Policy and Security Implications of the Financial Crisis: A Plan for America
James K. Galbraith

On June 16-17, 2008, I had the pleasure of meeting in Paris with an exceptional group of close observers of the financial system. The meeting was international and non-partisan, convened jointly by Economists for Peace and Security and by the Initiative for Rethinking the Economy. I presided over two days of off-the-record discussions.[1]

My intent here is to reproduce the general tendency, or center of gravity, of our discussions on certain important questions, without (for the most part) implicating any participant in any particular view. Thus what follows is technically my own opinion. Yet it reflects, as best I can, the much broader authority of a larger and distinguished group.

1. Extent and seriousness of the financial situation.

The depth and severity of the ongoing financial crisis provided the most important common ground early in the meeting. Participants placed it out of the league of financial events since the 1930s, including the debt crises of the 1980s and the Asian and Russian crises of the late 1990s. One called it "epochal" and "history-making." What distinguishes this crisis from the others are three facts taken together: (a) it emerges from the United States, that is from the center and not the periphery of the global system; (b) it reflects the collapse of a bubble in an economy driven by repetitive bubbles; and (c) the bubble has been vectored into the financial structure in a uniquely complex and intractable way, via securitization.

The crisis is a global crisis originating in the United States. This fact implies that it calls into question the governance of the global credit economy, so long centered in the US and on our reputation for fair and open dealing. One participant called it a crisis "of the legitimacy of the G1." Whether a global financial system centered in the United States, and on the dollar as a reserve currency, will continue for much longer is an open question in the minds of the group.

While some in the room chose to interpret the underlying source of the crisis as a matter of macroeconomic imbalances – savings and investment on one side, the trade deficit on the other – most took a darker view. This larger group acknowledges that the country at the center of the world financial system must run a current account deficit – otherwise there would be no dollar assets for the rest of the world to hold as reserves. The crisis emerges when the world loses confidence in the system that supports the valuation of the dollar, because of a perception of instability, mismanagement, and corruption, leading to a breakdown of regulatory authority and market order.

[1] The meeting was hosted by the Charles Leopold Mayer Foundation for Human Progress, on the generous initiative of Pierre Calame and Aurore Lalucq. A full list of participants is attached. This essay is forthcoming in *Challenge*, Nov.-Dec. 2008.

Bubbles are endemic to capitalism, but after the early 1930s they were not the major story. Rather, industrialization and technology set the direction. It was only in the late 1990s with the information technology boom that financial considerations – including the rise of venture capital and the influx of capital to the United States following the Asian and Russian crises– again came to dominate the direction of the economy as a whole. The result was capricious and unstable–vast investments in (for instance) dark broadband, followed by a financial collapse–yet it was not without redeeming social merits. The economy prospered, achieving full employment without inflation. And much of the broadband survived for later use.

The same will not be said for the sequential bubbles of the Bush years, in housing and now in commodities. The housing bubble–deliberately fostered by the authorities that should have been regulating it–pushed the longstanding American model of support for homeownership beyond its breaking point. It involved a vast victimization of a vulnerable population. The unraveling has social effects extending far beyond that population, to the large class of Americans with good credit and standard mortgages, whose home values are nevertheless being wiped out. Meanwhile, abandoned houses often become uninhabitable, so that unlike broadband the capital created in the bubble is actually destroyed, to a considerable degree, in the slump.

As the housing bubble collapsed, a commodities bubble has succeeded it, notably in oil, food grains and base metals. This is a speculative bubble, which cannot be explained by "fundamentals": oil prices have about doubled in the past year while total demand for oil is up only a few percent. The simultaneous price rises in energy, food and metals also tell of a common financial source. Regulatory changes, including the Enron loophole and the swaps loophole (both put into law at the turn of the decade by then-Senator Phil Gramm), and the London loophole (due to calculated negligence on the part of the CFTC) have fostered financial speculation in commodities. The creation of the London loophole in early 2006 just predates the explosive phase of the bubble, and this is probably not coincidental.

