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Meeting Summary

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HOST COUNTRY CHAIRMAN:
FRANÇOIS BUJON DE L'ESTANG

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EXECUTIVE SUMMARY

SESSION 1: FRANCE ON THE MOVE
ECONOMIC REFORM, SOCIAL DIALOGUE AND POLITICAL GOVERNANCE

Jean-François COPE

Panel moderated by Nicolas BEYTOUT

Michel CAMDESSUS
Olivier PASTRE
Nicolas BAVEREZ
Mario MONTI

Chair : **François BUJON de l'ESTANG**

Can France change? Although the intensive world growth is now unfortunately missing, **the conditions have never been so good for this to happen.**

1 The World is set up for a change

> *A new energy is coping with our time's problems on both sides of the Atlantic, in a period of major challenges*

Mr Obama's election is setting the stage for a broad change worldwide, and **France is undergoing a similar situation.** Nicolas Sarkozy was elected with a clear mandate to change almost everything, and he has initiated more reforms since his inception last year than France ever experienced in the last ten years.

France and the USA are reaching, at the same time, the end of opposite ideological cycles: the Socialist one here, the Conservative one over there. This coincides with the end of the overall economic cycle as well.

2 The French President is promoting change in France

> *Even France, famous for its reluctance to undergo reforms, is on the move, driven by a strong political will*

The French election created the conditions for a leap forward. The country was strained with an impressive decline, linked to deficits in the rule of law, a weak growth, a high average unemployment, huge public deficits, poverty hitting 12% of the population, 780 urban ghettos.
[illegible]cellent demography, brains, talents, excellent infrastructures, [illegible]n attractive civilization.

When 2007 brought about the conditions for change, the balance proved to be positive as a whole. The results are quite impressive: reform of the Constitution, change in the economic and social model, big steps taken in the field of diplomacy and defence, the French strategic posture revisited thoroughly...

Such a change was made possible by a thorough political reshuffling by the President: Nicolas Sarkozy opted for telling always the truth and tackling problems as they were**. He went back to basics:** "*Work more, to earn more*". And he thus met the secret agreement of the people.

Major changes are under way in France, backed by a good public support

The government could even get rid of the 35 hours scheme. Work is now a positive value. This is a genuine change, a fresh boost. This time, strikes and demonstrations were not allowed to kick the reform dead! Economically speaking, France is one of the best recovery cases in Europe, even if it still does not work enough and suffers from a huge public debt.

A major institutional reform is under way. **The people are ready for significant changes.** A culture of dialogue and negotiation is replacing the tradition of going on strike upfront. Things are getting less ideological, thanks to the decay of the left wing. The European framework is most welcome in France nowadays as a pattern for policies.

3 The French renewal impacts Europe too.

France is actively participating in the change of the EU. The new thrust is expressed, *inter alia*, by the Pact on Immigration, the Mediterranean Union, as well as by the initiatives taken to harness the current financial and economic turmoil with efficient solutions.

France's swift changes are enshrined in a larger European come-back, promoted by the French EU Presidency

Europe is also back in the field of geopolitics : It's Europe that took action first when the Georgian and the financial crises burst out. Moreover, thanks to the financial crisis, for the first time in recent history, the EU helped rescuing the US, with short-term solutions, a long-term strategy, and massive coordinated plans. **The guiding idea is to overcome institutional obstacles.**

4 Fundamental transformations are underpinning the on-going changes

Any foreign observer would note a deep evolution of the French public mentality.

The fact that liberal responses were found and heralded by France to the so-called "Crisis of Capitalism" witnesses major in-depth changes

We are witnessing in France the revival of an ancient and fruitful French liberal tradition. Even to address a financial crisis that cast a major blame on the system itself, the government refrained from stepping back into traditional French "etatism", and championed liberalism without meeting any significant opposition. Market integration and public policies coordination were the two conditions for further improvement, according to Jean Monnet, and this is exactly what is happening under Nicolas Sarkozy, in a magically positive manner.

TOPICAL SESSION:
THE INTERNATIONAL FINANCIAL CRISIS
WHAT WENT WRONG?

ONNO RUDING
MICHEL CAMDESSUS
CHAIR: EDMOND ALPHANDERY

A NEW GLOBAL FINANCIAL ARCHITECTURE?
LUNCHEON ADDRESS BY STANLEY FISCHER

We are undergoing a major crisis of the system, probably larger than we still believe

The crisis is affecting almost everybody in the world. It is not limited to the financial sector. It is a huge shock wave, not to be underestimated.

The Bank of International Settlements evaluates the net worth of the banks at some 4 000 billions $. 1500 billions were lost by American banks, slightly less by European and Japanese banks. There are huge problems with consumer credits in the US, where the corporate sector is in jeopardy ; municipal bonds, and the huge black hole of derivative products, remain unaccounted for. We have unfortunately a way to go until we know how serious this will be as an overall economic crisis, and, furthermore, the extent of the crisis is not yet determined.

We need knowledge on that amplitude and risk, to fathom a more accurate idea of what we are talking about. Let's assume losses up to 3 000 billion $ or higher. How much more State borrowing can we throw at the problem from already heavily indebted States?

Borrowings in the world were at a ratio of 8/1 fifteen years ago, they reach 25 – 30/1 today. This is the root of the imbalance and of the problem.

1 WHAT ARE THE CAUSES OF THAT SHOCK WAVE?

A multifaceted crisis

There cannot be one single reason to that crisis. One failure would not be enough to trigger such a disaster. This crisis is different from previous ones.

It is a crisis *of* the System, not *in* the system any more. It addresses confidence in markets, in policy makers, in the policy framework itself. We need more than money to solve it. We need to address the holistic issue in the first place. It's time to think big!

It is fair to add that we experienced a coincidence of various crises: an energy crisis and a financial one. The financial crisis has not fully created the economic crisis, which is the result both of the globalization and of local conditions.

The crisis has national and international elements. The banking sector has failed; even some States have been bankrupt. The Crisis has also put at test the financial globalization. Mistakes were made by many financial institutions, but also in the field of supervision and macroeconomics, such as the interest rates policy. The Chinese exchange rate, designed to boost an export-led strategy, has resulted in huge US current account deficits which were pretty large and unsustainable even before the oil price went up.

The crisis has tested many of our institutional frameworks. The Euro resists well, the EU institutions too, even if both the EU Commission and ministers were very slow to take joint international action in the initial phase of the crisis. Unfortunately, the IMF was not heard of very much during that crisis, and the coordination of policies was more some coordination of already taken decisions, than real joint decision-making.

Failures within the banking system caused the crisis to burst out

Things from outside did not help, but the main reasons of the crisis come from inside the banking world. Dominance of the front office, pushed by excessive bonuses and packages for the Board, has led us where we are. There was indeed a lack of knowledge, of professionalism and of experience, in large international operating banks.

Bankers are definitely to blame, but bankers bashing falls short of telling all the truth.

They were part of a system, in which the problem remains of *who will define what is the right profitability*? **The evil inside banks is mired in deficiencies at all scales and levels.**

In the many mistakes that led to the present breakdown, politicians claim that they have no blame to take. Indeed they all knew what was underway, and they did not take action. Moreover, the housing bubble was even *promoted* by politicians, who, for more than 10 years, pulled the banking system into allowing the poor to become homeowners, as part of their social policy package!

Casting the blame on techniques ond structures misses the point. Wisdom, anticipation and ethics were not up to what duty required

It is therefore unfair to talk only of a crisis of securitisation, in what happens to be a much more encompassing failure. The issue is all with the *wisdom deficit*, not with the instruments themselves.

It is also true that redundant indicators played their role perfectly, and that the crisis could nevertheless start burning under cover, just because decision makers did not read the warnings right. Why?

Why have we so easily forgotten basic ethical values and prudential wisdom? There were not enough people with grey hair asking the broader questions about the risks that were being taken. We need a *"garde champêtre"* for basic ethical values to be respected.

But when the lack of "mutual persuasion" at the most aggregate level involves giant countries, there is not much that any "police" can do, and the best you can do is to give those major players a greater sense of responsibility for their role in the system. Still, countries have more than one interest that they need to adjudicate in their relations, and there are limits to putting economic management of the system on top of the agenda.

2 WERE THE MEASURES TAKEN ADEQUATE AND SUFFICIENT?

We have addressed the crisis in the format of a G20, suggested by the Americans at the end of the Asian crisis. But this gathering is not based on any treaty. This is too weak a basis. **We have to go back to the IMF format**, but with an empowered and better-balanced IMF. The question of who actually runs and funds that Organisation of 186 Member States, designed for another historical period, is open. The Central Banks should be able to provide liquidity more easily when there is a liquidity issue, as the Fed is already doing internationally through the mechanisms of swaps.

The global support measures altogether already amount to almost 15% of the World GNP. **How will this be financed?** We are likely to undergo both deflation and inflation, as a lot of money will be issued from scratch, while still too little will be left for the private sector to run ordinary business. How much more State borrowing is possible is a question. We are off limits as a whole, and there is no classical answer to such a strategic question, which is perhaps where major risks begin.

Measures that have an appeal, because they would help restoring the banking structure, can prove to be very damaging from the macro economic point of view.

Finding out what the correct package of action should be is not an easy task

A seemingly good initiative can end up becoming the worst one. For example, demand for higher capital ratios in the banks is not the good answer, as it would freeze large amounts of money, and shrink credit.

The problem is all about trust, which has to be restored, rather than to upgrade capital ratios in the banks. The cornerstone both to trust and to economic regular functioning is adequate liquidity, and this is what should be cared about first and foremost. The election of Barak Obama might be a blessing in the process of restoring hope and confidence.

Actually, what we need most urgently is to convince the new emerging powers to rescue the system and help fixing it, rather than to distribute the blame for what happened, which is linked to the very system itself. **Focusing on Responsibility is buying a ticket for the next crisis.**

Yet, right as it may be, that line is not politically sustainable unless responsibilities are sought and addressed. It will be very difficult to explain why we bail out those who screwed the system, while we cannot find the resources to keep business running, employment, housing, etc... Where is the legitimacy of measures with no responsibilities at stake?

Conditions must be found to balance emergency initiatives and long term requirements

We could reduce the effects of the crisis by adopting rules that fit the situation, rather than by sticking to rules designed for markets that do not exist any more for the time being.
The main objective should be to prevent a credit crunch.
Governments are thriving to revitalise the inter-bank market that no longer functions. Will the amount injected be enough? **Governments will not be able to shower the banks with money twice, if it does not work this time**.

Increasing the equity of banks as a buffer against crises seems to be a safe move. That leads to lower risks, but to lower profitability as well by the same token, whereas under previous conditions, leverage increased profitability and risk altogether. **Who will set the right balance between those two opposite blends?** There is a dilemma. Banks are requested by the governments to stimulate the economy, and to reduce lending, in order to deleverage their balance sheet. It is difficult to do both, so who will tell what is the right move to take?

3. WHAT SHOULD BE DONE TO PREVENT SUCH CRISES FROM HAPPENING AGAIN?

We should not miss the benefit of the sense of urgency that the crisis is triggering. This is the only time when reforms have a chance to get through. We have to make a trade-off between the length of the crisis and the size of the reform. If we solve the crisis too fast, like in the 80's, the reform will be left unfinished, and another crisis will start brooding.

Understanding that we are tackling a crisis ***of*** the system, not another crisis ***within*** the system, sets a very different agenda and calls for structural measures on top of immediate reactions. The issues are fundamentally internal, *within* banks, *within* States, *within* the System at large. What we have to do, is to strengthen our banks and current banking system, not to overhaul it in a hurry.

We need a better regulation in every field - institutions, markets, and complex financial instruments, not a new overarching one. **The real question is, "what is it that banks should do and not do?"** and it cannot be answered in a single didactic manner. We should remember that what we are blaming now has promoted growth, and a lot of wealth, over the previous decades. Therefore, *yes*, we should rewrite the rules, but, *no*, we should not cut the freedom of banks and individuals.

It is essential to build on sound conceptions, and not just to tally to day's challenges

Fortunately enough, we did not hear the word "protection" yet, and this is a positive landmark of the change that globalisation has brought about. But we did not point at the risk of inflation either, and this is a creeping danger not to be underestimated, as it would be tantamount to another way of breaking loose, away from a sound World order.

What actually went wrong is not on the technical side, but on the moral one: greed twisted the system and screwed it up. Ethics matter in business, and the stock market system missed the point by focusing on one single criterion, the share price, and forgetting employment, productivity, creativity and everything else. This is where politicians ought to come into play, to recall all those factors, in the name of the people. And this is where a better regulation should address such issues as well, upfront, to prevent greed from jeopardizing the system. Selling or transferring risks without remaining part of it is an ethical, problem, if not even a legal one, much more than a technical one in the first place.

We need a European Integrated Regulatory System and Body. Giving supervision to some overall European supervisor might prove inadequate. The analogy with the ECB is superficial, as the supervision of banks is a matter of detail, hands on. **One of the fundamental responsibilities underpinning the global equilibrium is to evaluate the risks in a market**, and this should not be left with a single source of authority. A kind of College of National Supervisors has much greater credibility that a central supervision body.

Much of the issue is about regulation. But freedom and efficiency are at stake too

The point is more about actual relevance to the reality of the present banking business than about principles, whether it should be more national or more European: it has to be more relevant, one way or the other. We'd better rethink the role of credit rating, along the Basel code: Regulators are national, markets are global.

The risk culture, and the ethics of the banks are at stake; therefore, the supervision should not be moved further away from the banks, but fall closer on their back. We should be cautious to avoid Etatism. The issue is to be met *inside* the banks rather than *above and on the back of* the banks. Many leaders of many banks should adopt a different mindset. They have been too greedy, but the problem is wider.

We need to find a proper balance between flexibility and rules at all levels, globally, at the European level, nationally, and, last but not least, in the banks themselves too, where better balances should be found internally between front desk and analysts. More ethics, less arrogance should prevail in bank management. **How to achieve that deep reform, across the board, worldwide?** How to re-establish the proper distribution of power and responsibility to manage the risk at all levels is the key issue.

The change ought to be fractal: namely impact all levels with the same gist and thrust

We don't want to take this off the hands of competition to be entrusted to some advisory body, do we? And since politicians and governments have their responsibilities in what happens, it's a bit too much for them to claim a full transfer of responsibility into their hands, and pretend that now is their time to take over!

At that stage, one should keep in mind that measures with short term appeal can have advert consequences in the long run. State intervention can bias competition, create inefficiency and cronyism, and end up worsening things it intended to cure. The matter is a delicate one, and should be handled with wisdom and care.

There are lights at the end of the tunnel, but there is a price to pay to get hauled out of it. We should consider paying

There are savings in the world, which can match the requirements. But they are in the hands of owners who are not ready to lend blind, as they used to as long as fuelling the System paid back safely and decently. Now the System is scoring huge losses. Therefore, the potential lenders will have to be convinced by something else. We have to think about the modalities, how to tap the savings of the rich savers?

We, the European Union, should strongly support an increased role for the IMF. This implies that the IMF should address also developed countries, which requires extra financial support by surplus holders. Calling upon their increased involvement will imply offering counterparts, meaning at least that the IMF will have to be reformed, and probably more. One way of pushing that overdue reform would be for the Europeans, who hold 8 out of the 24 seats of the IMF, to cluster their shares and thus make a couple of seats free for other World players. Incidentally, this would bring the IMF to Europe, as they hold together some 30% of the votes, as opposed to the biggest present stakeholder, the USA with only 17%.

Indeed that need of fostering the IMF had already been pointed at, and a solution was decided upon In Hong Kong, at the beginning of the Asian crisis, 20 years ago, we had taken one single decision to meet the challenge of the soaring crisis: That the IMF would, from then onwards, have authority to conduct surveillance of capital flows as well as the current account of the balance of payments. That straightforward reform, although clearly geared to be "gradually" implemented, was then left on the backburner. And here we are, with a crisis stemming from the lack of what we had clearly designed at that time, namely an institution in charge.

This time, let us not repeat the mistake, and let us implement the Hong Kong declaration. But what kind of an IMF do we want now? How to organize the distribution of power inside of it? We have to engage in a dialogue with the power centres of the world, on what to do in that respect. In the 8O's, the IMF could persuade the Saudis to refund it, with appropriate conditionality. If we want to tap the money of the Chinese this time, we have to offer them conditions too. We will have to use some influence and convincing power. We need this, because the IMF will lack resources to fulfil the duties we are putting on it. This will not happen without reforming the IMF, in particular by giving a say to the lenders.

SESSION II: THE EUROPEAN UNION

AT MIDTERM OF THE FRENCH EU PRESIDENCY TO BE FOLLOWED BY THE CZECH REPUBLIC

Jean-Pierre JOUYET
Alexandr VONDRA

Chair: Peter Sutherland

Europe is at stakes: many feel humiliating that a country like Ireland has rejected the treaty, while a broad majority of its citizen are in favour of further integration.

1 The French Presidency gave a fresh impetus to European policies

The French Presidency has focused on the purpose of allowing Europe to assert itself politically. This was Mr Sarkozy's thrust, and it was kept carefully right through the events that gave shape to what was, altogether, a "crisis management presidency".

The momentum of unexpected crises was smartly used to leverage Europe's political influence and resilience

The Georgia crisis burst out on August 8th. On the 12th Nicolas Sarkozy was in Moscow negotiating a cease-fire. Europe won a commitment from the Russian to withdraw their troops, which actually retired on October 1st, while 200 observers deployed under the European flag, and negotiations were launched in Geneva. This was the first time that Europe played a key role in such a crisis.

The financial and economic crisis was met with equal swiftness, in a spirit of European cohesion. The French Presidency organised a European approach, and was thus able to ensure the future of the banking system on the continent. A pragmatic approach introduced new means of addressing such issues.

Tackling the crisis leveraged institutional issues. In the response to the on-going sharp economic downturn, Europe must remain united, and it seems necessary to keep convening meetings of Heads of State and Governments to address jointly the common risks. There is a need for the Euro zone to be represented as such in the IMF, since the Euro is the true anchor of European economy. Giving a specific weight to the Euro group as such, far from dividing Europe, is a means of enhancing its cohesion and togetherness. In the wake of the ongoing crisis, we are inventing a new way of managing the economy in Europe based on the Euro zone, in close connection with the British and the Pound. This raises institutional concerns.

While crises were managed, long term concerns kept boiling

Despite the attention paid to managing such a range of crises, the French Presidency did not forego the other major and long term priorities on the agenda. Such issues actually proved to be the most delicate ones to deal with.

Climate change was addressed. Migrations were dealt with as well. A European Pact on Immigration and Asylum was drafted, in full consultation with the countries where migrants come from, and was adopted by all 27 Member States.

In the field of defence, the French Presidency has laid the stress on reinforcing defence, beyond the debate about NATO. **As far as relations with third countries are concerned, closer relationships were developed with Southern and Eastern neighbours**. On the July, 13th Summit, 43 partners took part in the launching of the Mediterranean Union, which proves to be a great success. The emerging countries are not a homogeneous group: this is why summits were held with each of them, including Ukraine and ASEAN. **Attempts were made at designing a renewed transatlantic partnership**.

Significant changes were made, that need to be consolidated

As a whole, this period offered historic opportunities to promote Europe's views. They were seized and used by the French Presidency, in a way that many have commended with admiration. As a result of the recent developments, some lasting changes have been brought about.

First and foremost, Europe will have more economic and political debates, no more only technical ones, and this is by itself a big step forward. **The main challenge is now to keep the reactivity, but the next Presidency is prepared to keep pace**. The balance ought to be kept between responsiveness and long term commitments.

Keeping that momentum is a matter of organisation. The council and the ECB have been strengthened in due course, whereas the Commission, for its sluggishness, lost the initiative.

2 The Czech Presidency is being prepared in a spirit of continuity

Europe is a matter of coherence and continuity more than anything else

The key word for the Czech, as they prepare themselves to take over the Presidency from France, is continuity in cooperation, from the French to the Swedes through the Czechs. **More structural reform, more competitiveness is needed**. But this is a matter of on-going efforts, not of innovations.

