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THE SHOCK

Presenter: Martin Wolf

TRANSMISSION: Monday 14 November at 2000 on BBC RADIO 4

OPENING ANNOUNCEMENT: And now on BBC Radio Four, Martin Wolf, Chief Economics Commentator of the Financial Times presents the first in a two part series, New Global Economics. Since the start of the financial crisis the world now faces economic and political uncertainty, the repercussions of which may be far more profound then most people can imagine. Martin Wolf presents part one of New Global Economics - The Shock.

WOLF: The financial and economic crises of the Western world are now more than four years old. They became evident in August 2007; came to a head in the autumn of 2008, after the failure of Lehman Brothers; and have now become most obvious in the Eurozone whose crisis rages unabated. This, it is clear, is no passing event, but an enduring upheaval: financial distress, economic weakness and high unemployment continue. Now concern has shifted to worries about the bankruptcy of governments, not just of banks. None of the afflicted economies has recovered strongly despite extraordinary efforts by policymakers. Was 2007 the high water mark for the move towards free market capitalism launched by Margaret Thatcher and Ronald Reagan in the 1980s? Have the shocks permanently diminished the position of the West in the world economy relative to the rising East? One point is clear: the world has changed in fundamental ways.

TURNER: This has been such a shock to a set of assumptions that we've made that more people in positions of public policy authority, people designing policies, are attempting to go back to the basics and make sure that we challenge fundamental assumptions which we've just accepted in the past. It is incredibly important that we don't just patch the system up, but ask really searching questions about what was wrong with it.

LAGARDE: What is at stake at the moment is not just the stability of Greece, it's not the stability of the Eurozone, it's not the future of the Euro. It's actually the stability of the global economy because if things go south, all economies will be affected.

DERVIS: This crisis may in some sense be the thing that makes people realise that the old way of carrying on on a purely national nation state basis and catering only to very short-term local perceptions is not working. Of course leadership will be required to explain this.

WOLF: In September economic policymakers gathered in Washington DC for the annual meeting of the International Monetary Fund. The mood was gloomy. The imbroglio in the US Congress over raising the debt ceiling and the worsening crisis in the Eurozone raised widespread fears of a double dip recession, even of another meltdown. People had finally realised that this was likely to prove an enduring malaise in both the US and Europe. Christine Lagarde, former Finance Minister of France, has recently taken over as Managing Director of the IMF. She laid out her perspective on the economic situation at a press conference.

LAGARDE: The economic skies today look troubled, they look turbulent as global activity slows and downside risks increase. And we have entered into a dangerous phase of the crisis.

WOLF: The shocks of the summer had worsened the mood, but these, however bad, were just further episodes in a single long-running crisis of excessive private and public debt. The focus had merely shifted from the financial sector, which hit its worst moment in the autumn of 2008, to doubts about the credit worthiness of sovereigns; but it was then forced back onto the financial sector again with growing worries about the solvency and funding of Eurozone banks. The private sector is overburdened with debt. Governments, often over-indebted to begin with, are also borrowing too much as a result of the crisis. But excessive debt is not the only danger lurking in the background, as Christine Lagarde explained to me.

LAGARDE: What we see at the moment is a combination of two factors that have not been digested to return to something that was more balanced. We see this continuous imbalance between the public sector spending and the private sector spending. The public sector has had to engage and put huge amounts of money in the economy because the confidence had broken down, the banks were not lending to each other, they were not financing the economy, and nobody was investing. That has to recede, it has to phase out, and private demand - of which it is the ultimate purpose to invest and employ and create value and make money at the end of the day - has to pick up the baton. That hasn't happened and it has to happen. Number two, there is another imbalance and that also needs to be addressed and be restored, and that's the imbalance between the surplus countries that have to spend a bit more at home so that the deficit countries can reduce their deficit and we rebalance that imbalance that there is at the moment. And in my view, those are two reasons why we have this continuous race that takes our economies into significant crisis. The difficulty we have at the moment is that we have a combination of the sovereign debt question, which creates lack of confidence in certain countries; and, number two, we have banks that are, that *were* very weakened by the crisis, that have restored a bit of their strength but for some of them have gone back to the same little game that they were into and that are weak as a result today and again confidence is not there. But we need to address all issues at the same time and never forget that there is this twin imbalances that need to be redressed.

