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The Current Economic Crisis: A Long Term Perspective

The current economic crisis has three very distinctive features that have taken most people by surprise:

- . They relate to the impact of innovations in financial markets – with the housing crisis in the US revealing deep systemic flaws;**
- . The patterns of globalization – with developed countries slowing down dramatically while the developing countries sustain their growth;**
- . and booming prices fuels and food markets.**

In my remarks tonight, I want to consider each of these developments in a long run perspective to reflect on how what we think we know changes.

As I began to prepare these remarks along these lines, it occurred to me that Minos Zombanakis has been a central player in each dimension.

- . The first is as an innovator in international financial markets with his central role in creating the Euro-dollar market, itself an example of financial innovation;**
- . the second is his role in bringing about closer global cooperation both among developed countries and between developed and developing countries;**
- . and the third is his particular interest in dealing with the concerns raised by commodity markets –oil in particular and the central role he has played in facilitating dialogue between oil producers and consumers.**

As exemplified by the Athens Seminar meetings he has sponsored and directed for thirty years. So I think it is

especially fitting to reflect on these issues in a meeting honoring him.

Well let us take a step back, say to the mid to late 80s and ask what did people think they knew then?

First, many said that the US economy was in decline in part because of its capital markets, especially the reliance on the stock market which was said to emphasize short term profits while Japan was ascendant in part because it had a superior system with close relationships between banks and firms that allowed them to focus on the long run.

Second, globalization was not a word on many lips -- indeed some said at the time the GATT was dead -- simply the general agreement to talk and talk -- and the monetary system dysfunctional because it had generated such large imbalances,

and third, oil and commodity markets were still reeling from the mid 1980s slump when the dollar had strengthened in the US and we had lamented the plight of the farm belt and the oil-patch.

Move however to the late 90s. What did we think knew then?

Well we found out that what we thought we knew in the 1980s was all wrong. The US was ascendant, driven by innovation partly due to the flexibility and innovativeness of its financial markets based on securities. Japan and later Asian economies had succumbed to severe financial crises, in part because their systems were opaque and built on “crony capitalism” and the relationships between firms and banks too close!

Meanwhile globalization had been reinforced by roaring capital flows and an unprecedented trade agreement – the Uruguay Round – which formed the WTO. The conventional wisdom now was that was that globalization was good for the developed world --- especially the United States -- but according to many protesters who filled the streets, and many in Africa and Latin America that had experienced almost two decades of stagnation, the trading system was damaging and unfair to the developing world.

And what about commodities? Well growth was increasingly oriented towards a new economy, based on information technologies and services and away from basic commodities

such as oil and food. Though towards the end of the decade, oil market was picking up, I still think our friends from Saudi Arabia would have leap to sign long term contracts locking in the oil price at 25 dollars a barrel!

And in response to these developments we saw several reactions. The Doha Round was launched and called the Doha Development Agenda because it was an effort to make the trading system work for developing countries, and in particular it focused on agriculture to help farmers in poor countries get higher prices for food by cutting subsidies. We saw developing countries in Asia accumulating foreign exchange reserves and maintaining stable (undervalued) dollar exchange rates to prevent financial crises and we saw declines in the development of new oil supply capacity throughout the world. And meanwhile innovation in the US financial markets continued even though there were already warning signs with the bursting of the dot.com bubble and the problems with corporate governance associated with Enron's collapse.

But how different things look now from what we thought we knew just seven years ago. First, we've found out in the US that the risk we thought our markets had reduced remained in

the system. That it was *our* system that had become so complicated that it lacked transparency. Indeed the lack of any relationship between those who originated debt and those who held it had become a fatal flaw. And our regulators look just as bad and out of touch as the Asians some disparaged just a decade earlier.

And now developing countries have done splendidly and attitudes towards the global economy have shifted. Africa, Asia Latin America, all have experienced unprecedented growth. The power balance has shifted. And where are the protesters? Not at meetings of the World Bank and the IMF! What we're now seeing is disenchantment with the system in the developed countries, especially the United States! The American public is now saying its we who don't benefit from trade and trade agreements. And distinguished economists such as Larry Summers, Alan Blinder, Paul Krugman and Paul Samuelson are expressing similar doubts as to whether development abroad benefits the United States. Hilary Clinton wanted a time out from trade agreements and Barak Obama wants to renegotiate NAFTA. Fast Track has been suspended. Indeed assuming the Doha Round could end this year it would be hard to get the US congress to be enthused about something

called the Doha Development Agenda. The claim is that the rich benefit from globalization but workers in the developed world have lost. And of course the pace of global growth and probably a build up of global liquidity have led to a very tight oil market and soaring food and metals prices. We have been reminded that we continue to live in a material world!

So where are we headed? You can see why I hesitate to make forecasts! Well I look at what the IMF Outlook and it says more of the same. The growth projections are for slow recovery in the developed countries with growth at two or three percent at most while developing countries are set to average seven percent annually through 2013. And commodity prices according to the OECD and GAO are set to remain high for the foreseeable future.

But is the current cycle going to turn into a trend? I don't think so. If there's one thing that's certain it is that it's foolish to extrapolate. What these reflections indicate is that what we think we know is bound to change yet again.

So how should we respond? I still believe the developed countries are better off with open trade and financial markets.

But there are challenges for these to be sustained. For the developed countries the key lies in policies which result in a more progressive income distribution due to tax changes and improved measures to help workers deal with change and dislocation. The developing countries -- the large emerging countries like India and China and Brazil need to stop taking the system for granted and move the direction of sharing systemic responsibility in both the economic and environmental areas.

And will we be able to adapt to the commodity boom and bust? The fact is the current crisis presents a unique opportunity to focus on conservation and achieving a more sustainable process of development. For the US will finally embark on serious policies to promote conservation and alternative energy. For the trading system to remove the obstacles that penalize farmers in developing countries. And for the Europeans to aid the world in exploiting the real potential of bio-technology. But if commodity prices fall again, as they could if global growth actually declines as countries fight inflation, there is also a distinct danger we could go back to our ill-conceived ways.

And in the financial area? Can we extend the purview of regulation to all those who create systemic risk without constraining innovation and the genuine potential for a better allocation of risk through markets? Will authorities over-react so that we throw the financial baby out with the bathwater?

The challenges are numerous and the outcomes uncertain. But one thing I am certain of. Minos Zombanakis will continue to devote himself to dealing with these challenges and helping to making our world a better place!