The Czech Republic's ambition, during its Presidency time, is not to compete with France, but to provide bridges, to improve cohesion, to complement what was achieved by contributing another way round, to provide adequate moderation, rather than leadership.

There will be continuity in so far as pragmatism will remain key to steering Europe right through difficult times

The Czech Republic has some credentials for doing well in that respect: In the field of economy, the Czechs learned from their own deep and fast transition how to act rapidly. On Russia, they have a first hand, yet now unemotional position. They are adamantly liberal because of having badly experienced the opposite 40 years long, and therefore know better what it means, not for fanciful reasons.

<u>This is no time for ideological heroism.</u>

Pushing the climate package through will not be easy, and it will take designing and negotiating a balanced solution about environment, economy, energy security, etc...,that all 27 countries of the Union can accept, as different as their conditions, interests and views on that fundamental issue may be. Banking regulation, notation agencies will also remain on top of the agenda.

European institutions are part of the problem, not only of the solutions

This will take place in an era of political transition, since the Commission is coming to an end, the Parliament will be in session only in the first quarter of the year, before another one is elected. **On top of that, the institutional problem will have to be solved too.** The background fact is that while 70% of the people support the EU, only 35% support the Treaty which is meant to turn that support into facts. That discrepancy must be overcome.

3 The European conundrum is still loaded with problems to face

The French Presidency has been commended for acting swiftly, accurately, and in a fairly innovative way. Yet, beyond that brilliant phase of leadership, endorsed by the Union at large, Europe seems to remain without a stable functioning leadership.

As far as institutions are concerned, we have to be clear with the Irish. They will vote again and should do so on the basis of guarantees, for which everybody else is very open. But they should also receive a very clear warning: The choice is between Lisbon or Nice, not about a mix.

Enlarging Europe further does require an appropriate institutional framework. Europe needs confidence and stability. Other countries cannot let any single player damage the "acquis". Yet, even if "*No enlargement without the Lisbon treaty*" was a position of policy, indeed a major political stance, is an attitude like "*Lisbon or death*" actually feasible?

> *Europe is in the World, and has to take the World's changes into account carefully*

The Europeans should manage their expectations carefully about the new American President, as whereas Mr Obama is expected to solve everything in the World, he will have to stand for the interests of the USA in the first place. Actually, the expected New Deal on the other side of the Atlantic, with new attitudes on climate change, energy, defence, is heading in a favourable direction, with a much better attitude towards European integration.

Promoting an improved multilateral order and addressing the global challenges will therefore require initiatives and a spirit of cooperation from both sides. Europe has a role to play more assertively. **Moreover, Europe has three challenges of her own to face**: one on its Mediterranean side, the other on its Eastern borders, including Ukraine, and a third one is dealing Russia, which is not the easiest one to meet.

SESSION II (cont.): THE EUROPEAN UNION

Toger SEIDENFADEN
Edgar BUCKLEY
Andre AZOULAY

Chair: Elisabeth GUIGOU

1 Referenda are backfiring devices

The Irish referendum was humiliating, and proved that referenda are purely destructive mechanisms. A system based on either Yes or No will never allow reaching an agreement between 27 Member States. The Constitutional and Lisbon disasters, caused by referenda, have to be overcome. If we are not convinced by such disasters, what will it take for us to be convinced that referenda are definitely not the right way to proceed? We have had referenda in all situations, all kind of governments, good and bad, new and old, of all sizes. We know now that running one is a structural risk in itself, designed to make things worse while pretending to make them perfect.

A referendum about EU matters is by nature a catch 22 situation, doomed to fail

Not only is it technically impossible to agree by Yes and No, at 27, on very intricate issues, but it puts actions ahead of the political mandate, while clearance should come before action is undertaken. It destroys accountability: since we make the sovereign people itself responsible, we put the people themselves in the dock if they take a decision that cannot stand. **This should not be played with.**

Furthermore, referenda are not fit to the gist of European political history. The decision-making process must be anchored in the electoral practices to which people are used.

In any referendum, there is an inbuilt advantage to the "No" side. Moreover, a referendum is a free kick. You can kick the government without bringing the other side in. Some wonderful opportunity indeed to express discontent without paying the price for it! **The fate of Europe is therefore put at risk** about almost local contentious issues, and Europeans have to foot the bill for narrow national inside games, which is not acceptable.

The Union needs treaties and referenda kill treaties without even addressing them

It is utterly unfair, in an Union, to be driven into taking collective decisions on the basis of one single country's vote, which is the consequence of any negative referendum, the result of which is, by its very nature, a breach of the European spirit itself, however important the question posed can be.

The reason why treaties have so far run the risk to fail, is that their stakeholders were merely national governments and bureaucrats, and that they reflected the interests and vision of those stakeholders. It did not happen by accident, but as a straightforward consequence of the way in which matters had been dealt with. It is structural, and it's a deep problem. **We cannot have by the same token such patterns of negotiation *and* referenda, since this is doomed to fail.**

Discarding referenda is indeed not an expression of a fundamental lack of democracy. It's time to make the Berlin decision become a positive fact, because we need treaties, and the referenda are merely a method to undercut each and every of them.

To address that challenge, let us place the democratic debate at the beginning of the process, and discuss the substance, rather than to call upon the sovereign people to agree or disagree when everything has been packed together beyond its reach, and along other structure's logics. **The solution is to politicise the European negotiations**, and therefore to endow the negotiators with a strict political accountability.

The negotiators ought to be legitimised one way or another. They have delegitimized themselves under the present course of things, because they have no price to pay for the No! What happens currently? A duly elected and mandated government participates in a long and difficult negotiation, the 26 other countries accept the negotiator's credentials, an agreement is reached with their full and cleared participation, and then they get a No from their people, and yet they are still around! This is a denial of responsibility and it highly contributes to making people even more euro sceptical, as there is no visible consequence to their vote about Europe in their national political life.

The problem is all about empowering the negotiators properly and holding them accountable

Negotiators should be elected. You would get the crisis, if any, at a healthy moment, upfront, and someone could be held responsible at every moment of the process. This is a flexible way of addressing the need for treaties, together with the necessity of rooting them in people's sincere and enlightened agreement.

Governments would not loose control if they allowed negotiators to be elected before the drafting process begins. Negotiators would just come into play for the negotiation between those two fundamental terms, conveying an upload of legitimacy into the process itself.

The threat of having to resign when faced to a "No" would compel governments to campaign for the "Yes", and would also bring people to think twice, because, very often, the opposition is at least partly in favour of the Yes too, and should therefore be fired too, abiding by such a rule, which would put the country at loss.

At the end of the day, the issue is all about mutual trust, which calls upon mobilising each and every stockholder's sense of responsibility in a clear and effective manner

Indeed, one should even consider that, if a democratically elected government negotiates for 2 years for a treaty which is in line with the obligations which we signed up in the first place, the *electorate* should be told, before the vote, that *they themselves* should resign from the European Union if they disagree *ex post* on the result of such sincere and open negotiations, and that it would not be possible any more to remain a member of the Club after repudiating one's duly accepted original obligations.

The level of trust embedded by the citizen in the European construction is on average not lower than what we think it is. We don't need that supposedly democratic blessing of an ex-post popular consultation to bridge the supposed "gap" between "Europe" and the people. The European level is not further away from the people, than the federal government in the USA is from its citizens. A referendum organised across Europe would be kind of a "Coup d'état" against the sovereignties, without providing a solution either. Reaching agreements on a treaty will always be a compromise, not a very beautiful baby.

2 Defence policy is a touchstone for Europe's destiny

The idea of a European defence, separate from NATO, remained unheard of until the end of the cold war. We had a nuclear block-to-block system; NATO never used its forces.

The meaning and scope of defence have changed since the collapse of USSR, but the relevant structures have not been fully adjusted to that fundamental shift. It is high time to move forward in that field.

With the collapse of the USSR with all its conventional might, we discovered that operations would have to be conducted in Europe and elsewhere, and that in dealing with them, the strategic interests of the US and the EU might not fully coincide. In 1992, it was decided that the European joint exterior policy should include a security policy. In the 1998 bilateral Summit at Saint Malo, Britain and France decided that the EU should have a military capacity. In 2004, the civil aspects of that scheme were settled, with comities set up and a European Defence Agency. ESCP became an institutional reality. 20 missions were conducted, most of them small scale, with a ¾ civilian component.

This construction is clearly not finished. We still do not have adequate military capability; we lack enabling capability, strategic airlift, communications, civilians, helicopters, a permanent military planning and command HQ, etc... In the beginning, the USA, and UK refused the idea of a European operational HQ. The Americans and all others have given up opposing this, except the UK.

There are more general shortfalls. 70% of Europe's land forces are unable to operate outside their territory. A think tank, *Eurodefense*, has shown that EU countries have 1,5 more men, but only ¼ equipment as compared to the US. We do spent a lot, but very much on duplication. We have failed to establish the right level of strategic convergence amongst ourselves. Indeed, we are plagued with two structures (NATO and EU) which, instead of being mutually reinforcing, in fact damage each other. We are doomed to fail in Afghanistan if we do not overcome that absurd deficit of synergy, because they need civilian support over there, which NATO cannot provide. And that failure might kill NATO.

There are two reasons to that situation. The first is that the 27 EU Member States hold very different positions to defence, from a 5 to 2,5% share of their GNP; the second is that there is a longstanding difference in visions about NATO and European security, with the USA and France holding the opposite positions. Furthermore, the ESDP, so far, is not about *the Defence of Europe* proper. It is mere Defence policy, all about risks and dangers in the rest of the world, but it does not address conflicts affecting Europe itself, which are within NATO's purview. More voices call for genuine European defence. The feeling is there, realities should follow.

New conditions are making the overdue changes more likely to happen

Yet, new strategic trends are coming up. The impact of Iraq and Afghanistan has persuaded the US that they need both NATO and the EU. On the other hand, France has decided to come closer into NATO. There is an emerging willingness to reform NATO. And a new Euro Atlantic strategic partnership might be dawning.

France will reintegrate NATO more thoroughly. The idea of an autonomous EU HQ will get through. Both allies and Member States will push to cooperation. The new Transatlantic Partnership will set an overarching thrust. **This will lead to overcoming or overriding Turkish objections about Cyprus**, which have been in the way of any EU/NATO closer togetherness. Patience about this long lasting blockage of all joint developments is running out, and steps could be taken to get through. There are mechanisms for that.

We do have to tackle new security tasks together, in the fields of energy, cyberspace, etc... This means that NATO structures will have to be reformed, to realign them to new and present challenges.

Many reasons remain why some might still be sceptical about European defence schemes

"The Brits" seem to be in the way of everything. And they are. Why? The European leaders set themselves in 1999 the goal to create a fully capable 60 000 men rapid reaction force. 9 years later, it remains hypothetical. Improvement on long range transport was coined as essential, but remains unmatched.

Enabling capacities remain deficient. Helicopters, intelligence and reconnaissance, precision munitions, CCC systems are below requirements. The truth is that the British are unenthusiastic with what a Brussels drafted report phrases as "*a familiar pattern of underachievement*" by European leaders who "*celebrate inadequate outcomes, and set themselves unrealistic goals*". It's true. Are "the Brits" dragging their feet? On the contrary, the British come up on top of the league in all tables: European defence spending, defence equipment, 2006 procurement. As far as European deployment is concerned, UK comes first. And the second best is ... Estonia! Then the Netherlands, and fourth come the Irish, who are not even in NATO! No surprise that "the Brits" don't take seriously the ministers who don't deliver, even if it is true that the British government is getting slightly less sceptical now!

But now is the time to overcome all the blockages, disappointments and difficulties, to meet the requirements of the incoming future

Barak Obama will demand more from the EU in Afghanistan, under article 5. Civil support in the first place. He will rely more on EU, in general, to manage small crises. A more prominent place for EU defence will have to be reflected in documents and in the Treaty. Unfortunately, the Lisbon Treaty will not be available before the end of 2010 at the earliest, which is too late for the necessary defence build-up.

The French Presidency is doing much to speed up the necessary changes. **We have to change on all fronts**. A better cooperation between the EU and NATO as well as amongst EU members, a better relation between the EU and the USA, will have to be unravelled. Furthermore, the EU must be able to contain crises all by itself. **NATO is in a crisis.** It is a scandal that the EU and NATO don't work closer together. Many EU Official admit that NATO is the backbone; many NATO officials know that EU capacities are needed to supplement the Organisation's ones. How come that integration remains lagging?

Europeans should face the reality that nobody else will care about their security. We should not expect anybody to take the burden off our shoulders. We should not expect the Americans to come and rescue us once again. There are 200 Congressmen in Washington, waiting for it, to tell us to get lost.

3 <u>The "Mediterranean Union" is a major breakthrough</u>

The "Union pour la Méditerranée" was a major initiative of the French Presidency. The UM has both the European dimension, and a Euro Mediterranean perspective, that will impact the Middle East, and the Israel Palestine everlasting conflict.

We need to provide an answer to tell the Mediterranean countries that there will be a League for them to play in. We have to fix some rules of the game. There will be no way back. Now, as opposed to previous schemes, we have something which makes sense for all stakeholders. "Union" means something. We know that it is not a gadget, that it is possible to achieve the purpose of that Union.

In as much as it clusters a policy of Civilisation together with development issues, empowering all sides in a spirit of mutual respect, the UM is a great breakthrough

When the Barcelona process started, in the 90s, the people in the South received 50 times more aid than before. They achieved many reforms thanks to that. Yet, the ideological and cultural divide keeps deepening. The EU had given a lot, yet we are further apart than 10 years ago. And this is true in Egypt too, as measured by the Pew institute. It was high time to provide another answer. The UM is doing it, because it walks on two legs.

The Euro med alternative, it's not just for Europe and the Mediterranean. It means also that we are providing another scenario of co development and a model for the World.

The World Community is expecting something: We can do it, we are actually doing it. It is realistic. It could deliver quickly. It is an historical *rendez-vous*. The simple fact that a bureau of the UM was established, with an Israeli Deputy Chairman sitting together with a Palestinian one, is already an achievement. Indeed, it's a revolution.

There is a chance for peace embedded in the "Union pour la Méditerranée". A new momentum was given. The Arab Initiative for Peace, 5 years ago in Beirut, has set the stage, but it enjoyed no leverage at the time. This initiative was providing an answer to all Israeli requests over the last 50 years, but it was left in abeyance. Now, the region is undergoing very significant changes, which could help revitalising such paths towards peace.

We are not in a deadlock any more. The UM can leverage all this. Thanks to the very creative French Presidency, Europe is now closer to all sides at stake! The mere fact of calling a Conference with all Arab countries and Israel, the EU, the Maghreb Union and the Arab League, to review everything, is a fantastic success. This is indeed paving the way for the new American administration itself, as the Europeans are credible to both parts. Such a success would rebuild Europe's influence and credibility. Much of the role of EU was to be an alternative to the USA. The election of Barak Obama should change that!

Barcelona was not a failure but the UM reaches much further. It is a project of civilisation. In Barcelona, there was great reluctance from the Arab side to discuss ideological issues, which can now be addressed within the new framework. The UE wants to get closer to the South, but it is a community of values too, so there is room for discussion to determine how to serve both purposes well. The dimension of mutual respect was missed in Barcelona. The South does not want to be the clone of the EU countries and cultures. The people of the South are moving, their way.

DINNER KEYNOTE ADDRESS

AMERICA AFTER THE ELECTIONS

The Power to Lead in a Multipolar World

Joseph S. NYE, Jr.

The election of Barak Obama can already be coined as a transformative election, something which ushers in a cycle of several periods of domination by one of the major parties.

Mr Obama's election is likely to hallmark one of the fairly rare "transformative elections" which shift power from one Party to the other for a long period of time

It will probably be one, because of the current financial crisis, which will bring about a turn in the overall cycle. Governments will have a bigger role now, due to the crisis, and this should support a long lasting democrat period. The other reason for this to happen is the change in the electorate. There is an overwhelming majority among younger people, and in the Hispanic minority, who voted for the President Elect, and these are the faster growing parts of the constituency.

Is it "transformative" about American power too? Mr Medvedev recently said that the current crisis was the beginning of the end for the American might; Hugo Chavez keeps saying that Beijing is now more important than the US. The considerable decline of the dollar seems to validate such judgements. Yet, the idea of a decoupling of the American economy does not quite fit the facts

The financial crisis has profoundly transformed the nature of the American financial system. The backbone of the system suddenly passed from 5 to 0 investment banks. What we could call "the New York consensus", based on the assumption that American finance is paramount in the world, is no longer true. America has lost a lot of its attractiveness within a couple of weeks.

In the realm of the real economy, the short term trend is heading for a sharp recession. Whether this will be a long or a short one, experience will tell. According to some economists, the prospects of the recession to be short are 75%... against 75% too for a longer one. Forecasting baselines are blurred.

Is America undergoing a transformative phase as far as its power is concerned? Not really!

In the long run, what does the collapse of the New York model mean for the American power? John McCain was right, to say that the American economy is fundamentally sound. It is still rated N° 1, as opposed to China scoring 34th.... even an ailing American economy remains far ahead of any other flourishing competitor.

Yet, American power is bound to diminish relatively, by 20 to 25% during this century, not because it would be vanishing, but due to the rise of the rest, which in itself is good.. But China will not challenge the USA for quite some time; neither will any minor powers nor the European Union. Moreover, there is a strong desire in the US for a stronger Europe.

Power always depends on context, and should be measured against a wide range of variables. It is basically three-dimensional: *Militarily* speaking, the World is *uni-polar*. The USA is THE power. In the field of *economic relations* among states, the World is *multi-polar*. Europe is able to balance American power in that respect. When it comes to *trans-border relations*, encompassing terrorism, drugs, epidemics, and so forth, *power is chaotically distributed*, along other lines than what makes countries' might.

The crucial change is the diffusion away from any State's control of many aspects of what usea to build up power. This is thoroughly changing the stage worldwide.

Another subtler dimension is power diffusion from State to non-State actors. This is far more difficult and dangerous to cope with, and it is happening around the world, as the unprecedented diffusion of information and knowledge empowers almost everybody to an amazing extent. For example, in the 70^{s}, telling about the accuracy of satellite imagery would have been a breach of top-secret classified information in the USA. Now everyone can download much better pictures for free from the Internet! The spread of technology has empowered new actors., lower level ones. On 9/11, a non-governmental actor killed more Americans than the government of Japan had been able to do on December 7th, 1941.

Why do we need American leadership? Because collective good steering is essential for all, including the Americans themselves and that no such collective oversight will be possible without American leadership. Barak Obama fully understands this. He has displayed great contextual skills, which will serve well for that purpose of joining forces. In an information age, we have to adjust our vision of leadership. It used to be hard power *hierarchy*, now it stems from *attracting* others to you.

We also need to rethink the idea that the power is a zero sum game. It's time to move away from the notion of "*power over*" to that of "*power with*", meaning that you can increase your own power by empowering others.

Fortunately enough, the conscience of that fundamental change in the very conditions of power and of its consequences, is spreading too, allowing for new positive cooperations.

Take the example of China, which makes climate change for the worse by opening another coal-powered factory a week... If we feel harmed by such developments, shall we bomb them? This is obviously not within scope. The only way to sort out such threats is to engage with the authorities in charge, and deal with them on a peer to peer basis. Our interest meets the empowerment of a rival authority, which will thus be enabled to tally the challenge that *we* are facing and that *we* cannot manage.

Barak Obama has the skills for that, and has demonstrated it in his campaign, which was driven by emotion, vision, communication, and organization. His contextual intelligence enables him to exert smart power, which he learned from the bottom up.

SESSION III: MASTERING GLOBAL CHALLENGES

THE ROLE AND RESPONSIBILITY OF RISING GLOBAL ACTORS: CHINA-INDIA-RUSSIA

T. NINAN
LORD (LEON) BRITTAN
ANATOLI CHUBAIS

CHAIR: LOUKAS TSOUKALIS

The West is concerned about emerging powers. We should understand that there is a difference between what we say, and the tone we say it, through which they receive the message. Our positions are what they are, but they should not be presented to nations enjoying very old civilisations and a high degree of sophistication themselves as telling them what they ought to do. They know better about their interests, and we have to talk to them. We should try and understand better what they need and want for themselves and for the world , which they are definitely able to contribute shaping together with us.