WOLF: During the IMF meetings, I also met with Tim Geithner in his grand offices next to the White House. He has been involved in grappling with a series of shocks since the beginning. He was President of the Federal Reserve Bank of New York when Lehman Brothers failed. He is now US Treasury Secretary. The governments that are finding it hard to borrow are being forced to cut their spending and raise taxes, but those with more room for manoeuvre need to pay attention to the consequences of over hasty tightening.

GEITHNER: A lesson of many past financial crises is you see the broad stance of fiscal policy, sometimes monetary policy, turn too restrictive too quickly at a time when growth is still fragile, undermining prospects for recovery, delaying the healing processes to happen and eroding ultimately the long-term fiscal position. So there’s a very good case in the current environment for everybody stepping back and looking at how to recalibrate strategy to make sure you’re strengthening growth.

WOLF: Are we actually facing something that is really a major global event, or is it really something that just concerns the already very battered and weak developed world?

GEITHNER: No, I think the slowdown in growth you saw at the early part of this year - in part because it was precipitated by what happened to oil prices and the disaster in Japan - was a synchronised global slowdown in manufacturing but also just in spending. Europe made that worse. Our flirtation with our debt limit fight in the summer was bad for confidence too. But this is a generalised slowdown. No country’s immune to it.

WOLF: You’ve introduced some very important regulatory changes here, also worldwide. There’s been a lot of very public pushback. Do you think that you will be able to hold the line as it were and you’ve got in the right place as far as financial regulations? Or are we, as some argue, killing the recovery because we’re killing the financial sector?

GEITHNER: Well there’s this terribly difficult balance you face at a moment like this. We all are seeing the trauma, the terrible damage done by the crisis, want to make sure we’re building a financial system that doesn’t leave our economies vulnerable to this kind of thing in the future, and so there’s a overwhelmingly compelling economic case, financial case, fiscal case for building a much more stable, more resilient financial system. But you have to do that carefully because if in the process of doing that you add to the pressures on economies till they end up in crisis, then you’ll do a lot of damage too, and we’re trying to get that balance right. But I am very optimistic that in the United States, and I think in Europe where the damage was most acute, that you’re going to see sustained political support for the core set of reforms that we think are most essential. Those are about you know stronger capital cushions, so there’s less leverage in the system, making banks less vulnerable to funding pressure and crisis, making sure derivatives are subject to more uniform oversight, global margin rules, things like that. There’s a very strong economic case for that, very strong political support for that, and I think we can achieve that. You know you’re going to see a lot of pushback of course and a lot of complaining, a lot of concerns. And this is causing more uncertainty to the financial sector that’s still under some pressure, but we have to make sure that we’re taking a view to the long-run and I’m pretty confident the United States, at least, we’re going to get that balance right.

WOLF: So we are going to fix this and we are going to get out of the crisis?

GEITHNER: I think so, but of course you don’t want to just *hope* that’s going to happen. You need to *act* in the service of making that more likely, and that’s what we’re trying to do.

WOLF: Timothy Geithner, US Treasury Secretary. Two particular policy mistakes stand out: one is that financial regulation, far from making the system sounder, actually promoted unwise lending; another is that the 17 disparate countries which share the Euro operate without the backstop of a proper central bank. This is proving to be very dangerous in the current turbulence. The full implications of these twin errors for the manageability of the Eurozone financial crisis has become horrifyingly evident.

WOLF: Was the banking system abused by governments as a cheap way to finance themselves? And what effect has this had on the financial system? Adair Turner is Chairman of the UK's Financial Services Authority.

TURNER: Well what's interesting is there are so many things as we progress through this crisis that make you challenge what we believed beforehand; and I think that if we step back and ask ourselves how we treated sovereign debt, we should not be at all surprised at the consequence. We said that sovereign debt was riskless, so this was a very favoured form of credit. Why, therefore, should it surprise us if a hell of a lot of this was issued? If you create a public policy bias in favour of a set of a particular form of credit, it should not at all surprise you that the borrowers of this credit end up borrowing more than they can really afford. So it is clearly the case that the issue of the appropriate treatment of sovereign debt is one thing that we have to go back to. I think, however, we also - and this is a crucial thing within the Eurozone - we have to think about the fundamental difference between sovereign debt issued by a country which is also a currency issuing authority and sovereign debt issued by a sovereign which does not issue its own currency. That sovereign debt, which is like Italian or Spanish sovereign debt, really has the status of state of California debt, not US Treasury debt. This was a fundamental I think failure within the design of the Eurozone system to understand that within it, the sovereign debt of these countries had a very different status than the sovereign debt of countries which are also currency issuers.

