

THE ST. PETERSBURG INTERNATIONAL ECONOMIC FORUM – 2009

4-6 JUNE 2009, ST. PETERSBURG

ECONOMICS DAY

NEW ECONOMIC MODEL AND LONG-TERM IMPACT OF CRISIS

In cooperation with KPMG

June 5, 2009

(14:30-16:30, Hall 8.2, Pavilion 8)

St. Petersburg

2009

Description:

The crisis has demonstrated the failure of the self-regulating market economy. Debate between followers of the Chicago economic school of Milton Friedman and supporters of more regulated systems.

Moderator:

Robert Thomson, managing editor of The Wall Street Journal, editor-in-chief of Dow Jones

- **Arkadiy Dvorkovich**, Aide to the President of the Russian Federation
- **Timothy Colton**, Professor of Government, Director of Davis Center, Harvard University
- **Nouriel Roubini**, Professor of economics Stern School of Business, Chairman RGE Monitor, New York University
- **Jon Cunliffe**, Economic Adviser to the Prime Minister of Great Britain, Official Assistance to the Prime Minister at Summit of Eight
- **Yevgeny Gavrilenkov**, Managing Director, Chief Economist Troika Dialog Group
- **Blair Sheppard**, Dean of Duke University's Fuqua School of Business
- **Alexei Reznikov**, Chairman of the Board of Directors OAO «VimpelCom»
- **Padma Desai**, Professor of Economics Columbia University

Transcript:**R. Thomson:**

Thanks for coming. I'm Robert Thomson, the editor-in-chief of Dow Jones and the managing editor of The Wall Street Journal. To my far right, we have Blair Sheppard, the dean of Duke University, Fuqua School of Business. And then as we move to the left, we have Yevgeny Gavrilenkov, who's the managing director and Chief Economist of Troika Dialog. To my immediate right, we have Tim Flynn who is the global chairman of KPMG, and you'll see from the banners that their generous sponsorship has made this discussion possible. Thank you for the money, Tim. To my immediate left is Arkady Dvorkovich, who is the aide to the president. He's a very modest man but for those of you who don't

know, Arkady has more influence than he lets on. Then to the immediate left of Arkady is Nouriel Roubini, a bit of a legend. He certainly made it so over the last year or so by having been right - which is not always true of economist. Then further left, we have Tim Colton, who is a professor of government, director of the Davis Centre at Harvard University and a well-known Russian specialist. And to his left, another very well-known Russian specialist, Padma Desai, who I think first came in to St. Petersburg in 1964. And so, 45 years later, at the age of 51, she has an interesting perspective to share with us all.

I might start the first question with Nouriel. He's come from afar. Two years ago, apart from your present understanding of the potential for collapse, most people thought that what you might call the Anglo-Saxon economic model had been proven to be beyond comparison, that it was clearly the model that everybody had to adopt. The only question was how fast China should hurry up inflate the Yuan and just get on with it. Then, three months ago, you have to say the Anglo-Saxon model was completely discredited. The question was really how far the state should be involved and the more state the better. Well, I guess, if you were to have this debate now, again, perceptions are changing as we speak and the seeming ability of the U.S. economy and, in particular, some U.S. financial institutions, to dig themselves out of a hole has raised doubts really about what you might call the social democratic Continental model and its viability. So, where are we in the evolution of the modern model?

N. Roubini:

Well, my answer will be that it is work-in-progress, and you are absolutely right, the perception of what is the appropriate economic model are changing over time. And if you want to go back longer in history to after the Great Depression, there were a series of major regulations of the economy, of the financial system and also of other markets, with government intervention, and then starting with the Reagan revolution, we went towards a period of massive deregulation.

Actually, the deregulation process started under Jimmy Carter in United States. He started deregulating airlines and so on, and I think that while some of those regulations have been excessive, there was a clear observation that it's better to deregulate the economy. I think that the ideology of deregulation was taken in the Anglo-Saxon countries to the extreme and, especially in the case of the financial market, this ideology became one, in the last decade, that you should rely on self-regulation. We've discovered that self-regulation means no regulation and you rely on market discipline but when there is "irrational exuberance", there is no market discipline relying on internal risk management models. But as the former CEO of Citigroup, Charles Prince, said, when the music is playing, you got to stand up and dance, meaning, in other words listening to the internal risk managers because the risk takers are

those who are making money in these financial institutions, or reliance on rating agencies that had massive conflicts of interest because of being paid by those they were supposed to be rating.

So, all the basic pillars of, say, Basel-2, have already failed even before they'd been implemented. And I think the pendulum swung too far in direction of the Anglo-Saxon model of purely *laissez faire*, free markets without even prudential regulation and supervision. And one of the paradoxes actually of the previous U.S. administration was that it was so ideologically in favour of free markets that because of this ideology, <inaudible> they caused the biggest economic and financial crisis since the Great Depression and because of that, even before the current administration, they moved all the way to the opposite in a situation in which the Central Bank, Treasury and Government interfered in the economy in a massive and radical way.

So, in my view what's appropriate is something in the middle. I think, that, you know, market economies are those that work best. And if I have to paraphrase Churchill, I would say the market economy is the worst economic regime apart from the alternative. You know, this country tried Communism and it failed, so I think that models that are not market economies have been shown to be a failure. That's why, you know, Russia, China and many others moved away from them, but the thing that we've forgotten is also that the government plays an important role in the economy. It has to provide a social safety net. It has to provide public services. It has to provide the infrastructure. It also has to provide the appropriate amount of supervision and regulation of the economy including all financial institutions.

So, I think there is the Anglo-Saxon model, there is, on the other side, the Continental European model that has its own flaws because, in that Continental European model, there is too much government intervention in the economy, too much of a welfare state, and maybe the lesson of this crisis is that you have to find the right balance between market economies but also, at least in the financial market, proper regulation and supervision. But it's an evolving situation because right now with the U.S. so much involved in the financial institutions and even now, with GM and Chrysler, in managing private companies, some people are starting to talk about, you know, "state capitalism" as a new kind of model. And even in the case of China, while its economy is going in the direction of the market economy, there's still a significant and massive role for the government in the economy and a large amount of state-owned enterprises. Some people say that's a model that works. So, I would say we're in a phase of transition in which there's no obvious economic model that's the one, that's really the one that is right. And maybe different countries are going to have different models as well.

R. Thomson:

Thanks, Nouriel. He said he made mention of the famous Charles Prince and about how he'd get up and dance until the music stop. I think what Mr. Prince failed to realize is that for him it's now playing a funeral march.

Blair, what do you think the lessons are for a country like Russia, of the upheaval of the last two years, and the gradual piecing together of economies around the world.

B. Sheppard:

So, Bob, I think the term Anglo-Saxon is actually a problematic term because I think it's an extreme version of a particular view of economics that actually predominated. You can almost claim a very narrow piece of set of people from University of Chicago that we're actually speaking about. And so I think in a sense one of the things we need to do is actually is step back and say what really caused the problem, and I think an important issue is that we just got the basics wrong, right? We permitted a level of leverage in banks that was ridiculous. We allowed people to issue loans that held no risk. We permitted off balance sheet activities that never should have been permitted and so it isn't so much the case that the crisis itself reveals that one form of government is in play, but actually the system that was meant to regulate the Anglo-Saxon model itself failed. And so, I think the lesson for the U.S. and England is manage your own system the way it was managed in the first place.

I think the second issue, though, is that if there's anything, any lesson we've learned, we have this really interesting dilemma which is that we live in a globally interdependent economy but we have radically different political economies around the world and so the appropriate form of government versus market is actually quite different from country to country. But the more we solved that problem, we actually created a major problem internationally because you don't get harmonization around the world. And so, I think the lessons for Russia are really very tough, but there's at least three that I would suggest.

The first is whatever you do, do something - because if you don't act to re-establish trust, the system simply won't get started again. Second, don't do anything that will kill innovation that will drive us out of this crisis, right? All crises have the benefit of actually allowing winners to emerge who have really good business models, but that doesn't happen if there's no capital available for those firms to fund themselves. So whatever you do, don't kill. And third, don't over-diagnose the problem because it was really much simpler than most people are claiming it was.

R. Thomson:

Thanks very much, Blair. Arkady, when you look at what's transpired over the last 24 months, do you

think it was more human failure or systemic failure? Was it a failure, for example, in Wall Street, of individuals who have been blinded by greed and frankly who were less able than people presumed that the great men and women of Wall Street to be? Or was it that there's a fundamental flaw in the market system as articulated in the United States?

A. Dvorkovich:

Well, I think that it was a human failure that developed but those humans developed their own system and that system failed. I'm not from Chicago, but, as far as U.S. universities go, I'm from Duke and Duke is about playing basketball well. Some people know that playing basketball is about balance. You cannot throw the ball too hard or do something wrong as you're playing. You should have good balance. In this case, you'll hit the target more than your competitor and the balance was wrong.

