THE BROOKINGS INSTITUTION

POLICY LESSONS FOR EMERGING MARKETS

Washington, D.C.

Monday, June 6, 2011

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PROCEEDINGS

MR. LOMBARDI: Okay. So it's 10:35, I think we can start. So, welcome all to this event on policy lessons for emerging markets that is being co-hosted by the Asian Development Bank Institute and the Brookings Institution.

What prompted the idea for this event and, of course, for its underlying research program, is that the recent financial -- international financial crisis really highlighted a fundamental change in the structure of the world economy. Of course, this change made very apparent the unprecedented convergence in income of many emerging economies. But not only that, this fundamental change also goes much beyond convergence in income and has broad implications ranging from international financial stability to international policy coordination, and indeed, global governance.

And today we are here to discuss these issues with the help of a uniquely qualified panel. The discussion will draw from the latest collaborative research by ADBI and Brookings that has fed in the volumes displayed at the entrance: *Asian Policymaking for the Global Economy* and *Financial Market Regulation and Reforms in Emerging Markets.*

Turning to the panel. To my left I have Kemal Derviş. He is vice president and director of the Global Economy and Development

Program at the Brookings Institution. He has served as executive head of the UN Development Program, as Turkey's minister of economic affairs, and as vice president at the World Bank.

To his left, Masahiro Kawai. He is the dean and the CEO of the Asian Development Bank Institute. He has also been deputy vice minister of finance for international affairs in Japan, a professor at the University of Tokyo, and the chief economist for East Asia at the World Bank.

To my far right, Don Kohn is a senior fellow at the Brookings Institution. He's also a 40-year veteran of the Federal Reserve, where he last served as deputy chairman. In that capacity, Don advised the Federal Reserve chairman, Ben Bernanke, throughout the 2008/2009 financial crisis and also served as a key advisor to former Chairman Greenspan.

And to my immediate right I have Eswar Prasad. He is the new sanctuary chair in international economics at the Brookings Institution. And he's also the Trelawney senior professor of trade policy at Cornell and a research associate at the National Bureau of Economic Research. And previously, he was head of the financial studies division and of the China Division at the International Monetary Fund.

Before turning the floor to the panelists, just a few words on the rules of engagement. So, each panelist will have 8 minutes, and then

Don Kohn, who will speak at the end, will have 10 minutes. After their initial remarks, there will be a first round of discussion among the panelists themselves. And then we'll open up for Q&A from the audience.

So without further ado, I will now leave the floor to Kemal.

MR. DERVIŞ: Thank you, Domenico, and thank you all for being here. Thank you particularly, Dean Kawai, for your support, for the research, and also for organizing this event. It's been a wonderful cooperative relationship. And we're continuing to work together with the Institute.

The way we're dividing the panel's time is I'm going to focus just on a few stylized facts which I think are worth underlining or, to some degree, hopefully surprising. And then the policy discussion will follow from there.

The first thing I want to say is that, you know, there is no wide agreement on the structural transformation that Domenico mentioned: that the world economy center of gravity is shifting; the structural change towards the emerging markets in Asia; the fact that the world economy dominated by Western Europe, U.S., and Japan is no longer going to be what we're going to have in the coming decades.

But what I want to emphasize is that, to some degree, this is actually a fairly new consensus. If you look back 10, 15 years, the story

was still one of divergence. In fact, the per capita income growth average of emerging markets versus advanced countries only turned in favor of the emerging markets in the 1990s, so it's a two-decade phenomenon. Throughout this post-World War II period there was actually divergence even -- not just with the least-developed countries, but also with the emerging markets. Per capita income in the advanced countries was growing faster than per capita income in the emerging markets. So that's, I think, one point worth remembering.

Second, I do think we should be a little bit cautious in humble. Economists have made all kinds of projections, and you know, there was a time when, for example -- some of you may remember where Japan was going to take over the world economy. It was going to surpass the U.S., and all that.

