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FOREIGN POLICY AND THE GLOBAL ECONOMIC CRISIS

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FOREIGN POLICY AND THE GLOBAL ECONOMIC CRISIS

WEDNESDAY, MARCH 25, 2009

U.S. SENATE,
COMMITTEE ON FOREIGN RELATIONS,
Washington, DC.

The committee met, pursuant to notice, at 2:35 p.m., in room SD–419, Dirksen Senate Office Building, Hon. John F. Kerry (chairman of the committee) presiding.

Present: Senators Kerry, Kaufman, Lugar, Corker, Risch, and Barrasso.

OPENING STATEMENT OF HON. JOHN F. KERRY, U.S. SENATOR FROM MASSACHUSETTS

The CHAIRMAN. The hearing will come to order. Thank you all for joining us this afternoon.

Just when we think things may settle down for a moment, the markets have a way of deciding otherwise and sending a different message. I noticed today that the British bond sale failed, for the first time since 2002. And so, even today the implications of the current economic downturn are being felt globally, which is what we're here to talk about today.

The United States is not alone in confronting an economic crisis at this time. And what started here has now gone global and continues to reverberate beyond our financial systems into the daily economic lives of people everywhere.

The reality is, we don't quite know, yet, where the bottom is, or where the end is. And today's hearing grows out of a roundtable discussion which the committee held on this last month, where we began to scratch the surface of the global implications of the financial challenges that we face. And we're glad to do this before the full committee today.

Dennis Blair, the Director of National Intelligence, recently told Congress, "The primary near-term security concern of the United States is the global economic crisis and its geopolitical implications." That's an amazing statement, given the ongoing risks that we face from terrorism, two wars, rogue nuclear programs in Iran and elsewhere.

Blair warned that, "Time is probably our greatest threat. The longer it takes for the recovery to begin, the greater the likelihood of serious damage to U.S. strategic interests."

He also warned of regime-threatening instability. And today's economic crisis has already brought down governments in Iceland, in Latvia, and helped spark riots in Europe. Just this week, the

Prime Minister of Hungary offered his resignation over the economic situation there. So, the crisis is likely to be a driving force, a geopolitical force, for some time to come, and the political ramifications could well become even more serious.

If there is one lesson that we should take away from the experience of a number of these countries, it is to not underestimate the severity of these economic challenges, or the urgency of tackling them head on rather than deferring tough decisions.

Last week, several of us had the opportunity to speak with Dominique Strauss-Khan, the managing director of the International Monetary Fund, and Bob Zoellick, president of the World Bank. We spoke about the snowballing financial crisis brewing in Central and Eastern Europe. They made it clear that if we don't act quickly, we risk replacing an era of promise and progress with one of soaring unemployment, instability, and a rollback of the influence and ideals that we have spent decades building. We also spoke about the need to strengthen our international financial defenses, particularly the IMF. And I'm pleased to join with Senator Lugar in supporting a dramatic increase in the IMF's capacity to respond to this crisis, just as Treasury Secretary Geithner has proposed.

The IMF, along with the World Bank, is the best channel that we have to bolster emerging and developing markets as the economies and the banking systems and the political systems are all strained around them.

The upcoming G–20 meeting in London is an important opportunity to enlist global support for decisive action on this issue. Strengthening the IMF, however, is only one component of a much larger challenge. We have to fix our banking systems, not just in America, but in every major financial center.

To be sure, our economy and the global economy have reached this moment of crisis, but, as bad as the news has been, it is clear that, if we come up with the right solutions, if we move together, if we move with a certainty and confidence in the choices that we make, then there will be great opportunities, going forward.

There's a great advantage to being the first to move in global finance. Washington has waited too long, already, while financial institutions remain frozen. Lending will not happen until banks have removed their toxic assets, and we hope that the Treasury plan, announced this week, will help us do just that.

As we put our own banking system in order, there will also be new challenges waiting for us abroad. We're going to have to confront the potential for increased political instability, large-scale failures of other countries' financial systems, escalating financial protectionism, economic nationalism or trade wars that could help to deepen the crisis, increased poverty and hunger in the developing world, and competitors exploiting financial instability in ways that diminish our influence.

And these problems are not confined to traditionally unstable corners of the globe. Europe is facing some deep financial challenges. Turkey, Indonesia, Pakistan, three of our most important partners in the Muslim world, all face acute balance-of-payments crises.

We also need to confront the fact that there's a great deal of anger out there among people who blame the model that we exported. Even as we restore confidence in our markets, we need to find a strategy to project leadership, share burdens, and spread stability as the problems reverberate on a global basis. And as we balance the domestic and global demands of this crisis, we need to be warned that, in cutting corners for short-term savings, we risk creating far greater costs down the road.

We're pleased with the panel that we have here today. The witnesses are a superb collection of innovative thinkers, all of whom think about, work in and around this sector on a daily and lifetime basis, and they will help us paint a fuller picture of the new foreign policy dynamics that these challenges create.

Martin Wolf is the associate editor and chief economics commentator at Financial Times. George Soros is the chairman, Soros Fund Management and Open Society. And Lawrence Lindsey is president and CEO of Lindsey Group and former director of the National Economic Council.

Senator Lugar.

OPENING STATEMENT OF HON. RICHARD G. LUGAR, U.S. SENATOR FROM INDIANA

Senator LUGAR. Well, thank you, Mr. Chairman. And I join you in welcoming a very distinguished panel, who will offer insights into the global financial crisis and recommendations for United States policy.

As you pointed out, at this stage no one knows for certain how long or how deep this economic downturn will be. With the administration's announcement of a plan to manage the so-called "bad assets" on the balance sheets of banks and corporations, we are at a critical moment in the resolution of our banking crisis. The fundamental strengthening of our banking system is a necessary precondition to the return to solid economic growth.

I am hopeful that, as this plan is implemented, the U.S. Government will be judicious about sinking taxpayer money into banks and corporations that are insolvent. As many experts have suggested, we need a careful triage of financial entities to determine which ones can stand on their own, which could become healthy with a reasonable infusion of additional capital, and which are insolvent beyond repair. Banks that are insolvent should be either liquidated or, in some cases, merged with other banks. Depositors should be protected, but shareholders may have to take their losses. U.S. taxpayer funds should only be used for recapitalization of troubled banks in limited cases, and the terms for government assistance should be uniform and transparent. The goals must be to restore discipline to the banking sector, reestablish investor confidence in healthy banks, and ensure that banks have the capacity to contribute to economic growth. Actions to address our own economy are vital, but, given the linkages between our financial sector and that of other countries, we cannot achieve economic recovery in isolation from the rest of the world.

The United States must provide leadership in restoring the health of the international financial system. In particular, the lending capacity of the IMF must be increased. The Obama administration has proposed increasing this capacity by $500 billion, of which the United States commitment would be $100 billion. I will be very interested to learn from the witnesses views of this proposal and whether they believe it's appropriately sized for the problem.

As we work with other nations, our government must pay attention to how the global economy, and our role in it, can be rebalanced. Some level of deficit spending is appropriate at this stage of the crisis, but the United States budget deficits that are projected cannot be sustained without extreme risk to both Americans and the international community. We cannot depend indefinitely on China investing heavily in United States Government debt. Some thought must be given to how we work with China and other nations to establish more sensible global balance that depends less on demand by American consumers.

We also must be cognizant of the incredible pressures this global financial crisis will place on stability and peace. We have to expect additional political, economic, or even national security shocks. We know, from history, that societies under severe economic stress often do not make good political choices. In the face of job losses, wealth evaporation, homelessness, hunger, and other outcomes, the fabric of many nations will be tested. The crisis is likely to stimulate nationalism that could lead to demagogic policies or governments. And under such conditions, some nations might experience a retreat from democracy. This, in turn, increases the possibility of violent conflict within and between nations. Consequently, maintaining international cooperation in addressing the economic crisis affects more than our own prosperity.

The upcoming G–20 meeting must be a success, not just in the proposals that are adopted, but also in the tone that is established for subsequent cooperation. The meeting should offer a clear message that the major economies will cooperate on financial restructuring and resist protectionism.

The United States must prepare itself for changes in its international role. We should ask ourselves, What will be the basis of United States national influence in the future? Why will nations continue to listen to us? What leverage over rivals can we preserve? And how can we ensure that we will still be able to rally friends behind vital United States objectives?

The global crisis has increased the skepticism in emerging economies about American-style capitalism and is likely to reduce enthusiasm, within the United States and beyond, for liberalized trade measures that would greatly benefit our country.

I do not believe that we are facing a precipitous collapse of United States influence, but we have to be far more deliberate in executing a rational plan that gets the most out of United States strengths and compensates for our new weaknesses.

I thank the chairman for calling this hearing and very much look forward to the testimony of our witnesses.

The CHAIRMAN. Thank you very much, Senator Lugar.

Mr. Wolf, would you lead off? Mr. Soros, next, and then Mr. Lindsey. And we're glad you were able to arrange to be here, Mr. Wolf; I know it's not a normal role within your sphere, but we admire your voice and perceptions and, I must say, your home base is an important document for all of us to read, these days, and we appreciate its quality.

STATEMENT OF MARTIN WOLF, ASSOCIATE EDITOR AND CHIEF ECONOMICS COMMENTATOR, FINANCIAL TIMES, LONDON, UNITED KINGDOM

Mr. WOLF. Thank you, Mr. Chairman and members of the committee. I'm very, very honored to be here to discuss——

The CHAIRMAN. Can you press your mike? The button, there?

Mr. WOLF. I apologize.

The CHAIRMAN. There you go.

Mr. WOLF. Thank you, Mr. Chairman and members of the committee. It is my great honor to be here to discuss the current economic crisis and its impact on American foreign policy.

May I add that, as a British citizen, and so, as a grateful foreigner, I am particularly honored and well aware of the extraordinary role of the United States in promoting freedom and democracy across the globe over the past seven decades.

Yet, it is clear that we are experiencing the most dangerous financial and economic crisis since the 1930s. It is also a crisis for foreign policy, as you have noted. A deep recession—and that is sure—will shake political stability across the globe, and, as important, it threatens the very longstanding U.S. goal of sustaining and creating an open and dynamic global economy. And perhaps most important, the United States, rightly or wrongly, is currently seen as the source of the problem, more than of the solution, across the globe.

The crisis is, therefore, a devastating blow to U.S. credibility and legitimacy as a world leader. If the U.S. cannot manage free-market capitalism, it is asked, who can? If free-market capitalism can bring such damage even here, why adopt it? If openness to the world economy brings such dangers, why risk it?

As shock turns to anger, not just in the U.S., but across the world, these questions are unquestionably being asked. If the U.S. wishes to obtain the right answers, it must not only address the crisis at home, as is, of course, widely understood, but also do what it can to rescue innocent victims abroad. And this is not just a matter of charity, it is a matter of the highest enlightened self-interest, as American policymakers have understood for many decades.

The decisions taken in the next year will, I believe, shape our world for decades. So, what has to be done? I'm going to make a few suggestions, in the limited time available to me, focusing, above all, on the G–20 and on the International Monetary Fund.

First of all, we must realize that this is, indeed, a crisis of the global economy that the U.S. played a dominant role in creating. If that achievement, with all the promise it offers, is to survive, the crisis will also, by definition, have to be solved globally.

Second, the meeting of the G–20 heads of government in London is a recognition of the global nature of this crisis. Management of the world economy can no longer be achieved by the leaders of advanced economies alone. While not all the countries there present are systematically important, all systemically important countries will be there. The world looks for achievement at this summit; it must not be disappointed.

Third, the immediate priorities for this summit are to agree on how to sustain demand, fix the global financial system, and avoid a collapse into global protectionism. The longer term aim must be to reconsider the regulation and structure of the global financial system and reform the system of international economic and financial governance. Some progress has already been made on these fronts, but it is not nearly enough.

Fourth, there is a very good chance that this crisis will lead to a much deeper decline in the world economy than is even now expected, and thereafter, a mere—no more than a slow and limping recovery. This risk of extreme outcomes has to be eliminated, if at all possible.

Fifth, if emerging economies are to trust themselves or the world economy in the future, it is essential to offer generous assistance now. At the moment, as I have remarked, they blame the West for what has happened to them. It has been helpful that the Federal Reserve and other central banks have advanced loans to a few selected central banks, but much more than that is needed.

But, sixth, the current lending capacity of the IMF is only about $250 billion, which, as I think everybody knows, is grossly inadequate. The U.S. administration has proposed that this be raised to $750 billion. And that is the very least that is now needed. It is important to remember that global foreign exchange reserves overwhelmingly held by emerging economies rose from about $1.5 trillion to $7 trillion between January 1999—that is, shortly after the Asian financial crisis—and the peak they reached last year. And this is surely, at least in part, an indication of the extent of the demand for reserves around the world. It will be far more efficient if reserves were pooled than if every country tried to insure itself in this extremely expensive way. And that is what the IMF exists to do, and it should be used for this purpose.