We trusted that the people can behave rationally. That's a good starting point in any kind of activity and any kind of business. But then you should understand that people behave rationally in their own interests. And when people can get money from excessive risk-taking, they will do this since they're getting money for this. It's not about the failure of people in this sense. They did what they want to do in any case and they will do this always. They will forget about the crisis after a few months when the crisis will stop and they will do the same. It's about the failure of regulation. This stimulated this kind of excessive risk-taking from the very beginning. We should still base our policies on the assumption is that people will behave rationally, that people would like to get profits. They want money. Everyone wants money to live a little better. Countries want to live better. That's why China will behave rationally in its own interest. United States will behave rationally in its own interest. And we should not try to identify the model.

We should try to understand that we need to locate the system that we'll not prevent innovation, as was rightly said just now. But at the same time, we should not allow innovation that lead to systemic issues, systemic crisis. So, we need more regulation on the behavioural side rather than on the side of market structure. We don't need more government in the economy. This will lead to slower growth. We do not need more protectionism around the world since this will lead to slower growth.

But we need to find a way to take into account the interests of other people without disturbing the system in general. As the president said today, the monopoly in each particular case is very dangerous since it doesn't take into account the interests of other parties. We're not against any particular player in market. We're against the U.S. We're not against China. We're not against Europe. We want every player to have the same rights, the same opportunities, to preserve its own interests and hopefully, you should take this into account. This will probably lead to a better system.

For Russia, we found that our system, both our economic system in general and our regulatory system was just too big. But I think we managed to do something, actually, we reacted relatively swiftly, though some decisions were not implemented in time. We missed some opportunities. We reacted too slowly in some things, but during this period we did many things. And also, we managed not to over-diagnose the problem. For example, last fall, everyone was saying to us that we should allow the depreciation of the rouble by two times. Right now, immediately, and this will save the economy! We didn't do this since we didn't want any overreaction. We didn't want any panic in the market, in general. Without it we could go step by step carefully, identifying a stage at each particular time and solving the problems the problems that we face right now, not that we will face - maybe face - but maybe it will not appear in the future. And currently what is needed is coordination in the development of new models that will work properly and this is what we call for.

R. Thomson:

Padma, is there any model from your experience of economics globally and experience in Russia in particular? Is there any model that you can create based upon the money incentive? Is that model fundamentally flawed because you can't really draw a line that says, "Well, you can make money up to this point and no further." So, is the money model basically flawed?

P. Desai:

Well, before I come to the point of answering your question, I want to raise a certain basic point. When you say that I came to this city in 1964, about 45 years ago, it was a different city. The Soviet Union was a very different country. I lived here. I lived in Odessa. I travelled all the way from Moscow to Leningrad. I watched and observed life at very close quarters. I made Russia and the Soviet Union before that, my life's study. I speak the language, and I've been coming to this country often, twice a year, more or less. And for me to speak of Anglo-Saxon model or a European-type social democratic model, for a country which a generation ago was Soviet style, politically, an authoritarian system, economically, a planned system, how can you expect it to make that transition to an Anglo-Saxon model or to a European-style social democratic model in one generation's time?

That is the one question which I would like to pose here. It would seem to me that despite the caveat which I have introduced, Russia today is a very different country. People are making all kinds of choices. Their lives are materially better. The Russians, I like to think, are no longer employees of a communist state. They buy apartments, they choose their place of living, their jobs, and so on. And so the material life of the people has certainly improved and also changed. But underlying it, what is the

model? Has the transition taken place to a free market system? Also, the values underlying of a free market system, the trust among people, business units and so on? I think Russia is still far from that, while the material life of people has improved quite a bit.

The main feature of the current Russian model is that it is essentially an export-led model, and exports of oil, natural gas, metals, of course, vodka and also, if you get a Russian visa, the Russian visa is very, very expensive. I paid \$260 for a 10-day visa. So, I also like to think is an export item. Anyway, it's that kind of an export-led model but it also has a certain structure underlying it, and that structure, it is certainly state-controlled, state-managed. I mean, we all know that Gazprom is a state within a state. The oil industry, of course, that is Lukoil (which is private), but Rosneft is completely state-owned so that the role of the state in the ownership of the oil sector, the natural gas sector, is quite dominant. That led to a growth of about 7 percent a year for almost seven years. Underpinning of that very impressive growth rate in the last seven years was a political system about which my former colleague, Tim Colton, will probably talk more knowledgeably: the vertical system which is politically not quite free in terms of political debate, and not quite free in terms of elections, such as we know in the Anglo-Saxon and European world.

So, given that kind of set up, the country did grow at 7 percent for almost seven years, but what was missing there was a change in productivity. Was the labour force productive enough? This growth of 7 percent has led to, I mean, the current inflation rate, which in Russia is close to 12 percent a year. What does that signify? That signifies that while the economy was growing at 7 percent, the productivity of that economy was not growing at the same rate as the inflation rate. Real wages of labour grew but the productivity growth rate was not growing sufficiently. So now, when the crisis has landed - and the crisis came from outside because of the decline in oil and metal and natural gas prices - the policy options before the government, the central bank of Russia, I mean, the banking system of Russia, are very limited.

This morning we heard the discussion between President Medvedev and Prime Minister Koizumi and Former Chancellor Gerhard Schroder about the inflation rate in different countries of the world. The United States' inflation rate is close to zero, so is the European Union inflation rate. So is the Japanese inflation rate. So, these countries and their leaderships have lot of choices of stimulating the economy via running budget deficits, via banking. The central banks can expand money supply and reflate the economy. Russia does not have that choice because of a high inflation rate of 12 percent. So, President Medvedev, in his budget management speech last week, talked about bringing down the budget deficit in 2010, 2011, 2012. So, the whole question of expanding the budget deficit if the economy is going down is out of the question because the government cannot increase its public debt, because the

government cannot pour more and more money in because it might be even lead to a higher inflation rate.

Similarly, there is a restricted policy choice before the Central Bank of Russia. Why did this happen if an economy grows at 7 percent for seven years? What was lacking was productivity growth of people, labour, materials, resources moving across industries, across towns which is what the Anglo-Saxon model is all about.

Russia is still far from that. And so the question now, therefore, is how can one raise productivity in the economy and there are some green shoots, to quote a phrase from White House back in Washington DC, there are some green shoots appearing on the Russian scene. The rouble seems to have stabilized. The Russian stock market is going up. Foreign investment is trickling in, again, and these are some of the positive signs. My view is that for Russia to develop into a market system, not only become more productive, to use resources more productively, I think the answer so far as I'm concerned is more and more and more foreign investment interaction. That is the road to go down not only to get foreign cash investment but also foreign technology, foreign management technology and the kind of trust which the corporate governance by foreign interaction can develop in the Russian economy on a wide scale. I think that is the only answer and that is how the Anglo-Saxon model might develop.

R. Thomson:

Padma, you mentioned at the inflation word, the "i" word. Just to break things up a little bit: A one-word answer from everyone on the panel and I will start with you. Over the next 18 months - no more no less - in one word Padma, are you more worried about inflation or deflation?

P. Desai:

Am I worried? Are you asking me?

R. Thomson:

No, no, no, that's six words! Inflation or deflation? Globally.

P. Desai:

Globally?

R. Thomson:

Yeah.

P. Desai:

Oh, I don't think I'm worried about global deflation. Also...

R. Thomson:

Or inflation? You have to pick inflation or deflation. If you would worry about one thing, what would you worry about more?

P. Desai:

Global inflation coming after maybe a few more months?

R. Thomson:

Right. Tim?

T. Colton:

In a word, deflation.

R. Thomson:

Nouriel?

N. Roubini:

Deflation for the next couple of years.

R. Thomson:

Arkady?

A. Dvorkovich:

Deflation globally. Deflation in the developed countries and high inflation in the emerging countries.

R. Thomson:

Nouriel?

N. Roubini:

Well, I think that you know there is this open debate today about whether we should worry about deflation or inflation in the global economy and I would distinguish short-term deflation, that is over the next two years, because there are three things happening right now. An deflationary one: there is a huge excess capacity because of over-investment in the last few years by China, Asian emerging markets and now sharp, falling global aggregate demand and we saw this deflationary pressure. CPI is now having negative growth in the United States, in Japan, in China, in Thailand, soon enough also in the Euro zone. You have this slacking goods market, you have also slacking labour markets with the unemployment rate expected by U.S. to reach above 10 percent and in other advanced economies and, in spite of the rise in the last couple of months in commodity prices. I think that if you going to have slow economic growth then there will be also some slackening in the commodity markets.