So one has to, when one makes long-term projections, I think one has to be a little bit careful because there are all kinds of variables that are very hard to predict 10, 20 years in advance. And we'll come back to that.

Nonetheless, I would like to stress that what is happening now is unprecedented. Yes, Japan and also the Republic of Korea had a period of growth as impressive as emerging Asia, almost as impressive as China during a good part of the postwar period. But in the end, that affected a very small number of people relative to the overall world

economy, world population: Japan, 130 million; Korea, you know, 50, 60 million people. Now, what's happening is that a population of 3, 3-1/2 billion is achieving remarkable sustained rapid growth. And that, of course, does transform the world economy in a very profound way.

However, looking at the figures I think it is important to distinguish emerging Asia from the other emerging market and developing countries. The emerging market countries as a whole are growing faster. In per capita terms, if you take the whole set, more than twice as fast as the advanced countries. But emerging Asia is growing 3, 3-1/2 times as fast. So there is a very important difference between Latin America and some of the Mediterranean emerging markets and South Africa versus emerging Asia. Okay? So in some commentary when we just talk about emerging markets as a whole, I think one has to be a little bit careful, and it could be actually quite misleading.

And what is the key difference, in my view, between emerging Asia and the rest of the emerging markets and developing countries? It's really the savings rate. And the figures -- you know, the figures are quite startling. If we take the period -- the last decade from 1999 to 2009, the average savings rate of advanced economies was 19.4. The average savings rate of other emerging -- non-emerging Asia emerging market economies was 22.3. Somewhat higher than the

advanced economies, but only marginally higher. The average savings rate of emerging Asia was 38 percent. So, compare 22 to 38.

Now, of course, China is a big part of that with it's extraordinarily high savings rate. But overall, emerging Asia also saves a lot more than the rest of the world. And I think that is one of the fundamental reasons why the growth rate differential is there. Because this high savings rate, of course, translates into high investment rate: average is 34 percent for that period compared to 21 percent for the rest of the world. And it does so in a sustained way, less vulnerable to capital flow reversals, less vulnerable to the need to finance the domestic investment by foreign savings, okay?

It varies, of course, by country. India has had a small contribution of foreign savings, whereas China, you know, actually exports savings. But overall, if we look at emerging Asia as a whole, you have that fundamental difference rooted in the high savings rate, high investment rate, and sustainability because the national resources are financing most of the investment.

Now, question: Will it last? The chapter I wrote with Karim Foda, I think, looks at the various factors here. Other parts of the two and also Eswar Prasad's more -- somewhat earlier book looks at growth prospects. And I think one has to probably distinguish between a 10-, 15-

year horizon and a 15- to 30-year horizon. I'm more confident speaking about the 10 to 15 years. What goes beyond becomes much more speculative. But the indications are that at least for the next 10 to 15 years, the impressive growth of emerging Asia is likely to continue.

There is no indication that the savings investment rates will fall significantly. They may fall somewhat, but not significantly. There is, on the demographic side, it's true that China is going to face some demographic constraints soon, but not immediately. The famous Lewis turning point probably hasn't quite arrived yet in China. And the rest of emerging Asia still has quite a bit of favorable demography, particularly India which has a very favorable demographic structure.

And finally, technological progress, TFP, which is largely based on catch-up at this point, although there is some domestic innovation, too. I also think there is really no reason to believe that it will slow down in a significant way. There are studies quoted in the chapter of return to capital, which is still quite high. Not as high maybe as 10, 15 years ago, but even in China, return to capital -- despite the very high investment rate -- is still very high.

And second, when you look at firm level -- total factor productivity levels inside countries like China and India, you see there are great differences. So there is not only scope for catch-up from abroad --

in other words, catching up vis-à-vis countries at a higher level of total factor productivity -- but inside the countries there is huge scope for learning by firms that are less efficient from firms that have already become very efficient. So the internal transfer of technology is also going to be quite remarkable.