Seventh, in addition to increasing its resources, the government of the IMF must be changed. Asian countries, in particular, still remember with bitterness the humiliation they received a decade ago at the hands of the IMF and, in their view, the U.S. Treasury. They will want a bigger say in the running of the fund if they are to trust it. An important step is a huge reduction in Europe's voting weights, now about a third of the total, and also important is an end to the traditional practice of always having an American head of the World Bank and a European head of the IMF.

Eighth, serious thought must be given to making an annual allocation of SDRs—that is specialty drawing rights—the IMF's own reserve asset. This could satisfy the world demands for reserves at no cost in resources, and I have noted the recent remarks by the governor of the People's Bank of China on exactly this point.

Traditionally, the U.S. has regarded the SDR as a rival to the dollar as a reserve asset and treasured the ability to finance its external deficits through simple expansion of its own money supply. But, the economic developments of the past decade, and particularly the final consequences of the global imbalances, should have shaken this complacency. The ability to run very large current account deficits has turned out, in my view, to be a calamity, since it offers at least a part of the explanation for the current financial crisis in the United States and the world.

Furthermore, the United States needs to be able to export its way out of its current recession—otherwise, it is likely to be stuck with these terrible fiscal deficits for the indefinite future—to offset the higher domestic private saving and structural current account deficit. Increasing the purchasing power of emerging countries through an allocation of even as much as a trillion SDRs, a little less than 2 percent of the world GDP, would go a long way toward solving this problem. I fear that if this does not happen, a return to generalized protection becomes likely as a way for deficit countries, even the United States, to strengthen demand for domestic output and employment.

What I have outlined above is only a small part of the agenda, but it is a vital part. The more imaginative and energetic the U.S. now is, the better able it will be to restore its reputation and influence across the globe. This is unquestionably a time of decision. The United States has a choice of either doing everything in its power to restore and strengthen the global economic system it itself worked so hard to create or fails to do so. Choices must be made between outward-looking and inward-looking solutions. As we all know, we tried the former in the 1930s, and this time, as we know, we must try the latter.

Thank you.

[The prepared statement of Mr. Wolf follows:]

PREPARED STATEMENT OF MARTIN WOLF, ASSOCIATE EDITOR AND CHIEF ECONOMICS COMMENTATOR, FINANCIAL TIMES, LONDON, UNITED KINGDOM

We are experiencing the most dangerous financial and economic crisis since the 1930s. But it is also a crisis for foreign policy: A deep recession will shake political stability across the globe; and it threaten the longstanding U.S. goal of an open and dynamic global economy. Perhaps most important, the U.S. is currently seen as the source of the problem rather than of the solution.

This crisis is, therefore, a devastating blow to U.S. credibility and legitimacy across the world. If the U.S. cannot manage free-market capitalism, who can? If free-market capitalism can bring such damage, why adopt it? If openness to the world economy brings such dangers, why risk it? As the shock turns to anger, not just in the U.S., but across the world, these questions are being asked. If the U.S. wishes to obtain the right answers, it must address the crisis at home, and do what it can to rescue innocent victims abroad. This is not a matter of charity. It is a matter of enlightened self-interest.

The global economic crisis has become extremely severe: The financial system is on life support, with trillions of dollars of support by governments; three of the world's four most important central banks—the Federal Reserve, the Bank of Japan, and the Bank of England—have interest rates at close to zero, with the European Central Bank likely to follow; governments are also loosening fiscal policy aggressively, with the deficits of advanced countries that are members of the G–20 forecast at 6.7 percent of GDP this year and 7.6 percent in 2010.

This massive policy support comes in response to increasingly dire economic conditions: The International Monetary Fund forecasts that global output will shrink by between 0.5 percent and 1 percent this year, a downgrade of 1 to 1.5 percentage points in 2 months; it also forecasts that the economies of advanced countries will shrink by between 3 and 3.5 percent, the worst performance since the 1930s.

None of this is surprising. Not only did the global financial system seize up at the end of last year, but the Asian Development Bank has reported that the total loss of worldwide market wealth is $50 trillion, close to a year's world output. The loss of stock market wealth alone is $25 trillion. Demand for manufactures, world manufactured output and world trade in manufactures fell off a cliff at the end of last year: Germany's industrial output was down 19.2 percent year-on-year in January, South Korea's down 25.6 percent and Japan's down 30.8 percent.

Inevitably, and tragically, the most adversely affected are countries that have opened themselves up to global capital flows, particularly emerging countries in central and eastern Europe. These were the only significant group of emerging economies to be net importers of capital in the 2000s, with results often seen before over the past three decades when capital takes fright. These countries face the risk of a meltdown, precisely because they trusted both Europe and the capital markets. The consensus of forecasts for growth of Eastern Europe this year has fallen from

6 percent to minus 0.5 percent since last June. It will surely fall further. But all emerging economies are adversely affected by the loss of external demand, the shrinkage in global capital flows and the associated jumps in the price of borrowing.

In a recent article for the Financial Times, which launched our series on the "Future of Capitalism," I argued that it is impossible to know where we are going. In the chaotic 1970s, few guessed that the next epoch would see the taming of inflation, the unleashing of capitalism and the death of communism. What will happen now depends on choices unmade and shocks unknown.

Yet the combination of a financial collapse with a huge recession will surely change the world. The Great Depression transformed capitalism and the role of government for half a century. It led to the collapse of liberal trade, fortified the credibility of socialism and communism and shifted many policymakers toward import substitution as a development strategy. It led to xenophobia and authoritarianism. The search for security will strengthen political control over markets. A shift toward politics also entails a shift toward the national, away from the global. This is already evident in finance. But protectionist intervention is likely to extend well beyond the cases seen so far: these are still early days.

In emerging countries, the number of people in extreme poverty will rise, the size of the new middle class will fall and governments of some countries will default. Confidence in local and global elites, in the market and even in the possibility of material progress will weaken, with potentially devastating social and political consequences.

The ability of the West in general and the U.S. in particular to influence the course of events will also be damaged. The collapse of the Western financial system, while China's apparently flourishes, marks a humiliating end to the "unipolar moment." As Western policymakers struggle, their credibility lies broken.

These changes will endanger the ability of the world not just to manage the global economy but also to cope with strategic challenges: Fragile states, terrorism, climate change, and the rise of new great powers. At the extreme, the integration of the global economy on which almost everybody now depends might be reversed.

The decisions taken in the next year will shape the world for decades. So what has to be done? I suggest the following, focusing on the role of the International Monetary Fund.

First, we must realise that this is a crisis of the global economy that the U.S. played a dominant role in creating. If that achievement, with all the promise it offers, is to survive, the crisis must be solved globally.

Second, the meeting of the G–20 heads of government in London is a recognition of this fact. Management of the world economy cannot be achieved by advanced economies alone. While not all the countries there present are systemically important, all systemically important countries will be there. The world looks for achievement at this summit. It must not be disappointed.

Third, the immediate priorities are to sustain demand, fix the global financial system and avoid a collapse into global protection. The longer term aim must be to reconsider the regulation and structure of the financial system and reform the system of international economic and financial governance. Some progress has been made on these fronts. But it is not nearly enough.

Fourth, there is a very good chance that this crisis will lead to a much deeper decline in the world economy than is now expected and a slow and limping recovery. This risk must be eliminated, if at all possible.

Fifth, if the emerging economies are to trust themselves to the world economy, it is essential to offer generous help now. At the moment, they blame the west for what has happened. It has been helpful for the Fed and other central banks to advance loans to a few selected central banks. But much more is needed.

Sixth, the current lending capacity of the IMF is about $250bn, which is grossly inadequate. The U.S. Treasury has proposed that this be raised to $750bn. That is the very least now needed. Remember that global foreign exchange reserves, predominantly held by emerging economies, rose from $1.5 trillion to $7 trillion between January 1999, after the Asian financial crisis, and their peak last year. This is an indication of the demand for reserves. It would be far more efficient, however, if reserves were pooled than if every country tried to insure itself, in this expensive way. That is what the IMF exists to do. It should be used for this purpose.

Seventh, in addition to increasing its resources, the governance of the IMF must be changed. Asian countries, in particular, still remember the humiliation treatment they received a decade ago at the hands of the IMF and the U.S. Treasury. They will want a much bigger say in the running of the Fund. An important step is a huge reduction in Europe's voting weights, which are now about a third of the total. Also important is an end to the traditional practice of having an American head the World Bank and a European head the IMF.

Eighth, serious thought must be given to making an annual allocation of SDRs (special drawing rights)—the IMF's own reserve asset. This would satisfy the world's demand for reserves at no cost in resources. Traditionally, the U.S. has regarded the SDR as a rival to the dollar as a reserve asset and treasured the ability to finance its external deficits through simple expansion of the supply of dollars. But the economic developments of the past decade should have shaken U.S. complacency. The ability to run very large current account deficits, has turned out to be a calamity, since, in my view, it offers a large part of the explanation for the current financial crisis in the U.S. and so the world. Furthermore, the U.S. needs to be able to export its way out of its current recession. Otherwise, it is likely to be stuck with a huge fiscal deficit for the indefinite future, to offset the higher domestic private saving and structural current account deficit. Increasing the purchasing power of emerging countries, through an annual allocation of about 1 trillion SDRs (a little less than 2 percent of world GDP) would go a long way toward solving this problem. I fear that if this does not happen, a return to generalised protection would become likely, as a way for deficit countries, such as the U.S., to strengthen demand for domestic output and employment.

What I have outlined above is only a small part of the agenda. But it is a vital part. The more imaginative and energetic the U.S. now is, the better able it will be to restore its reputation and influence across the globe. This is a time of decision. The U.S. can either do everything in its power to restore and strengthen the global economic system it worked so hard to create. Choices must be made between outward-looking and inward-looking solutions. We tried the former in the 1930s. This time we should try the latter.

The CHAIRMAN. Very good. Thank you, sir. Very helpful, and we appreciate it.

Mr. Soros, welcome. Glad to have you here. As a personal friend, it's good to see you. And also, we have enormous respect for your thinking on these areas, so have at it.

STATEMENT OF GEORGE SOROS, CHAIRMAN, SOROS FUND MANAGEMENT AND OPEN SOCIETY, NEW YORK, NY

Mr. SOROS. Thank you, Mr. Chairman.

The CHAIRMAN. Can you push your mike? There's a button there. Thanks. Why don't you just leave them all on, and then you guys can intervene when you want.

Mr. SOROS. Thank you for the opportunity to testify today on the global financial crisis.

I shall try to summarize briefly the main points of the argument I present at greater length in my written testimony. As you will see, my points are very similar to those of Martin Wolf.

First, the current financial crisis is more severe and more widespread than any we've experienced since the 1930s. The international financial system has actually broken down and had to be put on artificial life support.

Second, the countries on the periphery of the international financial system are even more severely affected than those at the center. The rich countries could effectively guarantee their financial institutions against default, but the less-developed countries, ranging from Eastern Europe to Africa, could not extend similarly convincing guarantees. As a result, capital is fleeing the periphery and it is difficult to roll over maturing loans—$1.4 trillion of bank loans are coming due in 2009 alone.

Third, to stop the capital flight, the international financial institutions, particularly the IMF, must be reinforced and reinvigorated. The primary responsibility lies with the United States, both as the originator of the crisis and as the dominant financial power. If we fail to live up to our responsibility, we shall cease to be the dominant financial power. If the multilateral system falls apart, every country will pursue its own interests unilaterally and China is liable to come out ahead. As things stand at present, China and the United States have a common interest in assisting the periphery countries. We must seize the opportunity, even as we address our own recession.

Fourth, the upcoming G–20 meeting on April 2 is a make-or-break event. Unless it comes up with practical measures to support the countries at the periphery, markets are going to suffer another sinking spell, just as they did on February 10, when the authorities failed to produce practical measures to recapitalize the U.S. banking system.

In the preparations for the G–20 meeting, profound attitudinal differences have surfaced between the United States and Europe, particularly Germany. To put it in an oversimplified and exaggerated form, the United States wants to reinflate, Germany and Europe want to regulate. Actually, we need to do both, but the re-inflation is urgent, and regulatory reforms will take time. Therefore, it should be possible to overcome the differences and find common ground in the need to protect the periphery countries from a calamity that is not of their own making.

As things stand now, the G–20 meeting will, in fact, produce some concrete results. The resources of the IMF are likely to be doubled, mainly by using the mechanism of new arrangements to borrow, which will require congressional approval. The capital increase will be sufficient to enable the IMF to come to the aid of specific countries in difficulties, but it will not provide a systemic solution for the developing world.