In energy and food, financial forces are up against inelastic supply, which is why this bubble pushes up the consumer price index and the previous two did not. The relative narrowness of the markets into which money is being poured assures that macro-expansionary effects are minimal; higher prices translate to higher costs. Yet, where short-term supply responses exist, as in the production of coal and more intensive farming, including conversion of grain to ethanol, those responses are also environmentally destructive. The resulting concentration of wealth in oil barons and landlords is profoundly corrupting. Finally, the compounding increase of oil and grain prices in the poor countries leads inexorably to food crisis, hunger and to a developing humanitarian and political disaster. The bubble will burst, of course – *after* these effects have been felt.

Securitization is a long-standing practice, created in the United States by the government sponsored enterprises Fannie Mae and Freddie Mac. It is a major reason for the success of American homeownership policy since the New Deal. But the question is, at what point does it go too far? At what point are standards dropped too low? It should be clear by now that nonconforming home loans cannot be safely securitized, because the credit quality and therefore the value of the asset cannot be reliably assessed. Further, in the regulatory climate of recent years (where as William K. Black pointed out, political appointees brought chainsaws to press conferences), ordinary prudential lending practices broke down completely. The housing crisis was infected by appraisal fraud, a fact overlooked and therefore abetted by the ratings agencies. "No one looked at the loan package." Now the integrity of every part of the system, from loan origination to underwriting to ratings, is under a cloud.

Fraud is deceit, a betrayal of trust. And it is trust that underlies valuation in a market full of specialized debt instruments, off-books financial entities and over-the-counter transactions. That trust has, as of now, collapsed. The result as John Eatwell phrased it is that financial crisis takes the form of *market gridlock* – a systematic unwillingness of institutions to accept the creditworthiness of their counterparties. This is especially grave where a counterparty has no direct resort to a lender of last resort – and so the crisis naturally erupts in parts of the system that are outside the direct purview of central banks. In other words, deregulation is a vector of financial crisis. The economist-physicist Ping Chen tied this to a larger theoretical point: the logic of efficient markets and rational agents, which is based on Brownian motion, is in error. Unregulated financial markets depend on information and social networks that are inherently unstable and may be explosive.

The message of these three points for the next American presidency is fairly clear. No one in the group expects the financial crisis to have disappeared, or even to be under stable control, by January of 2009. At that time there will no doubt be immediate priorities: more fiscal expansion, fast action against the wave of home losses to foreclosures, plus fast action against financial speculation in commodities would seem as of now to head the "to-do" list. But the financial problems will not go away. And that means that a benign credit expansion, such as got underway for Clinton in 1994 and carried him through his presidency, is not in the cards now.

Instead, the next administration will face an internal demand situation similar in some respects to that of the early 1990s under the first George Bush, when banks and other lending institutions–deeply damaged by the third world debt crisis of the early 1980s– chose to sit quietly on large portfolios of US Treasury bonds and to rebuild their capital by exploiting a steep yield curve. They did not reenter the business of expanding commercial and industrial loans until 1994 - five or six years after credit dried up. However, where the steep yield curve will come from, this time around, is an unanswered question.

Further, the next administration will not enjoy the climate of reliably stable prices that has been the norm since the early 1980s, making possible the non-inflationary demand expansion that brought us to full employment by the end of the 1990s. Every step in that direction risks being bedeviled by the instability of oil and basic commodity prices, and by the precarity of the dollar itself. Forces hostile to policy initiatives will exploit these vulnerabilities, to discourage and thwart any systematic strategy favoring economic growth or a new direction for economic development in the next presidency.

Such is, for instance, the obvious implication of the "IMF audit" recently announced for the United States, no doubt with the approval of the incumbent Treasury Department. Inflation headlines will be taken up by the longstanding fiscal doomsday chorus in Washington and on Wall Street. In other words, a problem that has its origin in the deregulation, mismanagement and corruption of the financial sector may become, in American political discourse, a perceived problem of public fiscal management and irresponsibility. If this happens, it will severely challenge the ability of presidential leadership to place economic growth on a fundamentally new and more constructive course, and to deal with critical issues such as the infrastructure deficit, energy and climate change.