Therefore, this type of slacks are going to be deflationary. Of course, the concern about inflation is based on the fact that right now that most countries, advanced economies but also emerging markets, are running very large budget deficits. And that for the time being, these budget deficits are also being in part monetized. That monetization of the deficits in the short run is not inflationary for two reasons: One, there is this lack of capacity in the labour markets. Two, there has been a collapse of velocity in financial markets, so banks are hoarding that money, not lending it or spending it; and therefore it is not inflationary but once the global economy is going to recover from this crisis next year and the recovery is going to be more of a bust. The risk is that if you keep of monetizing these budget deficits, eventually that is going to go first in asset inflation, and part of the rising commodity and equity markets in the last few months, actually, I think is a liquidity event. But more importantly vengeance is going to lead also to inflation, so that is why I say 2 years down the line an inflation issue potentially unless we mopped up that liquidity.

A. Dvorkovich:

Just a word. I said "deflation" since what I'm worried about is really a long period of very slow growth if we will choose the models that we are basically choosing right now involving more protectionism and more government intervention. And this government intervention that we are having right now will bring inflation afterwards. We will have slow growth then inflation, that is most worrying scenario that it might appear. The most that I worry right now is in terms of inflation is about United States actually, not about Europe. If the dollar will be inflated heavily, due to the quick accumulation of budget deficits, that is major risk for the global economy and hopefully it will not happen because it will destroy the trust and the stability of international monetary system. But again hopefully it will not

happen and governments will determine exit strategies in time.

R. Thomson:

Just to be provocative, do you think that the German government is mistakenly over-focused on inflation?

A. Dvorkovich:

I think that the German government is preparing for elections right now and there are some biases in their behaviour, so we will see in the few months what will happen, it's a little bit of a biased policy at this point. But we are talking much more about the strategies in the United States at this point.

R. Thomson:

Tim [Flynn], KPMG. Four letters. What are the four lessons for the world economy of chaos? What are either the four things to do? What are the four things not to do?

T. Flynn:

We'll I think, if you'll look it where we are, the business model or the economic model, there's not one, right choice. I think what happened is that things got to an extreme and anytime things get to an extreme, they've got to reset and come back. I think we are in the fundamental resetting of the global economy, there is no question about that. The consumers not going to lead us out of this. We need stimulus and other spending to help lead us out of this. The developed countries have to save it more. The emerging countries have to build a consumer base and have stronger consumers. So, a number of things that have to happen in the economy.

If there are four things I would look at, we've talked about the regulatory environment, and talked about the model. Transparency: I think one of the things that got us into this problem was lack of transparency in terms of really having visibility, what was really going on. The incentives were not aligned properly, and so the incentives drove a behaviour that people acted to take risk which did not contain a risk and so, they floated through their businesses and put it out and put a fee on that but the fundamental did not retain a risk, that was the critical part. Governance: I think there was a failure in governance in terms of the corporate level and across the system. Maybe, too many regulators. Maybe, too many people following the pack. You know that Warren Buffett says the most dangerous five words in business are "everybody else is doing it" and we got caught up in that - it must be okay, "everybody else is doing it" - instead of taking a step back, analyze the implications to business model

and ask it is right for us to do it. And it goes to show some key lessons; you can't follow the pack, you can't rationalize things, you've got to have your own values, your own metrics and sit back and say "are we doing things the right way as part of the process?" and not get caught up in the flow.

R. Thomson:

Warren Buffett also famously said, there are three classes of people: There are innovators, imitators, and idiots, which is probably quite true.

A. Dvorkovich:

What is the statistical distribution of these groups?

R. Thomson:

I think the idiots lose most of the money and the innovators make most of the money. The imitators make a little less and some of them lose money.

Yevgeny, is Russia learning the right lessons from the chaos?

Y. Gavrilenkov:

Yeah, I think Russia also probably is teaching about it these days. We had a crisis in the 1990s, a very turbulent time and if you remember, the IMF, other international financial organizations, Western governments recommended Russia not to spend money, contain inflation, bring macroeconomic stability. What we see these days, we see the same western governments doing what they are doing to stimulate their economies, trying to avoid the collapse of the financial system. These were also the concerns of the Russian government. I don't want to defend the economic policy seen in the 1990s, I still believe that was a right lesson and I think that, at some point, Western governments will need to do the same.

I think all those problems which emerged most recently - and here I agree at this point that it is really not only a reaction of private financial institutions, hedge funds, whatever, we can not blame only them - I think it is a economic policy which was typical and not only for Russia but it was also the case in the United States. This is quite understandable, as understandable as in the 1990s in Russia where we wanted to maintain a sort of stability, the same happened in United States after September 11, in order to maintain and support the spirits and spending activity. That was a same sort of policy: cutting the rates, increasing budget deficits, stimulating domestic demand, and then where the problem comes is when you have negative real interest rates when banks are able to borrow, say at one percent. They

would try to get rid of this money as fast as possible and to take excessive risks, and, in order to somehow diversify the risk, they invented these were structural products and tried to sell them on the market. It meant that, probably yes, they could get rid of a part of this risk but it didn't disappear from the whole system and that's where the problem is.

And what has the Russian government learned from that lesson? I think it is once again that economic policy should not be as populist as it was in the 1990s, as it was after 2001 to 2003. Unfortunately, it was also quite populist since 2004 and 2005, when the oil price started to rise and we decided to diversify the economy by spending too much. Government spending was growing by 30 to 40 percent a year and that was the reason why inflation was in double digits. I'm sure that if other governments were able to spend or were willing to spend 40 or 30 percent more every year and then their inflation could be also double digits.

So, that is the same lesson and I really liked this statement when I read the program: it says that the market, the system collapsed, a very strong statement, so what are the new paradigms? I think not true, in my opinion, this Capitalist system is not dead, and what we need to do... we cannot invent an ultimate regulator. That is a discussion what we have heard for almost a year and half; let's say after the middle of 2007. To regulate more. People forget that we are able to regulate, especially on the global level, if we have global rules. If you don't have global unified rules, you can regulate in principle. If you can regulate on national level, and have more or less understandable and mutually acceptable rules, then that is the basis for regulation.

President Medvedev mentioned this morning that when the U.S. economy for example is as powerful as it is, when the dollar is the global currency representing a quarter of global GDP, you have to be more responsible not to affect other countries, not to damage the economic situation in other countries who also rely on U.S. dollars as a reserve currency. We know what happened with Argentina in the 1990s when the IMF recommended to introduce the currency board. That was good for a while but after the mid-1990s, the U.S. dollar strengthened and Argentina was following the same monetary policy, over-appreciated its own currency against, for example Brazil, and the Argentinean economy collapsed. So, I think that's really an issue that we need to come back to: the need to discuss not only how to regulate the global or financial system in the global economy but how to agree on the mutually acceptable rules of the game. Maybe to some extent similar to a Maastricht Treaty, and then it will be a subject for discussion for how to regulate the system.

R. Thomson:

Yevgeny, thanks very much. Tim [Colton], do you think the economic crisis has brought Russia closer

to what should you might call the Western model? Is there more economic empathy or less economic empathy?

T. Colton:

I'm not sure there's been that much of a change, frankly, because the starting point was so different and I think this is one thing that history tells us. You can have a crisis emanating from a single source that washes up like a wave at different places in the system, and the response will be different if local conditions are different. We saw that in the Great Depression. That was a calamity, much worse than this one. It produced reactions everywhere but there was enormous variation from one place to the other. You had fascism in Germany and you had the New Deal in the United States and, if you like, Stalinism in the Soviet Union, all very different. So, this is more or less what I would expect. Not a homogenising effect. There is, of course, diffusion. There is more communication this time around than 10 years ago, the last significant crisis in the system, when Russia was kind of left to deal with on its own. This is different - meetings like this are testimony to that.

I would emphasize really the political side of this which has been implicit in what some of my colleagues have said. We can talk about models, and they are very useful constructs for many purposes but in terms of how things happen, in terms of how these notions get translated into real programs and real action, this is a very political process and I think this would need to be taken into account in the United States. Where this idea, this extreme self-regulating model come from? Well it was partly an idea in the head of some people but then it had to be sold and it took a long time, it took a whole generation, I think it is fair to say, for this to move from being an eccentric, outlandish idea to being in mainstream and now it is being isolated again because of a political response and a political reaction. One of the things - just the last point I would make here - is that we do see as a common factor in almost every country that is experiencing negative growth, and this would include Russia, is that politicians, political leaders, political players like growth because it helps to deal with the conflicts that inevitably arise in making and implementing an economic policy. Because there are winners and losers and not just a matter of a model and an approach but some people get more of the solution than others do and if you have growth, you are able to mitigate those effects and try to keep everybody happy or most people happy and that was certainly the model or the arrangement that Russia had in this decade. Now, for the time being, that is suspended and that is hard for leaders and we should feel a certain amount of sympathy for them - but not that much, it is their job.