Fifth—and this is the most important point I want to make—a systemic solution is readily available in the form of special drawing rights, or SDRs. The mechanism exists and has already been used on a small scale. SDRs are highly complicated and difficult to understand, but they boil down to the international creation of money.

The United States, Europe, and Japan are in a position to create their own money, and they are actively engaged in doing so in order to offset the collapse of credit. Less-developed countries can't create money that is internationally accepted. They are the ones who need the special drawing rights. Rich countries should, therefore, lend their allocations to the countries in need. They could do so without incurring any costs or deficits. The recipient countries would have to pay the IMF interest at a very low rate, the composite average Treasury bill rate of all convertible currencies. They would have free use of their own allocations, but the standing of the borrowed allocations would be appropriately supervised. This should ensure that the moneys are well spent. It's difficult to think of a scheme where the cost-benefit ratio is so favorable.

Therefore, in addition to the one-time increase in the IMF's resources through the use of the new arrangements to borrow, there ought to be substantial annual SDR issues, in the range of $250 billion annually, as long as the global recession lasts. So make this scheme countercyclical, the SDR issues could be made callable when the global economy overheats.

It's too late to agree on issuing SDRs at the G–20 meeting on April 2, but if it were raised by President Obama and endorsed by others, it would be sufficient to give heart to the markets and turn the meeting into a resounding success.

I very much hope that you will embrace the idea and encourage President Obama to propose it. It would make a tremendous difference to the world, and it would help the United States to resume its leadership position in the world.

While this is the main message I want to deliver, I also want to endorse President Obama's request for increased international assistance. The items included in the budget are well thought out. I would particularly comment, the increased support of the Global Fund to Fight AIDS, Tuberculosis, and Malaria, where our contribution mobilizes twice the amount from other donors, it would be a shame to cut it.

And I'll be happy to answer your questions.

[The prepared statement of Mr. Soros follows:]

PREPARED STATEMENT OF GEORGE SOROS, CHAIRMAN, SOROS FUND MANAGEMENT AND OPEN SOCIETY, NEW YORK, NY

The current financial crisis is different from all the others we have experienced since the end of World War II. On previous occasions, whenever the financial system came to the brink of a breakdown, the authorities got their act together and prevented it from going over the brink. This time the system actually broke down when Lehman Brothers was allowed to fail on September 15, 2008. That event transformed what had been a mainly financial phenomenon into a calamity that affected the entire economy.

Within days the financial system suffered what amounts to cardiac arrest and had to be put on artificial life support. That came as a shock to the business community and the general public. Everybody retrenched. International trade was particularly hard hit and is now down nearly $4 trillion from a year ago. The decline in employment has not yet hit the bottom, and the International Monetary Fund (IMF) estimates that globally more than 50 million people could loose their jobs by yearend.

The countries on the periphery of the international financial system are even more severely affected than those at the center. The rich countries could effectively guarantee their financial institutions against default but the less developed countries, ranging from Eastern Europe to Africa, could not extend similarly convincing guarantees. As a result, capital is fleeing the periphery and it is difficult to roll over maturing loans. Exports suffer from the lack of trade finance. Deutsche Bank estimates that $1,440 billion of bank loans are coming due in 2009 alone.

The capital flight is abetted by national regulators intent on protecting their own financial systems by tacitly encouraging banks to repatriate funds. When history is written, it will be recorded that—in contrast to the Great Depression—protectionism first manifested itself in finance rather than trade. To stem the tide, the International Financial Institutions (IFIs) must be reinforced and reinvigorated. Unless effective measures are taken to protect the periphery countries against a storm that originated at the center, the international financial and trade system is liable to fall apart.

The primary responsibility lies with the United States, both because it is the originator of the crisis and because it enjoys veto rights in the IMF. It is not just a moral issue but a matter of self-interest. We have derived great benefits from being at the center of the global financial system and we ought to do whatever we can to preserve that position. If the multilateral system falls apart, every country will pursue its interests unilaterally. Then China will be much better situated than we are. While we are, regrettably, still lagging behind the curve in dealing with the crisis, China is ahead of the curve. Its banking system is in relatively good shape and it can activate its large stimulus program faster than we can ours. The leadership realizes that it must ensure economic growth in order to avoid social unrest and it is both willing and able to apply additional stimulus if the current program is not sufficient. To support its export industries it will extend credit to periphery countries just as it did to the United States. As things stand at present, China and the United States have a common interest in protecting the periphery countries from a storm that originated at the center. We must seize this opportunity even as we address our own recession.

While the primary responsibility is ours, we cannot act without the support of the European countries which carry a disproportionate weight on the governing board of the IMF. Unfortunately the IMF is ill-suited to the novel task with which it is now confronted. It is used to dealing with the failures of government policy, especially at the periphery; now it is confronted with the failure of the private sector at the center. To make matters worse, the IMF is deeply unpopular with public opinion both at the periphery and at the center—and that includes Congress. Moreover, there is a profound disagreement between the United States and Europe, particularly Germany, about the nature of the problem and the right remedies to apply.

The United States has recognized that the collapse of credit in the private sector can be reversed only by using the credit of the State to the full. Germany, traumatized by the memory of hyperinflation in the 1920s that led to the rise of Hitler in the 1930s, is reluctant to sow the seeds of future inflation by incurring too much debt. Both positions are firmly held and can be supported by valid arguments. In the case of Germany's opposition to the use of the German state's credit for the rest of Europe or the rest of the world, they are valid only from a narrow German point of view. Be that as it may, the controversy has dominated the preparations for the forthcoming G–20 meetings on April 2.

That meeting is a make or break event. Unless it comes up with practical measures to support the countries at the periphery of the global financial system, markets are going to suffer another sinking spell just as they did on February 10, 2009, when the authorities failed to produce practical measures to recapitalize the United States banking system. To put it in an oversimplified and exaggerated form, the United States wants to reinflate, Germany and Europe want to regulate. It should be possible, however, to find common ground in the need to protect the periphery countries from a calamity that is not of their own making. Actually, we need to both reinflate and regulate but reinflation is urgent and regulatory reforms will take time to implement. The urgent task has to be carried out mainly by the IMF, imperfect and beleaguered as it is, because it is the only institution available. The regulatory reforms will involve reforming the IMF and establishing other institutions.

Periphery countries need to protect their financial systems including trade finance, and to enable them to engage in countercyclical fiscal policies. The former requires large contingency funds available at short notice for relatively short periods of time. The latter requires long-term financing.

When the adverse side effects of the Lehman bankruptcy on the periphery countries became evident, the IMF introduced a new short-term liquidity (STL) facility that allows countries that are otherwise in sound financial condition to borrow five times their quota for 3 months without any conditionality. But the size of the STL is too small to be of much use, especially while a potential stigma associated with the use of IMF funds lingers. That is now being remedied, but even if it worked, any help for the top-tier countries would merely aggravate the situation of the lower-tier countries. International assistance to enable periphery countries to engage in countercyclical policies has not even been considered.

The fact is that the IMF simply does not have enough money to offer meaningful relief. It has about $200 billion in uncommitted funds at its disposal, and the potential needs are much greater. As things stand now, the G–20 meeting can be expected to produce some concrete results: The resources of the IMF are likely to be effectively doubled, mainly by using the mechanism of the New Arrangements to Borrow (NAB) which can be activated without resolving the vexing question of reapportioning voting rights in the IFIs. NAB will require congressional approval.

The capital increase will be sufficient to enable the IMF to come to the aid of specific countries in difficulties, but it will not provide a systemic solution for the developing world. Periphery countries are reluctant to apply to the IMF for support as seen from the fact that the recently introduced short-term liquidity facility that allows qualified countries to borrow without any conditionality has had no takers. A more radical solution is needed. Such a solution is readily available in the form of Special Drawings Rights (SDRs). The mechanism exists and has already been used on a small scale. There is a pending issue of SDR 21.4 billion ($32.2 billion), which only requires approval by the United States to become effective.

SDRs are highly complicated and difficult to understand but they boil down to the international creation of money. Countries that are in a position to create their own money do not need them but the periphery countries do. The rich countries should therefore lend their allocations to the countries in need. This would not create a budget deficit for them. The recipient countries would have to pay the IMF interest at a very low rate: The composite average Treasury bill rate of all convertible currencies. They would have free use of their own allocations, but the IFIs would supervise how the borrowed allocations are used. (The World Bank, which has devoted a lot of resources to developing poverty alleviation programs, would be better suited for this task than the IMF.) This should ensure that the borrowed funds are well spent. It is difficult to think of a scheme where the cost/benefit ratio is so favorable.

In addition to a one-time increase in the IMF's resources there ought to be substantial annual SDR issues, say $250 billion, as long as the global recession lasts. To make the scheme countercyclical, the SDR issues could be callable in tranches when the global economy overheats. It is too late to agree on issuing SDRs at the April 2 G–20 meeting, but if it were raised by President Obama and endorsed by others, it would be sufficient to give heart to the markets and turn the April 2 meeting into a resounding success.

The SDR proposal, arcane as it is, makes eminent sense. The United States and Europe are actively engaged in creating money to replace credit. SDRs would provide money to less-developed countries which cannot create their own—at no cost to those who make their allocations available.

One of the obstacles standing in the way is the well-known negative attitude of Congress toward anything connected with the IMF. The SDR issue does not require legislation. Nevertheless, it would be very helpful if Congress expressed a willingness to authorize the NAB, which does require congressional approval and supported the SDR issue in principle.

As we have seen, the IMF is far from perfect, but it is more needed than ever. It has a new mission in life: To assist the less-developed countries to protect their banking systems and enable them to engage in countercyclical fiscal policies. How well it fulfills that mission will have a major impact both on the survival of the international financial and trading system and on our leadership position within that system.

While my testimony focuses mainly on the role of the IMF, we also need to dramatically expand foreign assistance. President Obama pledged to double United States foreign assistance and the proposed budget moves us toward that target, if not as quickly as I would like. I urge you to do no less than he requested and to look to supplemental appropriations to meet more ambitious goals. We need to help countries deal with the immediate impact of the financial crisis and help ensure that we continue to make progress on critical areas such as HIV/AIDS. Now is the time to do more, not less.

One particularly innovative funding instrument is the Global Fund to Fight AIDS, Tuberculosis and Malaria. It has demonstrated remarkable results in the last 7 years, working to fill a gap not met by our bilateral programs. But for the first time, it faces a funding shortfall—there are more qualified proposals than there is financing available. Historically, the United States has provided one-third of the financial needs, and we should recommit to that goal. A particular benefit here is that the United States contribution mobilizes new money from other donors, increasing our impact.

The CHAIRMAN. Thank you very much, Mr. Soros.

Mr. Lindsey.

STATEMENT OF LAWRENCE LINDSEY, FORMER DIRECTOR OF THE NATIONAL ECONOMIC COUNCIL, WASHINGTON, DC

Mr. LINDSEY. Thank you, Mr. Chairman, Senator Lugar, members of the committee. I am grateful for this opportunity to be here today.

I associate myself with the perceptions that were stated in your opening statements. I also associate myself with the bulk of the comments of my colleagues on the table. My comments are mostly a difference of nuance.

I think that America is a cause as well as a country and we represent the concept of economic and political freedom, and actually that our security as a nation is inextricably linked with the survival and success of liberty around the world. That's why I think policymakers must be particularly careful not to take actions that undermine those causes when they deal with current crisis.

In my testimony, which I ask to be included in the record, I point out that there are a number of ways we can do a disservice to our cause, and thereby to our country. And, listening to my colleagues' comments, I would like to briefly comment on a third.

First, although it is very common to think that this crisis was created by America, I think that the data do not actually support this conclusion. Obviously, we are the largest economy on the planet; we, therefore, have a disproportionate share of any financial crisis that may exist. On the other hand, I included in my testimony two charts, one on the global housing bubble, which shows that, in fact, the bubble in the rest of the world was actually greater than it was in the United States. And second, in the amount of leverage in the real estate market, which shows, essentially, that there is no difference around the world between the amount of leverage we extended and the amount of leverage everyone did.

The causes of this crisis were global in nature, they were miscalculations by the global economics profession, miscalculation in the consensus view of global central bankers, and in the private sector. I don't think it was uniquely United States the cause of this crisis.

Second, I think that there are many calls today to reverse some of the policies that create greater economic and political liberty around the world. And because it was the expansion of liberty that led both to an unprecedented advance in global prosperity and the improvement in security in America over the last 25 years, I think it would be foolish for us to reverse it.