For these reasons, the Paris group agreed that in the next administration the problems of the financial sector should take a very high priority, as an integral part of broader economic strategy. The financial crisis needs to be addressed at its most fundamental level, which is the purpose, functioning and governance of financial institutions–and their regulators. Let me add to this my view that as a political matter, it will be essential to keep the financial origins of the larger economic problems in plain view, and for this purpose also a vigorous program of regulatory oversight and reform will be essential.

2. The unstable macroeconomic environment.

The United States economy was driven forward in the 1990s by a credit expansion focused on information technology investment, and in the mid–2000s mainly by a vast expansion of housing credits, which fueled construction and also sustained, to a large degree, middle-class consumption. These sources of demand expansion are now exhausted, and even going in reverse. Meanwhile, large increases in fuel and food prices drain purchasing power, forcing delays in all forms of consumption and investment that can be postponed. This accounts for the massive drop in (say) automotive sales reported early in the summer.

US effective demand in 2008 is being supported by fiscal expansion. The tax reductions enacted in January had a large, one-time effect on consumer purchases in May – a "sugar shock" to total demand, though part of it will leak to imports. Increased federal government spending– especially defense– is playing an important role, as second quarter data confirmed. So is the effect of lower interest rates on the value of the dollar, and on demand for exports. All of these sources of demand growth will be absent next year.

Further, starting in mid-summer states and localities began to implement austerity budgets imposed on them by falling revenue projections, which are a function of falling property valuations, shrinking residential tax bases, and stagnant sales tax revenue. Meanwhile, home equity loans are defunct, pensions invested in mortgage backed securities are underfunded, and private investment will likely follow the consumer into a slowdown. There is very little chance that any new sources of demand will arise in the private sector. While in technical terms a recession will probably be avoided in 2008, absent major effective action 2009 will see stagnation, and recession then cannot be ruled out.

Given the fact that vacated and unsold houses (unless destroyed outright) stay in inventory for a long time, there is little prospect of a housing recovery any time soon. Nor will a new expansion of loans to the broad population be collateralized by home values. A recovery in housing should indeed not be expected within the policy horizon of the next presidential term. Something good could happen, for reasons largely unforeseen, as it eventually did in the 1990s in the technology sector. But to bank on such a happy development would be an act of faith. More likely, there won't be good news from private credit markets in 2009, 2010 or 2011. Achieving economic growth *in some other way* will therefore be an overriding policy goal.

The only other known way is fiscal policy, and this raises two questions: how much fiscal expansion will be needed, and over what time horizon?

Calls are now being heard for a "second stimulus package"; these reflect the fact that the first stimulus package, while effective, was necessarily short-lived. But the same will be true of the second stimulus package. And once the election is over, will the coalition presently supporting short-term stimulus will stay in place? If not, what then?

If the above analysis is correct, the political capital of the new presidency risks being depleted, quite quickly, in a series of short-term stimulus efforts that will do little more than buoy the economy for a few months each. Since they will not lead to a revival of private credit, every one of those efforts will ultimately be seen as "too little, too late" and therefore as ending in failure. Meanwhile a policy of repetitive tax rebates can only undermine the larger reputation of the country, for it is unlikely that the rest of the world will happily continue to finance a country whose economic policy consists solely of writing checks to consumers.

What is the alternative? It is to embark, from the beginning, on a directed, long-term strategy, based initially on public investment, aimed at the reconstruction of the physical infrastructure of the United States, at reform in our patterns of energy use, and at developing new technologies to deal with climate change and other pressing issues. It is to support those displaced by the unavoidable shrinkage of Bush-era bubbles but to do so efficiently–with unemployment insurance, revenue sharing to support and expand state and local government public services, job training, adjustment assistance and jobs programs. It is to foster, over a time-frame stretching from five years out through the next generation, a shift of private investment toward activities complementary to the major public purposes just stated. It is to persuade the rest of the world that this is an activity worthy of financial support.

