fail. So it becomes a fiscal issue of the first order.

Mr. ROYCE. And governments have only limited ability to offset decreased private demand.

Mr. JOHNSON. And this is the problem of limited debt capacity, even though in the United States, we are relatively in a good position compared to other industrialized countries.

We start the whole crisis with debt and GDP around 40 percent, and you have to expect given the experiences between other countries that the total increase in debt GDP, privately held debt and GDP, will be at least 30 percentage points, and could well be 50 percentage points.

So we will end up with 70–80 percentage points, and that is with the kind of limited fiscal stimulus that you have already implemented and that is assuming that there is a couple of more tries in that same way.

That is a high level of debt. You can go further. You can go as far as Japan. You can go to 150 percent of GDP, or 180 percent. That is not a good idea. That becomes very expensive, and if you start to undermine the credibility of the United States Government, and if people around the world start to worry about the creditworthiness of the United States Government, which I would emphasize is not the current situation, and I don't see that in the immediate future, but if you get there, then it is a whole different kind of global economy we are looking at, where we no longer issue reserve currency, and we no longer have the kind of position with regard to power around the world.

Mr. ROYCE. The last question to Dr. Levy. You made the point that the WTO is more feeble than it appears, lacking any enforcement powers. Ms. Wallach's view is that it is all powerful, and would you just care to comment on that, Dr. Levy.

Mr. LEVY. Yes, sir. I think what has often been very useful for governments around the world when they have abrogated an agreement or have acted inconsistently with an agreement, is to point to the WTO and say—and we could say this here, it is like our Supreme Court. They made us to do it. They issued an edict.

But there is no Federal Marshal Service for the WTO in the same way, and we have seen countries—and what happens is that you have two countries that reach an agreement, but every time a dispute settlement panel simply renders a judgment that says you have either acted in accord with your agreements or you haven't.

After that a country can retaliate or not retaliate. If it does, it is essentially an unwinding of the agreement. There is no Marshal Service that forces you to act.

Mr. SCOTT. Thank you. Thank you very much. Let me just shift for a second, because this G–20 economic summit presents our country with an extraordinary opportunity, and we talked about having this happen as our President is being placed at least in a relative position of strength given the fact that we passed the economic stimulus and providing leadership.

But there is some sobering things out here as well that we need to examine, and particularly as it relates to three problematic areas that I think are certainly problems. One is China, and the other, Russia, and of course the situation in Pakistan which certainly would involve taking another look at our trade issues.

And if we undergird all of this with the fact that that economic stimulus money is based upon money we are borrowing from China, from Russia, from these very same countries that we are having a problem with, grappling with.

Secondly, of the 15 major manufacturing nations that account for 80 percent of the world's manufacturing, the United States ranks the lowest for the proportion of production goods that are exported.

And I think I would like to get your response from these two basic phenomenons. We are leveraged beyond our debt. What strength of position are we in to bow up to China to tell them what they should and should not do when they are holding over $1 trillion of our debt, and I think that puts us in a very vernal position. Dr. Levy, and Dr. Bergsten.

Mr. LEVY. Thank you, and you raise an excellent question, and I guess I don't think the concern that sometimes is expressed that China has got this stock, and they are going to use this as a cudgel to beat us with is our concern, but I do think that we have to think very carefully about attacking China over issues, such as trade balances, because it is fundamentally inconsistent with trying to borrow a great deal from them.

If we were to borrow a great deal, to slip into jargon, current account surplus and capital accounts deficits are related. You simply cannot be borrowing a great deal from the rest of the world and say we also want to run a current account surplus, or even balanced trade.

So this will—we saw this with Secretary Clinton's trip to China most recently. We can say, Thou shalt not manipulate your currency, but we cannot at the same time say, And also please buy lots and lots of Treasury bonds.

Mr. SCOTT. Dr. Bergsten, and then Dr. Morici.

Mr. BERGSTEN. Well, no, actually I slightly disagree with that. We can and should take a much tougher line toward China on currency manipulation, and we are probably within our rights to do that.

They are violating the most fundamental rules of the international economic system. The IMF has very clear strictures against competitive undervaluation. We are perfectly within our rights to hit them.

Even if we succeed beyond our wildest dreams and get them to let the currency go up 20 or 30 percent, which I think it still needs to do, they will still be running trade surpluses.

They will still be adding to their reserves and for their own reasons will continue to put most of that into dollar assets. So I really don't worry about that too much. They are not going to dump the dollar.

However, there is a more fundamental reason if your concern is correct. China is the second largest economy in the world. It is now the biggest exporter in the world. It has 1.3 billion people.

We are not going to order China around, and it is much more fundamental than whether they hold Treasury bills. So we have to get used to the fact. I have published two books on this topic in the last 3 years and have studied it very carefully.

We have to find new ways to work with China: Hitting them hard where they are violating the rules of the game, like on currency, but working with them where they are with the program, like on fiscal stimulus.