In fact, the biggest threat to our security today derives from that part of the world in which political and economic liberty have made the smallest advances in the last 25 years, particularly the Middle East. I think we, therefore, do ourselves a disservice, both economically and to our long-term security as a nation, when we undermine liberty, either by our own actions or by failing to set an example in these areas.

The third point that I would like to make today, that is not in my written testimony but was raised by my colleagues, is the strain that the United States is placing on total global resources today by our large and historically unprecedented proposed budget deficit. We are proposing a budget deficit, a public-sector borrowing requirement, in the President's budget alone, of 16 percent of our GDP. On top of that, not in that budget were the borrowings that will be undertaken by various institutions, such as the TALF, the new PPIP, and the PPIF, which are off-budget borrowings.

I am not a critic of budget deficits. I would even—I've been called Keynesian, and I probably am, but I'm a Keynesian who believes in using a sharp pencil. And when you start with 18 percent of GDP, and you start thinking about how one would finance it, obviously you can only get there through placing enormous strains on global resources or directly resorting to the printing press. Last Wednesday, the Fed announced that it would—seeing the same problem, would actually start using the printing press.

I think we need to take the budget deficit, therefore, that we are contemplating, particularly in the long term, into account in its effect on global economic recovery and our claim on global resources.

These are the general principles I have in mind. I look forward to answering any specific questions the committee might have. And again, I thank you for the opportunity to be here today.

[The prepared statement of Mr. Lindsey follows:]

PREPARED STATEMENT OF LAWRENCE B. LINDSEY, FORMER DIRECTOR OF THE NATIONAL ECONOMIC COUNCIL, WASHINGTON, DC

Thank you, Mr. Chairman and members of the committee. It is my honor to be here to discuss the current economic crisis and its impact on American foreign policy.

Let me begin by stating the basic principle that underlies my thinking. I believe that America is a Cause as well as a Country. From our inception as a new nation, we have been a champion of the cause of both economic and political liberty. Many generations of American patriots have given their lives to not only defend our own freedom, but to end tyranny abroad. They did so not only because they believed that it was the right thing to do, but also because our own freedom and our own security are inextricably linked to the success of liberty around the globe.

I therefore believe that the biggest threat from the current crisis is the threat that it poses to liberty as governments react to events. Economic distress makes it easier for demagogues to come to power who are not friendly to either America the Country or to the Cause we represent. Even in the world's established liberal democracies there is a risk that elected leaders adopt narrow self-interested parties that might seem to be a short-term remedy to a domestic political problem, but actually exacerbate a global downward spiral.

Therefore, if we truly want to bolster the cause of American security we must by our own actions work to continue the advance that liberty has made around the world over the past quarter century. There are a number of specific things that this Congress can do in this regard.

First, we must stop thinking and speaking of the current global crisis as one that originated in America. We demean ourselves by doing so and only encourage those who wish us ill. America played its role and made its share of mistakes, and the fact that we are the largest economy on the planet means that our mistakes were quantitatively larger than that of any other country. But an examination of the facts suggest that we did so not because we are Americans, but because we are humans, and humans just about everywhere on the planet were doing the same thing.

Consider the first two charts attached to this testimony. The first chart shows house price appreciation around the globe during the recent bubble from 1997 to 2008. We all know that one of the root causes of the current crisis was very rapid and unsustainable appreciation in real estate prices. But America does not stand out as at the top of this list; house price appreciation here was less than in most other places. The only two exceptions to rising house prices over this period were Japan, which was suffering from the ongoing collapse of its earlier bubble, and Hongkong, where it made a transition from governance as a British territory to its current status as a Special Administrative Region of China.

The second chart shows that the excess leverage which contributed to our house price appreciation was also not an American phenomenon, but a human phenomenon. Our mortgage debt to GDP ratio was not exceptionally out of line with that of other countries.

It is, and always has been, comforting for politicians in other countries to blame their own problems on America. There is nothing we can do about this since their only alternative is to blame themselves. But we shouldn't encourage it. This was not an American created crisis—it was a globally created crisis.

Some of the blame lies with the economics profession which developed a wrong headed consensus view that inflation targeting was the right way to conduct monetary policy. Unfortunately, their definition of inflation was focused on goods and services prices and left no room for the incorporation of asset prices. The Federal Reserve was a part of this process and the bulk of the American economics profession also held to this view. But it was a global consensus within the economics profession, and not just the American economics profession.

Not everyone shared this view. We debated this issue on the Federal Open Market Committee while I was a Governor, most notably at our meeting on September 24, 1996. In his famous Irrational Exuberance speech later that year Chairman Greenspan specifically warned of the risks inherent in not incorporating asset prices into our calculations, saying on December 5th: "But how do we know when irrational exuberance has unduly escalated asset values which then become the subject of unexpected and prolonged contractions, as they have in Japan over the past decade? And how do we factor that assessment into monetary policy? We as central bankers need not be concerned if a collapsing financial asset bubble does not threaten to impair the real economy, its production, jobs, and price stability. Indeed, the sharp stock market break of 1987 had few negative consequences for the economy. But we should not underestimate or become complacent about the complexity of the interactions of asset markets and the economy."[1]

But it was not just a consensus within the economics profession that was supportive of "inflation targeting" while simultaneously ignoring asset prices. Politicians around the world and of all political persuasions were also quite supportive of a monetary policy that let their constituents' assets rise in value in an unlimited way as long as goods and services inflation stayed under control.

The political reaction to the Greenspan speech was extremely negative, coming from members of both political parties. As a guest interested in adhering to good manners, I will not quote any of the reactions of Members of the Congress to the Greenspan speech. Those interested in researching the issue can easily do a nexus search of the topic. And I would add that there were plenty of members from both parties in both the Congress and in the Clinton and Bush administrations that opposed any actions that might have interfered with the asset price advance of the past few years.

So, it is not an issue of a mistaken view of the economics profession any more than it is a mistaken view of Americans that led to the current crisis. It is a human phenomenon: Everyone loves the kind of party that occurred. In fact, the response among European decisionmakers was even more supportive of this asset-price inflating doctrine than here in America. When then-Chancellor of the Exchequer Gordon Brown established the rules that gave the Bank of England independence from Her Majesty's Treasury, he explicitly made inflation targeting the sole objective of monetary policy. Moreover, he explicitly made the British Retail Price Index, similar to our Consumer Price Index, the measure of inflation that the Bank of England was to use. Like our CPI, the British RPI excludes asset price changes from its calculation.

When the political leadership of Europe negotiated the treaty that established the European Central Bank they also created a single mandate of inflation targeting. Moreover, they chose an inflation index that also did not incorporate asset prices in the calculation. As a result, the European Central Bank has been far slower to react to the developing economic crisis than has the Federal Reserve. In addition, loans that supported asset prices that European banks made, particularly to Eastern Europe, were at least as egregious as those made in America.

But a second set of policy mistakes that led to this current crisis were decidedly non-American in origin. During the 1990s, many of the world's newly developing countries, most notably China, managed their currencies in a way designed to increase exports and build foreign exchange reserves. We used to call such policies mercantilism, but diplomacy got in the way of the modern usage of that term. During the 1990s China actually devalued its currency in the face of rising exports. America's efforts in the current decade to get China to adopt less Mercantilist policies were slow to bear fruit. The small improvements that occurred in 2007 and 2008 have begun to be reversed in recent months.

The reason that this contributed to the Bubble and its Crash is that the result of a currency managed to maximize exports is a buildup of reserves which must find a place to be invested. China purchased hundreds of billions of dollars of U.S. Treasury and Agency securities, driving down our interest rates and facilitating the development of the housing bubble. The world saw the perverse economic result of Chinese workers and peasants being underpaid by their own government in order to finance the building of McMansions in America.

But this result had its positive geopolitical side. After the fall of the Berlin Wall, a foreign policy consensus developed that the best way to incorporate China into a peaceful global community was to promote prosperity in that country. The argument was advanced that richer nations have more of a stake in both maintaining the peace and in preserving the existing world order. Chinese mercantilism, though eco-

[1] The transcript of that meeting reports that I said, "Everyone enjoys an economic party, but the long-term costs of a bubble to the economy and society are potentially great. As in the U.S. in the late 1920s and Japan in the late 1980s, the case for a central bank to ultimately burst that bubble becomes overwhelming. I think that it is far better that we do so while the bubble still resembles surface froth, and before the bubble carries the economy to stratospheric heights. Whenever we do it, it is going to be painful, however." A very interesting analysis of the FOMC's approach to this issue is provided in "Bubble Man" by Peter Hartcher of the Sydney Morning Herald.

nomically inefficient, was a relatively painless and diplomatically acceptable way of advancing that cause because it led to rapid industrialization and capital formation.

This observation about the relationship between the Bubble and Geopolitics leads to a very important second point we must bear in mind. As painful as the current crisis is, it follows at the end of a very long boom that brought tremendous gains to literally hundreds of millions of people on this planet. Perhaps half a billion people in Asia have joined the global middle class in Asia alone during the last 10 years. The same is true for perhaps 200 million people in the former Soviet Empire and a similar number in Latin America. Hundreds of millions of children who would never have received anything more than the most rudimentary education now have acquired the skills to provide both for themselves and for future generations. Health care and life expectancy have increased tremendously. On a very real human level the past 25 years have meant improvements for the human condition on an unprecedented scale.

Closer to home, real per capita disposable personal income in America grew 68 percent between 1980 when we began our experiment with open capital markets, free trade, and less regulation While America the Country has been partially responsible for this, the real credit goes to the Cause that America represents: Economic and political liberty for the individual. Our foreign policy must keep this in mind as a central abiding principle and we must continue to assert American leadership in these areas.

A more prosperous world has helped make America a more secure place. Indeed, the greatest increased threat to our security comes from one of the few parts of the world in which real per capita incomes have not increased since 1980: The Middle East. (There are a few exceptions to this in some of the smaller countries of the Arabian peninsula.) Our long-term global interests require us to continue to advance the causes which have led to global prosperity. If I could sum them up briefly these are the free movement of goods, capital, and ideas.

Today many of those causes are under assault. Some mistakenly interpret these objectives as the cause of our current crisis. Some merely oppose these ideas to advance their own power or their own special interests.

Since the end of World War II America has led the movement toward freer movement of goods across borders. This accelerated rapidly with the Kennedy Round of Trade negotiations in the 1960s, with the adoption of NAFTA under the leadership of Presidents Bush and Clinton, and the extension of that principle to a host of new free trade agreements.

Today free trade is under assault. Congress recently, and probably inadvertently, set off a trade war with our second biggest export market, Mexico with a provision in the just-passed stimulus bill regarding access to America by Mexican trucks. Europeans have objected strenuously to the Buy America provisions in the stimulus package. By themselves these are relatively small measures. The great worry is that they might become part of a trend toward protectionism. We learned the hard way during the 1930s when ill-advised legislation—the Smoot-Hawley tariff—ignited a global trade war. We must not do it again. America should continue its historic leadership in promoting global free trade.

There is also an attack on the free movement of capital and ideas. Our own Government has been guilty of this in both the case of the Dubai Ports case and in the matter of the purchase of Unocal by a Chinese oil company. Again, taken by themselves these are relatively minor matters. The risk is that they develop into a trend. But other countries are already beginning to do the same, placing limitations on foreign ownership of not only corporations, but also farm land. Isn't it simple common sense that two countries that invest in each other are much less likely to go to war with one another than two countries without such cross-border investment? Obviously domestic security issues and intellectual property protection are essential. But shouldn't those issues be addressed regardless who happens to own a particular company or sit on its board of directors?

The free movement of capital and ideas is also under assault by some who are now proposing increased restrictions on a variety of global financial intermediaries including private equity firms and hedge funds. European politicians in particular argue that financial intermediaries such as hedge funds are to blame. But no hedge funds have been bailed out in this crisis. The bailouts have gone to regulated financial institutions such as banks and insurance companies.

These regulated institutions often erred by taking risks that only hedge funds and private equity firms should take, but their mistakes led to bailouts because they lack the discipline that hedge funds have in having their limited partners, not depositors or contract holders, suffer whatever losses they might incur. Because they lacked that discipline, these regulated institutions actually took on greater leverage than the hedge funds and private equity firms they were trying to emulate. If we are going to have a prosperous global financial system going forward then we need to make sure that we regulate those firms, such as banks and insurance companies, who are betting the funds of innocent people like depositors and holders of insurance contracts.

I believe that the most straightforward way of doing so is to reinstate minimum leverage ratios for these institutions that are in addition to the supposedly more sophisticated risk-based capital rules that are in place. Risk weightings and even supervisory judgments are inherently linked to the recent performance of the particular asset class in question. Recent experience has taught us that recent performance is not necessarily a fool proof guide to future results.