As noted, this strategy will have to be developed in a hostile environment of unstable oil and food prices. However, it would be a mistake to interpret that instability as *inflationary* in the sense normally meant to invoke a monetary policy response. In particular, money wages have not changed or caught up; real wages therefore fell–and quite sharply–as commodity prices jump. As Ben Bernanke acknowledged in a recent speech, nothing in the present movement of price indices can be attributed to wages. In Bernanke's telling phrase, "the empirical evidence for this linkage is less definitive *than we would like*." (italics added)

For this reason, practically nothing in the standard formulae governing responsibility for fighting inflation applies. Those formulae were created for a world where Federal Reserve policy acts as a deterrent (through the conduit of "credibility") against excessive wage increases. But excessive wage settlements have been unknown for a quarter-century. What is happening, instead, is a price bubble created precisely in the financial markets! There is no lender who was ever scared of higher interest rates. There is no energy trader who is deterred from pushing up the oil price, by the threat that someone else might have to pay a few extra points of interest on a bank loan six months or a year hence.

Federal Reserve policy – caught between a weak economy and unstable commodity prices – is thus faced with a conflict of objectives and a shortage of instruments. It can "fight inflation" – raising interest rates to support the dollar and hold down the cost of imports. This Luiz Carlos Bresser Pereira calls "exchange rate populism"–a familiar phenomenon in Latin America, attractive to political leaders but corrosive to development. If the Federal Reserve takes this route, the normal channels of domestic economic recovery will be blocked, and in addition to that, the financial markets will probably unravel, so that a defense of the dollar a pure monetary policy strategy is probably unsustainable, even in the short run.

Or the Fed can continue to deal with the ongoing financial crises, supplying liquidity as a first priority, in which case the dollar will settle wherever the consensus of international reserve holders decides it should go. In that case, a spiral not of wages and prices but of rising commodity prices and further falls in the dollar cannot be entirely ruled out.

Neither option is attractive and it is clear that something else should be done. But what?

It is mantra in some quarters that Presidents do not comment on the actions of the Federal Reserve. But in this situation, comment is needed. An appropriate comment on the larger role of monetary policy does not amount to interference in routine decision-making, e.g., of the Federal Open Market Committee. Rather, it should reflect the core reality: the Federal Reserve and other financial regulatory agencies failed in their responsibilities in the past decade and now they must take up those responsibilities again.

The entire point of a regulatory system is to regulate. It is to subordinate the activities of an intrinsically unstable and predatory sector to larger social purposes, and thus to prevent a situation in which financial interests dictate policy to governments. That is however exactly the situation we have allowed to develop. The job of the Federal Reserve and of the other responsible agencies must now be, in part, to re-establish who is boss. Specifically, there must be a thorough-going revamping of the financial rules of the road, to dampen financial instability, to deflate the commodity bubble, to reduce the enormous monopoly rents in the financial sector, to set new terms for credit management and to generate productive capital investment where it is most required. This is in large part the Federal Reserve's job, though it has strong inter-agency and international dimensions.

Only when financial speculation is brought to heel will the forces pushing up commodity prices be defused. Only when they are defused, will the ordinary business of setting interest rates become manageable. We have been taught, over many years, that "inflation is everywhere and always a monetary phenomenon" which only the Federal Reserve can cause or cure. But no! Inflation is not everywhere and always the fault of easy money. It can be–and at the moment it is–a financial phenomenon, driven by uncontrolled speculation in commodities and the sinking dollar. This must be dealt with by direct action affecting the way the financial markets work, and the underlying markets for energy and food. It cannot be dealt with effectively by hiking interest rates, except by doing so drastically, and then at enormous costs to the real economy.