Can I say one word on Pakistan? It has come up two or three times. As I think Mr. Royce said at the outset, the best thing we can do for Pakistan is to reduce barriers to their exports to the United States, particularly of textile products.

We did a study at my institute of a possible free trade agreement between the United States and Pakistan. We showed how it would actually support the United States economy and not hurt it. But just as a marker, if you want to do something serious on Pakistan, we have done a very comprehensive analysis of how that could be done through the trade instrument.

Mr. SCOTT. So you agree then, because while you are on Pakistan, I wanted to get to that, and then I will get to you, Dr. Morici. But right now all of our trade basically with Pakistan is military; military equipment, military procurement.

Are you saying that our trade should be more balanced by decreasing the military end and increasing economic——

Mr. BERGSTEN. No, increasing the civilian, economic end.

Mr. SCOTT. Increasing economic?

Mr. BERGSTEN. Yes. You and several of the other members have asked about how to stabilize Pakistan.

Mr. SCOTT. Yes.

Mr. BERGSTEN. An essential part of that has got to be to create jobs in Pakistan so people aren't out on the streets and becoming Jihadists.

Mr. SCOTT. Right.

Mr. BERGSTEN. Again, no country has ever been able to achieve sustainable development without integrating with the world economy and expanding their trade. We have it within our power to support Pakistan moving in that direction, and we should take a very hard look at that.

Mr. SCOTT. Now let me ask you, number one, you definitely feel they are keeping their currency artificially low?

Mr. BERGSTEN. Absolutely.

Mr. SCOTT. And do you also agree that they are depressing their domestic consumption?

Mr. BERGSTEN. Yes, through a bunch of policy errors. I don't think it is quite as devious as Dr. Morici does. I think they would actually like to get their consumption up, but they have moved painfully slowly to do so. I am very critical of that too.

Mr. SCOTT. And do you believe that this is a consciously concerted effort for them to grow their economy by exploiting, exporting to targeted markets in the United States and Europe?

Mr. BERGSTEN. That is part of their development strategy, but remember that 80–90 percent of their growth over this 30-year period, including the last 5 years, has come from the domestic economy.

Ninety percent of their investment is domestic. Ninety percent of the growth and demand in the economy is domestic demand. It should be 110 percent, because their trade surplus should go down.

So it is not the bulk of their economic success story but it is an element that disrupts internationally, and yes, we have to worry about it very, very greatly.

Mr. SCOTT. Right. Thank you. I am going to go to Dr. Watson. I think you wanted to comment on this?

Mr. MORICI. Yes. It is important to recognize that we have two distinct sets of problems; the problems with the banks, which we could discuss how to fix, and a deficit in aggregate demand, a structural deficit.

If we reinflate the economy with a stimulus package, we will get back to the point, and because we have a large trade deficit, we have a deficit in aggregate demand, and unless we encourage people to borrow out against their homes, we could have another bubble, or the Federal Government keeps having more and more stimulus packages.

The only way this can be addressed is by changing the trade deficit so that you are not spending 5 percent of what you earn abroad, and the only way in the end that can be changed is through oil, and through trade with China.

With regard to China, while we cannot bully them and determine what they will do if they don't do what we suggest, just as it is a sovereign nation, it can set its exchange rate wherever it wants.

And since it is doing so in a way that violates international law, then the thing is that we can't reset the exchange rate, because we are the reserve currency. But we can tax dollar on conversion to the point to provide the same relative prices within the economy that an equilibrium exchange rate as thought about by international economists would be.

So we have that, and if we keep going down the path that we are going, and instead we keeping borrowing, then the problem that you worried about gets worse and worse. From the rest of the world, we have borrowed about $7 trillion as near as I can figure, or sold off stock. You know, securities.

And that is about what this all publicly traded stock in the United States is worth right now. So we have gotten ourselves to the point where we could get bought up.

Mr. SCOTT. That is right.

Mr. MORICI. It is not very smart.

Mr. SCOTT. Thank you. Dr. Watson.

Ms. WATSON. Let me see if we can come to some agreement. When our President goes to the G–20, and they have been discussing this creation of a new framework for regulating, and several of you have mentioned regulating the international financial system so that we can present and anticipate a crisis like this from reoccurring, what would a new super, super, international institution or framework be like to stop, or to shorten a future global recession?

What would you suggest? And anyone that wants to take a bite of that apple, please do. Dr. Johnson.

Mr. JOHNSON. I think pursuing such an international structure is an illusion. I think it is a distraction put forward by politicians who want to hide the fact that their domestic regulatory structure has failed completely.

And I think they failed for a very simple reason. Their banks became too big and too powerful. I think that is true in the United States regrettably, and it is much more true in other countries as I mentioned before.

In Europe, the banks are much larger relative to the size of the economy, and they are actually more powerful if you can believe that than in the States, and I think unless and until you address that issue, the power of the big banks, your infrastructure is always going to be overwhelmed.