By way of example, **the World is rightly concerned with China's exchange rate**. It is an important matter, but not the key to everything. The Chinese have been increasing the rate. And it is quite likely that is the American demand for it has not been so brutal, it would be done! Strident claims have not helped; this is not the way to engage with China, because they can resist that kind of pressure for long.

1. INDIA is driven further into World integration by the blow of the crisis

India has been a reluctant globalizer. Its Achilles heel is not the crisis; it is oil, as 70% of its energy is imported. In the past, India watched currency crises overtake many countries one after the other, without having ever been affected by any of them. India watched from the sidelines. But should oil prices raise sharply, the GDP immediately shrunk, and inflation was triggered. These were the basic patterns.

The country has accumulated reserves up to 300 billion $. The Central Bank heavily influences the currency, and imports are still a small proportion of the GDP. Therefore, India would have expected to remain ashore from the present financial crisis.

Despite its still limited exposure to the World, India suffers from the world crisis as roughly as many others do

It is true that over the years, the engagement with the world has grown. The share of trade in GDP soared from 15%, ten years ago, up to 40 % nowadays, and even 55% and more if services are accounted for. Foreign investment accounts now for 20% of the Indian stock market, and foreign direct investment went up from 2 M$ to 25 M$ a year. Indian companies have borrowed overseas. Outbound FDI overseas is about 15 M $ worth.

As a whole, India is integrating slowly and carefully with the rest of the world. As a result, despite they don't have subprime or securitisation problems, no failures, although the banks are safe, with no complex conduits, no rampant innovations, the stock market lost 50% since January. The fund portfolio sunk from 280 billions $ down to 80. Industrial growth rate has fallen by half, from 10% to 5%. The GDP growth rate is under 7%, which conveys the feel of a recession in a country where it used to be much higher. The upbeat mood has given way to a sharp pessimism. Corporate profits have fallen by 35%. We experience lay offs, sales are falling; consumers are not spending any more beyond their immediate needs. Interbank transactions are slowing down, leading into a range of periodic liquidity crises.

How could such a relatively insulated system be shaken so hard and so suddenly? India remains a mainly internal driven economy, but the crisis reveals internal problems, brought to the fore by external currents.

The sudden lack of liquidity in the world at large has meant that external trade credit dried up, and companies had to fall back on internal credit. The price of acquisitions abroad, previously negotiated, could not be met any more, unless with money harvested from inside India. Indian banks had therefore to pump money out of India into the rest of the World, drying out internal credit. Rupees have been turned into outbound dollars, and fell by 25% against the $. More liquidity has been sucked out, while the share of domestic credit in financing the economy has grown by 24% in a few months.

The world crisis unravels internal pitfalls of India's economy, and calls for further changes in order to mainstream development properly

But there have been domestic issues too. India had set the stage for the crisis by its mismanagement of the energy sector. The prices of oil products are government fixed, and, for political reasons, the government did not pass on to the market and consumers the peaking oil prices. Then the State-owned energy companies were in the red, and turned on to the banks, which contributed a lot to drying out liquidity even before the crisis from abroad was felt. This is a typical case transferring a fiscal option into the market, and creating a liquidity problem.

Up to July, the central bank combated inflation, and it kept that position too long, creating a domestic base for the financial crisis, which hit India although the banking system is thoroughly safe - 70% state-owned, well regulated, with up to 30 % of the bank money in hard cash. Nothing to worry about, indeed. And yet...

On top of that, the business cycle itself has turned. We experience a change in consumers' mood and business optimism, and this is a big concern, as deadly factors in the system itself prevent a timely change from tallying that challenge.

Two committee reports suggest more integration in the world as the right thing to do. This is necessary for infrastructure funding through foreign direct investment, which is direly needed in India. But the government has only still 6 months to go, backed by a shaky majority, and would not address such issues in an election period, as 70% of the constituency remains outside globalisation concerns, even if here is now a clear understanding across the country that engaging with the rest of the world is beneficial for India.

The Indian middle class is smaller than the Chinese one. The majority is not part of the market, and since India is a democracy, that majority governs the politics with domestic issues. This is by nature a steady long term tendency.

India is fundamentally a status quo Power, but it wants to be at the high table. **It will ask a greater role for the World Bank**, to facilitate bringing more investors in the field of infrastructure, which is at present the weak point of its economy. It will require also more representation for itself in the IMF.

The relation to Russia used to be the corner stone of India's foreign policy for decades. But Trade with Russia has declined. There is very little face-to-face business contact left. What remain are just State-to-State issues, in particular in the field of Defence equipment, which the Russian provide for cheap and with good quality. But even in that area of procurement, India is moving towards Western and Israeli offer. Towards China, the basic attitude is wariness. China is resented as a long term threat. This drives India rather towards Japan, even if China is by now India's largest trade partner, which creates some substantial discomfort. Moreover, there is always that unresolved border dispute....

So, the country is travelling through a tunnel, but there is light at the end of the tunnel: oil prices have fallen, the Indian growth remains domestic driven, and the financial backbone is sound. Therefore, India should get back to growth as soon as things clear up.

2 CHINA at the crossroads, from power to participation in World management

Europe and China share the same fundamental interest in World Trade

The relations between China and the EU may have been less important than those between the USA and China, but they are by far more positive, and growing faster, to a point that the Americans begin to feel bad about this, urging the European to regard China as a strategic threat, which they don't. This is a matter of potential transatlantic disagreement.

Yet, in the last couple of years, considerable strains have hampered the relations between China and Europe. The Europeans felt that the much expected liberalisation in China remained disappointingly incomplete, suffering from ownership caps in many areas, and ridden with the obligation of building local partnerships in China, not to mention continuing and well documented complaints about the Chinese breach of property rights, whereas the Chinese felt that anti-dumping restrictions from our side were hitting their trade in an unfair manner, even if only in a very small proportion.

Beyond such concerns, the real cause for the increased strain in those relations was the EU/China 235 billions Euros trade deficit, close to the USA/China one. Chinese exports to the EU grow faster than to the USA, partly because of a shift of manufacturing from other South-Eastern countries to China.

Even more worrying is the fall in UE inward investment to China since 2005. In 2007, the level was down to 1.8 billions $, to be compared with 6.2 billion $ in 2006. Russia and India have been attracting more EU investments since then.

Yet, **the fundamental relationship has not changed**. China wants foreign investment, and they want Chinese companies to go global. They will liberalise, with a better legal framework. Interesting enough, they have proposed to work out such a framework with the EU.

Moreover, new themes are emerging in that relationship. The focus is switching from trade issues into deeper cooperation, for example in handling climate change. China is no longer just on the defensive in that respect, but wishes to participate to the global endeavour. Of course, they will not accept caps on carbon emissions, but they are decided to move to a low carbon economy. It is fortunate for the World that the worst pollution is in Beijing, where the leaders live and suffer personally from it, which brings the issue more directly to the forefront as if it were happening in some remote area of the country.

The problem of climate change threatens to harm China much more than Europe, for many geographical and demographic reasons, and for that reason inter alia, the central government is now dedicated to curbing pollution and enhancing fuel efficiency. The current plan has set ambitious targets, such as gaining 4% energy consumption per unit of output every year, promoting renewables, undertaking massive carbon capture and storage. This is a very important shift, which underpins the overall trend.

China is affected by the crisis, and keen about contributing to solve it. They are just not fully prepared to play a major role in that respect. They are aware of the need to upgrade their capacity to do so. They work on it, cautiously.

How is all this affected by the global financial crisis? Even at the time of impressive growth rates, when someone talked about an incoming "decoupling" of the Chinese economy, and it becoming an autonomous source of growth, nobody actually believed this in China, because they new that, even if their growth can be shielded to a certain extent from trouble in the West, that trade relationship is so important to the very structure of their economy, that they would suffer anyway from any substantial diminution in World demand.

Despite the low exposure of their banks, they are not an insulated stock market, even with their close capital accounts. The sharp fall in their equity shows this. Their real economy will be affected too. In absolute terms, the growth rate will go dawn, even if it is bound to remain impressively high.

The government has already injected 500 billions $ in infrastructure and other mainstream projects. The question remains, to what extent will China respond to suggestions and requests that they should focus more on encouraging domestic consumption, and open an internal market for what the World would temporarily not be able to buy any more. It's probably too early to say. **Less benign consequence: there will be a slowdown in measures of further liberalisation.** Not that the Chinese leaders would head back to State-run economics, but out of some instinct feeling of nervousness to protect their still fragile wealth.

There is, in China, a fear of European protectionism, to be avoided. The EU and China are the biggest beneficiaries of cross-border flows. They both need an open global system. They have a joint vested interest in promoting open trade and resisting the drive towards protectionism. This is an area for mutual support, in which the EU has to engage itself resolutely. Let us resist protectionism! **The balance has shifted**. The subjects of cooperation and contention have changed. Europe and China must both resist to closing in on themselves. Mutually beneficial increase in the mutually beneficial relationship remains possible, realistic, and indeed probable.

Chinese and European need each other. They will have to ease up the process of carving out common interests by dropping some of their mutual inhibitions. They seem ready to do so, and the crisis is making matters more pressing.

The desire to see China make a positive contribution to the management of the World should be conducive to more open attitudes. There is now less nervousness about sovereign funds in Europe, as we desperately need their cash! But the Chinese are less prone to coming into play: they are aware that some of their foreign investments have plummeted off, as a result of the crisis, and their public opinion is extremely angry about such z loss of Chinese wealth, so hardly earned. This is why the Chinese will be very cautious in picking and choosing where and what to buy. They will of course have a development strategy of their own to underpin their shopping choices.

When we talk of reforming and strengthening the international financial system, we shall need China in. Europe should be at the forefront to support and argue in favour of China's enhanced role, such as to increase China's voting rights in the IMF.

The West is sometimes mistaken with China, thinking that, because China is not a democracy, it should be able to speak out its views with clarity. Yet, it is as diverse a world as the West. China is more of a puzzle than we would wish, but this allows us to influence the internal debate in China.

China will increase consumption inside the country, whenever and to the extent they will deem fit: they have a middle class of over 500 million people, roughly the size of Europe, who do not earn more than 500 $ a month, but spare 200$ out of it, and can release an enormous purchasing power at any time. Since a 7% growth rate is still to be expected, which leaves margins for manoeuvre, the government is not under too much pressure to opt for any specific solution, and keeps watching out before taking action.

We have to enter into some grand bargain with China, to assert that we shall -- on both sides -- maintain our markets open, and agree on sharing a greater part in the world governance. China is not thriving to carve itself a larger part of the world governance. It has always refrained to push in any direction, even in the WTO. They don't intend to use their huge amount of American government bonds to leverage the US government. Once you have a highly indebted partner, his debt becomes the problem of the creditor, and China des not want to make things worse with its debtor. They will keep acquiring paper, but more from Europe, to spread the risk.

3 RUSSIA to be won over again...

The Georgia War this summer pushed the West and Russia further adrift from each other. Russia did not choose to make war in Georgia. It was forced into it by the Georgian president. 450 Russian peacekeeper had been deployed ten years ago, many of whom were killed before by Georgian, and Russia had not reacted.

Deeper down, 5 events in the last 15 years shaped Russia's attitude towards the West:

1 **NATO expansion.** The point was not whether this should happen or not, but about the smart way to do it. The way it was done just removed the Berlin wall 1000 km further east, thus preventing Russia ever to join.

2 **Belgrade bombing**. That bombing ruined Russia's trust to the West. And the Russia/West relation altogether. And this is the understanding of each and every Russian, including the most pro-western ones.

> *From all Russian's point of view, the West has been aggressive and has deceived Russian's trust in 5 key occasions, which the West does not interpret as breaches of agreement at all*

3 **Iraq war**. This received a mitigated response in Europe, but a strongly negative one in Russia. This widened the gap between Russia and the West.

4 **Kosovo**. Russian leaders asked not to do this, as it was a direct violation of the international law, a breach of all UN rules. Abkhazia and Ossetia would follow. Despite all the warnings, it happened.

5 **US-NATO missiles sites** are being planned in Poland and major radar in the Czech Republic. Supposedly meant to intercept Iranian missiles? If this was the real intention, why not accept president Putin's proposal to design it together, and place it in Azerbaijan, much closer to the threat, much better fit for joint protection? Russians feel unsafe if Americans have missiles within 6mn from Moscow; even if the truth is that the missiles to be deployed in Poland are *interceptors,* which cannot hit Moscow in any way, but can only shoot incoming missiles. Actually, Russians know very well that the radars are not aiming at them at all. The missile shield issue is used to raise indirectly another question, namely whether the former Warsaw Powers are allowed to behave as full fledged NATO members, and, deeper down, to address the basic concepts of security – whether it relies on a protective belt or not. Reducing the time for a missile to hit its target increases the danger of an accident to happen out of any relevant political control, just for lack of time to take action. The mere fact of reducing time changes the picture.

Of course, all this was not arranged with a special purpose to harm Russia. But that's Russia's perception, once again even in the most western friendly circles. This explains the reaction about Georgia. And it may explain as well the deliberate gesture of announcing the

Kaliningrad missiles on the very day of Mr Obama's election, which was probably unfortunate, but tells a lot about the new prevailing mood in Moscow.

All Russians resent very badly many steps taken by the West without, perhaps, any intention to harm them, but in a way that itches their national pride and serves their government...

The truth is that we, from both sides, made so many mistakes, that we cannot be but optimistic for the future! We cannot be worst than we have all been, and we might understand that it is high time just to stop. What should be done now, by Europe? We can still rebuild this relation. The French President's action, this summer, has reopened ways forward. That's what we need. Both sides would benefit from an improved Russia/EU relation.

Russia is strongly affected by the crisis. Their GDP growth will not exceed 4%, which is kind of a shock as compared to previous two-digit figures. There is always a threat of protectionist steps being proposed. Unfortunately, the process of the Russian accession to the WTO is becoming sadly politicized. It is ridden with emotions, as a Treaty with Georgia and Ukraine is asked as a prerequisite!

The Russian political scene interferes with the economic and diplomatic issues. But whoever takes sides against the power in place loses the elections, because the people support the government and its policy. One should understand that, when Medvedev is tough against the US, this may help to liberalize, because it displays assertiveness. The worst way for the West to foster change in Russia is to make pressure on Russia for democracy. This is a major mistake, helping the communists and the right wing to gain momentum.

SESSION IV: IS A NEW " COLD WAR" DAWNING ON EUROPE?

Implications of the Georgian " wake up call" for the Future Security of Europe

Pierre MOREL
Anders ASLUND
Wolfgang ISCHINGER

Chair: Peter SUTHERLAND

1 **<u>The War in Georgia should not be regarded as a revival of the Cold War</u>**

Is a new "Cold War" dawning on Europe? If only it could be just a Cold War ! The truth is that we would not even be able to afford it any more in terms of budgets! There may be some nostalgia, even fascination, about that period, but we are in another configuration, with more global dimensions.

More local questions and events are at stake too. The Pandora's Box of ethnicity has been opened up. The ethnic map of the Caucasus *Limes*, of the Balkans, is now at stake. We are not any more in a simple "Cold War".

The war in Georgia meant more than Georgia. It is indeed a centuries old frozen conflict. There is a heavy historical backlog from the last century at stake over there. After the collapse of the Soviet Union, there was a *de facto* system, based on the Moscow agreement of 1994.

The Russian-Georgian relationship is a rather slurry one. When the war burst out, Europe had to improvise a policy for something that reached beyond what the eyes can meet, and was deeply rooted in a very old historical contest.

Then came the brutal attack in August, which was coined as "genocide" by the Russian media, quite abusively. Such excessive rhetoric inflated Russia and gave way to a disproportionate answer from that country. Russia wanted to punish Georgia, with a powerful mobilisation of identity and pride, pepperered with some intellectual criticism of the dysfunctionning or security in Europe at large.

Europe had to improvise; it could put together the 12th of August Agreement, foreseeing a negotiation. That was a strong initiative, followed up with a sustained pace, as the talks were already starting on August 15th. Observers from 20 countries were there within three weeks: This displayed both the ability and unity of Europe.

The Security Council resolution on September 1st, asking Russia for a way out, came in the wake of those steps. China, on August 28th, had shown that it did not approve Russia's demeanour. Separatism is one of the 3 evils for China, with extremism and terrorism. There was global disarray about that situation, as it was heralding the risk of explosion anywhere, and as the game was being played beyond the rules.

The European Security Architecture is at stake. The notion of "Zones of influence" is at the root of the debate, leading the Russians to call for a "Helsinki II", which should rather be designed as some "Helsinki+", to prevent a major shift in underlying concepts. We don't want to slip back into the notion of Zones, which was a Soviet concept. The Georgia events have damaged Russia. Images of Russian tanks crunching neighbours had tailed away over the last decades, they are back.

The Georgian case has a very different flavour for Russians and for the West. The thinking patterns about it are different in the first place

Georgia is a "Near Abroad" for Russia. In a way like the former Yugoslavia is a "Near Abroad" for us. Ukraine is both. It is in Russia's "Near Abroad" and in ours too. On top of that, it conveys an existential gist for the Russians, because of the "Kiev Rus" of ancient times. In that perspective, the absolutely overriding US requirements for radars and missiles in the region, which some still find non understandable, should be reviewed with the Poles and Czechs in the framework of a broader vision of our common vicinity.

Ukraine is a touchy issue for so many reasons, including the Black Sea Fleet lease expiring in 2017. It is badly divided on NATO, and mainly against joining. The come back of the idea of " Defending Russian citizens abroad" in the Russian policy is a big concern to all border countries, from Latvia to Ukraine, where large Russian minorities are part of the people.

NATO is a defensive alliance, rooted in article 5, and would be undermined by any extension to Georgia or even Ukraine, because this would make the commitment to article 5 most unrealistic. T**he commitment of the West to NATO will not whither.**

We have to understand the Russian, but it's a two way street. On Kosovo, we had gone quite far to save everybody's face. Like Egon Bahr in 1973, the Troika had managed to build a sustainable situation without addressing the contentious issues. Lavrov refused, because Russia felt compelled to stick to a stiff position for some reasons that did not pertain to Kosovo.

The mistake was not a Western one.

2 Russia is part of the World, economically speaking. And it shows, as the crisis hits it

Russia is by no means an autarcic economy any more. It is shaken by the world crisis

Very much like Indians, the Russians believed that they were a safe heaven. They are not. On the contrary, they are most vulnerable. They have enjoyed very good micro economics over 9 years, and they have built up huge reserves amounting to some 600 billions $. They have also experienced budget surpluses of10% of the GDP.

Like the Indians, but the other way round, they have a high dependency on energy, which makes up to 60% of exports, 20 % of the rest being minerals, mainly metals. Oil and gas provide 50% of the government's revenue, 18% of the GDP. Russia is extremely dependant. It needs a 70$/barrel price for oil to balance its budgets. The huge financial reserves have quickly diminished from 600 billion $ down to 485, with 30 billion $ lost in a single week, 50 other ones transferred to the banks. Russia is experiencing a capital flight.

Stock markets fell in July, for internal causes. Then international finance froze up, a bit more for Russia, due to a political risk premium, which was not needed on top of everything ! Domestic banking then froze up, despite all the money poured in. Major structural problems appeared. Because the country's banking intermediation system is not good enough, Russian money goes out of Russia, and Russian firms have to borough that money back from abroad, which makes them vulnerable to outside trouble, while the capital flow comes from inside Russia! 5 state banks own 50% of the banking business, and don't serve the business well. 1 billion$ is needed, 1 million$ only was available!

Indeed, Russia's problem is that it highly depends on foreign structures for lack of good internal ones

The corporate sector was far too leveraged abroad. Many a billionaire lost huge chunks of his fortune in the crisis. Some oligarchs had even to be bailed out. Big construction projects are suspended. The metal sector is hit all over the world, and it is a big shock for the Russian economy. JP Morgan forecasts a real 0% growth next year for Russia.