But we must also make sure that we leave a lightly regulated sector that can actually take the risks inherent in any economy that are inappropriate for the more heavily regulated sector. The tradeoff for little or no regulation is that it is the investors in those funds, and not the general taxpayer, enjoy the benefits of success and bear the burden of losses. In various global forums, the United States should defend the rights of financial intermediaries to operate with relatively light regulation provided that they do not possess any claim on the taxpayer.

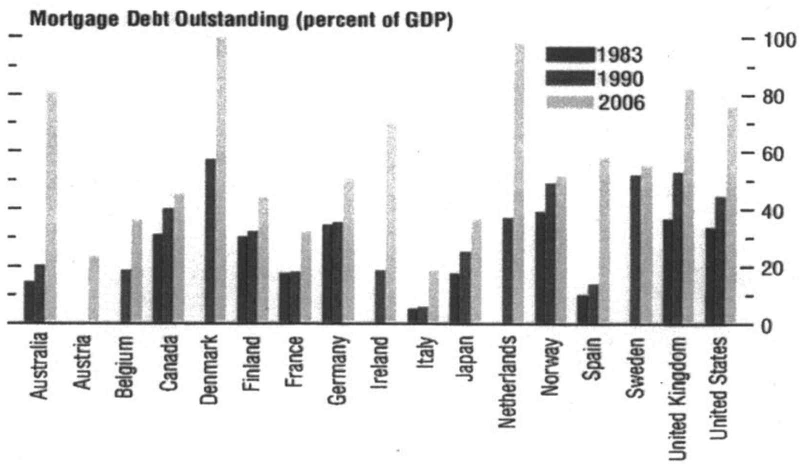
Our security as a nation depends crucially on a resumption of the path we have been on for the last quarter century toward ever greater global prosperity. But that prosperity requires a continued effort by the American Government to promote the causes that have made America great: Economic and political freedom in particular. That may not be the politically popular thing to do in times of economic stress, but putting the long-term security and prosperity of America and the world ahead of short-term political popularity is what leadership is all about.

A Global Housing Bubble

House Price Change:1997-2008

South Africa	398%
Ireland	201%
Spain	191%
Australia	169%
Britain	168%
Sweden	153%
France	150%
Belgium	147%
Denmark	124%
New Zealand	105%
Netherlands	105%
Italy	104%
United States	**85%**
Canada	70%
Switzerland	23%
Hong Kong	-26%
Japan	-33%

Source: Economist, The Lindsey Group.



Sources: National accounts; European Mortgage Federation, Hypostat Statistical; Federal Reserve; OECD Analytical Database; Statistics Canada; and IMF staff calculations.

Senator LUGAR [presiding]. Well, thank you very much, Mr. Lindsey.

Let me, on behalf of the chairman, call for a short recess. We have a rollcall vote that is proceeding; that is why the chairman left, hoping that he would be back by the time your testimony was concluded, Mr. Lindsey. But, any event, I know that we all want to raise questions of the three of you. So, if you'll forgive us for a moment, I will call for a short recess and go vote. The chairman will arrive shortly and will proceed with the hearing. We thank you for your indulgence.

[Recess.]

The CHAIRMAN [presiding]. The hearing will come back to order. Thank you. I'm sorry, folks, about the vote, and I apologize, Mr. Lindsey, for having to run out on you, but I did read your prepared testimony, so I'm not wholly unprepared, here.

Mr. Lindsey, you began your testimony by saying America is a cause as well as a country. And that is true. Is it important for us to make any acknowledgments here about how this began in order to have credibility in the fixing? And can we avoid some of the down sides that some people see if we don't do that? Do you want to, first, respond to that, Mr. Lindsey?

Mr. SOROS. Well, I think that it's recognized——

The CHAIRMAN. Hit the mikes again.

Mr. SOROS. I think one needs to understand what has happened, that basically in the last 25 years or so, we—the global—the international financial system has been developed on false premises, and it has collapsed. And we do have a very serious——

The CHAIRMAN. When you say "on false premises," can you fill that out?

Mr. SOROS. Yes. Basically, the assumption was that markets are self-correcting and should be left to their own devices.

The CHAIRMAN. Is it fair to say that Alan Greenspan acknowledged that in public testimony before the Congress?

Mr. SOROS. I'm sorry?

The CHAIRMAN. Alan Greenspan came before the Congress, a month or so ago, and said, "I didn't realize the degree to which the markets would not regulate themselves."

Mr. SOROS. That's right.

The CHAIRMAN. That was an open statement.

Mr. SOROS. Yes. Yes. And I respect the fact that he has acknowledged this. And now we have to—we actually have two problems. One is that the system has collapsed, and we have to rebuild it on sounder grounds. We must rebuild it. We do want an open trading system, we want global financial markets, but we have to put them on sounder grounds. But, more urgent is to arrest the collapse, which is having devastating human consequences. So, the first task is to stop the collapse, to reinflate, in fact, in order to keep the financial system afloat. And the second, then, is to reconstruct it.

And as Mervyn King, the—of the Bank of England, has—who has also acknowledged the mistakes of the past—has very wisely stated, what we need to do in the short term actually is directly opposed to what we need to do in the long term. In other words, right now we have to compensate for the collapse of credit by increasing the money supply, which we are doing through expanding the balance sheet of the Federal Reserve. And in the longer term, of course, we must avoid doing what we did in the past, which was to build up a chronic current account deficit and spending up to 6½ percent more than we were producing. So, that's the longer term. So, we—but, we can't get back to a balanced position——

The CHAIRMAN. What's the one-two-three of arresting the collapse?

Mr. SOROS. Well, basically we have to increase the money supply to compensate for the decline in credit, we have to recapitalize the banking system, and we have to deal with the crisis in the housing industry and prevent housing prices from overshooting on the down side the way they overshot on the up side. So, those are the three domestic. And then the fourth—and we mustn't forget it—and that is, in fact, the subject of the hearing——

The CHAIRMAN. The G–20 piece has to——

Mr. SOROS [continuing]. Today—is, we have to also look after and help those countries which are affected by the global economic recession and are not in a position, without international assistance, to do what we are doing, which is to reflate. We need to do that for—in our enlightened self-interest, because reinflating the economy is a global task, and we need the less-developed world to stimulate domestic demand. And the issue of SDRs would help them to do that.

The CHAIRMAN. What do you think of that, Mr. Lindsey?

Mr. SOROS. Pardon?

The CHAIRMAN. I was wondering about Mr. Lindsey's response.

Mr. LINDSEY. I think that you will find very little disagreement on the overall strategy we should be following, on this panel. I've known both gentlemen for a long time. I do think there might be a small difference in the nuance with which we approach different tasks.

The first challenge I think that we have to keep in mind here is the importance of fixing the banking system first. And that is going to require an enormous strain on capital—on global capital markets, to fill a hole. The hole is here, the hole is in Europe; it's even bigger in Europe. The hole is even bigger in Asia, as a share of their total banking capital.

The CHAIRMAN. Effectively, you're talking about a lot of banks that are insolvent.

Mr. LINDSEY. Yes.

The CHAIRMAN. That's the bottom line.

Mr. LINDSEY. Yes. We probably—I mean, there are a variety of estimates that are out there, and the answer is: No one knows for sure. But, in the United States the number is between $1 and $2 trillion, as the size the hole.

The CHAIRMAN. Right.

Mr. LINDSEY. And I think it's important that we fill that hole as efficiently as possible, because when we do it in an inefficient way, we put, like, $2 of strain on the——

The CHAIRMAN. What's the most——

Mr. LINDSEY [continuing]. Capital markets in order to fill $1 worth of hole. And I think that that's a mistake, because——

The CHAIRMAN. Well, it's fair to say that TARP probably fell in the inefficient category.

Mr. LINDSEY. The TARP has fallen—the way it—yes, the TARP is in the inefficient category. I've felt that, a long time, yes.

The CHAIRMAN. Now, I don't want to make this into the Banking Committee, but I do want to understand how we're proceeding forward here to restore confidence. The plan that's currently on the table offers a public-private partnership to buy a certain number of assets. It seems to me that is going to help with liquidity, but I'm not sure that it addresses insolvency.

Mr. LINDSEY. Yes, Senator. And I think that the Congress should take a closer look at the approach. I think the Secretary misspoke yesterday when he said that the public sector and the private sector share equally on the up side and down side. That is true for very small changes, but, in fact, on the down side, the public sector will carry about 92 percent of the losses, and the private sector, just 8 percent.

The CHAIRMAN. Yes, I——

Mr. LINDSEY. Whereas, both share 50–50 on the up side. And I do think that, you know, before we proceed, discover that's the case, and then try and do a clawback, like happened with AIG, which would destroy what credibility we have left, that we, you know, take a sharp pencil to it now, know that's where it's headed, and realize that that may not be the most effective way, or efficient way, of injecting money into the banking system.

The CHAIRMAN. I'm not going to go down that road right now, because I want to keep the hearing moving on the international piece, but there is a lot to talk about with respect to that. But my time is almost up—on the international piece, Mr. Wolf, going back to what Mr. Soros laid out as one through four, we have increased the money supply, we have done a significant chunk on the housing, we've put a very significant stimulus up, as has China, we have now put forward a mechanism for at least removing some of the toxic assets. Let's not worry about cost, for the moment; I'm worried about it, but, for the purpose of this discussion—the question now is on the recapitalization. Is that fair? Is that the big hanging-out-there issue? In terms of the global sense of confidence.

Mr. WOLF. In terms of the confidence people have in the U.S., specifically, rather than the global solution, I would agree that the question of whether the U.S. has a credible policy overall to fix its banking system over the next 12 months or so, ideally sooner, is certainly an extremely important one. I think that——

The CHAIRMAN. And the key to fixing our banking system——

Mr. WOLF [continuing]. In your—in the case of fixing your banking system. However, I would go along very much with what Mr.—Professor—Mr. Lindsey said. The—it is clear that, in all the respects that you listed, policy in other Western countries—and in this context, I am actually including Japan for this purpose—is behind on all those fronts. So, while I think, in every respect, the U.S. policy is far from having resolved the problems it faces, and is creating some new ones, as we discussed, in the fiscal and monetary areas, it is clear that the U.S. is ahead of most other places in addressing these problems. I think the reason for that is that the crisis became evident—we won't need to discuss its origins; we don't really have the time—in the U.S. before most other developed countries, and most other developed countries have, correspondingly, been relatively tardy in responding.

The CHAIRMAN. Mr. Soros, you deal in the market in this way—is it your judgment that people are holding back with a kind of reserve wish that somehow, because of the things already done—the increase in the money supply, the reinflation, to some degree, through the stimulus and other things—that those assets that are currently toxic may somehow reappreciate and that they can avoid a crunch? Is there that calculated a sense of delay, or is it just that this is such a big chunk of money that people are having a hard time wrapping their hands around it? Certainly the response from Congress so far would indicate real reluctance up here for people to deal with reality.

Mr. SOROS. No, I'm afraid that this will not be sufficient to recapitalize the banks or remove enough toxic assets to enable them to resume lending.

The CHAIRMAN. But, do you think that is the calculation?

Mr. SOROS. That is—it's not sufficient for that. It may turn out to be useful, in conjunction with the stress tests that are currently conducted, which may result in the need for the banks to accept lower valuations for the toxic assets, in which case the asked and the—the two prices, bid and ask, may actually come together. As it is, I think that will only happen in the very high-class assets, where actually providing liquidity to the buyer does improve their ability to bid. So, yes, I could see, on AAA assets, bid and ask coming together, and actually thereby providing some liquidity to the banks. But, it does not solve the problem where it comes to the toxic assets. So, I think there is more work to be done, and this is just a one step along the way.

The CHAIRMAN. Well, let me say, in fairness, without letting the cat out of the bag on this, I actually asked the President this at the caucus luncheon that we had today, and he made it very clear that he understands there is more to be done and there are next steps. So, I think the stress test is a very important measuring point so that people can get a handle on exactly what the pricing might be and what the levels of toxicity are.

Senator Lugar.

Senator LUGAR. Mr. Lindsey, you mentioned your opposition to the size of the President's budget request, and I, along with the chairman, do not want to get into a domestic quarrel today. Clearly one of the dilemmas that it presents, in whatever size, is—at least some of our staff have come up with the thought that $3.1 trillion, or 53 percent of United States debt, is now held by foreign investors and foreign governments. This is up from $1.5 trillion since the end of 2003, about 5 years ago.

Now, it's important to identify where we obtain the money to fund this budget formula. Presumably, much will be borrowed in the United States, but I think there's a presumption that much of it will be borrowed abroad.