Maybe it will look good for a while, but the next time the bubble or the boom comes along, you will have repetition of these same problems in a slightly different format. I think that certainly the key issue is breaking up of the big banks. Banks that are too big to fail, and some of them are too big to rescue, are too big.

Ms. WATSON. Are creating the failure, right?

Mr. JOHNSON. Absolutely. Look, they are holding the entire world economy hostage right now. They are saying if you take measures that are contrary to our interests, and we are the only ones who know what could go wrong because we are the only ones who understand the complexity of our banks—and I think by the way that they don't understand it, and that is how we got into this mess.

But leaving that to one side, they are saying that unless you do what we say, and unless you hand over a large amount of taxpayer money, that we will be a major problem for the financial system, and for the global economy.

And I think they are right, unfortunately. I think we have gotten ourselves into a situation where they are right, and we can't allow that to continue into the future. I think you have to consider ways to break up these banks, and so you have to consider size restrictions on them, which is a very crude way to do it, but I can't think of any other way to prevent this problem from reoccurring, perhaps in an even worse and more spectacular fashion.

Ms. WATSON. Dr. Bergsten.

Mr. BERGSTEN. I want to put one caveat on the question you raised about the role of international participation in financial regulation. It is clear that serious regulation has to occur at the national level. I fully agree with Dr. Johnson on that.

But I think there is a role for international cooperation—that is in trying to set consistent internationally agreed standards against which to benchmark national financial regulation.

This was done with great success after the Asian crisis 10 years ago, one root cause of which was weak banking systems throughout those emerging markets. Out of the crisis came agreement on an international banking standard that was worked out by regulators of national governments together.

It was then embodied in IMF surveillance of national systems. So what you got was an international agreement on best practices template. National governments then tried to approximate that as best they could, and then the international system monitored and pushed and prodded to get the standards up to snuff.

It has been a big success over the last 10 years. One reason the Asians have not been hurt more by the current crisis is that their banking systems are enormously better than they were 10 years ago.

It is tougher now for the United States, who thought its financial regulation was the gold standard, which turned out not to be the case, we have to be subjected to that now.

But trying to get international agreement on the objectives of financial regulation, and then as national governments implement that monitoring internationally and try to bring everybody up to speed, is a useful part of the process, but regulation still takes place almost totally at the national level.

Ms. WATSON. Dr. Morici.

Mr. MORICI. To begin again, I agree largely with what has been said about international regulation. The Europeans for cultural reasons are inclined to always recommend an international body, and I think it should be accepted as for what it is.

The real problem lies in domestic regulation. We need to revisit some of the things that we have done. For example, permitting large financial supermarkets to emerge and for commercial banks to be part of investment banks, has created a lot of cultural compensation and incentive problems.

There are things constructively that we could do in the derivatives market without creating the nightmare of over regulating the systems, and simply providing that derivatives have adequate posted collateral by the ultimate party that is going to have to pay out when the value of the asset goes down, and that requiring that if those guarantees are provided by international entities that their central banking authorities guarantee that those writers of the swaps can put out just as well as ours can. Things of that nature.

There are other things that we should look at, but it is largely a problem of domestic regulation and the fact that frankly the bankers view regulation the way that most of us view the tax code.

And they are very good at it, and so we are going to have to start to consider whether there needs to be changes enforced in the way that the bankers view lobbying and regulatory structures, and things of that nature.

Ms. WALLACH. Regarding what structure, I have no expertise, but as regards the actual rules that need to be in such a system of regulation, on the point of the importance of having domestic rules correct, and having banks broken up, part of the issue for the

G–20 again is to review the existing WTO rules regarding financial services, because, for instance, the market access obligations now in those agreements will limit the standstill in new regulations, for instance, make clear obstacles to those kind of domestic policy goals.

And just to make it very concrete, for instance, in the United States commitment to this particular agreement, one of the things that we agreed to do to meet these obligations was to get rid of Glass-Steagall.

It is actually in the footnote of the United States GATS commitment, because the market access rules don't allow you to have firewalls between the different kinds of businesses within the bank.

You are not allowed to limit the size of a bank quite explicitly in the Article 16 GATS market access rules. So these are very concrete changes that need to be put into place, and the carve out that Dr. Levy mentioned doesn't really fix the problem, because the carve out says that you can only—shall not be used as a means of avoiding the members' commitments or obligations under the agreement, which is to say you can only use the exception as long as the exception doesn't apply to things that violate the agreement, which is the only reason that you would need the exception.

Mr. SHERMAN. I thank the gentlelady from California. Since the discussion of waterboarding, President Obama announced that America does not torture. He was wrong. We are going to do a third round of questioning. [Laughter.]

There may be only one person doing the torturing, and I know, Dr. Johnson, that you have to catch a train pretty soon. Now, one quick comment about Glass-Steagall, and that is the big investment houses—Bear Stearns, Lehman Brothers, Merrill-Lynch, and Goldman-Sachs—did not engage in commercial banking until very recently.