The problem is that this regime is entirely legitimised by economic growth. If this argument comes to dwindle of fail, the regime will seek to find itself other credentials, drawing on the national feeling. **Nevertheless, the fears about a dictatorship in Russia are reaching too far**. It's true that President Medvedev asked for an extended presidential period, probably for Mr Putin, but Russia is far too rich to be authoritarian.

Actually, we can observe that Russia is quite milder on all points, save the highly symbolical announcement of a future missile deployment in Kaliningrad. There are quite many openings. Russia has so few relations with US (4% of its trade, as opposed to 50% with EU) that the UE should step up to its privileged position in the relationship. **Yet, Russia remains in the process of learning to be a part of the World,** and of understanding that it needs more reforms. This is good news, as, whereas booming periods are times of corruption, depressions foster moral rearmament.

3 Russia could and should learn to cooperate better with the West

In 1997 when the first enlargement round was decided, we all agreed on 2 pillars, enlarging, *and* building a fair West-Russia relationship. The fact is that the second pillar deteriorated since that time.

There are quite different views in the transatlantic communities: a John Bolton will blame NATO for what he calls "*the Bucharest mistake*" of not taking Ukraine and Georgia on board, whereas enlightened voices insist that "*NATO should have built up its relation to Russia*", as a contribution to the Trilateral Commission puts it in writing.

Russians have very good reasons why they should feel concerned with the future of their place and role in the World

Russia faces threats from all sides, with a declining population. Its defence budget is 1/6 of the US defence budget. There is no way for Russia to engage in any superpower struggle. No surprise that they feel scared, or at least cautious. What they want is to be accepted as equals, no more as the losers of the Cold War. We in the West are not sensitive enough to such feelings.

In Central Asia, we cooperate with the Russians quite well, against drug trafficking for example, that kills 10 000 people in Russia every year, where a million of heroin addicts are recorded.

A challenge was made to the West by Medvedev. The West remained sceptical. We should indeed take up this challenge. There is a permanent advantage in keeping connected to Russia. Russia should be persuaded, not threatened. They can understand that, otherwise, they would be isolated, which is worst for them. Unless we don't clear up the global picture with Russia, we risk to be lurching from one quarrel to another. We should be talking through microphones rather than through megaphones

President Obama should resume nuclear reduction talks, to rebuild the relation with Russia. The time before missiles and radars will be operational in Eastern Europe and Kaliningrad leaves some time left to review the issue at stake. There is a need to promote and upgrade the NATO/Russia cooperation. This contains a huge untapped potential

The steps which the West had to take in former Yougoslavia were bound to worry the Russians. Both sides failed to iron out the klinks.

In 1999, NATO decided to take strong action in Yugoslavia. But, as Henry Kissinger rightly phrases it, *"Moving the East/West security line further east was not likely to be met with Russian requiescence"*. NATO's deeds were considered in Russian patterns of thinking as the construction of a Western sphere of influence. Moscow is stuck in the zero sum approach. It's up to us to introduce them to the modern European win/win philosophy. But for that philosophy to rub on them, Moscow has to score points sometimes too. Once again, let us refer to Henry Kissinger, who insists that never have our interests be so well aligned, and that we must not waist that opportunity.

On Kosovo, one has to recall that Russia could have worked with the West and avoided what they now blame. When Bush and Putin met in Sochi, it was made clear that we consider Ukraine and Georgia an essential part of European security. The fact that the principle of their right to join NATO was agreed upon is good, it being understood that delaying implementation is just responsible management

The Russians should not bypass the fact that, before bombs hit Belgrade, 750 000 Kosovars had to flee their country to escape ethnic cleansing organised by Milosevic, whom the Russian backed.

As a whole, there is a major need of bringing both sides' understanding closer together, to ease up the great potential of a mutually beneficial improved cooperation and dismantle, as much as possible, such misunderstanding that can arise from opposite interests and *Weltanschauungen*.

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Opening Session on FRANCE "ON THE MOVE"
Economic Reform, Social Dialogue and Political Governance

Jean-François Copé
Deputy at the National Assembly
Chairman, UMP Parliamentary Group
Former Member of the Government

Dear Friends, it is a great pleasure to be with you here today. First of all let me just say that we are experiencing a very disturbing financial crisis and that years of work of the Trilateral Commission to promote a fair international order can be very helpful for political leaders. I think that your contribution is very important to us, especially that the strengthened dialogue between America, Europe and Asia will be necessary to fight the crisis.

I was asked by Nicolas Beytout to *answer a* ***question of whether France could change?*** That is a terrible question for the French people --as you can imagine -- but as it is a very difficult topic and it is good to talk about it just now, this week. The very same question the Americans were asked in the presidential election earlier this week, and the victory of Barack Obama, showed that he was more effective in embodying the change the Americans were looking for, and that made him an undisputed winner. His personality, his career, his story were themselves a sign of change.

However, after the enthusiastic night of November 4th, we have to go back to reality. Barack Obama now faces two gigantic challenges that must be addressed together, despite their conflicting priorities. He must at the same time reconcile America with itself and he must reconcile America with the world. These are two major promises and they must be kept in order for America to meet the hope for change that have sprung up in the United States and in the world after Mr. Bush's two terms.

This change also became an issue in France a little over year and a half ago. As mentioned by Ambassador Bujon de l'Estang, during our presidential election arose *the great issue of "change"*. Let me be frank: in all our campaigns when we politicians are talking about "change" it's always said to prove that before it was night and after it will be day. For decades, the French Left has managed to embody progress and the right wing was written off as conservative. But then everything changed during Nicolas Sarkozy's campaign. I am not here to promote the president, probably because we don't need to do that here, but I want to give you a picture of what we are living through in France.

Nicolas Sarkozy deliberately chose the theme of a break with the past and spoke very openly to French voters during the presidential and legislative campaign in 2007 about his determination to achieve change. He did not play down the challenges that France has to face to maintain its political and economic position, and by voting for him the French made a clear choice to support change.

Let me remind you that before him politicians on the right wing were completely inhibited, unable to say what we think. Let me give you a few examples. Delinquency has been a real problem in France for many years and I as a mayor in a city with a very high delinquency rate can testify that it is a very significant problem. So, when we on the right talked about delinquency, people said, "don't mention it or you are going to be accused of being close to the extremist right". So, we did not say a word about delinquency. When we wanted to talk about decreasing taxes, people said "no, don't talk about cutting taxes, you are going to be accused of being ultra-liberal" and that is very far-right. When we were talking about Europe, we were told remember what the Gaullists said: "if you are for Europe, you are against France." So, we didn't dare talk about anything.

What happened, and what was the novelty with this campaign, is that Nicolas Sarkozy decided to bring all of us to say: "we are going to change the way we engage in politics, we are going to change the method, we are going to change the words", and that made the difference. Most of us now, in all we say, try to tell the truth to the French people. For years politicians thought that they cannot frighten the French people by telling them about the need for reforms, the sweeping changes taking place in the global economy, as if the French could not take the truth. That is a particularity of our country: the French people are very much involved in politics, and in history, while they don't like the economy and geography very much. The problem for us is to bring them with their history and politics also the knowledge of geography and economics.

Let's look at *the issue of jobs*. We've had in France a world famous legislation created by the Left that proved that if you want to lower unemployment you had to work less in order to share the work. This was the sadly infamous legislation of the 35-hours working week. With it we have tried to put an end to this vision from the past, i.e. that to earn more you had to work more. It was hard to explain to the French people that they can work less and earn more because you usually think the opposite, just like with bringing up children, whom usually you tell that if they want to be successful they have to work more in school. But, when you tell people that for years and years and years you eventually succeed in convincing them that it is possible. That makes it very hard to turn things around and take a step in the opposite direction, but we did it. Although this is still a work in progress, we have already completely changed the labour legislation on this matter by providing certain mechanisms. We have deregulated overtime and we allowed companies to negotiate working hours with their employees. Today the 35-hour week for everyone is practically over and work is a positive value once again. This is not only a genuine ideological victory, but also a genuine change in mentality that will give our country a fresh boost. That is the main change that is taking place at the moment in our country.

Also very important is that we did not give up in the face of obstacles. France has a reputation of having lots of strikes, which is not completely wrong, but we are improving. The fact the government last year refused to give up in face of the strikes in the public services, the utilities and transportation, also had an impact on a lot of things. Of course a lot of work is still ahead of us, but we have no other priority.

Despite the crisis, we will have to reduce government spending and balance the budget. It is a big challenge, especially given the economic situation we are now facing, but we are doing everything we can to make the government less expensive and more efficient, also through a reduction of the number of government employees. We are also taking actions to strengthen our social-security system, so that it remains more effective and less costly, and we are investing in education and innovation to improve our schools, universities, and research. We also want to make businesses located in France more competitive by reducing the costs of investing. Work on these reforms, which are all typical structural reforms, has started at the time when I was a minister of budget, when for example we changed and capped the business tax and income tax regulations.

There is one very important thing that I want to mention at this moment, even if the government is not outstandingly popular because it takes unpopular decisions: *public support for reforms has not wavered.* The French are still in favour of change. Polls that were conducted last week showed that 57 percent of the French think the government reforms are either appropriate or insufficient and only 41 percent thinks there are too many reforms. This shows that things are changing in France. It doesn't mean that everything is taken enthusiastically, and I wouldn't say that people consider that all we are doing now is very necessary or very good. Of course not! But people in France are conscious of what we have to do.

Another reform that took place in France was *institutional reform*. Under the previous system, the president and the government decided everything and the members of parliament passed reforms with their eyes nearly closed. The French system now is increasingly more like the American one, where the president is very powerful, but the members of parliament have gained new powers and also become the crafters of change. As a chairman of the parliamentary majority, I want members of parliament to be at the forefront for two absolutely major changes in our country.

First is the question of our *local institutions*. France has too many levels of administrative institutions: municipalities, syndicates of municipalities, departments, regions, central government, and European institutions. One of the main goals for us is to merge departments, regions and maybe also syndicates of municipalities. From abroad it seems a normal task, but for our country it poses a great challenge because at stake are tens of thousands of locally elected official posts, many civil servant jobs at these institutions, large public spending, and a significant political challenge. This reform is another proof we are working on broad structural reforms.

Usually politicians think that the major reforms of institutions are structural changes of these institutions, but personally I think that is not enough. We must not only reform the structures, and this is true for France as well as for other countries, but we also have to upgrade quality of services as well as quality of life for employees to take into account their careers, their wages, to allow them progress all the time. To make this happen is yet another very important challenge lying ahead of us.

As you can see we are working on a whole series of projects aimed at making France move forward again. This is of course very exciting, but what I want to underline is the acceptance of change from the French people who understand better and better that there is no other way. That's why *France also participates in the process of change in Europe, on the international stage.*

Three years ago we were considered the black sheep of Europe because we were the ones who voted down the Constitution. Today things have changed. *We are at the forefront of the new European dynamic.* The failure of the Irish referendum could have impaired the dynamic, but nothing of that sort happened. Since the beginning of the French EU presidency we have undertaken many initiatives, setting a number of priorities, and here let me point to the *Immigration Pact and the initiative on the Union of the Mediterranean*. In each of these cases, our goal is to overcome the existing institutional obstacles and build a Europe of solutions. We have a problem that, while European citizens have asked for the creation of a "Europe of solutions", we for many years have only answered with bureaucracy, giving away too many elections to the euro-sceptics who talked about a "Europe of problems" without a proper answer from our side. Now we are working on another way to talk about Europe, but especially on *building a Europe of pragmatic solutions.*

This is exactly what happened during *the financial crisis*. Usually when there is a problem, the United States comes to Europe's aid. Now for the first time it is Europe who comes to the aid of the United States and to the rest of the world as the financial system was collapsing by bringing a short-term solution and a long-term strategy. This doesn't mean we are alone in doing it, but this time we were not only the price taker but also a little more of a price maker. In a few days Europe set up a massive coordinated plan to stabilise financial institutions with French initiative, British creativity and imagination, support from Germany, Spain, Italy, and others, while working in conjunction with the European Central Bank. This is all very new that first 4, then 15, then 27 members responded with more than 1,500 billion euros in guarantees and capital contributions making it possible to avoid the worst. Even though we are far from finished with this crisis, at least we can say that this time around we had an urgent answer.

It is the responsibility of political power, and its honour as well, to be there when everything falls apart. To stay in control and keep a level head when the crisis occurs. We can see that we have had made a lot of progress since the crisis in 1929. Usually people coming from other fields of work than politics say that politicians are useless. We hear all the time that they don't need us. Except in crises. When there are major crises those who sometimes give less sense to the politicians that lead the country, this is when they say we need you. I think this time is the best time for politicians to show that they can be very useful.

However, let there be no doubt, public opinion in France, Europe, the United States and around the world wants change. In my belief, our citizens would never forgive us if we thought that everything could go back to the way it was. “Business as usual” is impossible when we have allocated considerable public resources to limit the damage in the banking system; when hundreds of thousands of debt-ridden families have lost their homes in the United States; when tens of thousands of businesses cannot obtain credit; and when millions of people might lose their jobs in the world. I think it is very important to say that now, because we cannot forget what happened in September, October and now in November.

This financial crisis will of course come to an end, maybe in weeks or months. But we must not forget that people are looking at us to introduce new measures, new decisions in order to adjust to what has happened. We need change in this area too and France intends to play a driving role in this process. Things went too far. There were excesses that shook the entire world, and we must prevent this from happening again. I am not talking about questioning capitalism or free enterprise. Of course not! In the economic sphere it is agreed that this is the best way to create wealth and to give everyone an opportunity to develop their talents and realise their potential. I wanted to mention that because I am French and I know that sometimes from a foreign perspective when a French political leader talks about economic reforms people are afraid of his intentions. But let me remind you: there is no freedom without responsibility, no freedom without regulation.

My political beliefs are on the right and I support the free market, but I think the time has come for *new regulations*. This doesn't mean *more* regulation, but *better* regulations starting at the European and international levels. There is no doubt that economic globalisation has clearly outstripped political globalisation. Market mechanisms are not restrained by borders, but our regulatory mechanisms are. Something has to give in this imbalance. The regulation issue will of course be one of the main topics of the upcoming G20 meeting in Washington on November 5th. France is putting all its energy to prepare for this meeting with all our European partners. We can improve the existing ground rules and come up with new ones to fill the gaps. This is critical for rebuilding confidence and is a prerequisite for getting the global economy moving again.

In order for change to succeed on the international level, a substantial improvement in *Franco-American relations* is necessary. For several months we have been talking about the issues where we have divergent views, like the war in Iraq. But what brings us together now by far outweighs what kept us apart. This can be seen in Afghanistan, where France has sent reinforcements to contribute more actively to stabilising the region. This is another major change that can be attributed to Nicolas Sarkozy. Without giving in to the touchy, but somewhat naïve “Obamania” sweeping Europe, we can hope that Barack Obama's election will help improve this situation even further.

After addressing all these changes in France and in French society and on the international stage, I would like to answer the question: ***can France change?***

It's easy, but I'll do it anyway: “Yes, we can!” Some attribute this slogan to David Axelrod, the favourite spin-doctor of Barack Obama. As I am French and I am proud of my country, I would like to make sure that everybody knows who invented good ideas, so let me tell you something. This is not an American idea; it's a French idea. Our slogan for the Sarkozy campaign was “All together, everything is possible,” and that is not very far from “Yes, we can.” I have read in American newspapers that Obama was very interested in the French election campaign, which means there is yet another opportunity to create closer ties between our two countries. The question of whether France can change is now somewhat, a little bit, obsolete. France has been changing on an unprecedented scale for a year and a half. So *the real question is whether France can change as quickly as the world around it*. That is a question we can all ask of our countries because it's a challenge all the time for us, as we are political leaders.

The best response for us is to fully participate in the changes taking part around the globe, to fully play our role, to put a mark on the change -- the famous French touch -- in order to make sure that we still can be proud of what we are doing. This has to be done in close partnership with our European friends and through an increasingly constructive relationship with our friends in America, Asia, and the rest of the world.

Session on France
An “Outside View”

Remarks by Mario Monti

I find it fascinating to observe the evolution of political culture in France on the topic of the market economy. Only three years ago -- not thirty, three -- this was the country where President Chirac said “liberalism is as dangerous as communism.” Secondly, a well known public opinion poll found that France was among the 20 countries in the world with the lowest response to the question “do you believe that the market economy is good for growth,” while China was at the other extreme. Thirdly, France is a country where in an everyday political debate each reference to the market economy would come with the connotation “ultra-liberal” or “Anglo Saxon”. Historically, of course, this is untrue because the market economy in Europe is a German and German-Franco invention put into the Treaty of Rome in 1957. Anglo-Saxon? The economic stance of the UK in 1957, twenty-two years before Margaret Thatcher, was not neo-liberal, if anything then rather paleo-socialist!

Michel Camdessus said that the French are not totally reconciled with market competition. I indeed had a few opportunities to find this out when I was in charge of implementing competition, alas in France, which gave origin to those very interesting conversations with Nicolas Sarkozy. Later came the Nicolas Sarkozy with his campaign based on an agenda of bold reforms, and he gets elected. What was his first signal at the European level? In June 2007 during the European Council in Brussels, Mr. Sarkozy successfully achieved his objective of dropping reference to free and undistorted competition as one of the objectives of the European Union in the treaty. So to me certainly that was not a good signal, which led me to write a critical article on the issue in *Le Figaro*. Two days later I was invited to become a member of the Attali Commission to liberate French economic growth, and this was a great chance to see from within a piece of France's cultural elite, and how things moved.

It was already mentioned the numerous proposals for reforms of the economy that came from the Attali Report that was reworked within the parliamentary group chaired by Jean-Francois Copé. Pedagogically how did we present the reforms to the President of the Republic? Certainly not as a form of an adhesion to the abstract of the market economy, but simply trying to argue for each of the ideas that by reducing the rents and privileges would not only improve economic efficiency, but would also go hand in hand with equality and a feeling of social justice. I think these proposals helped.

Now the French Parliament on August 4th of this year has finally adopted the *Loi de Modernisation de l'économie* which introduces many of the reforms proposed by the Attali Committee, also in areas in which in France were critically backed away from, such as in the distribution sector: there are more liberalised systems in place now following a slow contraction of relations between producers and distributers, reduced barriers of entry into commerce. Some people have observed that this happened on the anniversary of August 4th, 1789, when the *Décret relatif à l'abolition des privilèges* passed during the French Revolution.

One of the things introduced by the *Loi de Modernisation de l'économie* is a small but highly significant institutional change concerning precisely the way competition is enforced in France, leaving aside the competencies of the European Commission for broader EU relevant competition affairs. So far, it was a mess because there were powers vested in the Ministry for economy and finance as well as in the *Conseil de la Concurrence*. This reform, which is now a law and is expected to go into force on January 1st, 2009, introduces a single independent competition authority in France, simply called *Autorité de la Concurrence*. This law takes away from the Ministry of finance the power to approve or ban mergers and gives that to the new independent competition authority. The minister will keep, like in Germany or Spain, the power to invoke on some occasions other general public interests beside competition, but the bulk of the power will now be in hands of the new authority.

Now on to my final observation about the *financial crisis:* the financial crisis this time happened, unlike when it took place in Mexico, Russia or Indonesia, right at the heart of the financial capitalism of the United States. In a matter of weeks the country that has been the standard bearer of the market economy across the world violated many of the principles of the market economy. Time magazine in mid-September had an editorial in its U.S. edition titled, “How we became the U.S of France,” pointing to the fact that all those nationalisations done by Francois Mitterrand were relatively modest compared to what the U.S. had brilliantly done in a matter of weeks. Now what a wonderful opportunity for this country to claim that it always said that indeed the market economy is ultra-liberal, Anglo Saxon, etc., etc. What a wonderful opportunity to relax, sit back, and undo the politically costly efforts of its domestic structural reforms. On the contrary, I think we all agree the process is going on. I see very positive signs that France has embarked on structural reforms and the course is being kept even though there is this wonderful historical opportunity to escape it.