In addition to restoring effective regulation, the government has other weapons. Notably, there is a stockpile of oil–the Strategic Petroleum Reserve. Why not sell from it and burn the energy speculators, as Paul Davidson has proposed? And if it is sensible for the U.S. to use stockpiled oil in this way, it is surely also sensible for other countries to stockpile grain (when it is available) in order to stabilize the price of food. These measures are appropriate instruments against the price instabilities we presently face. As for the dollar, an aggressive, unilateral defense–which is likely to provoke offsetting action by the European Central Bank and other major players– would amount to a "race toward global depression." The alternative is collective action to stabilize the major currencies, including the dollar, with respect to each other. This will be taken up in the next section.

3. The Future of the International Monetary System.

The Paris group included several senior experts on the structure and governance of the international monetary and financial system. Almost all agreed that the present system is in trouble, and that major changes are on the horizon if not actually imminent. Whether those changes will come by evolutionary steps or by directed reform was an open question. There was no consensus as to the ideal structure of a new system, but certain lines of the discussion were nevertheless revealing.

The present international monetary system suffers broadly from two critical flaws. First, it has failed to provide stability, hence predictability, to ordinary business activity. Financial flows almost entirely determine the ups and downs of exchange rate movements, with the result that these are largely haphazard, unpredictable, and subject to manipulation; meanwhile the underlying financial networks are opaque and subject to large systemic risks. Second, it does not provide a framework within which individual countries can pursue coherent development, growth and full employment strategies; on the contrary it subjects them to harsh discipline and erratic performance. It is no accident that the major success stories in the developing world – China and India since 1980–were precisely the two countries that did not use bank credits and so remained insulated from financial shocks. Since the late 1990s, these two have been joined by others (notably Argentina) who have realized that often the most effective financial strategy is to detach from the international system.

Within this unstable and capricious context, the United States has enjoyed a highly favored position, especially since the early 1980s, as the provider of the sole major reserve currency. For how long the dollar can hold this position is a grave uncertainty facing the United States. But the same uncertainty also faces the world, much of which is well-served by having a single reserve currency, and especially by having it be that of the US. It is precisely because the United States has been willing to maintain a high level of effective demand despite violating every imaginable balance-of-payments constraint, that the world economy has been able to grow, and largely to flourish, since 2001. The United States could do this, because its debts are in its own currency and at low rates of interest.

A shift to a multi-polar system would remove this feature. It would be, therefore, extremely risky, because such a system has no consumer-of-last-resort. If no country or region is willing (or able) to run up debts, the others cannot pursue export-led growth toward full employment. Most of the world understands this, and as a practical matter most of the world supports America in its role. The real danger of a collapse is thus not a challenge to American leadership from the outside, but decay and disorder arising from within.

The Bretton Woods system tried to deal with instability through capital control. The idea was to keep private international financial players in check, with a global money and a clearing union to settle international accounts, and a system of adjustment that favored expansion by surplus rather than contraction by deficit countries – thus pushing all players toward full employment. The Havana Charter of the ITO, which was never implemented, stressed the need for this type of asymmetric adjustment, along with exemptions for developing countries from the rigors of free trade. Some in the group favor returning to that vision as the starting point for the design of a new system. Most regard that ideal as unattainable, and seek instead the narrower objectives of better control over instability and a greater tendency toward growth and high employment – that is, to cure the flaws of the dollar-reserve system rather than to replace it.

All participants understand that the survivability of the dollar system cannot be separated from the reputation of the United States, especially in three areas. The first of these is geopolitical: the U.S. gained financial preeminence after World War II because it was the recognized and accepted leader of the non-communist world. America provided security to that world and received financial privileges in return. In the years since the Cold War, it has become increasingly clear that the United States is not providing very much security to others, and has instead become itself a source of instability in many eyes. The financial position of the country cannot fail to pay the price for this.

The second area where reputation is important is that of financial governance: the U.S. owed its financial preeminence in part to a widely-shared conviction that U.S. financial markets were comparatively clean, stable and transparent. Obviously that reputation has come under great strain in recent years. The resulting uncertainties do not affect the liquidity of Treasuries, but they do affect the valuation of the dollar, and the attractiveness of dollar-denominated securities as reserve assets.