And their nonregulation is much a part of the problem. Merrill-Lynch, the fact that we had repealed Glass-Steagall is the only reason why we were able to walk away from Merrill-Lynch without a huge amount of taxpayer money.

So speaking as a member of the Financial Services Committee, it is not the fact that we reduced some of the 1930s regulation. The problem is that we failed to create any new regulation for the new financial instruments.

It is as if somebody said there was a spike in automobile accidents and it is because we abolished some of the 1910 buggy whip rules. It is not whether you kept the buggy whip rules or repealed them. If you don't have a vehicle code for automobiles, you cannot run a transportation system based on them.

Dr. Johnson, you intrigued me a bit on how we could stimulate our economy without a freeloader problem. Were you basically talking about the TALF program, where the Fed goes out and buys various debt instruments, or perhaps you could just add to your ideas on how we could accomplish that goal?

Mr. JOHNSON. Certainly. Well, the TALF program is of course designed to support the credit market, and the problem as you know very well is the breakdown of securitization distribution, and the Fed is essentially stepping in and becoming part of the commercial funding for that market.

I think that is regrettable, but probably unavoidable under these circumstances, and I support it. But it is not enough, or it is not the complete part of what I was talking about, which is quantitative easing.

Quantitative easing is when central banks actually go out, and for example, in the case of the Bank of England right now, they buy long treasuries. So instead of limiting their operations to short term government obligations, which is their bread and butter, they actually try and operate further down the yield curve.

And basically they don't like to use this term, but in the vernacular they are printing money. They are issuing money, and they are trying to fight off deflation. They are trying to push inflation back up toward 2 percent, which is informally what they were aiming for before.

And this kind of action and demonstrating this would tend to cause the United States dollar to depreciate, just like the British pound has depreciated by 20–30 percent since these kinds of policies were put into place, and that concentrates the minds of your trading partners considerably.

Mr. SHERMAN. Now why is it printing money to issue currency to buy long term treasuries if it is not also printing money to issue currency to buy short term treasuries? Why is one "printing money"—and I guess a third way to go—I mean, the Fed can do three things.

You can print money for long term treasuries. You could print money in return for short term treasuries, or you could just print money, and go buy whatever you want to buy with it.

Now that is really printing money, and is not being seriously discussed, except by crazy bald Members of Congress. Now, why is it considered more printing money to buy the long term treasuries?

Mr. JOHNSON. Well, that is a mechanism of policy, but you are absolutely right. They could print money to buy things in your basement that you no longer want for example.

Mr. SHERMAN. Because as I understand the TALF program, they are going to use cash to buy these various debt instruments, but they are going to get the cash by selling treasuries. So the private market is getting all the cash that the Federal Government or the Fed is spending on the student loan paper, and the Small Business Administration paper, the credit card paper.

But the private sector is giving the Fed a bunch of greenbacks for the Treasuries that it is selling. Instead of doing that, they could just do half of it. That is to say, buy the paper by printing paper money, and not selling any of their treasuries.

Mr. JOHNSON. Yes.

Mr. SHERMAN. But going back to my question, why is it considered more printing money for the Fed to sell treasuring, or rather buy long term treasuries versus short term treasuries? Why is one thought to be more inflationary than the other?

Mr. JOHNSON. Well, I don't think we actually know enough about quantitative easing to make that determination since this is a relatively new program, and a relatively new idea.

Ben Bernanke actually flagged it as a possibility back in 2002 in a speech, and he was regarded and earned the reputation of the name of Helicopter Ben. His nickname was Helicopter Ben after that speech for having even floated this possibility.

Mr. SHERMAN. Helicopter meaning an illusion to the idea of dropping currency from a helicopter?

Mr. JOHNSON. No, he said that ultimately what you might need to do is tax cuts that are financed by printing money.

Mr. SHERMAN. Tax cuts what?

Mr. JOHNSON. Tax cuts that are financed by printing money, and so basically help people with taxes, and you send everybody a check, and that check is—obviously you are drawing on the Federal Reserve, and that is an issue of money.

Now that is a fairly drastic step to take, and this is the kind of program that the Bank of England has right now, is a step in that direction. But the central banks I think are rightly—don't want to go crazy with the printing of money because you don't want inflation expectations.

You don't want people to suddenly start expecting 20 or 30 percent inflation next year. You want them to go back to expecting 2 percent inflation next year, which is what they were expecting more or less for a long time, and now those inflation expectations have come down.

Mr. SHERMAN. I would rather them anticipate 4 percent inflation than anticipate 4 percent deflation.

Mr. JOHNSON. Well, l think that is also my position, and I think that is where the central banks of course would never say that in public, but I think that is increasingly where they are learning with this, too.

But it is to error on the side of a little bit too much inflation, and then deal with those consequences, than to have 4 percent, or even a 1-percent deflation, which would be absolutely devastating given the debt levels and the structure of debt in this country.

Mr. SHERMAN. Yes.