Now, what are the problems posed by that? Without getting into specific detail, the Chinese are often mentioned, because they have pointed out recently, themselves, that they would like for the dollar to be pretty solid and want to make certain we're doing the right things in our economy so that all their money that's in dollars would not be depreciated. Likewise, just 2 days ago, they mentioned a potential international fund or currency or financial equivalent other than the dollar, in which they and other people in international finance might use to diversify their portfolio. Now, always there were hints that there might be a worry, in due course, about the Chinese loaning us money, but the fact that this has come up a couple of times from the Chinese themselves presents another worry. Perhaps the best bet is for everybody still to go to the dollar, in terms of safety, for reserves and sovereign funds. What is your own judgment about the parameters of this problem? And should this influence our domestic debate, quite apart from our international debate?

Mr. LINDSEY. Senator Lugar, I think you've identified it correctly. Our budget is not just a domestic issue, it is very much a foreign issue. And simply because of the way the numbers are. If you go to the back of the President's budget, there's a page that's hard to fiddle with, and it has to do with the total expected borrowing requirement. And in the current year the number in the President's budget is $2.65 trillion.

Senator LUGAR. Borrowing.

Mr. LINDSEY. Of borrowing. That is—the CBO would estimate, is a little low, but why don't we work with it. And——

Senator LUGAR. We were at $5.9, according to my figures, at the end of 2008, so $2.75 on top of the $5.9.

Mr. LINDSEY. Yes. This is—now, we have 6 months left to the year, and we have borrowed about $700 of that $2,650, which leaves us with $1 trillion $950 billion more to borrow in the next 6 months, by the President's budget. On top of that, any borrowing you have for PPIP, PPIF, TALF, whatever it may be, would be on top of all that. But, let's just focus on that $1.95 trillion.

Now, our personal savings rate's going up, and you said some of it will be financed domestically over that period. If we're lucky, I guess, U.S. household savings, including paying off those credits and everything else, all of it, would be about $300 billion.

Senator LUGAR. Right.

Mr. LINDSEY. OK? So, now we're down to $1 trillion $650 billion to raise in the next 6 months. Well, there are exactly two—there's three sources left. One, you can crowd out domestic investment. And that's not good for the economy. Two, you can borrow it from abroad. And three, the Fed can print it.

Last Wednesday, the Fed did the same math I just did and said, "Oops, we're going to have to be printing some of it, because we're never going to get there." Fed said we're going to buy $300 billion. So, that takes the $1 trillion $950 down to $1 trillion $650 billion over the next 6 months.

To put that into perspective, that is 100 percent of the GDP of China over the next 6 months. So, even if the Chinese didn't need anything, didn't buy a car, didn't build a building, threw everything into lending it to us, we would just cover our borrowing requirements.

Senator LUGAR. In the next 6 months.

Mr. LINDSEY. Over the next 6 months.

So, it is very much a foreign policy issue. And the mention was, well, yes, these other countries need money. Right? Iceland's failing, and Hungary and the Czech Government fell, and what have you. Well, when we borrow from the rest of the world, we are crowding out those other countries.

So, the only two answers are borrowing and global money creation. And I think we should just concede we're going to have money creation; and both of my colleagues have. But, believe me, this is very, very much a foreign policy issue, and the President's budget is, I believe, destabilizing to the global financial system. Not because I'm against budget deficits; I've got no problem with it. As I mentioned, I'm a Keynesian. But, I'm a Keynesian with a sharp pencil. And when you take the sharp pencil to it, it doesn't add up.

Senator LUGAR. What—explain to us what it means that the Treasury prints money or creates money. What's—how is this done, and what's the effect upon our economy of that kind of creation?

Mr. LINDSEY. The Treasury doesn't create money. My former colleagues at the Fed, that's their job. And what they do is, they—well, we used to say "run the printing presses." It's now done with electrons instead of paper, most of it. But, they hit the button, and the electrons happen, and they generate $300 billion, and they buy $300 billion Treasury debt in the process. So—because, you know, I'm gray-haired, I think of it as "printing the money," and—that's basically what happens. We expand our money supply in order to buy the Treasury debt.

Senator LUGAR. What are the implications, then, for us in doing that?

Mr. LINDSEY. Well, I have no problem with the $300; I'm worried about the other $1 trillion, 650 billion. And I think the amount of money creation that would be necessary to cover the budget demands would be very troubling for the price level in the United States.

Senator LUGAR. And that's just for the next 6 months.

Mr. LINDSEY. Yes.

Senator LUGAR. You're back in the same predicament, presumably, in the next year or the next two.

Mr. LINDSEY. We're back in the soup. It's a little bit—under current numbers, it's not quite as bad, but it's still bad enough, that, yes, there's a problem.

Senator LUGAR. Thank you, sir.

The CHAIRMAN. Just to expand the dialogue, do either you—Mr. Soros or Mr. Wolf—want to respond to that?

Mr. WOLF. Well, I would like to add something. The concern is a completely legitimate one, and we certainly cannot imagine that the world's markets have an infinite taste for either the U.S. dollar or U.S. Government debt. It is striking, however, and it is particularly striking to many of us—for instance, people living in Britain—that here we have a country that appears to be in the throes of a very severe financial crisis, and its currency is strengthened, and its government long-term interest rate has been more than satisfactory, by any standards. So, it appears, at least at the moment, maybe surprisingly so, that world markets—and we are talking about integrated world markets; we can't separate American for foreigners; they're all in the same market—are perhaps extraordinarily complacent about this situation and seem to be quite happy about accepting this amount of paper. And I wouldn't wish to conclude from that, that that will necessarily be true in the future, because, of course, as we have perceived very well in recent years, markets can change their minds. And when they change their minds, they can change their mind very brutally. But, it is important to remember that the U.S. dollar and the U.S. Government have a number of very substantial advantages, in terms of credibility, liquidity, long record, unquestioned survival, which other competing currencies or bond markets do not have. Other governments are going to have very large fiscal deficits. There is clearly very substantial money creation in other countries, because, indeed, they're affected by similar crises. The question of the survival of the euro is at least—I'm not saying it will disappear, but certainly it's a more natural question than the survival of the dollar.

So, for all these reasons, I am actually somewhat more relaxed, in the short run, by which I mean the next 2 or 3 years, about the ability of the United States to sell all this paper and to sell these dollars, and for the rest of the world to hold it. There is an extraordinary demand for safe assets out there in the world, and there will be, without question, an extraordinary increase in desired savings across the whole world, because that's what this sort of recession means.

So, I'm not panic-stricken in the short run. The crucial thing, however, is that this doesn't go on for many years, because then the question of credibility will unquestionably come into play, and that is why having a global solution which allows the U.S. partly to export its way out of this, have a stronger world economy as part of the solution, and a credit fiscal package—profile or path out of this, does indeed become essential.

The CHAIRMAN. With the indulgence of my colleagues, I just want to interject because I think this is an important point to be making here. There is an agreement and I think, Mr. Lindsey, you agree—there's been pretty near unanimity that we've got to spend some money to get out of this hole.

Mr. LINDSEY. Absolutely.

The CHAIRMAN. We've got to spend some money to stem the housing issue. We've got to spend some money to put people back to work and turn the confidence around. We've got to spend some money to recapitalize the banks. We've got to spend some money to strengthen the IMF and keep some of these Eastern European and other countries afloat. There's almost unanimity on that. So, you've got to be a little careful about holding out this great big debt as something preventing action—we're forced into this situation. A lot of us are really unhappy about it, because, for the last few years, we've actually been fighting against some of the policies that have helped put us here. But, we're here. The President has made it clear, his budget in the out years is clearly focused on reducing the deficit. But, you've got to grow the revenues to be able to begin to get there.

Go ahead, Mr. Lindsey.

Mr. LINDSEY. Senator Kerry, I agree. I have no problem spending money. I would simply point out that if you're in this bind, it is essential to spend money as efficiently as possible. And therefore, if you have a, why don't we call it, a $1½ trillion hole in the banking system to fill, it would be imprudent to borrow $3 trillion to have some jury-rigged system——

The CHAIRMAN. Do it the right way.

Mr. LINDSEY [continuing]. To come up with filling up the 1½.

The CHAIRMAN. I agree with you. That's a good point.

Mr. LINDSEY. And that's where I would start, and that was my comment on the——

The CHAIRMAN. Let me cut myself off, here, because I know some colleagues are time-sensitive.

Senator Kaufman, do you mind if Senator Corker were to go and then we come back to you?

Senator CORKER. I really don't want to jump in front.

The CHAIRMAN. OK, all right.

Senator Kaufman.

Senator KAUFMAN. Thank you.

I'd like to talk about, kind of, some of the political implications of this economic crisis.

Mr. Soros, I think it's fair to say that Russia and China have done everything they can to avoid an open society. And the general consensus is that that's OK, kind of, because the people of Russia and China thought they were doing better economically, they had hope, they had the idea they were going to do better, their children were going to do better. What do you think the implications are, in Russia and China, of this economic crisis, in terms of politically?

Mr. SOROS. Well, I think that China, of course, is also in a crisis. Exports have fallen very sharply. And China is not a democracy. And the rulers know that their hold on power depends on their ability to keep the economy growing. So, for them, the top priority is to assure—or to do everything possible to stimulate the economy and maintain the target 8-percent growth—well, it may be only 6 percent, but something of that nature. And they are in a position to accomplish this, and they did respond with a very large stimulus package. And they've made it clear that if that's not enough, they're going to do more. They also have large currency reserves, and they are liable to use those reserves also to finance their exports. Just as they did in the past lend us the money to buy their goods, they might do the same for others, as well.

So, I think that they will, in fact, be able to recover faster than we will. And if they don't, you may have political and social unrest, and you could even have a breakdown, which would have a very negative effect for the rest of the world. So, it's not a desirable outcome in any way.

Senator KAUFMAN. Right.

Mr. SOROS. So, that's as far as China is concerned. And it's very important, since we have common interests with them, that we should find the proper way to work together to restart the world economy. And that's why I think using the IMF is a very important foreign policy objective for us and why I think the SDR issue would be really a major accomplishment for the United States.

Russia is a somewhat different situation, because there is a—the—there's tremendous resentment in Russia. Putin has been popular because he has actually, through the boom in oil and gas, been able to provide both security and stability and economic improvement. Now you have a very severe financial crisis, a collapse of the Russian stock market, and a debt crisis, and a severe economic decline. And he is no longer so popular, and there is a real danger that he will become increasingly repressive and perhaps also aggressive to divert attention from the troubles at home.

So, I am afraid that, from a foreign policy perspective, Russia is a possible source of disturbance of peace. Tensions with Georgia, for instance, could easily escalate again to military action. Russia has used gas as a geopolitical power tool, may do that again. Russia is eager to reestablish control over Ukraine. Ukraine is in a very serious both financial and political crisis. So, I see that as a major trouble spot in the world.

Senator KAUFMAN. And how—so, if that occurs, what are the implications for the United States, in terms of—both the Russian leaders and the Chinese leaders in the past have used us kind of as a villain, someone to turn to when things are bad, to explain why things are bad in their country. Do you think there's much chance of that happening? And how do you think it would impact on United States-Chinese and United States-Russian relations?

Mr. SOROS. Well, I think it's a very difficult task, because, on the one hand, Russia has become aggressive, and we must resist aggression, because otherwise we reinforce it. So, on the one hand, we have to support Georgia, Ukraine, et cetera; on the other hand, we do have common interests, many common interests, with Russia, so we must really have a two-pronged approach. On the one hand, resist potential aggression, but, at the same time, try to develop the common interests and have a change of heart, perhaps, in the Russia leadership, which there is some possibility of achieving.

Senator KAUFMAN. Thank you.

Mr. Wolf.

Mr. WOLF. I'd just like to add a couple of comments, because I think it's very important, and I think George brought this—Mr. Soros brought this out very clearly. These really—there are obvious similarities. As you pointed out, these are not democracies. They are very different cases, and it's really important to understand this, particularly in relationship to this crisis.

China has, in some very deep sense, invested its whole future, to a degree that most of us would have regarded as unbelievable 15 years ago, in opening up to the world economy. It is—astonishingly, this country—this giant country has the highest trade ratios of any big country in world history. They're three—ratios of trade to GDP in China are three times those of the United States. It's quite extraordinary how far they have bet themselves on the world economy. Of course, they don't have a completely liberalized capital market. We know this. But, they have accepted a vast amount of foreign direct investment and a large number of investors, though by no means all are very happy with their treatment here.

China is riding the sort of tiger of development. They see the future as moving in their direction. They are largely stability-oriented, and I think they view this crisis, I suspect, not so much as an opportunity as something that they have to riding through.