So I do believe that based on these factors and, you know, more details are given in the books, it is not imprudent to say that barring some major political upheaval or, you know, things that are really exogenous to the economic analysis, that the growth will continue.

In terms of international weights, one has to remember that there are two parts to this. One is the growth in domestic constant prices. So, China may go from 10 to 8-1/2 to 7. I mean, the new Five-Year Plan targets 7. But China has tended to exceed its own plan targets. But even if it's 7 percent growth in domestic constant prices, if you add to that a tendency for a slowly appreciating real exchange rate, in terms of the overall weight in the global economy, you know, it is the combination of the domestic growth with the exchange rate appreciation that gives the change of weight in terms of market prices.

So, again, looking at China, I would not at all be surprised that 9 to 10 percent of that combined effect will continue for another decade.

Tomorrow, I have to do an advertisement for another book, which is *Juggernaut* by Uri Dadush and Shaw. Some of these things will be discussed just across the street. And I think we'll have another occasion to discuss some of the medium- and long-term growth projections, because the book very nicely actually has a model based on a Cobb-Douglas function, which brings in these various concepts.

Now, second to last point -- no, two more points very quickly: coupling and decoupling. I'm going to leave maybe to Eswar Prasad to say a little bit more on that because one of his books looked into this in great detail. My feeling, based on some analysis using Hodrick-Prescott filters, is that the basic story is that there is trend decoupling. In other words, the trend growth in the advanced economies and in emerging Asia is sustainable decoupled with the Asian growth rate being sustainably at a much higher level. But that the cyclical component is still there, that there is still some -- in other words, if the U.S. economy really slows down, it will have an effect on emerging Asia and vice versa.

The second part of the story -- which is detailed and I think with some care in Eswar's book -- is that there is also beginning to be a lot of interdependence within the developing and emerging market world. So the correlation of growth between, say, Latin America, Brazil, and China is much higher than it was in the past. And so, I think that that's an

interesting part of the story.

Finally, when you think of all these global imbalances debate, I think they're important. But when you look at the figures, at least in a mechanical way -- if one goes deeper in terms of what creates investment demand, what creates technological progress, exports are really very important, of course, for the Asian economies and they've had the advantage in the past of being relatively small and having the global market to export to. But in terms of the actual contribution of net exports to total demand, I think the figures in the book are sobering. There were only 3 years in China where net exports contributed more than 2 percentage points to overall demand.

So, I think one can exaggerate the degree to which net exports have been driving the growth rate. They have been an important factor, but domestic demand, investment, domestic technological progress, I think, have been in fact the dominant factors. So I don't think that export, even if China had to run a zero current account balance or even a zero trade balance, I don't think that would necessarily have a hugely negative effect or even substantially negative effect on the overall growth rate.

Finally, before Domenico shuts me off, looking forward into the longer term, let me just share with you. We'll have time to come back

maybe. I think there are two major constraints, apart from politics, which are obviously always there to be remembered, but that could constrain the growth in the longer term much more.

One, I think, has to do with natural resources and the climate. I think over a longer horizon, emerging Asia and particularly China will have to take that constraint very seriously. There are indications that it is, but I think it will become a major constraint.

And second, the issues around income distribution, which could lead into politics, of course. Growth has become very un-equalizing in emerging Asia, as the last three decades have been in the U.S. And I think if that un-equalizing tendency continues with massive concentration of income at the top, that could create new policy challenges that, you know, may not be easy to deal with in these countries. As long as growth is very rapid, everybody gains quite a lot. And I think the income distribution problems can be on the back burner to some degree. But even a small decrease in the growth rate and a continued trend towards more unequal distribution could create problems in the medium to long term.

Thanks.

MR. LOMBARDI: Thank you very much, Kemal. So I would now give it over to Dean Kawai.