Mr. MORICI. I would point out to you that there is a parallel issue with regard to whether you buy short term paper versus long, and that is by buying long term paper, you can—or selling it, or whatever, you can reassert your sovereignty over your monetary policy.

We have lost the ability of the Fed to influence long term rates because of China's investing in our capital markets and so forth, which we have had decoupling, and if the Fed had an active policy of not just targeting the Federal funds rate, but with targeting the 10-year Treasury rate, and the 20-year Treasury rate, that sort of thing, that would give it an ability to determine the slope of the yield curve in a very nice way, which would be very useful for regulating the economy.

Mr. SHERMAN. Because right now long term treasuries are yielding 50 times the interest rate of short term treasuries because——

Mr. MORICI. Well, it is not hard. I mean, if we take it to zero, we can get infinity, okay?

Mr. SHERMAN. Right.

Mr. MORICI. But the point is that if we raise them back up again the long rates aren't going to change very much. We have established that, because we essentially have a fixed rate of exchange rate system with China, and it buys and it fixes the exchange rate.

Mr. SHERMAN. And also if we buy long term treasuries, the Fed gets a better yield, and turns that money back over to us.

Mr. MORICI. Yes.

Mr. SHERMAN. When you can borrow short term at zero, borrowing long term doesn't seem like such a good deal. Then of course you get the quantitative yield. So the slightly radical approach is buy long term treasuries.

The truly radical approach is just print money, and do something with it that the Federal Government wants to do with it.

Mr. MORICI. Well, where would you like to create your jobs? If you just print money and give it to the Federal Government, you will create your jobs in very different places than if you buy long term bonds, because that will put money into the capital market where it might actually get used to build houses and things of that nature.

So the money will go to different places, and it is important to recognize who gets the first round of money, just like whether or not we have Buy America or not, and where the benefits go.

Mr. SHERMAN. Yes, I mean, you can buy that commercial paper, which we are being told is worth 100 cents on the dollar, and you can buy the long term. You really can't buy the short term treasuries in effect much because the interest rate is already at zero.

Mr. MORICI. Right.

Mr. SHERMAN. Let us see. You know, I could keep you guys here for a long time. I am not going to run out of questions, but I think we have run out of time, and the President is right. There is a limit to the amount of torture that America will engage in. Thank you very much for coming.

[Whereupon, at 1:10 p.m., the subcommittee was adjourned.]

A P P E N D I X

Material Submitted for the Hearing Record

SUBCOMMITTEE HEARING NOTICE

Committee on Foreign Affairs

Subcommittee on Terrorism, Nonproliferation and Trade

U.S. House of Representatives
Washington, D.C. 20515-0128

Brad J. Sherman (D-CA), Chairman

March 9, 2009

TO: MEMBERS OF THE COMMITTEE ON FOREIGN AFFAIRS

You are respectfully requested to attend an OPEN hearing of the Subcommittee on Terrorism, Nonproliferation and Trade, to be held in **Room 2172 of the Rayburn House Office Building:**

DATE: Thursday, March 12, 2009

TIME: 10:30 a.m.

SUBJECT: U.S. Foreign Economic Policy in the Global Crisis

WITNESSES:

Simon Johnson, Ph.D.
Ronald A. Kurtz Professor of Entrepreneurship
Global Economics and Management (GEM)
MIT Sloan School of Management
(Former Chief Economist of the International Monetary Fund)

Peter Morici, Ph.D.
Professor of Logistics, Business and Public Policy
Robert H. Smith School of Business
University of Maryland
(Former Director of Economics at the U.S. International Trade Commission)

C. Fred Bergsten, Ph.D.
Director
Peterson Institute for International Economics
(Former Assistant Secretary for International Affairs of the U.S. Treasury)

Philip I. Levy, Ph.D.
Resident Scholar
American Enterprise Institute
(Former Senior Economist for Trade on the President's Council of Economic Advisors)

Lori Wallach, Esq.
Director
Global Trade Watch
Public Citizen

By Direction of the Chairman

The Committee on Foreign Affairs seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202/225-5021 at least four business days in advance of the event, whenever practicable. Questions with regard to special accommodations in general (including availability of Committee materials in alternative formats and assistive listening devices) may be directed to the Committee.

COMMITTEE ON FOREIGN AFFAIRS

MINUTES OF SUBCOMMITTEE ON *Terrorism, Nonproliferation and Trade* MEETING

Day *Thursday* Date *3-12-09* Room *2172 RHOB*

Starting Time *10:40 AM* Ending Time *1:10PM*

Recesses ☐ (_____ to _____)

Presiding Member(s) *Mr. Sherman*

CHECK ALL OF THE FOLLOWING THAT APPLY:

Open Session ☑
Executive (closed) Session ☐
Televised ☑

Electronically Recorded (taped) ☐
Stenographic Record ☑

TITLE OF HEARING or BILLS FOR MARKUP: *(Include bill number(s) and title(s) of legislation.)*

U.S. Foreign Economic Policy in the Global Crisis

SUBCOMMITTEE MEMBERS PRESENT:

Mr. Connolly, Mr. Scott, Ms. Watson, Mr. McMahon, Ms. Jackson-Lee, Mr. Klein, Mr. Royce, Mr. Poe

NON-SUBCOMMITTEE MEMBERS PRESENT: *(Mark with an * if they are not Members of HIRC.)*

None.