But, actually, let me be quite clear, China wants the United States to succeed. There's no doubt in my mind that China wants the United States to succeed and manage this, because the alternative for them is domestically very destabilizing. And I should stress, by the way, I am quite convinced that the choice for us is not between a democratic China or an authoritarian China, but an open authoritarian China and a closed and hostile one. So, that's a very different thing.

Russia is genuinely revanchist. It has not truly integrated in the world economy, except in commodities. It is essentially a commodity exporter, as, of course, you know, and has suffered huge losses as a result. The Government is, in some ways, quite frightening and unstable in its—not unstable internally; that's a different matter—but unstable in its attitudes to us, and much more inclined to make difficulties on principle, because it seems to me the Russians still view their relationship with the West in general, and the United States in particular, as a zero-sum one; namely, if the United States is doing badly, they're doing well. I think that's how they see it; pretty primitive.

I'm absolutely certain—and I've spent a lot of time in China, talking to Chinese leaders—that they do not view their relationships in the same way. Though, while I accept the similarity, it's a very important similarity, of course, I think we have to view our relations with these countries in very different ways, and also to recognize, of course, that, in the long run, China is going to be a great power with whom—with which we will have to form reasonably productive relations, over centuries.

Mr. LINDSEY. I agree completely, although one caution I would add to this committee with regard to China. I think their perception—Martin used the word "ride through," I think of it more as a "building a bridge" to the other side. And on the other side of the river, they expect to be able to continue or resume their large exports to us. And if that is not possible, then I think, you know, in 2011 or so, China will find that its bridge has not reached the other bank of the river, and then we're going to have the problems that Martin was talking about.

Senator KAUFMAN. Thank you. I just want—the only thing that compare anything is, they're both nonopen societies which are going to go through an economic crisis, and that's the implication I want to make.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Corker.

Senator CORKER. Mr. Chairman, thank you. And I know you hesitate to turn this into a banking meeting, but I just want to say that I think this is a very, very important issue, and I hope we'll have more hearings on this topic. I don't know of anything more important, and I thank you for having this hearing, and certainly appreciate these three distinguished witnesses that certainly carry a great deal of clout and many people in the world listen to.

I think, at the same time, it's actually important for us to be very honest about where we are financially, regardless of how we got here. And I hope that we'll focus on that in an important way.

And with that, I've had a lot of time with Mr. Lindsey in the past, and certainly appreciate his contributions, so I'm going to focus on Mr. Soros and Mr. Wolf.

We had a gentleman come into our office, Mr. Soros—and I know that you've had tremendous experience as a financier around the world—who made a presentation, from Hayman Advisors, a man named Mr. Bass—looking at where we were—where Europe is today. OK? And I know we've talked about the relative differences, as far as how we progressed on focusing on the financial institutions. But, he laid out some pretty alarming information—if it's true—would say that there's a calamity coming in Europe, regardless of what policies occur. And it's based on the fact that there's huge amounts of sovereign debt there already. The monetary financial institution assets, as it relates to the size of the GDP of the countries, is very large in some cases, similar to an Iceland-like situation before, in some cases. OK? There's huge structural deficits that are in place. And the interesting problem in those countries, as opposed to here, there are already high tax rates. So, in essence, while we don't want to use the ability we have here to tax higher, they are already at levels that are very difficult to go above, in some cases.

You add to that the fact that, in some—their financial institutions in many are leveraged, as a group, at 37 to 1, assets to tangible common equity, which is a huge amount of leverage—meaning, when you have a down side, it's even more problematic. And then, many of their loans are to countries outside of their own; meaning, they have no control over the assets. And the picture that he would paint is that, in many of those countries, there is a calamity coming that cannot be averted. And I know that you invest in countries around the world, or in—I wondered if you had any response to that, or have looked at that in any way.

Mr. SOROS. No, I think, Senator, you are right in saying that Europe faces very serious problems. Some of those problems are, let's say, within the Euro group, tensions within the Euro group, and some of it are outside. And, of course, Eastern Europe, the new members—states—are in various—are at the focal point of the crisis, because they have—their banking systems, largely owned by the Western European banks, and the households have borrowed in foreign currency—strangely, more in Swiss francs, for instance, in Hungary, than in euros, but in other countries, euros. But, most of the household debt is in foreign currencies. And as they come under—as the banks withdraw and pull money out of Eastern Europe, currencies have come under pressure. They are not part of the euro. And the households find themselves in a much deeper indebtedness than they thought they were, because most of the loans went to finance real estate. So, there is a very serious problem there, and it's very important for them to hold together. They are, of course, guaranteeing their banking systems. But, since you've got national banking authorities, they tend to—there is this, what you might call, financial nationalism within Europe developing, which is a danger to the European Union.

So, that is the situation. I think you assess it correctly. And I'm very hopeful that Europe will actually pull together and pull through. But, one should not—one should acknowledge the difficulties that they are facing.

Senator CORKER. And so far, that hasn't happened. I know—Mr. Wolf, do you have any comments?

Mr. WOLF. Yes, I—obviously, I didn't see this particular presentation, so I don't know precisely the numbers involved. Some of them that you've given me, I certainly recognize, particularly the leverage ratio in the banking system. In my view, that looks worse than it is, because you have to allow for the fact that there was an extremely large nonbank financial system in the United States which performed much of the function that was in the banking system in Europe, and that was more or less completely uncapitalized. So, I think if you look at the leverage and the total financial system, they're very similar, and I think the need for recapitalization, the numbers that Mr. Lindsey's given, will be very similar in Europe.

Is Europe unable to meet these obligations? Actually, if you look at it—in fact, it's already implicit in what you said—it's quite clear that the biggest fiscal challenge—again, one shared with the United States—is the long-term contingent liabilities associated with aging, very broadly defined. They're actually not dissimilar in scale. The big advantage the U.S. has, as you—one you mentioned—is, it starts with a lower tax level; though whether it'll be easier to raise taxes here will be interesting to see.

Senator CORKER. Hopefully, it'll be very difficult. [Laughter.]

Mr. WOLF. And, of course, more important, the demography of the United States is more favorable, and that means underlying growth trends are more favorable. That should make it a bit easier to manage this.

But, the point I would stress, which I think is more important for this purpose, is one implicit in one aspect of what you said, which is, this is a collection of countries, and their debt and deficit positions are very different.

There are a few countries—by no means all and not the biggest, with the one exception, namely my own—which have extraordinarily large banking systems relative to their economies. The U.K. is the only big country to fall into that category. I am reliably informed by my friends in the U.K. Government that this is all under control. [Laughter.]

It is a very interesting aspect of this crisis, and central to your considerations, because it's the border between financial and foreign policy that we have global financial institutions that are guaranteed by host countries which may be very reluctant or unable to meet all international obligations. I would like to point out the extreme difficulty created for the United States by the discovery that moneys going through AIG ended up in foreign banks. This is the problem for Britain multiplied almost by an order of magnitude. And it's a political problem as much as an economic problem, quite central.

Apart from that, which is mainly the U.K., otherwise the other case is Switzerland, which is not, I think, a concern at this level—the really big problem is, there are a number of Member States in the euro zone, a number of Member States in the European Union that are not members of the euro zone, which are quite likely to get into sovereign debt problems simply because of this crisis. I don't believe that will include the biggest countries of the European Union, but there are some less-than-large ones, and even quite sizable ones, that could be seriously challenged. And ultimately, the question there is not whether the big countries are able to rescue them, because I believe they are—we could discuss that in greater detail if you wish to—but, whether they will be willing to. Ultimately, this is not a federal entity, it doesn't have a federal tax structure, there is no federal government, and so, ultimately, if there were to be a very serious difficulty in the debt markets for particular countries' debt, you might find that some member countries would be—big member countries, like Germany, for example, would be reluctant to rescue them. The rhetoric we have at the moment suggests they would help them. And, of course, George Soros has proposed the creation of a European bond market, partly to deal with these problems.

But, we do have to recognize, in my view, the fundamental issue is not so much the scale of the problem, in aggregate, but its distribution across countries, and the less than perfect certainty, much less than perfect certainty, that strong countries would, in fact, rescue weak ones in a difficulty. We could well find a test of this within the next year or two.

Senator CORKER. May I ask one more question, based on what I'm hearing?

I'd love to, by the way, give you this information. I didn't call out specific countries, because I don't have any way of validating this information, but I'd love to give this to you and see if you wouldn't—if you would consider responding to some of the factual information that's here. You'll do that?

Mr. Soros, I met, yesterday, with the IMF and Mr. Lipsky. And I know there's—whenever—here in America, we talk about China and our debt and then people raising currency issues; that obviously gets everybody, rightfully so, up in great concerns. And I realize that that—right now, that's just talk, and we need to—what we really need to focus on is making sure we keep our house in order, short and long term. But, from your perspective, what is the reality of taking the SDR component, or some other component, but using that as a potential building block through the IMF for a reserve currency that is, in effect, the one that becomes our world currency, and not, in essence, using the U.S. dollar? What is the reality of that? Is that just talk, or is that something that might well become a reality in the future?

Mr. SOROS. I think it is much more than talk. It exists. In other words, SDRs actually exists. They are on the books of the IMF. It's not a new invention. It's very fortunate, because it would take quite a long time to put it in effect. It took a long time to devise it, and it was devised exactly for this contingency of a global shortage of liquidity; forgetting now about the solvency problem, as well, where it can be helpful also. So, this is the moment when using SDRs on a large scale could, in fact, make a major positive contribution in helping to resolve the problems of the world.

You drew attention to the problems that confront Europe. You are fully aware, of course, of the problems that confront us. And also, the problems that are confronting Eastern Europe are even greater than those that confront Western Europe. And, of course, the developing world is the most vulnerable of all.

And the SDR issue could help, particularly, the developing world, including, of course, Eastern Europe. And therefore, it would make a positive contribution, and I think it is an opportunity for the United States to exercise leadership by proposing it.

Senator CORKER. Of course, it will be very detrimental to the United States in proposing that, would it not?

Mr. SOROS. No, I don't think it would be detrimental, frankly. You could view it as an alternative to the dollar, but I can—I'm sure that the dollar will remain the world currency, even with the issue of the SDRs. The SDRs are a different kettle of fish. They are a reserve on the books of the IMF. They have to be converted into a currency to be used. So, they have to be converted into dollars or sterling or euros—or renminbi, for that matter—in order to be used for actual trading. So, I don't think they represent, in any way, a threat to the dominance of the dollar in the world.

Senator CORKER. I've got a colleague here, I know, that wants to ask questions. I want to thank you all, all three of you, for being here and for your input. I wish we had a longer time to be with you, and I hope there's a chance for you to come back, in the future.

Thank you very much.

Senator RISCH. Well, thank you, Mr. Chairman.

Actually, I just spent 3 days in Brussels, at the Brussels Forum, and sat through 3 days of economists debating these issues. I'm going to pass. Thank you very much.

Senator LUGAR [presiding]. Let me take advantage of that to raise one more question. You've all talked a little bit about the dangers of protectionism. Is it already the case that many countries, including our own, taking a look at their own problems, in terms of jobs, have become more protectionist? To the degree that that continues, this is not fatal to the scheme, but it certainly is a body blow. In terms of common sense, will countries come to some agreement? Domestic politics being what it is, Mexican trucks can hardly get across our border, we're still trying to keep sugar out of the South from Latin America, all the same old things, literally. And so, crisis or not, people are saying, "First things first." These are things ingrained in our policies in the past, and they're not easily expunged by summits or by other things. Other countries have similar difficulties.

Now, is there something about this crisis that is likely to change that ethos? And how might that come about?

Mr. WOLF. This is a subject I've thought about for about three decades and am very interested in. I'm, as it were, pretty relaxed. I know free traders like me aren't supposed to say this, but I am pretty relaxed about the sort of protection we are seeing. We have experienced protectionism like this in every significant downturn in the last 50 years. It was very bad in the 1970s and early 1980s. And provided—we must—have to accept that politicians meeting together in international meetings say one thing and behave a little bit differently at home. This is just the reality of the world. And the system we have—the rules governing the system—does, in fact, allow measures to be taken to protect industries, in exceptional cases. And it will be very surprising if opportunities of that kind were not taken, in this case.

So, I don't think that anything that has happened so far is devastating, as it were, to the survival of the world—of the world trading system, nor that anything that has happened should, in itself, be very surprising.

So, could it be more dangerous than that? Yes, I think it could be more dangerous than that. And that's what I've been trying to stress in my recent writings. Protectionism has not been used as a macroeconomic policy tool—that is to say, as a tool for dealing with general unemployment—in any major country since the 1930s. It's always been used to deal with the specific problems of specific industries, sometimes important, as in the case, for instance, of automobile production, or, in this case, the financial sector, obviously, where it's most significant.