European integration -- Jean Monnet teaches us all that the recipe for success in European integration is to have two things at the same time: market integration, but also public policy coordination and in some areas a common public policy. This is the recipe for successful globalised governance for 50 years at the continental level. Now what is happening in France right now is potentially magically positive, because thanks to the drive of the French president we are witnessing an accelerated effort to get more coordination among the public policy instruments. At the same time, thanks to the rapid recent evolution of political culture in France on the market economy, we are probably eliminating for the first time in decades a problem that was at the origin of many tensions between France and the European Commission, namely, the rejection of the market economy in France. So I believe Jean Monnet is going to live through more favourable years from now on.

THE INTERNATIONAL FINANCIAL CRISIS

Introductory note by H. Onno Ruding

The current problem with the balance sheet of banks is that on the left side nothing is right and on the right side nothing is left.

"I will follow the lead of a restaurant that opened in an empty bank building and then advertised: 'Put your mouth where your money was'."
(Warren Buffett, NYT, 17 Oct. '08)

CAUSES AND SOLUTIONS OF THE FINANCIAL CRISIS

One should profoundly analyze the various causes of the current crisis, not primarily to blame and punish those who were responsible but to understand the real issues. This is needed to formulate the right remedies and solutions.

FUNDAMENTAL CRISIS ELEMENTS

The fundamental elements of the current crisis consist of:

1. In the USA: the decline in the residential real estate market evidenced by a) the huge amounts of non-performing 'sub-prime' mortgages, which depress the financial health of the homeowners as well as the banks and investors worldwide (through securitization) who own these 'toxic' assets and, b) the decline in American home values. These developments are interrelated.

2. Globally: shortcomings in risk management of many banks.

3. Globally: the paralysis in the interbank market. This affects the backbone of all financial markets: the short-term (one day to one year) borrowing and lending between banks all over the world, even among large and strong banks. This huge market has dried up almost entirely since summer 2007, as evidenced by the excessive interest premiums paid in the few transactions executed. In fact, the central banks felt obliged to largely take over this market, hopefully temporarily.

4. Mainly in the USA and Europe: illiquidity and/or insolvency of many individual banks and several insurers. Largely resulting from factors 1 and 2 above, many banks faced liquidity and/or solvency problems, which were aggravated by withdrawal of deposits and savings and the collapse of their share prices. Other banks are in better shape but have capital ratios that – although not inadequate – are now considered too low.

All these factors are interrelated and reinforce each other into a downward spiral.

SOLUTIONS

The solutions to the crisis are found in two areas:

1. The urgently needed emergency measures – to stop the further deterioration of financial markets and institutions; and

2. The policy remedies – both in the private and public sector – that should be taken in the medium-term to improve the financial system and to avoid a future repetition of this or similar crises. This requires a 'lesson learned' approach rather than an ideological-political debate.

EMERGENCY MEASURES

Governments have taken several measures to deal with the acute crisis to stop further collapse of financial markets and institutions and to restore confidence. These measures were initially taken on a country-by-country basis, by national authorities to cope with their domestic problems, without sufficient awareness that this crisis is an international issue, at least an Atlantic (USA-Western Europe) one. It requires a high degree of international cooperation. More recently this cooperation has become stronger although each decision and each financing is still made nationally, also in the EU.

Though taking different forms from one country to another and with mixed success and with mid-stream changes in national policies, such as in the USA and Germany, the following categories of emergency measures were put into effect:

1. Support by governments (with budget, that is taxpayers, money) to the financial markets by buying specific financial assets owned mainly by banks which – due to their dubious quality – were losing value and/or had become illiquid. This was the core intervention ($700 billion program) by the US government to provide a bottom to the markets. This method has not yet been executed in the United States. The Europeans decided to follow a different approach. Secretary Paulson recently changed course and used a large portion of this $700 billion to support individual banks like in Europe (see 2).

2. Support by governments to individual banks and insurers to shore up their inadequate capital base by buying shares (in most cases preferred shares) or extending loans which qualify as capital. This is solvency, not liquidity support. Conditions are always attached to protect the taxpayers (high dividend or interest rate; repayment conditions) and to achieve corporate governance or even political goals. These conditions appear to be stricter in the cases in Europe than those in the United States. However, this partial state ownership of private banks and insurers is rightly seen as a temporary emergency device rather than a real nationalization. Governments are moving from an ad hoc approach to approving a safety-net facility for an overall amount, which can be used on a case-by-case basis. In Europe a growing consensus is emerging that this is the right approach, although it is still done on a national basis. The United States has moved into this direction as well (see 1).

3. Support by governments for the non-functioning interbank market by way of state guarantees to financial institutions lending to each other. Rightly, these guarantees come at a price. It is still early to reach a final judgment, but if these unique guarantees, made available for huge amounts, do not succeed in revitalizing the interbank markets, there will be not much else left that governments can do in this area.

4. Support by central banks to provide ample short-term liquidity support to all supervised banks that knock at their liquidity window. This is being done in most countries for huge amounts in a way that shows a growing degree of international coordination. Here, again, to avoid moral hazard, central banks should charge stiff interest rates.

5. Monetary policy measures by central banks by way of reductions in their official interest rates. This is also executed increasingly in a coordinated manner. However, these interest rate actions as such do not contribute to the solution of the financial crisis. On the other hand, as the financial crisis leads to a recession in the 'real' economy, the interest

instrument can be used as a remedy against this danger, provided the other danger of inflation is under control.

6. Finally, in the same vein as 5, a new set of government actions could be envisaged in the general policy area of economic stimulus through extra spending or lower taxation. This kind of emergency measure does not, however, directly focus on the financial crisis itself but rather on the economic fall-out of a recession. Experience teaches that economic stimulus measures have a mixed record.

MEDIUM-TERM REMEDIES

The required remedies are logically linked to the causes of the crisis and should focus on both the private financial sector and the governmental/supervisory framework.

I. In the private financial sector the following action is needed.

1. Foremost: a better risk management by the seniors at most banks and insurance companies. This requires better internal oversight, governance, internal discipline and transparency of data about risks and exposures, better understanding of the risks involved in new financial products, especially derivatives and "structured" products, better understanding of exposures that are assumed to be 'stand-alone' but are in reality correlated with other exposures (the contagion-effect and the need to assess properly aggregate risk amounts).

2. Compensation. The criticized bonus-amounts are not only seen as unacceptable from a social or moral point of view (particularly for loss-making companies or for banks that apply for government support), but they also provide the wrong incentives to recipients for increasing the risk (and possible reward) profile of their business transactions. More than the absolute amounts, the bonus system requires corrections: a) to link bonuses more to the overall results of the company than to the individual performance and, b) to pay not in cash now but in deferred payments or better yet, to pay in restricted shares that vest after 3 years or later.

3. Capitalization. Although much had already been achieved through the Basel capital adequacy requirements for banks, the bar should be raised by requiring higher capital ratios to provide for more equity as a solvency buffer against losses.

4. De-leveraging (this is related to 3). In recent years banks' balance sheets have undergone an unacceptable increase in risk through higher leverage (ratio of total assets to equity or capital). This was done through massive borrowings to finance additional lending in order to increase profits. Alternatively, assets were put off-balance through SIVs (structured investment vehicles). De-leveraging has two components, which should go hand in hand:

a) Reducing assets. This shrinking of the balance sheet takes time and may create losses. The huge amounts involved will unfortunately impact the 'real' economy negatively by reducing bank credit to industrial companies and individuals.
b) Increasing capital. This is already work in progress. Additional equity should come from private sources (existing or new shareholders) and/or from government support programs depending on the solvency conditions of each bank or insurer.

II. The second category of policy change is required in the public sector to remedy the shortcomings that became visible during the crisis.

1. Supervision of financial institutions. Stricter supervision is required; it should focus primarily on the areas mentioned under point I above. In most cases there is no need for additional legislative powers to increase prudential oversight of individual banks or insurers but rather intensifying and improving the existing instruments of supervision. The major exception concerned the independent American investment banks, which did not fall under the supervision exercised over commercial banks. (Only the SEC looked after investment banks but did so inadequately in so far as risk management and capital adequacy are concerned.) However, for the past few weeks, the investment banks have no longer existed or were forced to apply for commercial bank status (bank holding company). What should be done in the USA is to clean up and streamline the ineffective labyrinth of overlapping and uncoordinated federal and state bank supervisory institutions (for insurers no federal authority even exists, only 50 separate state insurance commissioners). In Europe, the EU should accelerate actions toward integrated supervision (see below).

2. Deposit-guarantee systems. Each country applied a different mechanism. Certainly in Europe, harmonization of the national facilities is required by agreeing on a substantial level of the guaranteed amount for private savers, but with a maximum amount to avoid moral hazard, distortion of competition and irresponsible behavior by banks and depositors.

3. Credit rating agencies. Changes are required to avoid conflict of interest situations and to avoid repetition of practices in which securitized bonds based on the collateral of sub-prime mortgages, etc. obtain AAA ratings.

4. Accounting and financial reporting rules. In two areas changes have been proposed: a) increase transparency on balance sheets, especially off-balance sheet assets and liabilities of banks and b) reconsider the 'fair-value' accounting rule ("mark-to-market") for bank assets which has aggravated the crisis by weakening solvency and depressing market prices by forced sales. However, this latter issue is not easy to solve: fair-value accounting based on current (market) prices is in itself appropriate but perhaps temporary exceptions should apply if 'markets' are in disarray and illiquid.

5. Monetary policy by central banks. A different cause of the crisis related to the prolonged period of too low (in real terms) interest rates and cheap borrowing which indirectly has fuelled the crisis through unsound practices of financial institutions, especially leveraging and risk-taking. This requires adjustment of macroeconomic policy in the future.

6. Liquidity support by central banks. Contrary to 5, this is an area where central banks acted as lender of last resort in an alert way by correctly providing huge short-term liquidity to banks to prevent the crisis from further deteriorating. Central banks even substantially softened the requirements for borrowing banks to provide adequate collateral by accepting all kinds of low-quality bank assets. Over time, this practice should return to normal.

FINANCIAL SUPERVISION IN THE EU

Whereas supervision of financial institutions was executed in the past on a purely national basis, the EU countries have gradually increased coordination among national supervisors. The financial crisis has added strength to the arguments in favor of integration of supervision by way of one European supervisory institution. Whether this role should be entrusted to the ECB or to a new and separate body is an important but subsidiary decision. Several member states are not yet willing to agree to such a change for reasons of retaining national sovereignty in this financial area. This argument is less convincing if one takes into account that they already had – rightly – agreed to give up their financial sovereignty by establishing the euro and the ECB. The structure could follow the ECB in that the EU adopts a 'federal' supervisory model in which the national supervisors continue to handle the many smaller domestic banks. Supervision of the +/- 40 large and European or cross-border banks should be given to the central EU supervisor where one governing body makes the decisions.

The current proposals aim at intensification of the coordination but it remains a fragmented structure of national supervisors who can make their own decisions. Whereas it is true that – fortunately! – we have not yet faced a serious problem around one of the large, international financial institutions based in the EU, Europe should stand ready to cope with such a major issue. Proposals for a 'college' of national supervisors or one 'lead' supervisor (of the country of the head office of the bank involved) are probably insufficient. One European supervisor can not be created soon, but this is the time to act.

IMF

Until a month ago the International Monetary Fund was regrettably almost absent from the global economic-financial stage: no lending to deficit countries and no impact on macroeconomic policies of its member countries. This situation is likely to change. Many countries did not need IMF financial support because they could easily finance their deficits, if any, in the private capital markets. A growing number of mainly emerging countries is now expected to borrow large amounts from the IMF. The IMF should stand ready to serve both emerging and developed countries provided it attaches the appropriate doses of conditionality on macroeconomic policies. For the time being, the IMF is sufficiently liquid to do so. If the demand for its resources continues it can resort to its members with surpluses.

The more difficult question is whether its members will allow the IMF to resume its role as a major player to influence the global economic-financial system and the macroeconomic policies, especially of its larger members, through multilateral surveillance, early warning systems, etc. For many years many countries – especially the G7/G8 and more precisely the USA – wanted to decide the course of macroeconomic policies among themselves and did not like (public) IMF criticism and proposed corrective measures of their own domestic policies. A reinvigorated role of the IMF is needed in the coming years, with the likelihood of a global recession and balance- of-payments financing problems for many countries.

REGULATION AND DEREGULATION; ECONOMIC SYSTEM

Since 1980, the world has experienced a wave of deregulation and liberalization, particularly for financial markets and institutions. These developments have contributed substantially to economic growth. One element is financial innovation. Important examples are securitization of assets and derivative products. On the one hand they provide advantages such as instruments (like credit derivatives) that enable banks and investors to hedge certain risks and transfer these risks to other institutions, as an appropriate defensive device of risk management. On the other hand, it is true that excessive use of these innovative instruments by those who aggressively applied them to increase their risk profile for short-term profit opportunities, acted as one of the causes of the financial crisis.

We should take the needed corrective actions to curtail this excessive use, but we should also avoid overreacting by a backlash of aggressive regulation or re-regulation.

It would be a misunderstanding to assume that deregulation and liberalization equal less supervision by authorities over financial institutions. The contrary is more accurate: deregulation should be accompanied by strict supervision.

In recent weeks voices are heard saying that the financial crisis is evidence of the failure of capitalism, free markets and 'laissez-faire' economies. Particularly, the American or Anglo-

Saxon type of capitalism is being blamed, including the 'Washington-consensus' as the policy recipe for emerging and other countries. The other view holds that our capitalist economic system as such is not at stake – as still being the best, or the least bad one – but that a number of dangerous and unacceptable elements have developed in recent years which should be corrected. One of the arguments presented by the latter group is that the financial crisis was made possible by mistakes not only in the private financial sector, but also by governments. The cost of a financial crisis is unacceptably high, but the cost of incompetent actions by governments to deal with financial crises in several countries in the past has not been trifle either.

There exists a risk that the necessary actions by governments to address the current crisis may lead to a swing too far to the other side, in the direction of: protectionism, nationalism, de-liberalization, interventionism, state aid, over-regulation and *étatism*. Measures with short-term appeal may have longer-term adverse consequences. State intervention in the longer run implies risks of moral hazard, distortion of competition and discrimination.

Remarks by Michel Camdessus

We all witnessed the crisis of the 1990s. This was a very frustrating experience for you, humble servants here, because I noticed that *you need crises to reform a little*. Forget about reforming deeply without a crisis. Then the crisis comes because you have not reformed enough before. During the crisis some reforms are started, but as soon as the crisis is over, forget about reform, any reform. And if you are not too bad in reforming and the crisis ends rapidly, the reform is not there. *So you have a trade-off here between the length of the crisis and the size of the reforms*. I hope that those who are now ruling the world will have that presence of mind and start reforming before the crisis is over. If not, we should be prepared for the next one. So, let's convey *a sense of urgency* to all those in charge of reforming. And let them face what has been missing and what contributes to explaining the present crisis.

What has been obvious is that *this crisis has its origin in the unregulated part of financial activity*: the sub-prime sector unregulated in the US financing organisations, the securitisation crisis of balance sheets, and of course these were precisely a scheme to avoid the liquidities and the supervision of central banks: Here we had no rules. The question now is to find the proper balance between the need to regulate and the proper flexibility to avoid having a too "étatiste" system stifling initiative.

We had no rules. We had no institutions in charge. Here my frustration comes again. Remember the beginning of the *Asian crisis*. In Hong Kong, we decided that from now on the IMF would be in charge equally of taking care of the monetary side of the markets and of the financial side, the current account as well as capital movements. We adopted unanimously in the framework of the Interim Committee a superb declaration urging clearly and urgently the Executive Board to take the necessary steps to change the articles for that. Then of course a few days after Mr. Mahathir gave a big speech saying "don't listen to the technocrats, the origin of the crisis was a Jewish conspiracy on Wall Street against the currencies of the Asian part of the world and that the best solution is not to liberalise and other similar, but to impose exchange controls". You also had quite a few people who already thought that the IMF was already extremely powerful, so you can't add huge new competencies. Debate started and ultimately the issue was put on the backburner. It is still there. This is very frustrating because we have allowed this bubble to develop and not to be seen and taken seriously by all the supervisors and all institutions around. Nobody was in charge. No one had the mandate or jurisdiction to deal with the situation.

Indeed, you can imagine that I share warmly what Onno Ruding has said about the need not to repeat the same mistakes and, this time, to implement the Hong Kong Declaration after these long 11 years. The question is: *what kind of an IMF do we want?*

Of course, when you give to this institution very important new responsibilities, you are entitled to think how do you organise the distribution of power there and the checks and balances within the institution in its dialogue with its membership. Then you have the problem of the voice of the emerging and developing countries. All of that must be settled, but there is no doubt that *you must have an institution with a responsibility for early warning and indeed for engaging in a strong dialogue with all its members*, particularly with the key financial centres of the world on what to do.

There is a third thing missing in explaining the crisis. When you have in the global village, no rules, no authority to enforce them, you have what you had in the village of my grandparents in recent centuries. If you didn't have a "*garde champêtre"* and/or an "*arrêté municipal"* to say what must be done or not, then the thieves had the power in the village. We organise our own villages. We must organise the global village to have basic not only regulation but also ethical values to be respected. If you don't have accepted police somewhere, the ethical values are at risk. Let's remember a little Adam Smith. Of course, you know that Adam Smith is not well known in France, but even in this country we have heard of the *Theory of Moral Sentiment* or even the *Wealth of Nations*. We understand that the market system is the most wonderful and appropriate way of organising the economy *provided* the actors accept to be ruled by moral principles respecting their neighbours and accepting a degree of moderation.

Possibly we should also ask ourselves why we have so easily in the exuberance of the market forgotten basic moral, ethical values in the financial business. How should we re-establish them because it is not regulation that will re-establish the basic values that we have forgotten? Of course, here comes to mind the mystery that is also behind this crisis: namely, the fact that *in financial institutions during the last few years we have seen a dramatic change in the balance of power between those in charge of analysing and monitoring risk and traders and such pushing to take risk and for short, rapid accumulation of profits*. How does one re-establish the proper distribution of power and responsibility to ensure that the risk is properly managed in these institutions?

I would like to mention a last problem about the *devolution of power and the respective power of nations and institutions*. During the past few months we have not heard much from the IMF and in Europe, even if recently things have been rebalanced somewhat. For some time the European Commission has also been silent and any so-called "coordination" was more a coordination of already-taken decisions than decisions taken together. Possibly here we need to correct something. But look at the IMF and its necessary reform. In which format should we discuss that?

Forget please that I have been an envoy of the French government to sell to the world the views of the government of this country. I have a problem here. We are working in the format the Americans have suggested, that is, the so-called G20. The G20 was an invention of the American Treasury at the end of the Asian crisis to establish dialogue between emerging countries and the G8. Fine, it worked and it does well. But it is not based on any kind of international treaty. Can you rule the world on that basis? Is it legitimate to discuss the future of the architecture not having the poorest at the table, not having a representative of the so-called G.7, I mean the Nordic countries, which have been so important in promoting ethical behaviour in the international community. Is it possible to have the Bretton Woods institutions being only supervised by a body that does not fit with what the treaties have established as the proper format for international cooperation? I put that question to you.

A NEW GLOBAL FINANCIAL ARCHITECTURE?

Stanley Fischer

Governor of the Bank of Israel; Former Vice Chairman, Citigroup, NY; Former First Deputy Managing Director, International Monetary Fund; Former Chief Economist, World Bank

This crisis is accurately described as the worst *financial* crisis in seventy-five years. Some say it is the worst financial crisis in a century, that is to say, including the Great Depression. We are probably not yet there, although we seemed to be heading in that direction until the IMF/World Bank meetings on the weekend of October 10-11, when the G7 and then the IMF agreed on a strategy – essentially that developed in the UK – to deal with it.