R. Thomson:

Thanks very much Tim [Colton]. Another one-word-answer question, and I will to start with you Blair this time. This has been a discussion I think from the People's Bank of China head, Zhou Xiaochuan, who has proposed a new global reserve currency. I think the Russian government has also suggested that less dependence on the dollar would be a good thing. Will there be a new global reserve currency in the next decade. Yes or no?

B. Sheppard:

A terrifying idea.

R. Thomson:

Yevgeny?

Y. Gavrilenko:

You mean changing currency?

R. Thomson:

The introduction of a new global reserve currency. Is there a possibility of one starting in the next decade.

Y. Gavrilenko:

I think not an artificial one. I think the Chinese currency will become one at some point.

R. Thomson:

Right. Thank you.

T. Flynn:

I really don't know. I mean, we will get one 10 years I guess.

A. Dvorkovich:

There will be more reserve currencies, a basket.

N. Roubini:

Yeah, I would also say, there will be more reserve currencies, a basket, and probably the relative power

of the dollar is going to decline in relative terms.

T. Colton:

That would be my guess as well.

P. Desai:

The dollar will remain a reserve currency as the United States economy improves.

R. Thomson:

There's a lot of talk about the so-called Anglo-Saxon model. Nouriel, when you look now the structure of the U.K. economy and the U.S. economy, these are becoming too quite different economies. I think state spending as a proportion of GDP in the U.K. in 2011 will be around 48 percent. So, is it wrong now to use the words Anglo-Saxon model?

N. Roubini:

We'll you know, in the case of the U.K., of course there was the legacy from the 1960s and 1970s of it being more of a Continental European Social Democracy and during the Thatcher revolution there was something reduction of the role over the state, but the size of government spending, taxation and state spending as a share of GDP remained rather high, but what made it "the Anglo-Saxon model" was the belief in very aggressive deregulation of the goods market, competition, of labour markets and kind of like a light touch approach to regulation of the financial system, so in some sense you could say there was something of an Anglo-Saxon model with the caveat that there certainly was a still a significant role for government spending in the economy. Models are just abstract constructs but I would talk about the Anglo-Saxon model as much as I would talk about also a Continental European Social Democratic model as well.

R. Thomson:

Arkady, when you talk about models, do you use the words "Anglo-Saxon model" or the "Continental model" or is it the British model or the American model? How is the discussion framed?

A. Dvorkovich:

I have some difficulties with these models but I certainly can talk about values, partially described as democratic values, democratic ways of freedom, fairness, etc., etc. That's what really important, not

models. If you take the model of corporate governance in the United States, for example: Is it good or not? I don't know if it's good or not. We can see some really good cases where corporate governance is really the best, but we can also see really bad cases, discredited, as some part of the model, if you like.

I don't like labels like capitalism, socialism and things like this. It's misleading. Nobody has pure capitalism or pure socialism. It has always been a balance amongst various things, related to traditions, political systems, etc., etc.

If you ask an American citizen, he will tell you that he or she believes that business is the main thing and people should get rich by working hard, by doing business. If you ask a Frenchman, you get the complete opposite; business is the worst thing in the world, the state should do more, the states should provide social support, etc., and we should regulate business and don't allow business to do what it wants. So, it is not about the model, it is about people who will believe or not believe in certain values and the state's role in the economy.

I think that we have some difficulties with models since Russia was moved to a certain system at some point of time. We had proposals about which model we should import into Russia, without any account and giving respect to Russia's traditions, legal systems - Russia's good traditions, not the bad ones, not corruption, but we have some good things in Russia - without taking into account what people actually think about those things. So, some really good models were discredited in the 1990s. That is one of the major problems. That is why we should be careful about talking about models in particular in Russia.

We will talk about the best experience. Yes, that is the right thing. What is the best medical system in the world? I am not sure that the American one is the best system. Probably, there doesn't yet exist the best system in the world; we should work together in constructing a new one.

What is the best education system? Probably, the Finnish one, as far as we know right now, based on the results. Should we take the Finnish system into Russia? It is not clear whether the same system will work in such a big and different country as Russia. So, in each particular case, we should choose the right way for the economy to develop each particular sector to find the best ways of regulation.

But also I think that there is some sense in creating global regulations but keeping national supervision systems for the implementation of regulations. So, may be in many cases like accounting, the financial sector, we can find ways to construct international models, not national models, and to allow the governments to supervise the implementation of the systems.

R. Thomson:

Blair, at the end of last year, I was with Rahm Emmanuel who, some people would say, is the second

most powerful person in the world, at least the second most powerful person in America. He said never waste a good crisis because the crisis is a great time to change policy. But now there is a sense in the United States that the crisis is ebbing away. I mean there's some individual deleveraging going on in commercial real estate, but the real moment of crisis has passed. Does that also mean that the real moment of economic policy change is past in America?

B. Sheppard:

I would be careful about assuming that the real moment of crisis has passed. If you remember, the real wealth was lost, destroyed, the second fall of the Depression, not the first. So, it is a little premature to declare victory. But what the question said, I think it would be a tragedy if we did not effectively reflect on what has happened and what it means for policy and there are two things that are extremely troubling.

The first is that I don't see an honest reaction or an honest discourse from those who are engaged about what went wrong in this particular case. Essentially, what's happened is that the field has been given to people who are asserting a completely alternative view and no one is acting as a thoughtful apologist for the preservation of the present system. I think the danger of that is that you miss Arkady's point, which is that the 20th century illustrates that singular models create historic chaos: the assertion of an academic hypothetical view of the world which says there is one way we should behave, misses nuance. I want sort of highlight a point here. If an anthropologist were sitting on the stage, they would say there had been four relational forms since time began: there has always been hierarchy; there has always been markets; there has always been communities; and there has always been sort of tit-for-tat kind of friendship-relationships, and that societies are compositions of those four things that regulate each other. The community actually regulates the market because the community causes people to worry about not making so much more money to someone else that they actually destroy the sense of community in the market. In some ways, this has been going on since the time began and one of the mistakes we made is to assert that one of those relational forms is predominant to the others.

So, for example, in United States for years we were saying we should have marriage contracts. That is the silliest thing I've ever heard because in some ways, though the original form of marriage is creating a dependent relationship to manage a child who has no control over their life unless the two people who have to actually work together and certainly in a very independent way. So, imposing a kind of market principle on that circumstance, one of the silliest things we've ever had. But that was the extrapolation of a singular idea on humanity rather acknowledging new ones.

So, what worries me now is because we see ourselves getting out of it, we aren't having the very critical

debate about what were the behavioural issues that we got wrong that we should fix, right? So, Tim's has implied four, Arkady has implied three or four, everyone on the panel has implied a few but until we actually say what really, really went wrong, what are the lessons we learned and how do we apply those lessons so we don't create incentives to cheat yet again, which is what invariably happens. We are missing a huge opportunity, right? But I don't want it to be a conversation about abstract models because that is just going to create the next chaos.

R. Thomson:

Padma, do you think we've learned the right lessons?

P. Desai:

Do I think we have...

R. Thomson:

...learned the right lessons over the last two years.

P. Desai:

So repeat your question, please.

R. Thomson:

Padma, have we learned the right lesson? Blair was talking was talking about...

P. Desai:

Oh yes, yes.

R. Thomson:

... that we will have wasted a historic opportunity, if we don't understand what really went on, the dysfunction of individuals, and the dysfunction of systems. But do you think that from your perception of the debate, particularly in the U.S., are people learning the right lessons over the last two years or has the debate been much more empty or vacuous than it should have it been?

P. Desai:

I think what the lesson that I have learned as an outsider who has lived in the United States for 40 years

and considers herself an American, but also coming from certain outside perspectives, is that the market system can be unequal, the Anglo-Saxon kind of market system, it can be unequal and that it can be destructive, these are two lessons which one learns. Now, when it comes to the question of the inequality of the market system and in the recent years, in the last 2-3 years, there had been so much debate in the United States about the middle class of America getting impoverished because of the - not quite impoverished - but being hurt because of the tax system. And so can the tax system take care of the inequality among our hard-working people and that is one of the issues, which is sort of hotly debated, but there the main concern is that, a proper tax system can be devised, which could take care of that.

But when it comes to the destructive impact of the Anglo-Saxon system, I do believe that self-interest is really a very powerful motivating force, whether you look at a slum dweller in the city of Bombay or an oligarch in Moscow. I mean, self-interest is a very powerful motivation among human beings, but if it does not work in the context of rules, in the context of regulations, then can it become destructive and that is the lesson we have sort of learned from the recent episode, which is still unfolding and I think there the whole issue of how much regulation. For example, the debate in America, should commercial banks and investment banks, especially investment banks, some of those, which have gone into difficulty, should they be nationalized? It seems to me a totally unworkable proposition, so far as the United States is concerned. I think it just would not work, that the banking system in the United States should be nationalized. I mean, they want to be left alone.

R. Thomson:

Nouriel, you...

P. Desai:

I would like his reaction, Nouriel's reaction to that.