Third, the U.S. has enjoyed financial preeminence because of its technological leadership. Investors go where things happen. This fact was prominently on display in the late 1990s – the U.S. got the capital inflow because it was the only country that could generate the technology boom. This asset too has been partly squandered, but it can be repaired. Doing so will be a major part of the challenge facing the next administration.

These fundamental issues are obscured by a superficial international regulatory discourse, according to which the central issues facing the financial system are transparency, disclosure, and better risk management by firms–the Basel II agenda. This agenda ignores systemic risk. Yet systemic risk in a changing world is the central and unavoidable question. Meanwhile the IMF, as an organ of world financial governance, is a spent force, discredited by its rigid ideology and asymmetric service to the creditor states. It is no surprise that developing countries do not want to work with the IMF anymore.

Participants from China, India and Brazil emphasized that regional financial agreements and, in certain cases, new institutions are already developing. (Of these, of course, the Euro is a major example.) Outside Europe these will aim not at fixing exchange rates, but at providing zones of management and predictability, through a combination of swap networks and capital control, especially inflow-control. Regional currencies or clearing units, in Asia and Latin America, seem increasingly possible. These will improve regional economic stability and reduce the demand for dollar reserves, but with adverse effects on U.S. economic stability unless something is done. Many of these developments have already, to a large extent, escaped direct control from the United States.

What should the United States therefore seek? Our discussions pointed at three major lessons for the next administration:

– First, the key-currency role of the U.S. dollar should be preserved as much as possible, as long as possible, even if it cannot be preserved indefinitely. This can best be achieved by explicit coordination among the major players, including the U.S. and its largest creditors in the developed and developing worlds. Here the status of China is central. The United States is simply going to be obliged, by the force of circumstances, to seek an accommodation with China in the interest of preserving–for as long as possible--an economic relationship that has greatly advantaged both countries.

– More broadly, the U.S. should accept both the inevitability and the benefits of regional stabilization blocs, which have the potential to mitigate the risk of financial crisis in large parts of the developing world, permitting sustained economic development. But in return, the emerging regions and their institutions should agree to support the dollar, by stabilizing reserve holdings and fostering investment in the United States.

– Ultimately, excess holdings of U.S. reserves can be reduced through the gradual revival of U.S. technology leadership, especially in the area of energy transformation. It is by selling what we produce that the U.S. can ultimately make the transition–if a transition is unavoidable–from financial hegemon back to "normal country." It is in everyone's interest that this transition, if it cannot be avoided, be as smooth, and as slow, as possible.

4. Policy Priorities for the United States.

As a final exercise, the Paris group was asked to consider what the major policy priorities should be for the United States, in the economic and financial conditions likely to face the next administration. This discussion produced considerable consensus on major points.

The next administration will probably face an acute situation in two areas: housing and oil. It is clear that efforts to stem the foreclosure crisis and the massive deflation of house prices now underway are constantly being overtaken by rapid growth in the scale of the crisis. Estimates range up to ten million households "below water" and a loss of household wealth on the order of $6 trillion. And the matter is extremely time-sensitive: once houses are foreclosed and abandoned, irreparable blight settles over the landscape, darkening and deepening the problems for many who were not foreclosed as well as for those who were. An effective policy to halt foreclosures and to keep families in their homes is a most urgent priority. If the next presidency cannot forestall a rising tide of home loss, no other problems are likely to seem solvable. For these reasons, a new Homeowners Loan Corporation (HOLC) and Resolution Trust Corporation (RTC) should be put in place urgently.

If the oil and commodities bubbles have not collapsed by January, bringing those prices down to reasonable levels will be a task for emergency action. Just as the S&L crisis brought re-regulation to the savings and loans, so the commodity crisis must bring re-regulation to the futures markets. Certain technical steps take priority, especially closing the Enron and London loopholes (as is now being done) and bringing credit default swaps under position limits in the commodity markets. More broadly, as noted above, the new administration can sell oil from the SPR (as was done in Desert Storm and following Hurricane Katrina). As oil prices are brought down, they should also be stabilized over a reasonable floor: the policy should not be cheap oil but oil sensibly priced to promote conservation without beggaring the middle class.