This is not so far the worst *economic* crisis in seventy-five years. But we have yet to see the full effects of the financial crisis on the real economy, and we may well reach the point where unfortunately we will have to say that too about this crisis. The economic situation has worsened markedly and rapidly in the last few months, as a result of both the financial crisis and the energy price rises that took the price of a barrel of oil to nearly $150, but we still do not know just how serious the overall crisis will be.

Further, and important to note, the extent of the crisis is not yet determined. It will be determined in part by future policy actions, both by countries at the centre of the international system, and by those in the periphery.

I will briefly discuss three questions about the origins of the crisis and the steps needed to deal with it presently and in the future. In discussing the third question, I will focus on the reform of the IMF.

First, there is a set of questions about how this happened. Second, what measures can be taken from now on to minimize the extent and the depth of the current crisis? Third, although crises will always be with us, we need to ask what can be done to reduce the probability and the extent of future crises.

By now the major suspects for the causes of the current crisis include (i) failures of regulation, particularly in the United States, particularly in the writing of mortgages and their securitization; (ii) the proliferation of sophisticated derivative-based financial instruments, many based on mortgages, whose risk characteristics were not fully understood; (iii) the housing price bubble in the United States, to which both of the preceding factors contributed; (iv) inadequate risk management within financial corporations; (v) inappropriate methods of compensation in financial corporations that contributed to excessive risk-taking; (vi) the charge that monetary policy – particularly in the United States – was excessively expansionary from 2003-2006; and sometimes, (vii) that international imbalances played an essential role in generating the problem. Rather than systematically discuss these factors, I will make a few points about the increasingly received wisdom.

Rightly, we focus on the major failures of supervision in the American and other financial systems. Things were done that should not have been done and that should have been stopped by regulation. The failure to stop them was one of the most important causes of the present financial crisis. In addition, the United States never took serious account of the dangers posed by its regulatory system. Following the Asian crisis, the IMF and the World Bank developed an excellent program, called the FSAP – Financial Sector Assessment Program – in which an international team of regulators and other experts in the relevant fields visits a country and provides a complete evaluation of the state of the financial system. The program is voluntary, but nonetheless most G7 countries have had one. The US refused, in part because they seemed to believe the IMF is for other countries, in part perhaps because they knew what the FSAP report would say: that the American system of financial supervision was not coherent and had to be fixed. For instance, there are at least 54 different supervisors of banks, 50 of them at the State level, 4 at the Federal level. Each state has its own insurance regulator, and there is no national regulator. All of this has been well known for a long time, but the problem was not attended to.

But the financial regulator is not in the best position to regulate individual firms. In his speech this morning, Onno Ruding mentioned the failures of risk regulation within firms. If anybody has to get risk control right, it is the risk controllers *within* a financial corporation. The people who work inside a company know far more about what it is doing than the regulator can possibly know. A good external regulator – and the Fed regulators I encountered while working in the financial sector were very good indeed – can see many things that insiders do not see, and can contribute importantly to controlling risks. But the risk management issues are fundamentally internal. I don't think from my limited experience in the private sector that the internal risk managers I met were not technically proficient. What was lacking, in the case I'm aware of, was somebody taking a system-wide view of the risks that were being faced, someone with the capacity to ask tough questions about the possibility of radical changes in the market environment.

There were not enough people with grey hair asking the broader questions about the risks that were being taken. There is a very sophisticated field in financial economics of portfolio management, which is an essential element in risk control. Its implementation requires massive statistical calculations and stress testing – things that were done well, within the context of a set of assumptions about the overall market environment. But people didn't step back and ask the questions about what could really go wrong, in a big way. That was in large part a failure of internal risk management. And risk management within firms will need reform, no less than does the reform of the external supervisory framework.

We are often asked how come *we* did not see this crisis coming? Well, there is a lot hidden in the "we". There were many people who saw this crisis coming. There was even an institution which saw the crisis coming, namely the Bank for International Settlements (BIS), which consistently pointed to the dangers of many aspects of the financial system that lie at the heart of the current crisis. The right question is not "why didn't we see this coming" but "why didn't we decision-makers take account of those warnings?" This is a question that arises in every case of an intelligence failure, and not only in the financial sector. It is of course the sort of question that Israel faced following the Yom Kippur War. I'm not sure how you deal with these issues – which no doubt have been intensively studied by the intelligence community – but part of the answer must be that you have to be much more suspicious and much less trusting of your instincts and your mindset than we all tend to be, while at the same time realizing that an economy cannot grow if no-one takes risks.

Although this crisis is generally and correctly blamed on events in the United States, there were also home-grown elements in some of the crisis countries, particularly in the United Kingdom, Spain and Ireland, which contributed to the rout of the real estate sectors in those countries.

Next point: we are fortunate that the Chairman of the Fed is a student of the Great Depression. Ben Bernanke's thesis was on the topic of the propagation of the Great Depression and the conclusion he reached was not that the Great Depression became "great" because money supply was not kept growing sufficiently fast, but because the credit mechanism broke down entirely. In February 1933 several states declared banking holidays, and in early March incoming President Roosevelt closed the entire banking system for over a week. Almost a third of the banks in the United States never reopened following the national banking holiday. It took many years for the credit mechanism to revive.

A few weeks ago Chairman Bernanke went to the Congress, following the failure of the first attempt to pass the TARP (Troubled Asset Relief Program) proposal, and warned that the American credit system was within days of freezing up. He knew better than anyone what could happen and what might happen in a situation as fraught as the one the Fed and the administration are dealing with. It is clear that the extraordinary actions that the central banks have taken in this crisis would not have happened without an understanding of what happened in 1929 to 1933. Almost every central banking rule has been thrown out of the window in terms of the types of loans that are being made by the Fed and by the Bank of England, and to less of an extent by the ECB. That is being done to try to keep the credit system operating, to try to minimize the decline in credit provision that we are going to see in the months ahead – that is, to deal with the credit crunch.

There is an inherent difficulty in this area in that you want the banks to lend more but at the same time you don't want the banks – which are likely already carrying larger risks than they would like on their balance sheet – to add excessively to their risks. This is a problem for which there is no simple solution. One way to deal with it is by state subsidies or guarantees for loans. That will likely be done in a large number of countries, at least for small and medium scale enterprises.

Finally, with regard to the causes of the crisis, I note for the record that I do not assign as great a role to the low interest rate policies of the Fed in the lead-up to the crisis as do many analysts. The relatively low interest rates in the period leading up to the crisis were in part a result of the high level of global saving, related to the massive surplus in the current account of China, an issue to which I will come shortly.

With regard to what can be done to minimize the costs of this crisis from now on, governments have at their disposal monetary policy – which is rapidly moving to reduce interest rates – and a host of financial interventions that the central banks and governments are now undertaking, including those to deal with the credit crunch. That is, governments have to continue to struggle to contain the financial crisis, in order to restore the operation of the financial system, most importantly the credit system. That is essentially the first phase of the crisis. In addition, we are now seeing more and more of the real consequences of the financial crisis, in the rapid declines in GDP growth and the onset of recessions in many of the advanced countries. Governments can and will use fiscal policy to try to replace some of the private demand that has declined as a result of the financial crisis and its ramifications. Their ability to do so will be in significant part determined by the cost of financing the larger budget deficits that are now en route. Those countries with large debt-to-GDP ratios, or whose government obligations are for whatever reason less attractive to investors, will have less ability to widen their budget deficits and thus to use fiscal policy actively.

With regard to the issue of what can be done to reduce the extent of future crises, much depends not only on what is done in the international system, but also on what is done domestically. In no area is this more important than in the reform of financial regulatory systems. Most – but certainly not all – of the work in this area has to be done in the domestic economy, or, in the case of Europe, at the intra-EU level.

The issues of the reform of the international financial architecture will be on the agenda in Washington, DC a week from now. They are unlikely to be resolved but one hopes that progress will made, or at least that a framework and timetable for future work will be agreed. I want to discuss five interrelated issues that are central to what happens in the reform process.

The first issue is the surveillance – the "mutual persuasion" of macroeconomic policy i.e. the coordination of policies among countries within a system in which what one country does can have a major impact on other countries and on the system as a whole; Secondly, the surveillance of financial systems and their supervision; thirdly, the closely related issue of surveillance over international capital flows. The fourth is governance – who runs these institutions? How can we get countries to feel they belong and to act accordingly? And fifth, lending: what happens when a crisis takes place and there is a need for loans to be made?

On the issue of surveillance over macroeconomic policies – surveillance that is designed to influence country policies – which is one of the key functions of the IMF, this has proved difficult within the treaty framework of the European Union, and even within the European Monetary Union. It is even harder to get countries not within such frameworks to agree to adjust their policies in light of the effects of their decisions on the economies of other countries. It does not much matter to the global economy if a small country uses the international system to its benefit without taking into account the system-wide impact of what it does. For instance, if a small country decides that it wants to follow an export-led growth strategy and maintains a significantly undervalued exchange rate, that doesn't make much difference to most countries in the world. But if a giant country decides that it wants to follow an export-led strategy to growth and maintains an undervalued exchange rate, then that may have significant global implications. That is what happened in the case of the Chinese exchange rate in the last few years.

The IMF was set up in part, and its rules were designed, to deal with the asymmetry between the ability of the international system to discipline those countries that run deficits in their balance of payments and those who run surpluses. This is a result of the pre-war experience in which France may have been on the side of those who, for a while, ran surpluses at the expense of others. If you run deficits in your balance of payments, at some point you get into trouble, so you are going to be disciplined. If you run surpluses all you do is to continue to build up your reserves. If you are willing to keep doing that, you can keep going with that strategy forever, or at least for a very long time. But that surplus is reflected in deficits somewhere else in the system. In this crisis, that was reflected in the United States' current account deficit which was pretty large and unsustainable even before the price of oil rose to nearly $150 dollars per barrel. But in any case, the U.S. deficit became unsustainable after the price of oil rose to historically high levels.

The international system had no way, and still has no way, of getting agreement on how to adjust to the problem of the Chinese current account surplus, or to the problems of large current account surpluses of other countries.

What can you do about this phenomenon? You can try to make the system more resilient, which is what the move to floating exchange rates did as the original Bretton Woods system collapsed. You can call for consultations and for stricter IMF surveillance, and you can raise the issue at every opportunity that there are inter-governmental discussions. But you can't force a country to float its exchange rate. In fact, the amended IMF Articles of Agreement say that it's up to a country to choose its exchange rate system.

What can you do? One possibility is to give the relevant countries a greater sense of responsibility for the international economic system, and you do that by giving them a greater role in running the system. In doing this, though, we have also to recognize that no country, including the United States, is going to put all the focus in its mutual relations with a major country on the issue of the management of their exchange rate. Nobody, including the United States, is going to base all its relations with a country as important as China on the exchange rate issue, however important it may be. So, we don't really have a good way of dealing with the problem of the asymmetry of the adjustment pressures on deficit and surplus countries respectively.

The second issue is that of the surveillance and upgrading of financial supervision.

In the first place there is a need to upgrade financial supervision at the national level. Following the establishment of the Financial Services Authority (FSA) in the United Kingdom in 1997, as the single supervisor of the entire financial system, many different national models have been developed. Generally a distinction is drawn between prudential supervision, the supervision over risk management by financial institutions, and conduct of business supervision, which relates to consumer issues and those issues often supervised by the securities markets regulator, including corporate governance.

There are many different supervisory models. The approach we in the Bank of Israel have been promoting during discussions of reform of the supervisory system is the Dutch model, in which prudential supervision over the entire financial system is in the hands of the central bank, whereas the supervision of conduct of business is in a separate organisation outside the central bank. Considering the amount of time that the bank supervisor in Israel, who is located in the central bank, has to devote to consumer issues, such as the banks' charges for check-clearing, I am in favour of leaving the conduct of business supervision to another body, and having the bank supervisor concentrate on the supervision of risks and risk-management within the financial system, which is critical to overall financial stability.

The question of whether financial supervision, or some parts of it, should be located in the central bank, or rather separated from the central bank, is controversial. Following the establishment of the FSA, it became fashionable to argue for complete separation. I do not believe that is the best approach. Certainly, in managing the current crisis we have gained enormously from having the banking supervisor at the table with us throughout, playing an integral part in every discussion, with all the data as needed. Those who have not worked in bureaucracies might argue that all this can be achieved through better coordination. The world does not work that way. Information flows between organizations are simply less efficient than those within organizations. Decision-making that has to be coordinated between organizations is slower and less clear-cut than when the decisions are made within a single organization. It is very likely that prudential supervision will return to central banks when the lessons of this crisis are drawn.

In reforming financial sector supervision, there is also the issue of supervision and coordination at international level. As Jacob Frenkel said this morning, the great financial institutions are – or at least were – global, and supervision is not. What is required is a considerable measure of cooperation and coordination. Coordination among supervisors has taken place in the context of the Basel Committee for banking supervision, and more recently in addition through the Financial Stability Forum (FSF). The FSF is a forum in which the regulators of all the financial institutions (insurance, banking, capital markets) meet, discuss issues, and make recommendations.

Originally the FSF included the regulators of G7 countries, and a number of international institutions. Now it has added other countries.[1] This structure makes for efficient discussions within a (relatively) small group of countries. It was developed in part to keep the IMF out of this business. It would have been far better to have the FSF more closely associated with the Fund, which has the legitimacy of being a global organization based on a treaty, rather than a self-selected body that develops recommendations among a small group of countries. This is not to under-estimate the value of the recent work of the FSF. The FSF report produced in April 2008 under the leadership of Mario Draghi, chairman of the FSF,

[1] The FSF members are Australia, Canada, France, Germany, Hong Kong SAR, Italy, Japan, Netherlands, Singapore, Switzerland, United Kingdom, United States, international financial institutions (IMF and World Bank), the ECB, and international standard setting, regulatory and supervisory groupings

Governor of the Bank of Italy, was an excellent first report on the conclusions to be drawn from this financial crisis. But once conclusions have been drawn, they need to be implemented in the international system. That is what the IMF can do. I am very pleased to see that in the run-up to the G20 conference the Europeans are arguing that the FSF should be somehow associated with the IMF: that would be a much more effective system for international cooperation and coordination on financial sector supervision.

The third issue about the reform of the IMF is that of surveillance over capital flows.

In 1997 in the annual meetings of the IMF and World Bank in Hong Kong – at a time when the Asian crisis was beginning to intensify – the IMF under British leadership and with the strong support of then Managing Director Michel Camdessus pushed for an amendment to the Articles of Agreement, to give the IMF the authority to conduct surveillance of capital flows as well as of the current account of the balance of payments. Subsequently there has been a great deal of critical rhetoric along the lines of promotion of "a headstrong rush to premature capital account liberalization". If there was one adjective that was used in making the argument about the capital account liberalization we were pushing for, it was “gradual”. The word “gradual” was emphasised all the time. There was never any thought that the IMF would insist that countries liberalize capital flows immediately. Rather we believed – and I continue to believe – that gradual liberalization of the capital account, conducted within an understood framework, is the best way for countries to improve their financial systems through integration into the global system.

Let me give you two examples of how not to liberalize capital flows. In 1997, two countries that got into crises were Thailand and Korea. While there is never a single reason for such crises, an important contributing factor was that both countries liberalized short-term capital flows and did not liberalize long-term capital flows. Implicitly, they encouraged “hot money” to come in, and they did not encourage “cool money” to come in. And then, as the economic situation deteriorated, the hot money did what hot money does, it left, and then the two countries got into deep trouble. These decisions were not made under IMF urging, although that charge has been made. I believe that if capital account liberalization – *gradual* capital account liberalization – had been among the missions of the IMF, the liberalization would have been done better. In any case, it is time to get on with this issue.

Fourth, on the governance of the Fund: it is well understood that the voting shares within the Fund need to be adjusted to reflect the changing structure of the world economy.

The current structure of voting shares – Fund quotas – is not very conducive to international tranquillity, because every time the quotas are changed the new quotas are an average of what they were last time they were changed and what they should be today. That is because the distribution of votes at the time a decision to change the shares is made is that of last time, and the countries whose shares are supposed to go down generally do not want that to happen. Given that the IMF has been and is a European-dominated (and American) institution, the voting shares are still quite far from where they should be to reflect the changed distribution of economic power in the global system, which should give a bigger weight to Asia and to other emerging market countries.

In this regard, let me mention a point that may be of some difficulty in this (Trilateral Commission) forum: the European problem. The problem is that eight of the 24 seats in the IMF Board are held by European countries. Reform of the quotas will be slow and difficult until Europe decides how it wants to be represented. For instance, Belgium and the Netherlands have separate seats. Both make important contributions to the discussion in the Fund Board, and have been generous in their financing of the IMF and the World Bank. Israel is a member of the Dutch constituency, and we highly value that membership and the high quality of the representation. Still, Europe does not need that many seats. There was one day when I was in the Fund that France and Germany announced that they would combine their chairs, which would have been an excellent move. The next morning, it turned out the announcement had been a mistake – possibly the musings of some idealist had been committed to paper and transmitted prematurely. In any case, this issue needs to be dealt with: if Europe can get itself down to two or three chairs, then reform of quotas and representation in the IMF will become much easier.

With regard to governance, I want to turn to a slightly different issue which is "Which countries in practice run the IMF?", or equivalently "Which countries run the global economy?" Fred Bergsten has called this the issue of the Executive Committee. It is difficult to run an organization with 186 members if you have to consult with each member on every decision that needs to be made. You need somehow to operate within a smaller group. At the time that Michel Camdessus and I were there, that group was the G7. If something needed to be done, you generally spoke quietly to the G7, which accounted for about 40% of the vote. (Occasionally the management would try to do something that some members of the G7 opposed, but that is a story for another time.) If you had the G7 on board, you basically had an agreement at the end of the day. But the G7 is not any longer very representative, and the world is trying to move beyond the G7.

The G20 contains most of the systemically important and or large countries. But the G20 is probably too large. The so-called executive committee has to be smaller, and the question will be "who is in it?" Those involved in reforming the United Nations will of course recognize that this issue is very similar to that of who should be in the Security Council. In the case of the IMF, it will be difficult to get to much less than 10 countries, but here small – a small group – is beautiful: perhaps a grouping such as the United States, two European countries, China, India, Russia, Japan, one or two Latin Americans, a leading Arab country, and South Africa. It will take many years until the G7 is replaced, but the direction is clear.

One other seemingly small issue: you need a convenient place to meet. The IMF is very good at convening meetings, but Africans, Asians and Europeans find Washington a long way away. My guess is that the convening power of the IMF will be greatly enhanced if it creates a convenient meeting place in Europe – probably by enlarging its Paris office.

Finally, turning to lending in crises.

I need to start with some central banking doctrine, that of the lender of last resort, an analysis developed in the nineteenth century, most notably in Bagehot's *Lombard Street*. The doctrine set out there has been developed to the point where when you consider what to do with a financial institution in difficulty, you ask whether its problem is one of *liquidity* or of *solvency*. If the institution is basically sound but is having temporary trouble in borrowing, then its problem is liquidity, and a central bank loan will enable it to work its way out of the difficulty. If the bank is fundamentally insolvent, then it needs to be reorganized, probably recapitalized, changing the management, sometimes having it merged, sometimes dissolved. That is a very nice and essential distinction, a critical guide to decisions. But when you are sitting in the middle of a crisis, you frequently do not know whether the problem is one of liquidity or solvency, and you need to make decisions on the basis of your best judgment as to which it is, act accordingly, and leave the final judgment to history.

Bagehot's point was that every system needs a lender of last resort, an institution to provide credit when the credit markets seize up, as they do from time to time. In his book the lender of last resort was the Bank of England. In the international economy, with respect to countries rather than financial institutions, the IMF carries out some of the functions of a lender of last resort. But the IMF's resources are much too small now to deal with the whole system. The IMF has about $250 billion available for lending, and it is clear that will be far from sufficient – to deal with this crisis the Fund will need access to much larger sums.