MR. KAWAI: Okay. Thank you very much. On behalf of the Asian Development Bank Institute, I would like to say thank you to the Brookings Institution, in particular Kemal, for hosting this event.

My discussion is going to focus on Asia's financial issues. The Asian financial system was not affected very significantly following the global financial crisis. Asia had its own financial crisis in 1997 and '98. Over the past -- the subsequent 10 years following the Asian financial crisis, Asia's financial systems became quite healthy, resilient, and that was the basic reason why financial systems in Asia were not affected significantly.

Of course, you can find some exceptions, like Korea's mini currency crisis in the fall of 2008. But generally speaking, Asia's financial systems were quite resilient. Non-performing loans had been declining. Risk management systems were put in place. Regulators and supervisors acquired the capacity to seriously supervise and regulate their financial institutions. So, when the financial crisis took place in the United States and spread to the rest of the world, Asia was relatively sound. However, the trade channel really affected many Asian economies.

On the financial side, the first reaction on the part of Asia to the global financial crisis was that many Asian policymakers were perplexed because they were told that the U.S. financial system was one

of the best and the UK financial system was one of the best. And then Asians were told to improve their financial systems to become just like UK or U.S. financial systems.

So in a sense, many Asian policymakers got troubled. What should I do? What should we do? So, that was really the first reaction.

I think now people realize that no matter how a country's financial system is developed, it's always important for financial regulators and supervisors, together with monetary policy authorities, to work together to make sure that the financial system would be sound. So, the role of regulators and supervisors and central banks would become very, very important.

So, one of the lessons that Asian policymakers have learned from the global financial crisis was that any rate, Asia will have to continue its effort that's been done following the Asian financial crisis and should continue to develop financial markets to deepen the financial markets, because financial markets are essential to economic growth.

And also, many policymakers realized that the process of liberalization would have to continue, although at the somewhat more measured process, in a measured way, not a, you know, very rapid liberalization. So China, India, many other emerging economies have been learning from the global financial crisis.

There are several challenges that Asian policymakers are facing. Continued process of financial sector reform, that's one. Second is managing capital flows. That's becoming a very important issue. The third is to strengthen regional financial cooperation. So, let me talk about these just briefly.

On financial reform issues, Asian policymakers have been making a lot of progress. Most countries in Asia -- most emerging economies in Asia have adopted Basel II capital standards. And liquidity standards have been improved and leverage ratios have been contained.

The bond market in Asia, which had been less developed relative to the banking system, has been growing very fast. And if you take a look at Asian bond markets in the global context, say, by taking per capita income in the horizontal axis and the stock of even private -- corporate bond issuance relative to GDP in the vertical axis. Globally, you observe positive relationship. You can observe that countries like Korea, Malaysia, are far above the international average for their respective per capita income levels. Taiwan is making significant progress also.

So, there are several countries which have made significant progress over the past 10, 15 years. There are other countries, like Indonesia, the Philippines, which have yet to catch up with the international average. But bond market development is a very important

challenge.

On managing capital flows, short-term capital flows have been coming to Asia since last year, in particular, when the U.S. Fed adopted the so-called QE-3. And even before that, the low interest rate policies taken by the U.S. and Europe generated capital flows into emerging market economies. And many Asian emerging market economies have been growing in a robust way, as Kemal explained.

Capital naturally came to Asia. Of course, capital inflows are welcome phenomenon. But too much capital inflows could be a problem, in particular short-term capital inflows. Essentially Asia has a lot of savings, so many Asian economies' short-term capital inflows are not necessarily needed, but capital inflows come. And how to manage capital inflows would be a problem -- would be an issue.

There are several ways to manage capital inflows. One is macro -- to use macroeconomic measures to manage capital inflows. Stabilized intervention in the market is one traditional way; allowing currency appreciation is another way. Many Asian emerging economies have been allowing currencies to appreciate. But at the same time, they have been intervening. So, they have been using a combination of intervention and some currency appreciation.

MR. LOMBARDI: Thirty seconds.