HEARING WITNESSES: Same as meeting notice attached? Yes ☑ No ☐
(If "no", please list below and include title, agency, department, or organization.)

STATEMENTS FOR THE RECORD: *(List any statements submitted for the record.)*

Statements of the witnesses, Mr. Sherman's January 6, 2009, Christian Science Monitor Article

ACTIONS TAKEN DURING THE MARKUP: *(Attach copies of legislation and amendments.)*

RECORDED VOTES TAKEN (FOR MARKUP): *(Attach final vote tally sheet listing each member.)*

Subject	Yeas	Nays	Present	Not Voting

TIME SCHEDULED TO RECONVENE _______
or
TIME ADJOURNED *1:10pm*

Subcommittee Staff Director

THE CHRISTIAN SCIENCE MONITOR

A stimulus that won't sink the U.S.

Three keys: A package has to be tough, temporary and self-reversing.

JANUARY 6, 2009

By Brad Sherman

WASHINGTON - These days, a modern depression seems almost within the realm of possibility. To avert this, we need an enormous, immediate stimulus. But unless it's well designed, it may not pass Congress; it may not achieve its objectives; or worse, it may sow the seeds of a disastrous decline in the dollar's value.

That's why the stimulus should be tough, temporary, and reversible. Federal dollars should be extended to private interests only on the toughest terms. Taxpayers should demand the highest yield, the largest equity upside, and the strictest limits on executive compensation and perks.

Being tough on those we bail out offers three important advantages. First, it increases public support, which we'll need to enact huge stimulus expenditures. The public is currently focused on executive compensation and perks, but it will need to focus soon on the value of the securities the Treasury is receiving, including warrants – stock options that would allow taxpayers to cash in on a rebounding company's success.

Second, by being tough on those obtaining bailouts, we can limit the number of companies seeking a bailout. If executives see the federal government as a source of easy, cheap money, why wouldn't they – and every other company – attempt to get a bailout? The government does not have that kind of money.

Third, getting a good deal on our investments will minimize the eventual increase in the federal debt, and the burden it poses to succeeding generations. Many of those companies receiving bailout funds will still go bankrupt, so we must generate profits on those that do not. We need to look at both the rate of return on the preferred stock, and the value of the warrants.

It can be done productively: When Warren Buffett invested in Goldman Sachs, he got twice the rate of return and six times the warrants as taxpayers received for a similar investment in the firm.

Meanwhile, Keynesian economics offers a simple, two-part prescription for the difficult times ahead: easy money now, and fiscal and monetary austerity when the economy improves.

The biggest reason not to provide the first half of this prescription is that the metaphorical patient will be unwilling to swallow the second half. How, in good conscience, can I vote for massive economic stimulus now, if I believe that we will not be able to adopt fiscal restraint later?

We in Congress love handing out money, whether it be in tax cuts, tax rebates, tax holidays, tax fiestas, benefit expansions, subsidies, bailouts, infrastructure projects, aid to states, aid to cities, or aid to individuals. Can we count on future Congresses to discontinue and then reverse expansionary fiscal policies?

If we adopt the fiscal stimulus practices the economy needs now, then both our tendencies toward profligacy and legislative inertia will cause us to leave the financial spigot on too long – perhaps permanently. Some members of Congress familiar with the process, and fearful of the result, may oppose opening the spigot at all.

What's likely to happen is that fiscal hawks will prevent us from getting the full measure of economic stimulus we need now, and that advocates of tax cuts and free spending will prevent us from turning off the spigot later. Thus, we could get inadequate stimulus in 2009, and continue that stimulus long after it is necessary, and even until it is harmful.

To avoid this, the stimulus package should be both temporary and self-reversing. The same statutes that provide a massive stimulus should also provide that particular tax increases and expenditure cuts go into effect in 2013, automatically. The statute could provide an automatic, temporary delay in these austerity measures if we fail to achieve 3 percent economic growth in 2012.

Sure, we should fine-tune the program later. But we need to give the upper hand to those who will advocate fiscal responsibility four years from now. If austerity in 2013 is mandated by statute, advocates of fiscal responsibility will have a fighting chance when budgets are negotiated early next decade.

Only if the economic stimulus proposal is tough, temporary, and self-reversing can we be confident that Congress will adopt a proposal that is big enough and fast enough. Only if the stimulus measures are temporary and self-reversing can we also make sure that the actions we take today do not eventually lead to inflation, higher interest rates, a declining dollar, and an enormous increase in federal debt.

Brad Sherman is a Democratic congressman from California, a certified public accountant, and a senior member of the House Financial Services Committee.