However, the IMF as lender of last resort has a problem: it cannot print money. Central Banks are institutions which, by writing down something on a piece of paper or in a computer, create money. That is why a central bank is different from other financial institutions, and why we need institutional arrangements – such as central bank independence – to keep governments from using to excess the power to create money. The IMF can create liquidity in the form of Special Drawing Right (SDRs), but getting approval to increase the supply of SDRs requires going to the parliaments of member countries, and thus is not a power that can be used rapidly, in a crisis.

Now, to bring all this together: In this crisis the Federal Reserve has made loans in the form of swap lines to twelve other central banks, including to the central banks of four emerging market countries: Brazil, Korea, Mexico and Singapore. These arrangements provide short-term dollar loans to the recipient countries, that is, they provide international liquidity. In providing such loans the Fed must take account of whether the country in question faces the equivalent of a liquidity or a solvency crisis. There is no clear definition of what these terms mean in the case of a country, but one useful definition is that a country facing a liquidity problem does not need to make major changes in policy, whereas a country facing the equivalent of a solvency crisis does.

Possibly we are now moving towards a system in which the Fed and other leading central banks will help deal with international financial crises by providing liquidity in the form of swap lines to countries facing a liquidity problem, while leaving the Fund to deal with countries that face a solvency crisis, one that requires the country to make serious changes in its policies. This would be done in the context of an IMF program between the country and the Fund, in which Fund assistance is made conditional on the country's implementing the policy changes needed to deal with its crisis. I believe the Fund has to be involved when conditionality is needed, and I base that judgment on what happened when the Clinton administration, facing its first international crisis, at first decided it would impose its own conditionality on Mexico. Then it discovered how problematic that was in the context of its overall relations with Mexico, and turned the Fund, which has international legitimacy in this area.

The central banks may also be active in providing funding for the Fund's programs, through the GAB (General Agreement to Borrow) and NAB (New Agreement to Borrow), arrangements that enable the Fund to call on member countries for supplementary funding of a program. This funding generally comes from the central banks. These arrangements could be expanded.

One of my great teachers, Professor Charles Kindleberger, used to say, “the international financial system doesn’t work unless somebody takes the responsibility for it”. In much of the 19th century, the Bank of England did that, sometimes together with the Banque de France. Then the responsibility moved over to the Fed, which handled the task with circumspection. Perhaps we are now moving into a period in which the Fed and other central banks will take that responsibility on board more fully and explicitly, in developing the new international financing architecture.

The system to which we seem to be moving, and should be moving, is one with strengthened financial sector supervision, including improved international coordination of financial supervision, with a strengthened IMF, one with more financial resources, one whose membership shares will be more representative of the current economic power of its members, and one that should have a much bigger role in improving the supervision of national financial systems and the international financial system. It may well be a system in which central banks will be more active in providing liquidity to countries in liquidity crises, and perhaps to supplement Fund resources when a country faces a solvency crisis.

Remaining to be resolved is the issue of how to deal with a country whose policies are causing serious economic stress in the international economy, generally because of the asymmetry between the incentives for countries with deficits and surpluses in the currrent account of the balance of payments to adjust. There will be difficulties in getting countries to agree on changing the distribution of power in the international institutions. It will take time to change the inner group of countries that in effect takes responsibility for running the international economy and the international institutions. And all along the way, there will be the fact that no country wants to give up its freedom of action on almost any issue, least of all the big countries. But that will need to be done if the international economy is to become stronger and less subject to crises.

AMERICA AFTER THE ELECTION:
The Power to Lead in a Multi-polar World?

Joseph S. Nye, Jr.
North American Chairman
The Trilateral Commission

It is a pleasure to be here with friends from Europe at the European meeting of the Trilateral. I was fascinated this afternoon at what a lively discussion you had on the future of Europe and learned a great deal from it.

Now, I am supposed to reciprocate by speaking in this marvellous setting. Your eyes will most likely be on other things I hope, about the future, and in particular about *the future of the new president and of American power and leadership*. The topic reminds me of something I used to tell my analysts at the National Intelligence Council, which is to be very careful about predictions. There is a famous story about a person who went to the horse races on what we call Veteran's Day, and you call Armistice Day. He said, 'I see a pattern,' and he bet all he had on the eleventh horse in the eleventh race and surely enough it came in . . . eleventh. There is also an American baseball player Yogi Berra, who is full of apocryphal stories, one of which is “never make predictions, particularly not about the future.” I'm about to violate all of this by telling you what I think is going to happen with the new presidency and American power, but you will have to take it with a grain of salt.

Political scientists have this term which they call *transformative elections*, which means that you not only have a change from one party to the other for a short period of time, but you also have something that ushers a 30-40 year cycle that one party dominates. There may be interruptions, but one side or the other is dominant. Now, if you look at the US elections, people generally say the Republican Party dominated the first third of the 20th century, the Democratic Party dominated the middle of the century and the Republican party dominated the end of the century and into the beginning of the 21st century. The great question is whether what we saw the other day was a transformative election or just a normal election, just as you would have Jimmy Carter interrupting the Republicans, or Bill Clinton interrupting the Republicans, and so forth.

My bet is, and this is a rash violation of all those rules that I gave you as I started, that for two reasons *it probably will be a transformative election*.

First, because of the current financial crisis there is a turn in the cycle of the balance between markets and the government. We obviously need both as we spent much of the day discussing, but the relative role of markets and governments is going to turn in this cycle. Remember Ronald Reagan said thirty years ago that government was part of the problem, not part of the solution, and I think that it is beginning to turn now. There is a belief that markets are crucial but governments have a bigger role than thought earlier, which may be one cause of this election being transformational.

The other is actually a change in the nature of the American electorate. What's fascinating is not only that Obama got an absolute majority, which Bill Clinton never got, but he also got an overwhelming majority among younger people, and those are of course the voters of the future. In addition to that, he got a large majority among Hispanic voters, and that's the fastest growing minority in the US. So those are grounds both on the substance and composition of the electorate that may suggest that this will be a transformative election.

What about *impact of the financial crisis on the future of American power?* That is a harder subject to predict. In fact, there were many who suggested, for example, that President Medvedev said that this is the beginning of the end of American power. Hugo Chavez, the president of Venezuela, has made a statement saying that Beijing is now more important than Washington, and a number of others have said these are the first signs the long-run American economic dominance is cracking.

If so, it lays as an interesting question. Such expectations should lead to a considerable decline in the dollar, but just the opposite has occurred. Six months ago, or a year ago, a theory about the decoupling of the world economy, that the old days when America sneezed the world got a cold are no longer true, was very popular. Well, guess what, it turns out that when Americans get the flu, everybody else gets the flu. In that sense, the view that this is the beginning of the end for the US I don't think quite fits the facts.

It is true that the financial crisis is epic in financial terms. It has profoundly transformed the nature of our financial system. If you look at the fact that a couple of months ago there were five investment banks and now there are none, that's the beginning of quite a considerable institutional change. Additionally, the so-called New York consensus, not the Washington consensus, that's less relevant now, which was that financial manoeuvring, that financial ways of doing things in New York were the model for others, that is no longer true. We've lost a lot of attractiveness that goes with the New York model.

But, the question is not whether this is epic for the financial world, it is. But *what are the effects on the real economy.* And there the question is to distinguish the short- and the long-term effects. In the short term, I think most would agree we are heading for a sharp recession. The key question is about its duration. Will it be prolonged, à la 1930s or Japan in the 1990s, or will it be a sharp recession but one that after a couple of years we recover from? A friend of mine, whom I asked about the issue, a distinguished economist who is close to Obama, said he thought that the prospects for the short recession were 75 percent and the prospects for the long recession were 25 percent. That does not mean this will come true, essentially since you can all put your own bets on this. However, I want to talk not of the short-term, but of the *long-term consequences.*

What does the collapse of the financial system and of the "New York model" mean for American power over the next 20-30 years? We are told that this is the Asian century, China is overtaking us, and so forth. When one looks at the real economy in the US over a period of couple of decades, it might be that John McCain was right, even though it was politically incorrect, to say that fundamentally the economy was sound. It's interesting that when you look at the American economy it is rated number one in terms of competitiveness by the World Economic Forum while, I would like to point out, China is rated number 34, based on a ranking that looks at some very important things such as political stability, the quality of higher education, the flexibility of labour markets, innovation, cutting edge role in new areas like biotechnology and nanotechnology and so forth, which lead to higher productivity, which in turn is the key to predictions in the long run. Now, that may or may not turn out to be true, but I guess I would put my bets in that direction.

On the other hand, it is also true, as the National Intelligence Council -- which does intelligence estimates for the president and is now briefing a report to President-elect Obama called “The World in 2025” -- said in one of its conclusions, which was briefed in the American press, that *American power will diminish somewhat by 2025*. That's not too surprising and it does not reflect the decline of the US or does it mean that those factors of optimism that I suggested are wrong. *It just reflects the rise of the rest of the world*. The fact that others are doing well, and if that is true that is good for the world as a whole, then it means that the American share of the global product should diminish somewhat over time. I think that is correct, but it has to be understood in a broader context.

When some people look at the current situation and see this as the end of American power, it's rather an old fashioned way of thinking about power and its distribution. *Power always depends on context and the contexts of power are very, very different in different areas*. Let me give you an example. If we think of a metaphor of a three dimensional chess game: on the top board of *military power* the world *is uni-polar*, the United States is the only military superpower and I suspect it will stay that way for another couple of decades or more, as I can't see China replacing us in that area.

But if you go to the middle board of this three- dimensional game, the board of *economic relations* between states, the world *is multi-polar*. What's more, it's been multi-polar for more than a decade. This is the area where Europe acts as a unity and is able to balance the American power. Indeed when you think back to Mario Monti, who talked to us this morning about his role preventing Jack Welch from merging GE and Honeywell, which were both American companies and had approval from the US Justice Department for their merger, and yet the transaction was stopped by the EU. If that is not a balancing power, then I don't know what is.

When you look at the bottom board of this three-dimensional game, the board of *transnational relations* -- things that cross borders without control of governments, whether it be terrorists, drug money, pandemics, or global climate change and so forth -- nobody is in charge: *power is chaotically distributed*. Therefore to call this time American hegemony or uni-polarity, or multi-polarity, means nothing at all, because these terms are misapplied.

Now if that is true, then it means we have to distinguish between two things when we think about changes in power. One is *power transition from one country to another*, and historically we know a lot about that. The power transition from Britain to the US at the end of the 19th century was handled quite well. The power transition from Britain to Germany was handled very badly and produced two world wars. I don't believe in the scenario the Chinese are going to create a power transition crisis in the 21st century analogous to that from 1914. For one thing, it is worth remembering that Germany had already surpassed Britain in its industrial strength by 1900, well before the war. China, whatever it's economic success, is not going to surpass the United States in total GDP, or GDP per capita, for quite some time. There is time to work on this problem and we have lessons we can learn. So we will be able to manage the power transition.

But the other dimension is what I call *power diffusion, not between states, but power diffusing from states to non-state actors*. That I regard as far more difficult and far more dangerous. Think of this for a moment. When I was in the Carter administration in 1970s, one of the great secrets which I would be put in jail if I told you then was that we had satellites that we spent billions of dollars on that could take a picture of Earth that was one meter in resolution and the Soviets had the same. But notice today any of you, or anybody, can go on the internet and get a better resolution picture for free. Global instantaneous communications were possible in 1970s, but reserved for large organisations with large budgets, governments, multinational corporations and so forth. Today anybody has that capacity by just going into an internet cafe, and if you use Skype it's free. So essentially, *the spread of technology has empowered non-state actors. They are not replacing nation states, which are still the key actors on the stage, but the stage is much more crowded than it used to be.* To illustrate this please look at 9/11. It is interesting to see that a non-state actor killed more Americans than the government of Japan on December 7th, 1941. That is a *privatisation of war*, that is a diffusion of power, and to my mind that is a much more difficult problem to manage.

In order to manage that problem, we have to rise up to what I called *the Paradox of American Power*, *which is that the largest power cannot protect its citizens by acting alone*. It has to learn to lead with others and until it does so it is not going to be effective. Why then do you still need any *American leadership?* The answer is provided by something that economists call a "collective goods theory". If the largest actor doesn't take the lead, then the others essentially won't either because there is the so-called free-rider problem. So it's essential the Americans lead, but they cannot lead by acting alone.

The good news is that I think Barack Obama fully understands this, and Obama is a man with a great contextual skill. In the book that Peter mentioned and which I have just published called *"The Powers to Lead"*, I talk about the fact that *we have to adjust the way we think about leadership in the information age.*

In the industrial age, leadership was hierarchical, much like a factory is a hierarchy and uses the *hard power* of hiring and firing and so forth. In the information age, it is not about being the king of the mountain and giving orders down the hierarchy. It's like being in the centre of a circle attracting others to you, getting them to follow you and do things that you feel are worthwhile. That means that you need more *soft power*, the power to attract, as well as hard power.

We also need to rethink the idea that power is a zero-sum, that if someone else's power goes up, then my power goes down and vice versa. Sometimes that is true and there are still many aspects of the world where that remains true, but there are also other aspects of power that are a positive sum. For that you might want to make the distinction of power *over* and power *with*, when sometimes you can increase your own power by empowering others.

Let me give you a simple example from climate change. China, which is now a superpower of CO_2 production, has the capacity to produce a new coal burning plant every week. What can we do about that? In traditional terms we could bomb the plants, we could put sanctions against China, and destroy the trading system, or we could find ways to help China develop its own capacity to deal with CO_2. That last element is essentially the power *with,* instead of the power *over*. Many of the new problems that I have described as coming from the bottom chess board require us to think differently about power, rather as a power with than over, and need leadership to be in the centre of the circle, rather than commanding from the top.

When I said that Obama understands this it is because he has the necessary skills and he has demonstrated them during his campaign. These *soft power* skills, as I have described them in my book, include emotional intelligence, vision and communication. Some people say, "of course he has those, but does he have the hard power skills?" My reply to that would be anybody who has come up through Chicago politics has hard power skills. Organisation is another hard power and Obama's campaign is regarded by those who know as one of the best- organised campaigns that they've seen in the last several decades. So there is no question whether this man knows how to combine hard and soft power. He clearly does. Moreover, what he also has is an extraordinary contextual intelligence, the knowledge to know when to use which skill, under what circumstances. That is what produces the *smart power* and is something that Obama has learned from bottom up. He doesn't have a lot of experience at the high levels of government, but as a kid growing up in rice paddies in Indonesia with relatives in Kenya and as a community organiser in Chicago he has an extraordinary contextual intelligence learned from bottom up. I think that it will serve him well.

I mentioned this afternoon that *we have to be careful of expectations*. Yes, the expectations for Obama are very high, and please notice as a leader he already started trying to lower, to dampen, those expectations with his acceptance speech on Tuesday night.

Please remember that events will often come in the way of the best predictions. There is a famous story attributed to Harold MacMillan that when one person asked him what is the biggest problem that a leader faces, he said "Events, dear boy, events." Some of the things mentioned here can be driven off course by unforeseen events, and that takes us back to my initial comments and cautions about never making predictions, particularly about the future. But with all these caveats, with all that said, I think that in fact our optimism at this point is justified and that…

"Yes, we can."

Session on Mastering Global Challenges

The Role & Responsibility of Rising Global Actors
China-India-Russia

RUSSIA-EU RELATIONS:
Deadlocks and Opportunities

Anatoli Chubais

General Director, Russian Corporation of Nanotechnologies – Rosnano;
Co-Chair, EU/Russia Industrialists' Round Table; Former Chairman, RAO-UES;
Former First Deputy Chairman of Russian Government & Minister of Finance

Being invited to address Russia's relations with Europe, I feel in trouble because I never experienced being in "foreign relations" business and, with this audience with experts and high-level professionals, the only thing I could do is to make a highly unprofessional, illiterate and irresponsible speech about this Russia-EU relationship! I shall try to cover the last decade since the mid-1990s: what happened over these ten-twelve years in our relations? I shall pick five events to remind ourselves on the real history of this period.

EVENT N° 1: NATO EXPANSION.

The intensive points of discussion between Russia and the West was not *"should NATO expand or not?"* The point was: which would be smartest way to do it and to start expansion from improving the NATO-Russia relationship and maybe to even seriously discuss Russia joining NATO. In those days, it did not sound that strange as it is now. Or, the opposite approach was to expand the geographical scope of NATO starting by Eastern Europe. Arguments were made that at the moment NATO would get Eastern Europe on board, they would make any joining of Russia simply impossible, not just for decades but at least for half a century.

For those who understand what was the post-Second World War, history and the Soviet-Eastern European relations, it's absolutely understandable that if Eastern Europe would join NATO it will close any future options to Russia to improve its relations with Europe. What happened later with numerous events – especially the Polish position absolutely understandable in historical terms – is just proof once again that that was the decision which actually, instead of getting rid of the Berlin Wall, just removed this Wall by 2 000 km to the East. That's the only outcome of this NATO decision if we try to take and understand the Russian view.

EVENT N° 2: THE BELGRADE BOMBING[2].

I believe that many of you remember this event and for me personally and in my political life that was the first time in ten years when I shared absolutely the same position with Mr. Zyuganov who is a leader of the Russian Communists (whose one major goal was to put me into jail): we regarded this event as absolutely impossible. My friend Yegor Gaidar went to Belgrade during the bombing and we tried to accumulate all the humanitarian arguments for not doing so. We discussed it with the Russian Orthodox Church and the Pope invited my friends: this was a first time in history when the Russian Orthodox Church and the Vatican made a simultaneous statement against these bombings. Our arguments were not accepted: nobody wanted to hear us. This bombing ruined not only buildings and bricks, the Chinese Embassy and Belgrade, but also ruined Russia's trust to the West. This may sound too strong but I believe this bombing is still misunderstood in the West. This bombing ruined something very deep and important in the Russia-Western relationship, not Soviet.

EVENT N° 3: THE IRAQ WAR.

This war was neither unilaterally supported in Europe nor in Russia. Probably the U.S. is still looking for the nuclear missiles of Saddam Hussein! The reactions in Russia were strongly negative to this war. This negativism throughout the world helped Mr. Obama to win the U.S. presidential elections. In Russia, we still have this accumulated negativism because of this decision.

EVENT N° 4: KOSOVO-SERBIA.

I know what was the signal given from Russia to the major Western leaders before this decision was made. I know how Russian leaders in private conversations with European leaders explained that they should not do it as it is in direct violation of UN rules with UNSC Resolution 1244 going against international law. In addition, if you do it, you will not be able to stop Abkhazia and Ossetia separating from Georgia. It was expressed openly without any ambiguity. As you know, all these arguments were not accepted and Kosovo separated from Serbia with recognition of an independent Kosovo.

EVENT N° 5: NATO MISSILES IN POLAND AND RADAR STATION IN THE CZECH REPUBLIC

The argument is that these missiles and radar station are the way to protect Europe and the United States from Iranian missiles. If I remember correctly, Iran is a little bit more South than Poland. That's why President Putin suggested that as an answer if there is a real threat from Iran, then it also becomes a serious issue for Russia as well. In this case, why not design something together? There was a practical suggestion put on the table that the Azerbaijan

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[2] From 24 March to 8 June 1999

Gabala Radar Station[3] would be put together under common commandership to really protect Europe, the US and Russia from a potential Iranian missile threat. There was no answer given except to sign the agreement with Poland and to make it happen.

I don't think that those events and steps were arranged by the US and NATO with a special purpose to harm and irritate Russia. That was the way how NATO understood the national interest of its members and tried to protect these interests, but what I am thinking about now is Russia's perception and, as you all know, *perception is reality*.

What I told you is my personal and professional view. For your understanding and the logic behind my thoughts, I am myself considered as a famous agent of the CIA, MI6, Mossad, IMF and World Bank, you would not find in Russia any politician with a more Western-oriented outlook than my friends and I. What I told you now, that is my position.

There is no way to understand Russia's Georgia events, there is no way to understand why Russia gave a military answer to the military invasion of Mikhail Shakashvili in South Ossetia without the understanding of all these preliminary events which happened before.