MR. KAWAI: So, I'm running out of time, yeah. Okay. So, capital controls are now commonly used by many emerging market economies.

I think capital controls can be an effective tool if they are used in a careful manner. The Chilean style is one way and also targeting the investors, like China or India's way, would be another way.

Capital controls should be considered as a tool for managing capital controls. In particular, could be categorized as a so-called macroprudential tool from the perspective of supervisors controlling capital flows. Could be useful policy measures.

So, let me finish in 30 seconds.

MR. LOMBARDI: Sure.

MR. KAWAI: Financial -- regional financial cooperation is very important because I think for many Asian countries, currency appreciation is needed. And in my view, currency appreciation has been very slow.

One of the reasons for this is that one single country has less incentive to allow currency appreciation because by doing so, that country loses international price competitiveness. So, if countries -- Asian countries get together, if they allow jointly a currency appreciation, then the impact on the individual countries would be limited.

Second is that capital controls -- if effective capital controls are imposed, then capital controls may drive capital to other countries -- other neighboring countries. So the region like Asia, which attracts a lot of capital, can get together and it can work together to discuss how capital inflows could be managed and, if possible, controlled in an effective way.

Thank you.

MR. LOMBARDI: Thank you. Eswar?

MR. PRASAD: Once upon a time, not too long ago, the answers were clear. It was very clear what emerging markets needed to do in terms of monetary policy: have an inflation objective with the flexible exchange rate.

Once upon a time it was very clear what exactly emerging markets needed to do to have strong and well-regulated financial systems. Perhaps some would have preferred the U.S. model, some would have preferred the UK model, but there was an endpoint. And once upon a time was actually not that long ago. It was just as far back as 2007. And then of course, 2008/'09 happened and, all of a sudden, the answers disappeared.

It's very interesting that, in fact, there's been something of a convergence of these debates across the advanced economies and emerging markets. On monetary policy, for instance, the debates that we

are having about central bank independence. What the Trade Office, between having single or multiple objectives versus the independence of the Central Bank, is exactly the same debate that is happening in the U.S. as it is in the other emerging markets.

The price we are paying, of course, for the convergence of these debates is loss of clarity in many of these matters. Now, one of the responses that initially took place in the emerging markets when thinking about financial development and regulation was that the '08/'09 crisis that revealed that, in fact, the old notions of well-developed financial markets with sophisticated financial instruments might actually lead you into ruin.

And in fact, there was a bit of a hiatus in the financial development process in many emerging markets. In fact, in countries like China and India, a very strong narrative also took hold that perhaps having a state-owned banking system -- or at least a partially state-owned banking system -- is actually very good at times of stress. After all, when the crisis hit it was the state-owned bank in China that pumped out credit, kept the economy afloat.

In India, the banking system is not quite split, but the state-dominated banking system is shrinking in size. But that's the part of the banking system that pumped out credit, kept the economy going.

Now, interestingly enough, it turns out that the emerging

markets have turned out to be much more enlightened than that caricature might suggest. In fact, even during the depths of the financial crisis, it turns out that the emerging markets were, in fact, moving forward in terms of their financial reform agenda.

And in fact, this is what initiated the project that Dean Kawai set out on: to think about what the lessons of the crisis ought to be for emerging markets. Because for emerging markets there's a set of issues that are tied together. First, there is the imperative of financial market development. Then there is financial market access because many people in the emerging markets are, in fact, lower income countries, don't have access to the formal financial system.

And there are very important questions here. Does greater financial access hinder financial stability or promote it? And it turns out, there wasn't that much analytical clarity on this issue. And here again, there was a sense that there was a risk that the wrong lessons might be learned from the U.S.

One favorite story, one heard from some Asian central bankers, was the U.S. was very good about providing access. In fact, it provided a lot access to homeowner loans to those at the very bottom of the income distribution, and look what happened. So there was a sense that we needed to bring these lessons together, and also talk about two other

issues that Dean Kawai referred to: monetary policies or macroeconomic policies, more generally, and also how to deal with capital account issues.