R. Thomson:

You suggested at one stage I think, that the banks should be nationalized. Were you wrong?

N. Roubini:

Well...

R. Thomson:

Just on that one small thing, were you wrong?

N. Roubini:

Well, the U.S. financial system is in fact under the control of the U.S. government, if you include the guarantees, liquidity, insurance, the capitalization, about 12 trillion dollars of resources have been committed to the financial system. About 3 out of the 12 has already been dispersed, practically every financial institution would have gone bankrupt unless the Fed had cut the interest rates to zero, therefore subsidizing and give them a net interest margin. They've been giving them something like 20 different programs between TAF, TCLF, PDCF, TARP, TALF, commercial paper, you name it. They can borrow something like 400 billion dollars with full FDIC guarantee, practically borrow at zero, they go through the AIG bailout, 15 billion to Goldman Sachs, another 350 to everybody else. So every institution, even those who passed the stress test would have been bankrupt if the government had not bailed it out. This is a massive subsidy of the financial system. Probably, it was necessary to avoid the total systemic financial meltdown. In my view, some of it has become excessive and paradoxically I think that while the government was saying, "We don't want to have nationalization of the banks" - by the way with the conversion of the preferred shares into common, 36 percent of Citigroup is going to be owned by the government, so the government is going to control Citigroup directly - but the paradox is that the attitude has been, "We are not Sweden and we don't want to nationalize the banks."

But then the right alternative would have been to do what you're do in corporate restructuring, meaning taking the unsecured claims of the creditors and convert them into equity, that is what you do when you have to watch that there are not enough equity. But we decided we didn't also to have a haircut given to the holders of this unsecured claims <inaudible> therefore what has been done is a creeping, partial nationalization of the financial system. If you really want the government to be out of the financial system, you would have to convert those claims into equity. So the financial system is under U.S. government control and ownership, effectively subsidizing it in 30 different ways.

R. Thomson:

But not quite nationalization.

N. Roubini:

It is not a formal nationalization, but it is in fact really, under the control of the government. I mean think about the amount of subsidy indirectly and directly that is being given to the financial system. Every institution would have gone bust if they have not received, for example, the liquidity support that

the government has given them. Traditionally central banks are considered as the lender of last resort - in this crisis, central banks have become the lender of first and only resort. Banks are not lending to each other, banks would not lend to other banks. Banks would not even lend to the corporate sector, that is why we had to create the commercial paper fund facility in order to lend money directly from the Fed to the commercial paper that the corporate sector converted essentially into living, working capital, and this is how the dysfunctional the financial system became.

R. Thomson:

Nouriel mentioned that Citigroup, which will have about 34 or 35 percent government ownership. One of the jobs of the editor of The Wall Street Journal is to decide on the composition of the Dow Jones Industrial Average with 30 stocks that make up that average and on Monday we removed General Motors and the Citigroup, which are two of the greatest names in corporate history globally. This brings me to my next question to Tim about a different kind of model, a role model.

I lived in China in the mid-80s for four years. Western companies were role models for young Chinese: GM, Citi, Lehmann Brothers, Chrysler. Chrysler Jeep was the first big manufacturing joint venture in China. Is the role of the Western company as role model to young people in emerging countries gone forever now? Are the reputations so tarnished that they're irreparable?

T. Flynn:

You know what, I really don't think so. Look, there is no question that there are failures, there are failures as business models, there are failures of governance, there are failures of risk systems, so there is no question that this has happened and taken place.

But despite all the wealth that has been destroyed in the last 24 months, think of all the wealth created in the last couple of decades. I don't believe you can take every corporation in the Western world and say: "They're bad, they haven't done a good job." There are many, many success stories, entrepreneurship stories that will continue to be role models.

I think what is important, going back to the point that Blair made, is that you have to look at both sides of the equation, we just can't look at all negatives because there's a number of very positive things has happened as well. Look at the rise of the rest of the world. I won't get it exactly right but if you go back 20 years, in the pre-crisis era, there were probably two dozen countries with GDP growth of 4 percent or more. If you go back just two years, there were a 120-some countries with GDP growth of 4 percent or more. Tremendous wealth has been created. Yes, it's got overheated. Yes people lost quite a lot. Yes, people were caught up irrational behaviour, but not everybody was. And I think from my standpoint,

there's resetting of the global economy, the re-institution of this proper balance between the role of government through regulation, the role of governance in the organizations, entrepreneurship, innovation, all those things are being re-examined. They're being reset and it is critically important.

Fundamentally, we'll be stronger coming out of this than we were if it hadn't happened. It is very painful, but it's a natural occurrence. I think you should look at evolution and I think that there is no single business model or no single economic model that says, "This is the right way to do it". Everything has to come together. The world is very different today than it was two decades ago and a decade ago, and I think there's a recognition that we can all learn from each other, nobody has it perfect or right, and those that are willing to adapt and change will come out of this stronger.

R. Thomson:

Yevgeny, do you think that for young Russians, the tarnishing of so many of these Western companies that were icons - seemingly not only successful but bringing with them an image of success - has changed their perception of Western companies?

Y. Gavrilenko:

I don't think so. First of all, people still drive American cars, American brands made in Europe or somewhere else, Ford operates in Russia and is producing something, GM here is also not dead yet. Let's also note that we have several financial institutions, Citigroup is in Russia <inaudible>. But I don't think so.

Russians - they've been looking not only at what happens like in the West, but I can tell you another story, which I was amazed to hear. A few years ago I met a friend of mine who I haven't seen for a while and he lives in the Far East, in Khabarovsk, and he mentioned that young people, graduates, students, they've never been to Central Russia, they've never been to Moscow, they've never been to St. Petersburg - they didn't what it looks like and it's quite expensive to travel there. But every second or third month they go to China, to Korea, they start speaking Chinese and for them the metropolitanism is there. So they're looking at what really happens in the Asian world, so that's where they are looking. Russia is a big country and we cannot say that people are exactly the same in Moscow or Vladivostok or whatever. It's not homogeneous in the way, say Switzerland is, or in Europe. I think there is no answer to your question. I don't think that the faith in American brands, European brands will decline, not at all.

R. Thomson:

Tim, as Padma, was saying earlier, obviously self-interest plays a role, markets plays a role, in every country, to a greater or lesser extent. But incentives were clearly one of the reasons for the downfall of Wall Street, if you want to characterize it that way. If you were advising Russia or any emerging country on an incentive system, what would that advice be?

T. Colton:

Well, I don't think any sensible government would ask for my advice because I'm not an economist. I'm a political scientist and therefore my mind tends to move in that direction and I think here about what the political system can do. It has also after all, let us down - it wasn't just the bankers and some in the economics profession, but the political authorities made a mess of it as well. But here too, there may also be some signs of hope, in as much as there has been a political correction.

Of course, something happened to drive the government in a different direction and that is something that involved popular choice to a certain extent, a change of leadership, a change of orientation, all of which was very difficult and is far from over yet. But my advice in part would be to make sure that you have built in to the system some sensible arrangement for periodic review and updating, and for change at the top. I think we have to accept that it's normal even to guarantee stability that you have to change the people at the top from time to time. And this I think is important to keep in mind in Russia's case, inasmuch as the change of government here in 2008 was only a very partial change; it went from one very strong, long-established leader to a protégée of his who has many skills and talents, but nonetheless has until now seems to have been working somewhat in the shadow of his predecessor.

I think history suggests that even authoritarian systems - and I don't think we need to put Russia entirely in that category, I think that would be unfair or an over simplification - but it almost doesn't matter how democratic you are or how authoritarian, if you are somewhere on that continuum, you have to find ways to get change at the top on a fairly regular basis. And I think there's some pretty good systematic evidence to that effect - renewal is important to life.

R. Thomson:

Thanks very much Tim. We are going to throw it out to the floor just after this next question I ask, which again requires a one-word, or actually a one-figure answer. It's about leverage. The European Union, or the Commission at least, is discussing whether there should be a formal limit on leverage. I know a hedge fund in London, that's a counter-party to Deutsche Bank who studied their leverage a few months ago and estimated that it was somewhere between 65 and 87 times. I spoke to the head of Nomura, Kenichi Watanabe, about four months ago and he said, "Whenever Nomura has gone over 20

times leverage, it's ended up in trouble." When Mitsubishi looked at Morgan Stanley to buy that stake, they found on average there was – and obviously it's on average and it varies by asset class – on average, Morgan Stanley had 35 times leverage. What is the right amount of leverage? Blair.

B. Sheppard:

You have to permit slightly different business models in the answer to that question, so I would refuse to accept a single point. But to differentiate commercial banks from investment banks from hedge funds, if commercial bank is leveraged by more than 20, it's probably a problem, if an investment bank that leverage more than 30, it's probably a problem, and if the hedge fund leverages more than 40, it's probably a problem.