WOLF: Adair Turner. Behind what is happening in the crisis is a long-term failure of a capitalist system, particularly in advanced countries. Real wages have been lagging behind productivity growth. This has led to rising inequality and weak underlying demand. Ever rising borrowing became the only way to sustain consumer spending, especially in the US. Kemal Dervis is one of the world's most experienced policymakers and was spoken of as a credible candidate to become Managing Director of the IMF. He played a huge role in reforming Turkey's economy in the early 2000s as Minister of State for Economic Affairs, was Head of the UN Development Programme, and is now at the Brookings Institution in Washington DC.

WOLF: Does he think the demand engine is now broken?

DERVIS: There was a time, the best times of capitalism when productivity rose, wages rose, the incomes of the middle classes rose, there was balanced demand and we had balanced growth. But this is no longer happening. So tackling this long-term support to broad based effective demand is not going to be easy, but I think it is part of the solution.

WOLF: Now some people would say you had this enormous financial crisis. Now, in addition to that, that comes along with a trend in which for a very long time rising productivity did not generate rising real wages across the broad sector of the population. Even though they had real gains in countries like China and India, they didn't really share in this. So some people would say there's something fundamentally broken in contemporary capitalism in quite a deep way. All this raises some pretty big questions, doesn't it?

DERVIS: It does and I do believe we don't really have the answer on how to do it without stifling markets and innovation, private sector. We've learned the private sector is essential for growth and for economic prosperity, but how to have systems where this private sector growth and dynamism and innovation investment leads to broad based gains for the whole population, how we can counter this excessive concentration of income at the very top? And there's nothing in the trends that show that's slowing down. I mean the US before the crisis had reached (if you include capital gains) 24 per cent of income going to 1 per cent, from 8 thirty years ago - 8 to 24. Well what if it goes to 33, one third? That is clearly something that will create big problems.

WOLF: Kemal Dervis, Vice President of the Brookings Institution. On one point almost everybody agrees: there is too much debt, both private and public. But what can be done about it? Try to reduce it too fast and risk a slump in demand. Try to reduce it too slowly and risk further financial shocks. So which to choose and where does government borrowing fit in?

WOLF: Larry Summers, former US Treasury Secretary, and more recently Director of the National Economic Council for President Barack Obama, has characteristically strong views.

SUMMERS: The most important lesson that students should take from a macroeconomics course is that things don't add up; that if any one household decides to spend less and save more, they will pay down their debts and build up their savings, but if *all* households try to save more and spend less, the result will be that there will be lower incomes and ultimately less saving and more debt. That is the kind of error that we are in danger of making. This fallacy of composition is present with respect to the idea that all individuals should save more. It is similarly present with respect to the idea that all countries should seek to export more. It is similarly present with respect to the idea that all countries should seek to reduce their indebtedness. This is particularly striking as an issue in Europe where there seems to be much more enthusiasm for the idea that countries on the European periphery, countries with credit issues, should reduce their borrowing, than there is that Germany should reduce its lending and associated exporting. In certain circumstances - when an economy is close to capacity, when high interest rates are choking off investment - it is very plausible that reducing deficits can lead to lower interest rates, more investment and more capacity. So the idea of expansionary contraction is a reasonable one. It is not, however, a reasonable one when base safe long-term interest rates are very close to zero. It is not a reasonable one when the constraint on investment is not capital costs, but lack of current demand.

WOLF: Larry Summers, now Professor at Harvard University. The focus of concern is the Eurozone where fiscal crises in a number of countries - Greece, Ireland, Portugal, and now Spain and Italy - are spilling over onto the banking system. Today's stresses are the result of the lax borrowing and lending of the first decade of the Euro's existence. Members of the Eurozone find they cannot go back to those happier pre-crisis times, cannot stay where they are, and cannot agree on how to go forward. Paul de Grauwe is a Professor of Economics at the University of Leuven in Belgium and an adviser to the President of the European Commission, Jose Manuel Barroso.

WOLF: What does he think the severe differences in competitiveness that have now emerged between the successful countries of the North and the struggling countries of the South mean for the Eurozone's future?