Yes, I do understand that by announcing the Kaliningrad missiles location on exactly the same day when Barak Obama was announced as the winner was probably not the best moment. That is tactical and they should have done it a week before. I believe that if we follow all these events and try to keep a vision of what happened, my understanding of the whole situation is that we from both sides made so many mistakes and absolutely wrong steps that the whole situation makes me an optimist because it is enough: now is time to stop for a minute to understand where we stand now and think.

Will one more pressure on human rights and democracy in Russia really help human rights and democracy or help the anti-Western and anti-US forces as so many times in our history before?

It is now time to think what should be done by Europe with our understanding that in all these mentioned events there was a special European role which was not simply following the Americans steps. Europe had and may have a very special positive role in rebuilding this relationship in finding the way out of this deadlock on where we are now. We actually saw it during the Georgia-Russia conflict and the critical and very positive role played by President Sarkozy in those critical moments, a role which could not have been played by the Americans because the situation has gone too far in US-Russia relations. This EU value, we must accumulate, preserve and use it in order to restart Russia's-EU relations.

That is my belief and I know that next Friday there will be the EU-Russia Summit in Nice. I believe that this Summit may give some positive signals i.e. the re-launch of the PCA negotiations. That is my optimistic, non-professional and illiterate position.

[3] Russian President Vladimir Putin proposed to jointly use the **Gabala radar station in Azerbaijan** with the United States on the sidelines of the June 6-8, 2007 Heiligendamm G8 Summit in Germany. The Gabala station is the only Russian military installation in Azerbaijan, and Moscow has leased it until 2012.

Anders Åslund

Senior Fellow at the Peterson Institute for International Economics;
Adjunct Professor at Georgetown University, Washington, DC

What I have been asked to discuss today is **how the financial crisis has hit Russia and how has it changed the perception of the economy.**

As Anatoly Chubais said, three months ago Russians looked upon themselves as a safe haven, not at all vulnerable to the financial crisis. On the contrary, what we see today is rather that Russia among the BRICs is the most vulnerable, which should not have come as a surprise. The strength that Russia has built up was a very good macroeconomic policy for the last nine years, which has entailed huge budget surpluses in the good times, the building up of very substantial reserves of no less than 600 billion dollars at the end of July, and also persistent huge current account surpluses in the order of 10 percent of GDP.

But the problem with Russia is of course the high dependency on energy.

Energy, oil and gas, now account for more than 60 percent of exports. Add to that 20 percent of other commodities, mainly metals. Oil and gas account for 50 percent of federal revenues and 18 percent of GDP. So Russia is extremely dependent on the international oil price, which peaked in July at 147 dollars but is now down to 60 dollars and it may continue falling. *Russia needs 70 dollars per barrel at present in order to balance its budget*, and that does not look likely.

Not surprisingly the huge reserves, the third largest in the world, have quickly diminished. In three months, Russian reserves have fallen from 600 billion to 485 billion dollars. Last week, 30 billion dollars disappeared. This is an accelerated speed and already 150 billion dollars have been transferred to banks, so it should not really be included in nominal reserves any longer because it is already committed for other purposes. One reason for the fall in reserves is capital flight, and now that Russia has been defending the exchange rate when it should let the rouble depreciate with the oil price. Russia's talked for years about inflation targeting, but has not really done it.

So how could this happen? Let me give the story stroke by stroke.

First the stock market fell very sharply. That started in late July because of three events: the sharp fall in oil price, Prime Minister Vladimir Putin made a vicious attack on Igor Zyuzin, the owner of Mechel, a big steel and coal company, and then came the war in Georgia. It is difficult to distinguish which of these three events caused the fall, but the fall was very sharp. At the bottom, the stock market was down 78 percent from May; now it is 70 percent.

Second, like for everybody else, international finance froze, but a bit more for Russia because of the internal events, which of course increased the political risk premium at a time when you didn't want to have a political risk premium.

And the natural *third* step was that the domestic banking sector froze up. The Russian government and the central bank have been pouring huge amounts of money into the banking system in order to keep it alive, but here Russia has a major structural problem. You can say that the Russian state puts the money abroad, and the big Russian companies borrow the money abroad, which means that Russian financial intermediation doesn't function properly and the problem is that half of the banking system is owned by five big state banks and state banks do funny things, but they don't service the private sector properly. Russian companies need 1 billion dollar loans, and Russian banks can give loans that are only a few million dollars. Therefore, for the big Russian companies there are far too big currency risks.

All this led to the *fourth* step: the corporate sector, and particularly the largest Russian businessmen, was excessively leveraged and they were leveraged abroad. So what has happened now is that one big oligarch after another has got margin calls, and right now the state is bailing out some of the richest men in Russia, for example, Oleg Deripaska and Mikhail Fridman. Makes you wonder how that would go down politically.

The *fifth* point is that all of the above has started hitting the real economy, and real estate got hit first. A lot of big construction projects are being halted because they all work based on loans. The *sixth* step we are seeing the metal sector being hit all over the world, so steel companies in particular are cutting production sharply. The *seventh* step is that the Soviet behemoths that have been revived are now losing out, particularly the automotive industry, which was not very good to begin with.

What will happen in the future, obviously, is that investment and consumption are bound to stop growing.

Until one month ago, the standard forecast for growth next year was 7 percent. As Anatoly Chubais mentioned, now it is about 3-4 percent, but I noticed that JP Morgan put a 0 percent growth forecast for next year if the oil price is at 50 dollars. Given the fast dynamics of the developments we are seeing, I think Russia will come out much worse from this situation because it is so dependent on commodities and because it has such a poor domestic banking system: so it is much more vulnerable to the crisis than in particular India and Brazil.

On top of this, you have the *political aspect*. This regime is entirely legitimised by the economic growth. If there is no economic growth, there is no ideology and there is no other legitimizing factor. So what will happen in this situation? I think we will see something that is quite dramatic, though it's a bit early to speculate about it. We can notice what is already happening. Mr. Putin has settled with Mechel without any problems. The corporate governance problems have clearly eased in Russia because they are too dangerous right now. The second change was in Bucharest in April when Mr. Putin declared that Ukraine's right to sovereignty and secure borders has ceased to exist; but it seems that it has stopped with Georgia and is not going further. Indeed, Russia is now pushing towards settling both Nagorny Karabakh and Transdniestra with a new energy that we haven't seen before.

My point here is that we should expect more positive developments because Russia realises that it is part of the world and we should expect more economic reforms.

My friends Yegor Gaidar and Yevgeny Yasin have always emphasized the lower the oil price, the more economic reforms take place in Russia. It will take some time for the Russian leadership to realise this. Some of them, particularly Mr. Putin, are still in denial, but the reality is quickly dawning on them. We are also likely to see huge structural changes in Russia thanks to this. Many revived Soviet factories will not survive; they shouldn't survive. And many of the oligarchs are unlikely to survive; they shouldn't survive as big businessmen. We are likely to see a new broad base of business middle class coming to the fore and we are likely to see a lot of other positive changes.

Boom is a time of corruption; depression is a time of moral rearmament.

Session on Mastering Global Challenges

The Role & Responsibility of Rising Global Actors: China-India-Russia

India: "The Reluctant Globaliser"

T.N. Ninan

Chairman and Managing Director, *Business Standard,* New Delhi

I would like to start by saying that India has been and remains a *reluctant globaliser*. Its Achilles heel is not the global crises that swept through now and before. Its Achilles heel is the oil. We import about 70 percent of what we consume. India has watched currency crises overtake one country after the other over the last quarter century, in Mexico, Brazil, Turkey, Argentina, Russia, much of East Asia, Korea, Thailand and so on, and almost never have any of these crises affected India or indeed has India suffered a similar crisis as these countries.

The problems that we have faced, or the critical points that we have faced, were linked every time to oil prices rising sharply. The first oil crisis in 1973-1974 resulted in runaway inflation and a political crisis that led to internal emergency rule and dictatorship for a short period. The 1980 oil price increase saw GDP shrink by 5 percent and once again runaway inflation. The 1991 oil crisis created a stage for economic reforms to begin, and of course today we have the 2008 situation before us. All of these problems that other countries faced, India watched from the sidelines and that is what has given -- both as a cause and consequence -- India a cautious external stance. We have built up foreign exchange reserves to the extent of 300 billion dollars, which is roughly equal to one-year of imports. The central bank heavily influences currency trading, and foreign banks account for less than 10 percent of the domestic banking sector.

Yet over the years, as the system has liberalised and opened up, and indeed globalised, engagement with the world has grown. So the share of trade in GDP at the time of the reforms begun in 1991 was about 15 percent, while now trade in goods is at 40 percent of GDP, and if you include services, technology exports and so on, it rises to above 55 percent. Foreign institutional investors account, or accounted until recently, for 20 percent of India's top market. Foreign direct investments multiplied many fold and went up from an annual average of just about $ 2 billion to about 25 billion a year. Indian companies have gone overseas. Outbound FDI was last year at about 15 billion dollars. Indian companies have borrowed much more overseas and the volume of foreign exchange trading domestically has again multiplied manifold.

This is a system that has been integrating slowly and carefully with the rest of the world. And this has now exposed India to a whole series of global currents, which is why India has been affected this time by the global crisis, by the liquidity problem and the economic slowdown. This is despite the fact we do not have a domestic sub-prime problem. We do not have a securitisation problem. There was no domestic failure by rating agencies, and we do not have rampant financial innovation or complex derivatives being traded on the market. And yet our stock market has fallen by 50 percent since January, and therefore the share of foreign portfolio investors has gone from a peak of $ 280 billion down to 70 billion. Industrial output growth has halved in last five months from 10 percent a year ago to 5 percent. Export growth is doing quite well, but has now fallen by more than half to 10 percent in September, and GDP growth, which was 9 percent for five years in a row, is now expected to slow to under 7 percent, possibly 6.5 percent, which for us already has the feel of a recession, although it may not sound that way to European audiences.

The upbeat mood that has characterised the Indian business scene for the last few years has given way to a sharp pessimism in the latest quarterly numbers, when corporate profits have fallen 35 percent and companies are resolving to lay-offs. In October, which was even worse than the July-September quarter, sales actually fell for companies. Investments were all but halted and consumers are not spending. Financially, we've had a liquidity problem with interbank transactions slowing down and there have been brief periods of overnight interest rates climbing to 20 percent and a more significant liquidity crisis which the central bank had to address.

The question is how has a relatively insulated system with no serious domestic internal issues, and in fact doing quite well, been shaken up so quickly in this fashion. The answers have to do with both external and internal issues and it is important to keep in mind that India remains substantially an internally driven system, and there are internal issues which have been brought to the fore by the external currents.

First, a look at external issues:

The lack of liquidity globally has meant that credit for Indian companies has more or less dried up, and so they had to turn to domestic money to finance trade. Companies that were acquiring firms overseas -- I'm sure you know the headline-hitting ones, but there were also a whole series of small and medium acquisitions -- and were anticipating they would be able to finance these acquisitions with the easy liquidity that prevailed globally suddenly found that there was no money going, and so they were forced to raise their money domestically. Indian banks that have international operations suddenly found that they could get money globally and so they had to take money from India to finance their international operations. So, the absence of global liquidity has meant that money was taken out of India to finance international operations, and of course portfolio investors overseas have been pulling out of the stock market. All of this has meant that rupees have been sucked out of the system to provide dollars globally and therefore the rupee has fallen by about 25 percent against the dollar in six months. The central bank had to intervene to try to stabilise the currency and make sure it does not collapse, and that has meant that even more liquidity has been sucked out of the system. Although nominally domestic credit from banks has grown by 24-26 percent this year over last year, there is no money available in the system because there are suddenly new demands being made of the financial sector.

So that's how the rest of the world has impinged on us domestically. But there have been domestically created issues as well.

We set the stage for the crisis through mismanagement of our energy sector, and I think by some central bank mistakes in adjusting too slowly to shifting global currents. Our oil companies are substantially government owned and oil product prices are government fixed. When oil prices went through the roof, inflation was already a problem as we had a 12 percent inflation rate, which was the highest in more than a decade. So, the government decided not to pass on the oil price increases to the consumer market and as a result the state-owned oil companies were in the red and needed liquidity. The government did not pay out subsidy bills on time because of a whole series of parliamentary issues and so companies turned to banks to finance what should have been paid by the government and consumers. That added to the banking system's liquidity problem, as these were large sums of money, not only from the oil industry, but also from chemicals, where gas is a main feedstock for fertilizer products.

As a result we had a fiscal problem being transferred into the market creating a liquidity problem. The central bank up to July -- and do bear in mind that in July oil touched 147 dollars briefly -- battled inflation by tightening money supply and raising interest rates, when suddenly the whole situation turned and the central bank reacted too slowly. Thus, the central bank and the government created a domestic base for the international currents to hit the economy as a whole.

However, I should say that our banking system is safe for a couple of reasons. First, 70 percent of the banks are state owned. Second, regulations have been very cautious, capital adequacy ratios are well over Basel limits, with average at 12.5 percent and even higher for the private banks, the central bank impounds up to thirty percent of the bank money in liquid government securities or in hot cash, and so banks are completely safe and secure. The main worry is not about the banking system, but about the non-banking financial companies that have been financed by banks. The central bank has responded belatedly and pumped in liquidity, lowered interest rates in last few weeks, and addressed refinance issues in specific sectors.

In a sense, the worst of the financial and liquidity crisis is over for India and what we are looking at now are the problems of the real economy. In this regard there has been a combination of forces at play. First, that the business cycle has turned, following a global shift from inflation and easy liquidity towards deflation and the absence of money, while domestic mismanagement and wrong decisions have remained. The issue to be dealt with now include lack of business confidence and a change in consumer moods.

It's been said repeatedly that India reforms only when there is a crisis because dead-weight factors prevent any real change until a crisis focuses the mind. We've had last year two committee reports that have focused on the financial sector and have argued in favour of integrating with the global financial system, increasing capital and work accountability, allowing foreign banks a greater role and so on. This was debated extensively, but in the situation that prevails today the government has actually been seriously looking into the reports to see what can be done in order to take the system forward. Therefore, significant moves are being made to open up even more foreign direct investments, for example, into the insurance industry, by raising the 26 percent foreign investment cap to 49 percent, a move approved by the government last week. A whole series of measures are now being announced almost every two days.

The problem is that the government has only six months to go before it faces a general election and it has a shaky parliamentary majority, so it is unclear what can be achieved in the little time it has left. In the medium term, the perspective is that oil prices have fallen, which is a great relief and removes a fundamental cause of the current turmoil. Second is that the Indian growth phenomenon is substantially domestically driven, which is slightly different therefore from China. The domestic growth drivers remain broadly in place, so when things return back to normal in the global economy in a couple of years, India should return to a sustainable growth rate of at least 8 percent a year.

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Conference Programme

FRIDAY 7TH NOVEMBER 2008

19h30-22h30 Opening reception & official dinner

MINISTRY OF FOREIGN AND EUROPEAN AFFAIRS

19h30-20h15 Reception *(in Salon de l'Horloge)*
20h15-22h30 Dinner *(in Grande Salle à Manger & Galerie de la Paix)*

Eric Besson
Secretary of State in charge of Strategic Planning, Public Policy Evaluation and the Development of the Digital Economy

SATURDAY 8TH NOVEMBER 2008

09h00-10h45 **FRANCE ON THE MOVE… ECONOMIC REFORM,**
(Salon Concorde) **SOCIAL DIALOGUE AND POLITICAL GOVERNANCE**

*Chaired by **François Bujon de l'Estang***

Keynote Speaker: **Jean-François Copé,** MP, Chairman, UMP Parliamentary Group in the National Assembly; Former Member of the Government

*Roundtable discussion moderated by **Nicolas Beytout***

Michel Camdessus, Chairman, Société de Financement de l'Economie Française (SFEF, former « SRAEC » Refinancing company for activities of credit institutions); Former Managing Director of the IMF and Governor of the Banque de France

Olivier Pastré, Professor of Economics at the University of Paris VIII-Vincennes St. Denis; Chairman of IM Bank (Tunis)

Nicolas Baverez, Lawyer, Gibson Dunn & Crutcher; Essayist & Historian, Paris

AN « OUTSIDE » VIEW:

Mario Monti, President, Bocconi, Milan; Member of the EU Reflection Group of the Future of Europe; Former Member of the European Commission (Competition Policy)

10h45-11h00: Coffee break (Salon Impérial)

11h00-12h30 **THE INTERNATIONAL FINANCIAL CRISIS:**
TOPICAL SESSION: ***What Went Wrong?***

*Chaired by **Edmond Alphandéry***

Introduced by **H. Onno Ruding**, Member of the EC High Level Expert Group on EU Financial Supervision, *with* **Michel Camdessus**

12h30-14h30: *Luncheon*

A NEW GLOBAL FINANCIAL ARCHITECTURE?

Lessons learnt from the Crisis on the eve of the White House Global Summit

Stanley Fischer, Governor of the Bank of Israel; former President, Citigroup International & Vice Chairman, Citigroup, NY; Former First Deputy Managing Director, International Monetary Fund

14h45-18h30: Session II: (Salon Concorde)

THE EUROPEAN UNION:

At Midterm of the French EU Presidency followed by Czech Republic

Chaired by ***Peter Sutherland***

Jean-Pierre Jouyet, Minister for European Affairs, France
Alexandr Vondra, Deputy Prime Minister for EU Affairs, Czech Republic

16h15-16h30:
SESSION II CONT.

Chaired by ***Elisabeth Guigou***

EU INSTITUTIONS & DEMOCRACY:

- "Saving Europe from the Tyranny of Referenda…"
  Tøger Seidenfaden, Editor-in-Chief, *Politiken*, Denmark

EU PRIORITIES:

- ***Building a European Defence Architecture:***
  Edgar Buckley, Senior Vice President for EU, NATO and European Cooperation, Thales Group, Neuilly/Seine; Former NATO Assistant Secretary General for Defence Planning and Operations

- ***"The Union for the Mediterranean"***
  André Azoulay, Counsellor to H.M. the King of Morocco; President of the Euro-Mediterranean Anna Lindh Foundation, Alexandria

20h30-23h00 *Dinner hosted by the French Group of The Trilateral Commission at the Musée des Arts Décoratifs in the Louvre*

America After the Election:

The Power to Lead in a Multi-polar World?

Joseph S. Nye, Jr.
North American Chairman, The Trilateral Commission

SUNDAY 9TH NOVEMBER 2008

09h00-10h30:
SESSION III
(Salon Concorde)

MASTERING GLOBAL CHALLENGES

The Role & Responsibility of Rising Global Actors

Chaired by ***Loukas Tsoukalis***

- India *and the Global Financial Crisis:*
  T.N. Ninan, Chairman and Managing Director, *Business Standard,* New Delhi
- China-EU Relations *in the light of the Global Financial Crisis*
  Lord Brittan of Spennithorne, Vice Chairman, UBS Investment Bank, London; Former Vice President, European Commission (Trade & Competition Policy)
- Russia-EU Relations: *Deadlocks and Opportunities*
  Anatoli Chubais, General Director, Russian Corporation of Nanotechnologies – Rosnano; Co-Chair, EU/Russia Industrialists' Round Table**;** Former Chairman, RAO-UES; Former First Deputy Chairman of Russian Government & Minister of Finance

10h30- 10h45
Coffee break (Salon Impérial)

10h45-12h15
TOPICAL SESSION IV:

IS A NEW "COLD WAR" DAWNING ON EUROPE?

Implications of the Georgian "wake-up call" for the Future Security of Europe

Chaired by ***Peter Sutherland***

Pierre Morel, EU Special Representative for the Crisis in Georgia, Brussels; Former French Ambassador to the Russian Federation
Anders Åslund, Senior Fellow at the Peterson Institute for International Economics; Adjunct Professor at Georgetown University, Washington, DC
Wolfgang Ischinger, Chairman of the Annual Munich Conference on Security Policy; Global Head of Governmental Affairs, Allianz SE; Former German Ambassador to the United Kingdom

- *End of the Conference –*

LIST OF PARTICIPANTS

(*) Executive Committee Member;
(**) Triennium Participant from other Areas
(***) Former Member in Public Service
(s) With Spouse

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