So, what this book that Dean Kawai and I did basically does is to frame the question and show the relationships among these different issues. And for emerging markets, when it comes to financial development, it's actually a much more basic set of questions. There is a broad set of markets that need to be developed. It's not about going into CDOs or CDS's. In fact, India just about a year ago permitted the use of credit default swaps in a very limited way. Credit default swaps, OTC, sounds horrible. But it turns out that, in fact, they know what they are doing. There is a real demand for this. And what the emerging market policymakers are enlightened enough to do is to respond to this demand, but in a much more controlled fashion, recognizing that they have capacity constraints in terms of being able to regulate these markets, but they understand that finance really is the lifeblood of modern market-oriented economies.

But again the issue is, what does financial development mean? And for emerging markets, it really is about getting the basics of banking right and developing a broader set of markets, like the corporate bond markets, without necessarily going into much more sophisticated instruments. And that, I think, is where a lot of the action is going to lie.

But overlaid on that is the difficulty that emerging markets face, which, again, Dean Kawai alluded to. That they're going to live in this world where their capital accounts are much more open. Whether they like it or not, capital controls are becoming less effective over time because the emerging markets' own corporates and financial institutions are becoming much more sophisticated in terms of operating abroad. With expanding trade there are more channels for money to flow in and out. So, keeping money out of the system is really not in the cards.

In fact, there are very strong forces that are going to lead to enormous increases in capital flows. One, of course, is the flow of capital from the emerging markets to the advanced economies. It's not that the advanced economies are going to be much more productive, but if you think about the financing needs that they have for their debt, those numbers are staggering.

Some calculations that I did for the Brookings Institution in collaboration with the *Financial Times* based on IMF data suggests that the amount of public debt that was accumulated from 2007 to 2011 -- of that amount, virtually 85 percent of the increase in global public debt was accounted for by the advanced economies. Advanced economies accounted for about 40 percent of the growth during that period, with the emerging markets accounting for the rest of it.

Looking from 2011 to 2015, and making certain assumptions about normal exchange rates, the amount of accumulation in global public debt -- central government debt -- is going to be about $11 trillion. Eighty-five percent of that is going to take place in the advanced economies. And again, if you look at growth on the other hand, emerging markets are going to account for 50 percent of overall growth.

So we're going to have this very curious phenomenon that the fast-growing part of the world is going to be sending money over to the advanced economies, which are going to be sucking up a lot of their own savings, as well as foreign savings, in order to finance their deficits.

Now, one interesting issue is whether this is going to be official capital or private capital that flows. Because one of the problems in the emerging markets -- take China as an example. You do have a very high saving rate, a very high corresponding investment rate. But the real tax in the system is the fact that depositors, including households who own about half of the deposits in the banking system, and household deposits alone account for about 90 percent of GDP right now, those are getting negative real rates of return. So there is a very powerful incentive both for diversification reasons and to make a decent rate of return, which is at least positive, to ship some money out.

Of course, right now what is happening is that those financial

markets are not well-developed enough to give households the opportunity to invest abroad, so a lot of this is taking place through official channels. One, of course, is the reserve accumulation. The other is through sovereign wealth funds. And then you have institutional investors, including pension funds, who are taking the money out.

So you're going to have capital flowing from the emerging markets to the advanced economies. But at the same time, as Kemal pointed out, there is a trend decoupling in terms of growth rates, that the emerging markets are the ones powering along. So there is going to be an equally strong impetus for private capital to be flowing from the advanced economies to the emerging markets.

So we're going to see this massive gross flow of capital around the world in both directions. And this, I think, is going to be a critical issue for emerging markets to deal with. And this comes back to Kemal's point about the vulnerability of emerging markets.