March 12, 2009
Opening Statement
Congressman Gerald E. Connolly
HFAC Subcommittee on Terrorism, Nonproliferation and Trade

Mr. Chairman,

Thank you for holding today's hearing to highlight the ripple effect taking place within the global economy and the potential ramifications for U.S. interests around the globe.

As noted in the CRS report prepared for this hearing, 40 percent of the world's wealth has been lost in the last 15 months. A global drop in demand for goods has led to the loss of jobs in virtually every nation. Global economic growth was estimated at 2.5 percent for 2008, but is expected to be at or near zero growth for the current year. The World Bank estimates that each 1 percent drop in growth could translate into as many as 20 million additional people living in poverty. Such dire conditions create fertile ground for public discontent and government instability. The dangers that could erupt in those situations – whether it comes in the form of a hard-line protectionist agenda or threats to public safety – will only exacerbate the current crisis. This should not be just the concern of any individual country but the rest of the global community, as well.

As many of my colleagues know, the effects of the financial crisis on foreign countries are not isolated to some abstract, far-off place. Many of our metropolitan communities are seeing the impacts up close. Let me use my home district in Northern Virginia as an example. Fairfax County is home to more than 360 foreign-owned firms representing nearly 40 countries. These international companies are dealing with financial challenges on both fronts – both here in America and back home. It is just one small example of our interdependence and highlights the importance of us finding a path to working together through this crisis.

I look forward to this discussion.

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CONGRESSWOMAN SHEILA JACKSON LEE, OF TEXAS

March 12, 2009

Thank you Chairman Sherman for hosting this important hearing. These financial issues are of importance to our domestic and global economy. I also want to thank the witnesses for dedicating their time to this matter. Their expertise and recommendations are essential part of the learning process. I would like to thank our witnesses:

- Simon Johnson, *Professor of Entrepreneurship*
- Peter Morici, Professor of Logisitcs

- C. Fred Bergsten, *Director of Peterson Institute for International Economics*
- Philip Levy, *Resident Scholar American Enterprise Institute*
- Lori Wallach, *Director Global Trade Watch*

What began as a bursting of the U.S. housing market bubble and a rise in foreclosures has ballooned into a global financial and economic crisis. The world now appears to have entered a global recession that is causing widespread business contraction, increases in unemployment, and shrinking government revenues. Some of the largest and most venerable banks, investment houses, and insurance companies have either declared bankruptcy or have had to be rescued financially. The world is facing the worst economic conditions since the great depression. Nearly all industrialized countries and many emerging and developing nations have announced economic stimulus and/or financial sector rescue packages, such as the American Recovery and

Reinvestment Act of 2009 (H.R.1, P.L.111-5). Several countries have resorted to borrowing from the International Monetary Fund as a last resort. The crisis has exposed fundamental weaknesses in financial systems worldwide, demonstrated how interconnected and interdependent economies are today, and has posed vexing policy dilemmas for governments.

The process for coping with the crisis by countries across the globe has been manifest in four basic phases. The first has been intervention to contain the contagion and restore confidence in the system. This has required extraordinary measures both in scope, cost, and extent of government reach. The second has been coping with the secondary effects of the crisis, particularly the slowdown in economic activity and flight of capital from countries in emerging markets and elsewhere that have been affected by the crisis. The third phase of this process is to make changes in the financial system to reduce risk and prevent future crises. In order to give these proposals political backing, world leaders have called for international meetings to address changes in policy, regulations, oversight, and enforcement. Some are characterizing these meetings as Bretton Woods II. On November 15, 2008, a G-20 leaders' summit recommended several measures to be implemented by participating countries by March 31, 2009. The fourth phase of the process is dealing with political and social effects of the financial turmoil. Significant foreign policy implications of the crisis are now emerging.

The role for Congress in this financial crisis is multifaceted. While the recent focus has been on combating the recession, the ultimate issue perhaps is how to ensure the smooth and efficient functioning of financial markets to promote the general well-being of the country while protecting taxpayer interests and facilitating business operations without creating a moral hazard. In addition to preventing future crises through legislative, oversight, and domestic regulatory functions, Congress plays a key role in generating policy options and informing the public through hearings and other means. On the regulatory side, the largest questions seem to be how U.S. regulations should be changed and, if changed, how closely those changes are to be harmonized with international recommendations. Other questions include: should the United States promote global regulatory standards to be voluntarily adopted by countries or should a supranational regulatory institution be created? Where would enforcement authority reside; at the state, national, or international level? Congress also plays a role in measures to reform and recapitalize international financial institutions. Also, should U.S. policies be designed to restore confidence in and induce return to the normal functioning of a self-correcting financial system or has the system, itself, become inherently unstable?

Thank you, I yield back the balance of my time.