DE GRAUWE: We are talking really about losses of competitiveness of countries like Italy, Greece, Spain, Portugal of the order of 10 to 20 per cent. That is their wages have increased by 10 to 20 per cent in excess of what say an equilibrium position would be. So they will have to turn that around. Now this is tough. In the past they could have devalued by say 20 per cent and it was done in just one day. Now they will have to spread it over a period of say six, seven years - which is tough, but it's feasible. And here I see two levels at which the ECB is crucial: one, it should be a lender of last resort in the government bond markets and thereby preventing a banking crisis; but then at the same time, in terms of providing support for economic growth, the ECB is equally crucial. And then what I see in the data is that it has been so conservative and in fact doing things that go against its own strategy. It has developed this semi-monetarist approach to policymaking which says that it wants to control inflation, so that inflation is not more than 2 per cent a year; and in order to do so, the growth rate of money, money stock, should not be more than 4.5 per cent, right? Now when we see the last two or three years, the growth rate of money has been extremely low - 1 to 2 per cent a year. In other words, what this suggests is that using the ECB's own test, it is too restrictive today and it doesn't act on this, which is very surprising. It's still somehow fearing inflation, so it's fighting previous wars instead of looking forward and looking at the risk that exists today.

WOLF: Under Mario Draghi, the newly installed Italian President, the European Central Bank did cut interest rates, but only by a quarter of a percentage point. The institution remains very cautious. Quite apart from the problems of competitiveness and sovereign debt, we still have a big concern over levels of private debt. But the policymakers' attitude is schizophrenic: the economy is over-indebted, so we need to reduce what we owe, but at the same time policymakers want credit to expand to prevent their economies from collapsing. Have we become like heroine addicts who need our fix of credit; we cannot live without ever more of it even though we know it is poison?

WOLF: Back to Adair Turner of the Financial Services Authority.

TURNER: If we were really clever, we would have realised in advance of this crisis how incredibly difficult it is to deal with deleveraging once you've allowed leveraging to go to an over the top level. I mean we ought to have realised that because Japan is a massive twenty year statement of that fact, but I think not enough lessons were drawn from that clear experiment there. We have to be simultaneously building the resilience of our financial system while not doing it so fast that we are making even more rapid the processes of deleveraging which are undermining nominal demand.

WOLF: Expansion of the central bank's balance sheet is part of that, isn't it?

TURNER: Well that is right and that is the rationale of quantitative easing. That is a clear lever available and that is actually one of the things that is important to say. The one thing one must not allow in these circumstances is a sense that as it were policy has run out of ammunition, that it is impossible to do things. The one institution which never runs out of ammunition in its own currency is a central bank. There are all sorts of issues about whether and under what circumstances it should use the ammunition, but a central bank has limitless capability to create its own currency. And that is a very important thing for us to remember, and if we ever go into anything remotely as bad as the early 30s, it can only be because we either forget or deny that rather important fact.

WOLF: So we have the weaponry if we wish to use it, but this weapon can also backfire. The debate over the printing of money by central banks rages on. An important novel element in the present crisis is the rising role of emerging countries. Although affected by the turmoil, they also managed to return to vigorous growth long before the developed world. Emerging countries are also more questioning of the competence of the advanced countries than ever before. They have as a result demanded a greater say in global affairs. One result has been the rise to prominence of the group of 20 countries in place of the old group of eight leading industrialised nations.

WOLF: The group of 20 includes all the significant emerging economies - among them China and India - while the G8 only included Russia in addition to the US, Japan, Germany, the UK, France, Italy and Canada. How is the world going to cope with this transformation? Mark Malloch-Brown, former UN Deputy Secretary General and minister in Gordon Brown's Labour Government, has experience of this transition.