Y. Gavrilenkov:

I would agree probably with Blair with those numbers but I don't think that the government should impose or regulators should set restrictions on levels. I'm against that. I think it's the responsibility of all the companies it also depends on the sector.

T. Flynn:

Those numbers don't sound unreasonable; to me the key is transparency.

T. Colton:

Visibility with the leverages and let the investor make the decision but pure visibility and consistently so they can see it.

A. Dvorkovich:

Buying or selling?

R. Thomson:

Distress or not?

A. Dvorkovich:

I think that, yes, the figures are probably reasonable but what we need is to have the right incentive for financial institutions. One of the proposals last year was to establish certain minimum requirements that a banking structure should deal with itself and its own balance. In this case, the bank will think twice

about stretching this deal. This is probably the right thing to do but as far as figures are concerned, well I would give lower numbers, I would say, and than my friends probably. But I'm not a financial professional to answer this in a categorical manner.

R. Thomson:

For a commercial bank, you think 20 is too high?

A. Dvorkovich:

Yes, I think so.

R. Thomson:

Fifteen?

A. Dvorkovich:

Yes.

R. Thomson:

Fifteenish?

A. Dvorkovich:

Probably yes. It's better.

R. Thomson:

Nouriel?

N. Roubini:

In my view, in some sense it doesn't matter whether you call yourself a commercial bank or investment bank, or insurance company or a private equity, or a hedge fund, or a finance company, or a sieve or a conduit, or a non-bank mortgage lender: they all do the same. They borrow short, they leverage, they lend long and in liquid ways. That's why we had the collapse of the shadow banking system. They are like banks that did not have access to lender-of-last-resort support or deposit insurance. Therefore you've had the equivalent of a bank-like run on most of the financial system, and for all of them leverage becomes dangerous and I think that all of them should have at least a tier one closer to 10

percent. It means that a leverage maximum of 10, more than that becomes very dangerous in my view. For all sorts of financial institutions, I think. That's one of the lessons of the crisis. More capital and less debt is the right way to think of it, in terms of giving incentive, of having some of your skin in the game and not playing with others.

R. Thomson:

Tim? As a political question, do you think there should be a government limit on leverage?

T. Colton:

Intuitively, yes. I think that's reasonable but I'm sure there are arguments on both sides of the question. But certainly in this environment, in the United States, I think if you put this to ordinary citizens and explain the consequences of doing it the other way, that you probably would get a lot of political support for it.

R. Thomson:

I guess some of those ordinary citizens are pretty hardly leveraged themselves.

T. Colton:

I thought you meant just for business!

R. Thomson:

Padma?

P. Desai:

Well, so far as the U.S. commercial banks are concerned, they are pretty well-regulated in terms of their capital asset requirements. But so far as investment banks, hedge funds, insurance companies, and all those are concerned, I mean, they did get over-leveraged but I don't think I wouldn't go for a number so much as a governmentally required diktat from the top.

R. Thomson:

Yevgeny?

Y. Gavrelinkov:

A short comment: I wouldn't separate this issue, leverage, from the central banks' benchmark rates. Look, when the Fed rates were 4, 6, 7 percent 20 years ago, the system was not highly leveraged. When rates go down, the system becomes leveraged. So it's what I keep saying: populism, stimulation of domestic demand - then you have an illusion that it will last indefinitely and you become highly leveraged. So I wouldn't separate this question from policy. Policy matters.

R. Thomson:

Right. Well you have an extraordinary array of talent arrayed before you. Do we have a microphone? If I could ask that you keep the questions short, otherwise, I'll have to interrupt you.

From the audience:

My question is very short and a very practical one. Right now, these markets are awash with liquidity, you can only look at labour to argue that, and at the same time, the microeconomic parameters keep deteriorating. So the question to all speakers if you can add something is, what and when it could probably go wrong? Thank you. I mean, the correction of the microeconomic parameters to the liquidity and the resumption of the credit giving, or vice versa, a new liquidity crisis?

R. Thomson:

Arkady, do you want to...?

A. Dvorkovich:

We do not expect any new liquidity crisis. We believe that problems may arise for particular banks with the quality of assets. So this is the kind of adjustment that you have to face. In any case and we would have to find ways to recapitalize the banking system. We have some facilities whether we have enough or not, time will show, but unless problems with balances of the banking system are resolved, a normal pace of credit-activity will not be restored. That's clear for us.

R. Thomson:

Blair? Do you think there's going to be another liquidity crisis? Or really a crisis of confidence, that's what we're talking about.

B. Sheppard:

I think the issue, in part, is you have to answer that country by country. Right? So I think in Russia you

have a system that's frozen and people aren't willing to free up money at all, so we have another liquidity crisis. You have got to get out of the first one first and I think you've got to manage to that. I think in the U.S. you have different issues, in China you have different issues. I think country by country, it's going to be different. In the U.S. I wouldn't spend my time preoccupied with a liquidity crisis. I'd worry about deflation followed by inflation. In China, you might, for funny kinds of reasons, but... that's a country by country analysis.

R. Thomson:

Just to be specific about it, I guess one measure of a liquidity crisis is inter-bank lending. Do you think that the inter-bank lending market will freeze up again?

B. Sheppard:

I think the variables that exist today are unlikely to lead to the same kind of global crisis that has occurred and what you're going to find is variable crises around the world. There are ways in which we could induce that if we chose to. And one of the ways that we could do that is if we mismanage the next hit that happens because, you know, it turns out that the commercial property hit hasn't happened yet. And if we mismanage that there's a chance that could – because it's very, very fragile. Right now, it's incredibly fragile. But I think actually the bodies that are engaged are actually on top of it reasonably well. Right? So the person I spend a lot of time talking to around this issue is the head of the Bank of New York because 20 percent of these transactions happen in their back office. And what's interesting is that it is quite a different issue, country by country.

R. Thomson:

Yevgeny?

Y. Gavrilenkov:

I think here we see a different situation in Russia than in the rest of the world. First of all, don't forget that Russia is an under-banked and low-monetized economy. As we know, the total money supply in the country slightly above 12 trillion roubles, which in dollar terms would only be 360 or 370 billion dollars, from which a fair amount is paper money, household cash. So, within the banking system, a very tiny portion of money.

And when Blair said that the markets are frozen in Russia, I would say the liquidity is there but the problem is high inflation. What happened in the past? Russia always operated in a negative-real-

interest-rates environment. The system has never tested with positive rates. Money was cheap, abundant, there was a strong current account, rising oil prices, and easy borrowing on global markets and as a result banks borrowed on the market. They never borrowed from the Central Bank.

Only just recently, six months or year ago after Lehman Brothers, the Central Bank became the lender of last resort. So what happened a year or five years ago, banks having borrowed at 2 percent from other banks on the market, were keen to lend at 12 percent, roughly, but it was a 10 percent margin which they got used to. These days, a few months ago, when overnight rates were increased, the Central Bank became the lender of last resort. So being able to borrow at let's say 10-12 percent, banks were able to borrow at over 20 percent and that's where the problem is. It's not liquidity, it's high inflation.

The Central Bank cannot bring the rates down until inflation comes down which means that we have to be less populist, in order to bring the inflation down. And global situation looks so different. The Russian system - we're not talking about particular oligarchs, particular companies, but the system in general - was not that leveraged as opposed to the global system which is much bigger relative to GDP or the American system. We didn't have any toxic assets on the balance sheets or those structured products and derivatives. And what happened via the global system doesn't work these days.

As was also the case in Japan in the 1990s, inflated assets and liabilities are always in cash and when suddenly assets collapse, we see mismatched between assets and liabilities and that's what the Japanese government was doing in the mid-1990s, for five or six years pumping money into the system. Also, are cut to around zero, budget deficits increase and until banks and companies restore balance sheets, they won't resume lending, or start normal economic activity. That's why liquidity is coming but the system behaves like a zombie.

R. Thomson:

Thanks Yevgeny. Another question.

E. Rybakova:

I'm Elena Rybakova, Chief Economist, Citibank for the CIS. Just carrying on from this topic. I wanted to ask you. We've done very well with the liquidity crisis and now we're in the second stage of bank recapitalization. How are you going to approach asset resolution?

President Medvedev said we're not going to have a centralized asset management company. So how are we going to ensure that there is transparency if you're going case by case? And will there be differentiation between domestic debt holders and foreign debt holders? And how are we going to

avoid special interest interference in this process? So the question for Arkady is how are we doing it, and to the rest of the panel, how should we be doing it?

A. Dvorkovich:

Our model is to allow banks to do it themselves.

E. Rybakova:

Did you give public money to them?