COMMITTEE ON FOREIGN AFFAIRS
SUBCOMMITTEE ON TERRORISM, NONPROLIFERATION AND TRADE
U.S. HOUSE OF REPRESENTATIVES
WASHINGTON, D.C. 20515

Donald A. Manzullo (IL-16)
Opening Statement

March 12, 2009

Mr. Chairman, thank you for calling this important hearing to examine our foreign economic policy in this time of global crisis. I am a staunch supporter of market opening agreements and an advocate for the benefits of global markets, but our current and pending commitments warrant close examination and renewed analysis. I look forward to hearing from our distinguished panelists today.

It is clear now that leaders in both government and business have failed to put the best long-term interests of our nation first. We liberalized trading on the assumption that our friends and allies would follow suit. Some of them have made steps in that direction, but not nearly enough countries have made nearly enough progress.

I have long supported opening more markets to U.S. goods and services through the negotiation of good trade agreements, but I measure the success of these trade agreements by how much it lowers trade barriers to U.S. exports. Not all agreements meet my high standards. The Korea-U.S. Free Trade Agreement, for example, failed to fully deal with the largest item in the trade deficit between the U.S. and South Korea – the sale of U.S.-made automobiles in Korea.

So in combination with expanding access to markets for U.S. goods, we must also work to make our federal agencies more responsive to the needs of U.S. exporters. I believe in export control reform that balances the needs of legitimate national security interests with competitiveness. Last August, Mr. Chairman, we were successful in finally convincing the State Department to clarify that the export of spare parts and components for commercial aircraft was indeed a function of the Commerce Department. For one major company with a significant presence in northern Illinois, this regulatory change will facilitate the export of approximately $1 to $2 billion in aerospace products all over the world except to embargoed countries or sanctioned entities.

I am also a strong supporter of vigorous export promotion programs to help small businesses find new markets and opportunities to sell their products and services overseas. One study conducted by the Small Business Exporters Association shows that getting more small businesses to export could cut out trade deficit in half. That is why I authored legislation last year to make sure that all the federal trade promotion programs are coordinated at the highest level of our government to insure that it is a truly seamless delivery of these important services to our nation's exporters (*Export Promotion Enhancement Act of 2008* – H.R. 5883).

We must vigorously enforce our own fair trade laws. Last summer, I was proud to work with Titan Tire and the workers at their Freeport, Illinois, facility to successfully stop the unfair subsidization and dumping of small off-the-road Chinese-made tires into the United States. Plus, we need to stop foreign governments from manipulating their currencies for a trade advantage. In the last Congress, I co-sponsored the *Currency Reform for Fair Trade Act* (H.R. 2942) to include undervaluation of a foreign currency as an unfair trade practice that can be subject to higher tariff penalties. That bill would help us rectify our trade imbalance with China.

We also need to create incentives to keep manufacturing in America. I am extremely proud of one of my hallmark achievements, in 2004, to phase-in a 9 percent tax deduction for domestic manufacturers. In other words, there is a now a huge financial incentive to reward manufacturers that keep jobs and production in America. Manufacturers would lose that tax incentive if they moved production overseas and then imported those goods back into the United States. We must also be careful when enacting more regulations, such as a "cap and trade" system to combat climate change, because many times those policies only provide an incentive to move production to countries not encumbered by similar regulations.

And speaking of domestic manufacturing, I'd like to touch briefly on "Buy America" because I resent the implication that the proposed provisions in the stimulus package regarding domestic sourcing were the first volley in some kind of trade war. I would argue it is only logical that money spent under the banner of "stimulus" should support American jobs. At the very least, we should know when and why a federal agency plans to waive Buy American laws so that our domestic manufacturers can be given a chance to bid on a given contract.

Supporting strong Buy American laws is not protectionism. Even the father of modern day capitalism and free trade – Adam Smith – said in his *Wealth of Nations* that "it is of importance that the kingdom should depend as little as possible upon its neighbors for the manufactures necessary for its defense." Now, I know that the devil is in the details here. Implementation of "Buy America" is tricky. But when it's done correctly, it is not only good for our American workers but it is compatible with our bilateral and multilateral trade agreements as well as current global practices.

I'd also like to note there is no database that I'm aware of that maintains a record or an analysis of how successful U.S. companies have been in winning overseas government procurement (or how successful foreign companies have been in winning U.S. government procurements). So there is no way to measure the effectiveness of the World Trade Organization (WTO) Government Procurement Agreement (GPA). Even if such a record is established, however, the role of offsets in government procurement overshadows any advantage we might have, particularly in defense sales overseas. As recent annual reports on offsets from the Commerce Department have shown, foreign countries require any ever increasing share of "offsets" to compensate for the purchase of U.S. defense equipment to the point where now the sale of a U.S. defense item results in less overall national benefit to the United States.

On a truly level playing field, I am confident our American firms can compete with anyone in the world. Global trade will help as we raise ourselves out of this recession but only if we simultaneously ease barriers to exports, incentivize investments in both capital and R&D, and stand firm in the implementation of our trade agreements.

I look forward to hearing from our witnesses concerning the way forward. Mr. Chairman, thank you again for convening a topic on this vitally important topic.

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