MALLOCH-BROWN: Until very recently, it seemed that emerging countries were in a sense sticking to their knitting; sticking to building their economies, dealing with a huge unmet agenda at home. I think starting with 2008, we've seen that shifting. The G20 replacing the G8 as the primary international economic coordinating body reflected the power shift, and while initially there was some kind of hesitancy on the part of the new members - China and others - quickly the signs became clear that they were taking this very seriously. I remember as Gordon Brown's envoy for the G20 meeting in London going to different capitals to kind of lobby for a strong support to an international rescue package, and quite simply the most sophisticated economic discussion I had in any capital about the issues was in Beijing: lots of smart people in think tanks who'd come out of government, lots of abrasive opinions about Western failure, but a real sense that something had to be done to fix this. Fast forward to now and I think that is even clearer. On the one hand, this is a Euro crisis and everybody keeps on saying it's for Europe to fix; but the interesting issue has I think been, through vehicles like the IMF, the willingness of developing countries to consider an additional credit line to save old Europe. And interestingly the countries that have blocked that are the US and the UK who suddenly seem more reluctant to sort of step up to an international rescue package than the emerging economies. And while it's one small episode in this whole crisis, to me it's a very kind of seminal one which points to the real shift and to these new countries starting to pick up the burden of shared leadership.

WOLF: Mark Malloch-Brown, Chairman of Global Affairs for FTI Consulting. With the second fastest growing of the large economies of the world after China's and a population of well over a billion, India is gaining a louder voice in world affairs.

WOLF: Montek Ahluwalia is Deputy Chairman of the Planning Commission and the right-hand man of India's Prime Minister Manmohan Singh, particularly for the G20.

AHLUWALIA: There has been one important change in the global growth arithmetic and that is, if you like, the autonomous capacity of the developing countries to grow rapidly has increased compared to what it was. That, however, doesn't mean that they're de-linked, so you've got to distinguish between a situation where the industrialised countries just slow down but in a world that's otherwise stable, as opposed to a situation where you have a financial crisis and God knows what's going to happen.

WOLF: So can the emerging countries help manage these crises? One possibility might be to increase the resources of the IMF substantially, even turn it into a central bank for the whole world by giving it the authority to create so-called Special Drawing Rights, which are a form of international money that can be used by governments in settling their debts. Thus Mr Ahluwalia sees the case for a much bigger fund playing a bigger role in economic governance.

AHLUWALIA: There is a case for ensuring that in the event of a major crisis the International Monetary Fund, subject to whatever governance restrictions you want, is actually able to do what a central bank is actually able to do internally. Now we've seen for example in the case of the US, and later in the case of the ECB, that when you're faced with a financial crisis you very often have to inject liquidity on a scale which only a few years ago would be thought to be completely mad, and the question is can we do the same thing internationally? I think the solution lies in authorising the IMF to issue new Special Drawing Rights, the SDRs, to itself and to be able to use that in any kind of international rescue effort. That's what Keynes had in mind originally - that you enable the fund not just to be a fund but act as a bank, i.e. to create its own money. Now for some reason we have never been willing to do that. We have never been willing to do that because we've assumed it's only the developing countries that we have to help and their needs are limited.

WOLF: You're really talking about the creation of a global central bank with the powers of a central bank. Is that do you think from the discussions you've been engaged in in the G20 in any way a realistic possibility?

AHLUWALIA: Well you know there were a number of things that people would have ruled out as being realistic in the national context - I mean QE1 and QE2 and central banks buying not just treasury bonds but buying corporate bonds. So many things have happened and I think the recognition that when the financial markets become that pervasive and interconnected, you have to have a lot more weaponry to deal with the problem, that is already there. But what is *not* there is to authorise an international agency to take those steps. Now frankly if the world is not comfortable about authorising the fund to do that, then basically what it is saying is these governments collectively haven't got a clue what the world needs. That's a very worrying situation to be in, so personally I think we need to think the unthinkable.

WOLF: So is there any hope that policymakers will rise to the challenges they face?

AHLUWALIA: The real problem in all of this is first of all an intellectual realisation that things are bad, and I think that's there and maybe this succession of crises was perhaps necessary to persuade people that it really is a problem. The other is political leadership. That is do you take the right decisions or do you willy-nilly push ahead with policies that are going to lead to bad outcomes? And I think you have to believe somehow that good sense prevails and that people will take the right decisions. And I think on that, I remain an optimist.

WOLF: Montek Ahluwalia expects that the world will do the right thing in the end, though not before exhausting all the alternatives - as Winston Churchill once said of the US. This programme has focused on the series of shocks with which the world is now grappling, but it is doing so in the context of big long-term economic shifts. Those will be the focus of the second in this series.

CLOSING ANNOUNCEMENT: Martin Wolf. The producer was Sandra Kanthal. You can download a podcast of this programme – details as usual, on the R4 website.