A. Dvorkovich:

Yes, exactly. Our solution was to increase the facility so that banks can increase their capital: they put one rouble into capital and we can give three roubles into capital. And these additional resources should be sufficient, if not, we will probably give more. It should be sufficient for these bad assets, without any further government intervention in this process. And finally, we have a system of monitoring systemic companies and in large cases where social interests are affected, we will also intervene on the side of the companies that owe to banks. But with only one purpose - to support people, not to support the banks or to support those companies. And that should be the purpose of this exercise. In this regard, we are not making differentiation between the Russian banks and foreign banks. Foreign banks should resolve their part of the problem, Russian banks should resolve their part of the problem. And this is the case, for example, in ongoing negotiations and restructuring of some of the Russian company's debts. Foreign creditors must meet with the company. Russian creditors will agree on the same conditions; that's the mostly likely outcome, but they have various sources of capital around the world, with or without the help of national government and the central bank.

There's one danger here: the danger of financial protectionism. If the government gives money to a bank, it wants this bank to give loans only to companies that work in this particular country. That's already happening around the world. There's a clear trend towards this kind of more dangerous financial protectionism that is destroying the international financial system.

The only way to avoid this is to coordinate regulations and supervision assistance. So there are some ideas like colleges of supervisors, the European Commission and the European Central Bank and I'm doing some work on this and we will be involved, certainly. We believe in some kind of solution is needed to preserve the integrity of the global financial system not to destroy national financial systems.

P. Desai:

Yes. I have also been sort of wondering about the recent announcement by the presidential administration here that there'll be no more support after the initial support through the Russian banks for meeting their foreign creditors and their margin calls, that there'll be no more support coming from the government.

Now, I have a question here. It would seem to me that during the months when the rouble was being allowed to decline gradually by the Central Bank of Russia, Russian banks were converting the rouble, which they anticipated was going to decline, into dollars. And by one report, which I read in the Financial Times, the dollar amounts stashed away by big Russian banks is in the amount of 110 billion dollars. And those are the resources which Russian commercial banks have to meet the margin calls from the foreign creditors. I just want your reaction to that. Should I believe this report?

A. Dvorkovich:

You should understand this clearly that banks have just one balance sheet. They don't have special money for meeting margin calls, special money to meet the depositors claims, special money to meet any other obligations: they have this idea that they're creditors basically. They have just one balance sheet and the resources that you mentioned, yes they converted some roubles into dollars and one of the reasons was that people who keep money in banks converted their rouble deposits into more dollar deposits, so banks accumulated these dollars, partially, in some accounts. This helps right now to repay external debt. This is why we don't have a huge deterioration in the official reserve position right now. Those have been accumulated by Russian companies, Russian banks, and they are using those dollars right now to repay external debt. But we will not if any special facility anymore to help repay in current external debt. We treat all creditors equally without distinguishing whether it's a foreign bank or Russian bank.

R. Thomson:

That somewhat mistaken report was in the Financial Times, not in the Wall Street Journal. Nouri?

N. Roubini:

Well, there's three aspects of a problem if a bank is in trouble. One is how you deal with toxic assets? Two, how you recapitalize the bank? Three, how you avoid the roll-off of short term liabilities and deposits, that are coming to maturity?

On the first one - I think that was the point of the question - I think there are four or five different ways of doing it, you know. It could be a bank separating his own good and bad assets with a good bank and

bad bank - that's one model. The second model, where the government buys the bad assets through an asset management company or otherwise so you have kind of aggregated bad bank. You have a third model, it's the U.S. one, in which the government provides subsidized lending for the private sector to buy the assets so that the price or billing mechanism for what's the value of these things, its a little bit more transparent.

You have a fourth model, where the government can guarantee the bad assets after a first loss and keep it on the balance sheets of the banks and they manage it. You could have a fifth model where the banks goes bust in like the RTC. The government then manages the bad assets because it takes over the bank and so on. And I think that, you know, none of them is a perfect model. They're trade offs. If the government buys the stuff and manages it, the question is always at which price you buy assets that have uncertain value. So having someone within the private sector will give this backed up than otherwise, but sometimes when the institutions are insolvent the government is having to take care of it as well. So it's a tough choice but these are the options and alternatives on the table.

From the Audience:

I'm Vadim Volkov from St. Petersburg. Markets are constituted by legal frameworks and any company has kind of double life. A physical life as it were and a legal life. It has a legal shell. This is important to note because the contemporary global world and is very closely related to the courses of crises is divided between as it were two legal regimes, the onshore regime and the offshore regime. And when Lehman Brothers went down, it's not Lehman Brothers. Lehman Brothers has the office on Wall Street. But it's registered in the British Virgin Islands. So what's really went bankrupt, the legal shell out there or Lehman Brothers as we know on Wall Street? Definitely, the consequences of these events like bankruptcies are borne by states and the territorial states, but the causes are outside them. So it's like most of the cargo ships, almost half in the world sale under the Panama flag, so most of the hedge funds, financial companies, investment banks, sale as it were in the economic world under the flags of the offshore havens. So this is not accidental.

So the question, therefore, I would like to engage the participants of this panel to reflect upon the problem of the offshore states because then they're really not states. They don't have responsibilities like states do, but because many things that the states have to deal with, and maybe Mr. Thomson can have another quick blitz, should the offshore economy zone be eliminated or not. The participants can answer this question too.

R. Thomson:

Tim [Flynn].

T. Flynn:

Let me put it in the context of my world, the accounting profession. We don't have a global accounting language and yet we have global businesses and from my standpoint we ought to have a global accounting language, one language that's implemented across the global markets, because what happens in one country I should say impacts the world when that company operates what raises capital, or what attracts investors, what sells products to consumers.

So I agree with you. I think that's one of the models that we look at. How do we deal with the connected world? There was a thought maybe, you know, 14 months ago that there was a decoupling effect and what happened in the U.S. wouldn't impact the rest of the world from an economic standpoint. I think we have proven clearly with the financial crisis, the spreading of toxic assets around the world, where they originated from in many ways how they get around the world were very connected today. And so that's why it's really important to look at how we bring some type of global regulatory environment, some type of oversight, the G-20 has talked about that.

N. Roubini:

I'll come back to the previous question.

R. Thomson:

That's alright, just...very, very quickly.

N. Roubini:

Yeah, very quickly. What needs to be done? If we are talking about Russia, I reiterate the same point, bring inflation down then probably the government won't need to recapitalize banks. Because when inflation is in double digits, you can't recapitalize the banks, so that's key issue. We always emphasize that Russia is the only country in the G20 where inflation is in double digits. If you look at the last page of The Economist, there are 42 countries listed there, and only four have double-digit inflation including Russia; Egypt, Pakistan, and Israel. So bring inflation down. Instead of subsidizing interest rates for buying Russian-made cars or for small businesses or agricultural producers, bring inflation down, bring interest rates down for the whole economy, then start thinking about what to do next.

From the audience:

What do you think of inflation targeting?

N. Roubini:

I'm not a fan of the inflation-targeting concept. That has a lot of drawbacks. That is a separate story. I was given only a few minutes.

R. Thomson:

I'm just going to ask Tim first of all, you are the political guy, you know, about all the moral issues. Is there a moral problem with companies being registered offshore?

T. Colton:

Do I think there is a moral problem?

R. Thomson:

Yes.

T. Colton:

I think there is an issue that has made its way into the public realm recently, and the Obama administration's going to have some proposals. Yes, I think all of these questions ultimately involve questions of value as well as of fact. And so I think you could call it moral, sure. But is it not very hard for one country to deal with in isolation? I think that's, I believe, the dilemma for the United States right now.

R. Thomson:

Is it a by-product of principle or is it a by-product of protectionism?

T. Colton:

I don't know that it's protectionism as much as it is citizenship. If you benefit from the regime - the domestic regime and system - that allows you to do this business, should you not contribute to its upkeep?

A. Dvorkovich:

This issue, I would say, was the main discussion point of the last G20 meeting in London. It was

discussed heavily and most of the fights were about offshore. Not about banks, not about money going to IMF. Everyone said that 1 trillion is okay, 2 trillion is okay. There's no problem there. Each step in the auction was 1 trillion, basically. But offshore took the attention of everyone, and there was almost a fight among some participants. One of the programs is that who is saying that it is offshore and it is not offshore. It's a very difficult issue, actually. What I'm talking about is a competitive tax and legal regime, basically, where you can have protection and where you can pay competitive taxes. So getting out of offshore is about the creation of competitive tax systems in your own country, not about creating a list of offshore. In the real world, we have offshore, we have competitive tax regimes and we have national governments basically allowing their own companies to go to offshore zones to be more competitive internationally; otherwise, they will lose competitiveness, they will pay 45 percent, whatever, in the income tax domestically. So this is one of the issues.

The second issue is about transparency. We can probably have offshore but we should know what is going on, what is the amount, who are the owners, what are the companies. We should have information. This is basic requirement for all these jurisdictions if you would like to keep them as a way to improve competition for Our companies.