The new administration can also work with food-producing nations to reduce export restrictions and hoarding. But as with oil, the price of this should be a commitment to new global policies aimed at stabilizing the supply and price of staple foods. Once these measures take effect, pressure will come off the Federal Reserve to defend the dollar or, worse, produce the deep recession that would be required to kill off demand for food and fuel.

These measures will tend to burn speculators and force financial institutions holding speculative assets to recognize their losses. But this must be done, and for the sake of an economic recovery it should be done sooner rather than later. The view of the group is that the major losses from an unraveling of the commodities bubble would be felt by hedge funds, private equity funds and other speculative pools, rather than banks – losses that the larger system can tolerate. There is no need for panic. It will be far easier to rebuild the financial system than to cure the urban and suburban blight that an unattended housing crisis will leave behind, let alone to undo the damage of conditions approaching famine in some countries.

Regulatory powers are a matter of will and determination as much as they are of new laws. A will to act can put an end to the self-fulfilling prophecy that governments are (in this area) intrinsically overwhelmed by the complexity of markets. The next administration should therefore move swiftly to repair the vast damage done to regulatory capacity in recent years. It should emphasize the acquisition of authority–filling in the regulatory black holes that have been allowed to develop. It should appoint strong regulators to vacancies on the Federal Reserve Board and elsewhere. It should rebuild the staffs of the regulatory agencies, paying adequately to tap and retain top talent, including senior experts. It should hire enough people to have systemic competence, and it should eschew zealots. The country needs an effective ongoing regulatory system, not a platform for the careers of a few new Rudy Giulianis.

One short-term fiscal stimulus package may be inevitable, given economic distress and the need for an early political victory in this area. But it should be pursued without illusions. The economy will not resume normal growth on the basis of a single such package. Fiscal expansion in the next administration therefore needs to be a long-term proposition, and it should focus on building institutions needed for the long run. Thus, general revenue sharing to support state and local public services, a national infrastructure bank, an energy and environmental program must all be conceived of as part of a long-term strategy to stabilize demand, provide jobs, and reestablish the technical basis for American global leadership and eventual re-emergence as a dominant exporter in advanced markets.

In addition, since the financial crisis will inevitably bleed into the value of private pensions, the next administration should consider steps to expand Social Security benefits, so as to put a more secure floor under the incomes of the elderly.

Long-term capital commitments are appropriately financed with long-term debts. Thus, the pay-go provisions of the budget process should not serve as a bar to action along these lines. However, there is no harm in programming progressive tax increases for future years, in order to keep budget deficit *projections* under control. If circumstances warrant, those tax increases can always be deferred before they take effect.

It was a central tenet of our conversations that these measures cannot be viewed, or undertaken, in isolation from the international financial position of the United States. Obviously, a successful speculative attack on the dollar would severely disrupt the orderly implementation of this or any other strategy. Equally obviously, a unilateral defense of the dollar via a campaign of high interest rates would severely aggravate the problems of the real economy.

The way out of this dilemma – the only way out – lies in multilateral coordination and collaboration – a joint effort by the US and its creditors. And this means that the next administration must return, rapidly and with a credible commitment, to the world of collective security and shared decision-making that the Bush administration has been at pains to abandon. An orderly disengagement from Iraq would send a major signal of the intent of the U.S. government to play, in the future, by a different set of rules.

Collective security, in short, is not merely a slogan. It is the lynchpin of our future financial and economic security–security that cannot be assured by any unilateral means. Only a collective effort will keep America's creditors committed to the stability of the dollar-reserve system, for long enough to effect the next round of economic transformation in the United States. Conversely, continued failure to appreciate the financial and economic dimensions of unilateral militarism is one certain route toward the failure of the next administration's economic and financial strategies. The two largest issues we face–how to maintain American economic leadership in much of the world and how to manage American military power–cannot be separated from each other.