There is, I think, a real danger that if this recession becomes very long and very deep, that the other methods we've talked about—fiscal, for example, or monetary—seem to be no longer effective or dangerous, that policymakers, in this situation, will turn to the idea of general protection as a way of achieving the Holy Grail, as it were, of ensuring demand remains at home.

And it is, for this reason, so important that demand policies, expansionary policies, be agreed across the world, and, in my view, particularly so, a subject we haven't discussed here, in surplus countries, which have more room for expanding demand to increase their absorption of tradable goods and services, and thus, relieving, to some significant extent, the problems of deficit countries, like the United States, the United Kingdom, and others. So, my concern is that, in that context, of course, people would even be willing to throw aside the rules that were agreed in the GATT and in the WTO, and we would then move from a series of—as it were, from a snowfall to an avalanche.

We're not there. There is no sign of it. But, if we don't fix this by orthodox macroeconomic policy means—and this is very much, I think, the thinking of somebody—of people in the 1930s, that that will happen. And that seems to me the danger we really have to focus on. It's not happened, there's not much of it around, but I think it is where we could be, 3 or 4 years from now, if we haven't fixed this.

Senator LUGAR. Mr. Wolf, though you mentioned, earlier on, as we discussed China, the importance of China's willingness to open up, to have—not a grand bargain, but at least for us to understand that we need to accept exports from China, a significant part of the market is here in the United States. And, on the other side, not explicitly, but implicitly, the Chinese have been interested in buying our bonds, for safety reasons, but also because this is something that keeps the demand going.

So, this is a very important flow. Counsel us a little bit about the China situation, since it's extremely important to us and to them. The fact, as you say, it's not a zero-sum game; there is a possibility, here, of seeing mutual advantage.

Mr. WOLF. Well, I agree completely with your description of the current situation, the trade between pieces of paper and real goods and services. And it just seems, in many ways, rather favorable to the United States. But, in the longer run—and by "the longer run," I don't mean the next 10 years, I mean the next 3 or 4 or 5—I do think, particularly in the context of a general deficiency of demand of the kind we're now experiencing and the associated dangers, that we should be expecting—and I think that's the focus of the discussion, at least on macroeconomic policy—that the Chinese pursue policies which start reducing their current account surplus significantly. I think it is really hard to stabilize the world economy. It's a view I've expressed in a recent book. If a major emerging country like this is running a current account surplus of $400 billion a year or so, which might conceivably in the long run rise further, I think it is desirable that we discuss with them ways in which this can be reduced. This will, of course, reduce their capital outflow, but it will also increase export opportunities from the rest of the world. In other words, the rebalancing of global surpluses and deficits, in my view—I think it's a view that Keynes would have had in this context, in this sort of crisis—is a central part of the discussion we must be having with other countries around the world, and China is a particularly important one.

Senator LUGAR. Thank you.

The CHAIRMAN [presiding]. Mr. Soros, fill out for us on the SDRs—a lot of people don't know what they are, these special drawing rights. They're part of the fourth amendment to the IMF articles, is that what you're limiting your comments to, or are you talking about the SDRs in the broader context that some people have talked about with respect to a full-blown currency concept under the IMF? Where are you on that? Just fourth amendment limited one-time draw, or are you taking broader?

Mr. SOROS. Oh, no, I'm suggesting an annual issue of SDRs while the recession—global recession is in place. Now, there is an existing pending issue—it's called the fourth amendment, and it's for $21.6 or $23 billion SDRs. And it is actually approved by a large majority of the country, and is only actually pending U.S. approval to——

The CHAIRMAN. Right.

Mr. SOROS [continuing]. Be over the 85-percent approval that is needed. That could be used as a sort of a trial run of how this would work. So, it's a very practical proposition.

There are some special difficulties or peculiarities with regard to that issue, because that was conceived 10 years ago to make up for the relative under-representation of Russia and Eastern Europe. And so, it has a more-than-proportional increase for those countries. So, I'm not actually necessarily advocating that we should use that right away. It could be used, but I think it could be perhaps only—or it should be used perhaps only after a better understanding has been reached with Russia.

The CHAIRMAN. Fair enough.

Mr. Wolf and Mr. Lindsey, I want to try to resolve, in my own mind—and perhaps it's good to have the public discussion—about the degree to which the European experience right now is the result of mistakes that they made on their own or the result of their having bought into the so-called "Washington consensus" about reforms of the last 20 years, and practices. For instance, many of our folks urged them, in the privatizing of banking structures and so forth, to open it up and allow the purchase of banks. And indeed, Western European countries have bought a significant component of the Eastern European banks, to such a degree that some of those countries are now holding assets greater than their own GDP, but also leaving some of those countries almost without a banking system, so that if they withdraw to themselves now and take care of business at home, those Eastern European countries are in triple trouble. How do you assess—Mr. Wolf, maybe you go first—how they wound up where they are today? Was it the credit default swaps, the rapid purchasing, the entry into our housing bubble that created their bubble? As we work our way through the anger that exists—and you've acknowledged that anger in your own testimony, and I mentioned it in my opening—we've got to have some sense of how we got here.

Mr. WOLF. Can I start——

The CHAIRMAN. Go ahead, yes.

Mr. WOLF. The story of Central and Eastern Europe, of course, is very complicated and—but, as countries concerned always remind us, they're all different. Nonetheless, there is a common element, which is obvious enough. And I think we have to start with—not so much with what they were told, but with what they themselves wanted. After the fall of the Soviet Union—a very important and blessed event—they were encouraged and, above all, themselves determined to join Europe and, in the same way, join the West. It's perfectly clear it was a common desire. George Soros, of course, knows much more about this than I did, and played a very large role in promoting this. This was both economic and political, and joining the European Union and the European structure was an important part of that.

In the process, they committed themselves to opening and liberalizing their economies and trying to become as much like ours as they could, and did so to a very substantial degree. They integrated in trade to an incredibly high degree, foreign direct investment, open capital accounts and all the rest of it.

And in general, looking back on this experience, if we leave aside where we are for now—and we can still get through this, I think; I have no doubt about it—it's been a big success. I think it's important that, you know, of all the things that has happened in the world, I think the opening to Europe and the integration of Europe is one of the great triumphs of Western policy, in the broadest sense, and of American policy.

Now, there are, however, it's clear, a few vulnerabilities. First, this became the only region of the emerging world, and truly the emerging only region, because of their commitment to this and their will to this to become a very, very large net importer of capital. After the Asian financial crisis, no other region was. They—all the other regions accumulated reserves, and, to some extent, therefore, shielded themselves against this shock. These became very dependent on continuing inflows of borrowing capital. They run large current account deficits, not all enormous—Poland's is relatively small, but some are gigantic—so, if all the capital is cut off, by definition, they immediately go into a depression, because the capital that supported their activity—some cases, very small countries, had current account deficits of 20 percent of GDP. You can see what happens if that's cut off. So, they became vulnerable on that point. They became vulnerable, as you rightly pointed out, because their banking system in—because in order to introduce high-grade Western banks, as it was seen, banking, it became part—they became part of Western groups. And nobody thought this will be dangerous. I mean, truth. I don't remember anybody ever saying, "We could get into a crisis in which the major banks in Italy, Austria, or Germany might start thinking we should actually have to serve our domestic interests rather than the interests in these countries." By the way, I don't think it's come to that yet, but that was something that we didn't think about. It is the most worrying aspect of this crisis, from the protectionist point of view, and that's something we didn't think about.

The third thing they became vulnerable to, inevitably, was Western European demand. They export an enormous proportion of their output to Western Europe. And the Western Europeans have plunged into a very deep recession. These are the prices of openness.

Now, for very small countries or countries in which with small economies—and Poland still has a very small economy—this integration in the world is inescapable. There's no other way they could have become prosperous. But, it is clear now that there were risks associated with that which we didn't fully understand, and some which they took to willingly, like borrowing a large amount in foreign currency, and therefore, the risk of currency mismatches. So, they made mistakes and we made mistakes. There's no doubt—and by "we," I mean, particularly, Western Europeans, in the advice that was given to them, but also, I think, others—the IMF, the Americans, and so forth. That's how we got here.

But, I would stress that, despite these mistakes—and they were, they made the region more vulnerable than it needed to be—the process, by and large, has been very positive. That means that, if we can deal with the problems they now confront—and I believe they're all perfectly manageable—with suitable support, with insistence that the banks that went and bought their banks continue to operate effectively throughout the region, with assistance to make sure that currencies don't collapse too much, from the IMF, Western Europe, and so forth, by successful policies to relaunch demand in Western Europe, which is essential and for which Germany is crucial—I think we can get through this. Mistakes were made, but I would not—and they're clear that they were mistakes, and I've indicated some of them, but I don't think we should start saying, because of those mistakes, that something fundamentally was wrong with the effort. It has actually been, in many ways, one of the greatest successes, in both economics and foreign policy, of the West in the last 25 years.

The CHAIRMAN. Thank you very much. Very good.

Mr. LINDSEY. Yes, if I could echo the point Martin made, and not just with respect to Eastern Europe, but the hundreds of millions of people around the globe who joined the global middle class, thanks to these policies, this is a step back, but it is a step back after two steps forward. It's not three steps back. We are still ahead of the game.

Senator, I understood your question to be a little different, in that it was sort of a, do the Europeans have their own blame, or did they simply get it all from us? And there, I would—I really don't think that—I think we have an excess of self-flagellation of this side of the Atlantic. If one goes back to the 1990s and looks at the creation of the ECB, the American economics profession was virtually unanimous in recommending that this was a dysfunction setup. I testified before the British Parliament to that effect. They put themselves in a situation where they created an optimal currency zone—excuse me, they created a currency zone that was not an optimal currency zone. They have no fiscal authority, they have limited immigration, et cetera. And so, a lot of the problems and the dysfunctionality that's now in Europe was really a result of a political decision they made 15 years ago with which we not only had no involvement, but, as Americans, tended to recommend against.

In addition, we Americans didn't tell the Irish to become a financial sector and follow the policies that they did. We didn't tell the Austrians and the Italians to do all the investing in Eastern Europe that they did. We didn't tell the Spanish to invest in Latin America to the extent they did. They did that without our help or participation.

It's more that Europe and America made the same mistake than we exported our mistakes to Europe. The world financial system is global in its precepts. London is at least as creative a place as New York is. And the monetary policies on both sides of the Atlantic were very accommodative of a bubble, for reasons that, you know, have causes to defend.

So, I really don't think that we should blame ourselves. We are part of the problem, but they're grownups and they made their own mistakes along with us.

The CHAIRMAN. Well, thank you all very much.

Mr. Soros, I want to ask you if you want to summarize and have the last word here, with respect to the foreign policy component of this and the challenge we face—if you just want to leave the committee with some last thoughts, pulling the afternoon together, that would be terrific.

Mr. SOROS. Well, all I'd like to say, what we have been, I think, saying all along, that the situation is very serious, that it is a genuine collapse of the financial system, the likes of which we have not seen since the 1930s. But, we have the experience of the 1930s to learn from, and we—I think we are trying not to make the same mistakes as we did then. So, the lessons of the 1930s were summed up in John Maynard Keynes' general theory which was published in 1936. We have the advantage that that book is now available, we can take it out of the drawer and dust it off and use it.

The CHAIRMAN. There's another interesting book, incidentally, which I just reread the other day, which is John Kenneth Galbraith's "The Crash of 1929"——

Mr. SOROS. Yes, very much so.

The CHAIRMAN [continuing]. Which is well worth the wisdom in it, particularly with respect to some of the——

Mr. SOROS. And just—in summary, I just would like to, once again, emphasize how we do have this special drawing rights, which, again, is in existence, is real, and it can be used and could make a major contribution to alleviating the problem.

The CHAIRMAN. Last question, Mr. Wolf. What's the most important thing that has to come out of the G–20?

Mr. WOLF. I think the single most important thing, given where we are now, there has to be a really big demand commitment from the surplus countries; otherwise, the United States ends up with this nightmare fiscal position. They are the mirror image of each other. I think that's absolutely central, and there must be clear and credible ways forward for the fund—IMF system of which the SDRs are part. Those are the two absolutely central elements, in my view.

The CHAIRMAN. And the "demand piece" means?

Mr. WOLF. "Demand piece" means that—I think, that the Germans, Japanese, and Chinese have to have a target for domestic demand, which clearly means that they start reabsorbing their surpluses at home.

The CHAIRMAN. Fair enough.

This has been excellent. We really appreciate it. It scratches the surface of complicated issues, but it's a terrific outline, and we're very, very grateful to all three of you for being with us today. Thank you.

We stand adjourned.

[Whereupon, at 4:34 p.m., the hearing was adjourned.]

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