R. Thomson: But I understand is that Ireland is kind of offshore. Ireland, is Ireland offshore?

V. Dvorkovich: I think not. Certainly, there is some limit in competitive tax policies as in competitive devaluations, for instance. But tax policy still, in any case, is a national matter. It's not an international matter. But transparency is not an international matter, you should be transparent.

R. Thomson: Do you think there'll be any agreement at the G20 level about restrictions on offshore activities?

Dvorkovich:

I think that we can have some agreement on criteria, not on legal restrictions. We can set legal restrictions by international agreement. The G20 is a discussion club, it's not in place to make legal commitments to some extent. <inaudible>

B. Sheppard:

Robert, a minute, I think you have to separate the question into two pieces. One of them is the sort of international competition among tax regimes - which is an important question, and the issues of

transparency associated with that, and then the competitiveness of nations. The second issue, which I think is at the heart of the question, is that, in the original idea of legal construction, there was a premise that society was allowing a firm to exist because it fulfilled some purpose for society. As soon as you're allowed to actually have your existence somewhere where you don't engage your major activities, that connection has been lost. So it permits you to get into a business you have no reason to get into. So insurance companies can become hedge funds. And so, if you think about what are the great successes of the legal regime was the failure of Arthur Anderson because it forgot its job was to manage the fairness of the equity markets and transparency in the system, it failed. That sent a huge signal to the other remaining accounting firms which is a very positive thing. If it was existing outside, it would be harder to have made that happen, first.

Second, I think, is that the dilemma we now have is that firms exist in many, many, many countries, right? And so, one of the huge failures of the senior bank leaders is that they forgot that by engaging in a kind of insurance play, which is by selling, by structuring products and then selling them all over the world and working it so that the rating agencies worked it appropriately, they were making a pretty cool profit play, but what they forgot was that they were putting their entire brand at risk. And as soon as they put their brand at risk, they put the entire industry's brand at risk. So the crisis we had was not a liquidity crisis. The crisis we had was that the world stopped believing in financial services. Now, I think, in the heart of that question is, isn't there a responsibility for leaders to understand that it's their job to protect the purpose that they have in society? And I think we've lost that.

Now, for one, I think we don't teach it enough in business schools. I think the fact that we can make it an arcane discussion of tax misses the point that leadership is about leadership. And I think that was at the heart of the question. And it worries me that we don't even hear that in the question. And I think it's a big failure. So one of the things - I think the question conveys is - do we have enough leaders today? And I would say no because they don't understand the moral responsibility of their firm.

R. Thomson:

Thank you.

From the audience:

My name is Sergey Pakhonov. I'm the Debt Manager for the city of Moscow and I have a question which is very close to my heart. There is an enormous amount of bad debt in the global economy and, essentially, that's what the present crisis boils down to. It takes many phases. The only thing is it will never be repaid. So the question is probably to Nouriel Roubini and to any other participant who would

like to comment. First of all, who is going to absorb all those debts? Right now, governments are doing it, and they are doing it inflating their debt. And to me, as a professional, the borrowing targets look absolutely unrealistic. Another question, should governments actually do it? And then if they do it, are we going to face sovereign defaults not just in emerging markets but defaults of countries like Great Britain and - God save us - the United States? Thank you.

N. Roubini:

My view is that the point you are making are very important because this is not just a crisis of liquidity or confidence its a crisis of too much leverage and too much debt, over-borrowing, by the household sector, even by some parts of the corporate sector in advance economies, leveraging up the financial system. So the private debt to GDP ratio in the U.S. is now something like 350 percent between households, corporates, financial institutions. And while there is a lot of talk about deleveraging, there is not much deleveraging occurring in practice right now. What's happening is, instead, those debt ratios are still remaining very high. And, as you pointed out, we're socializing the private losses and we're levering up sharply the public sector with very large budget deficits and with a very, very sharp increase in the public debt. And I think that the right solution to excessive debt is actually a conversion of that debt into equity rather than socializing those losses. You know, that's what you do in the corporate set-up where you convert some of the debt into equity. But even in that case in the U.S., in the case of GM and Chrysler, we have massive meddling of the government in that process not like in the private sector. The government is going to own part of GM, the unions, and so on. So even debt adjustment is not occurring in the financial system as they said. Instead of having the government providing all the support, they should have converted unsecured claims into equity.

And even for households, there is too much mortgage debt so you reduce the principal value and then you give the credit or the up-side in case the price of the home goes up again. That's essentially a warrant that is transforming debt into equity. So that's what should be done at the macro level, a massive debt-into-equity conversion, like a massive Chapter 11, debt restructuring. We're not doing it, we're leveraging up the public sector because we don't want to make distributive decisions, which is should we take losses or not? And, because of this, now much remaining public debt eventually may lead to a solvency issue. Traditionally, solvency risk was in emerging markets in the last decade. Countries like Argentina, Russia, Ecuador, a few others, defaulted. But the paradox today is that the sovereign risk is much lower in emerging markets because they learned the lesson of the past and public debt ratios are low; while sovereign risk is now rising in advanced economies. Take the Euro Zone where you have countries that a large deficit in debt and the banking systems, they're on one side,

too big to fail but those are too big to be saved like Greece or Ireland or Italy or Spain. We could have a solvent debt crisis, you can have auctions that are failing, you're having downgrades, you're going to have refinancing problems. And, as you pointed out, even in the U.S. eventually, if the deficit will be as large as they're expecting to be in the public debt, it's going to double as expected from 40 percent to 80 percent of GDP, eventually, even the U.S. could be downgraded. And if you're going to have sovereign risk and default in advance economies, then promises of bailing out, say, the financial system, are not going to be worth the paper they are written on. And that's why, while in the short-term, we need the fiscal stimulus to get us out of this crisis. I think that this should have fiscal consolidation in medium-term. That sustainability of the public sector is going to be a very important question ahead; otherwise markets and investors are going to very much worry about it as they are beginning to worry about it, as you see in the pressure upholding long-term interest rates on government bonds.

Y. Gavrilenkov:

Just a short remark. I think people will pay in any case. The only question is which people in which particular country and how many people will pay the debt and what will be the allocation, of course, among people. We can create rules where taxpayers will pay everything and it will be allocated among taxpayers in all countries; or people who put money in the wrong banks may pay too much money in the wrong banks; or people who cannot repay as the loans might pay; or people who work in the companies that cannot repay the loans might pay. In any case, it's people. It's not artificial governments, banks, or companies. We're talking about millions of people who will pay for these debts. What we are looking for is a more or less fair allocation, of course, since fairness, cannot be reached - that's clear, but we are trying to get to the point where it's more or less fair.

R. Thomson:

Tim, do you think a big country is going to be downgraded? Which one?

T. Flynn:

I will leave that to the economists on the panel.

R. Thomson:

But, conceptually, is it something that you worry about?

T. Flynn:

I think we have to worry about everything. I think you have to worry about it because if you don't, you'll go to the extreme and do too much. I mean, you have to realize it's a possibility, you have to worry about it, and you can overextend what we're trying to do and to the point that what we've made is going to be sacrificed. And there has to be sacrifice. We can't get out of this without sacrifice. And it's going to be spread across a large population of people in a large number of countries to make that happen. So if you don't worry about it, you're going to think it's not a problem and just keep spending, spending, spending, and then you're just going to hit the wall. So I think we have to worry about it. I think there has to be precautions, there has to be limits, and there has to be sacrifice across the globe to come out of this crisis. No one country, no one group of people, no one industry can do it by itself.

R. Thomson:

Yevgeny?

Y. Gavrilenkov:

Yes, I think there is another solution. What happens if a company defaults, the banks are under pressure, the U.S. government bails it out, increasing its own debt, then China or Saudi Arabia or other Middle Eastern countries buy American debt. We can avoid this intimidation between those failed companies and banks and final buyers of this debt. It can be direct purchase, acquisition of those companies by the Chinese...?

P. Desai:

So far as the U.S. situation is concerned, of course there is a lot of worry about the Treasury running a significant and an increasing deficit and the Federal Reserve selling bonds and bills and increasing its debt. But then, I think the question is what is the choice at the moment? I am a Keynesian and if private investment is declining, if the economy is going into a recession, if the unemployment rate in the U.S. economy is now hitting over 9% of the workforce, then what is the choice before the policy-makers except to think in terms of a massive stimulus through budget deficit and through their role of the Federal Reserve in the system. So, while we do worry about the increasing debt of the government and of the Federal Reserve, I do also think in terms of what is the choice at the moment of reviving the U.S. economy and how to, therefore, pull out the rest of the world as soon as possible out of the global recession?

R. Thomson:

We've just about reached the end of our time. And Padma has said, the big question is how to pull the world out of global recession, how to weight risk, how to assess the value of value. That debate is certainly being furthered a little bit today by our panellists. They've been very, very generous with their time and their thoughts, and we should be very generous with our applause. Thank you very much.