Collective security is, however, also more than simply a way of reducing risks and instabilities. It is the foundation-stone for many physical transformations of the economy to come. It is obvious, in particular, that the military basis of international power on which the United States continues to rely is completely out of date, and has been for decades. As Iraq has demonstrated to everyone including the professional military, military power alone cannot deliver stability and security at all – let alone at an acceptable human and social cost. Yet parts of the military establishment continue to develop, and to harbor, the technological talent and capacity for problem-solving which every aspect of our energy problem now needs. Shifting the basis of our security system away from one based on military equipment is a key step toward making those resources available.

And the same is true for other countries. China, for example, has long made energy choices favoring coal partly because the resulting power plants are diffuse and militarily expendable. In a secure world, that country would be far more willing to develop its vast hydroelectric potential, as the then-invulnerable United States did in the 1930s. Hydro power is carbon-clean, but militarily exposed. A stable reduction of military fears is a key step toward opening up markets that can potentially permit resolution of collective problems on the grand scale.

In short conclusion: from the beginning, the next US president will face acute situations requiring immediate action, especially in oil and housing. He should aim for early victories in these areas as the foundation stone for intermediate- and long-term programs. For the medium-term, institution-building and the restoration of competent and effective regulatory power over the financial system–both national and international– will be key.

For the long term, the goal should be the transformation of our energy base and the solution of our environmental challenges– the rebuilding of America, nothing less. And that can be done, only in an international financial climate made possible by a return to multilateral decision-making and a commitment to collective security. The American people are ready for this. The president should be prepared to explain that leadership in a world community–leadership of collective action on the grand scale–is America's true destiny. It is not in futile warfare, but in great endeavors, that a great nation finds its future, its purpose, its place in history, and prosperity, as well as security, for its people.

Participants in the EPS-IRE Seminar on Finance and Security, Paris, June 16-17, 2008

Americans:

BLACK, William K.: University of Missouri-Kansas City; Black is a former regulator, a criminologist and lawyer, and was the whistleblower in the matter of the Keating Five.
DAVIDSON, Paul : New School University, Editor, *Journal of Post Keynesian Economics*.
GALBRAITH, James: The University of Texas at Austin and Chair, EPS.
GUTTMANN, Robert: Hofstra University and Centre d'Economie de l'Université Paris-Nord
HARVEY, Thea: Director, EPS.
KREGEL, Jan: Levy Economics Institute of Bard College and University of Missouri, Kansas City. Formerly with the United Nations (UNCTAD).
ROSSER, Barkley: James Madison University, Editor, *Journal of Economic Behavior and Organization*.
WEBSTER, Lucy Law: EPS

French:

BLIN, Arnaud: Forum for a New World Governance
CALAME, Pierre: Charles Leopold Mayer Foundation
CHAVAGNEUX, Christian : Deputy Editor, *Alternatives Economiques*
DEMBINSKI, Paul: Observatoire de la Finance
FONTANEL, Jacques : Centre d'Etudes sur la Sécurité Internationale et les Coopérations Internationales, Université Pierre-Mendès-France, Grenoble.
GNOS, Claude: Université de Bourgogne
JACQUET, Pierre: Agence Française de Développement and Cercle des Economistes
KALINOWSKI, Wojtek : IRE
LALUCQ, Aurore: IRE
PARGUEZ, Alain: Université de Besançon
RAVEAUD, Gilles: Université Paris 8 Saint-Denis (note-taker).

Others:

AGARWALA, Ramgopal : Research and Information System for Developing Countries, New Delhi. Formerly World Bank Resident, Beijing.
BRESSER PEREIRA, Luiz Carlos: Getulio Vargas Foundation, Sao Paulo. Former Finance Minister of Brazil.
CHEN, Ping : China Center for Economic Research, Peking University and Center for New Political Economy, Fudan University.
EATWELL, John: President, Queens' College, University of Cambridge.
LIETAER, Bernard, Research Fellow at the Center for Sustainable Resources of the University of California at Berkeley.