I think from all indications, it looks like the emerging markets are set on a path to high growth. What could get them off this path to high growth? Traditionally, it used to be the case that emerging markets were very dependent on foreign finance and this was what led to a lot of emerging market crises.

I think there, the picture has changed substantially. If

emerging markets are vulnerable, it is not so much in terms of external factors anymore, but largely internal factors.

There are, of course, some countries, like India and Brazil, that do have foreign financing requirements. Brazil has a current account deficit. India has an even larger current account deficit, which could touch about 4 percent of GDP this year if oil prices stay high. So these are real vulnerabilities.

But on the other hand, India has a 4 percent of GDP current account deficit. But at the same time, it has about $310 billion worth of foreign exchange reserves. So again, the sort of vulnerability that emerging markets had on the external side is really not there.

The key issue is how emerging markets are going to deal with the internal issues. Kemal has already pointed out one very important vulnerability, which is rising social instability, or the tension that could arise from social instability if income distribution continues to widen enormously. But I think the financial system is going to be absolutely key in terms of the stability of these economies.

We've seen in the West that banking systems that don't work well can lead to disaster. In emerging markets, banking systems don't work very well, but they are still repressed. There is an enormous efficiency loss because of these banking systems not working well that

sometimes gets left out of the calculations.

Yes, the banking systems there are safer, but they're not really reaching a large part of the population. They're not providing access. In addition, there is a lot of growth opportunity that is being lost because the financial markets are not working very well.

So ultimately, I think even when one thinks about social stability, the financial system is going to be very important. And although, as Dean Kawai pointed out, capital controls may be one way of dealing with these flows of capital, what is really going to be important for these economies is to have the markets that can absorb and effectively channel these inflows of capital that are coming, whether or not the Fed does QE-3. There are going to be more inflows coming just because of the growth dynamics. And all of us in this room want better returns for our capital than what we can get in the U.S., especially given what is likely to happen to the U.S. dollar in the years ahead. So, we are going to be sending money there.

So, how these emerging markets deal with financial systems to both take care of the financial vulnerabilities and deal with this inflow of capital from abroad, I think, is really the key challenge ahead for them.

Thank you.

MR. LOMBARDI: Thank you very much, Eswar. And now

Don Kohn.

MR. KOHN: Thank you, Domenico. And it's a great pleasure to be here.

I think as the only non-author on the panel, I can say what these folks couldn't say, which is these are very, very excellent books. And provided me with a rich menu of thoughtful and thought-provoking articles and ideas and essays. So, I commend them to you highly.

This is the second book launch I've been on for Eswar, so I'm happy to be part of your publicity machine, Eswar.

MR. PRASAD: Thank you, Don.

MR. KOHN: As long as you continue to churn out such high-quality material anyhow.

MR. PRASAD: (inaudible), but I shall try.

MR. KOHN: I think it's evident from these books and from the discussion that over the past few years that the emerging market economies, advanced economies have become more tightly integrated and more similar, in many respects. And that the policy lessons flow in both directions, not just from advanced economies to emerging market economies.

It was the advanced economies who were subject to the severe financial crises and the breakdown of their institutions and

intermediations. It was the emerging market economies in Asia and elsewhere that were resilient in the face of these severe shocks, whose recoveries have been swift and pretty much complete.

The title of this session, I think, is "Lessons for Emerging Markets." When I looked at these books and thought about this session I thought, well, I'd begin with some lessons for advanced economies from the experience of emerging markets.

I think there are a number of lessons from the experience of the emerging markets that we in the advanced economies could pay attention to. One obvious and clear one is that strengthening financial systems pays off. The response of the emerging markets in Asia to the very difficult experiences of '97 and '98 was to strengthen their institutions. Put more capital, have much more rigorous oversight, weed out weak institutions, and all this made their systems considerably more resilient to the sudden drying up of credit and liquidity that came from the West.

Not that they were immune. There was a very sharp drop in credit and a very sharp decline in production. But certainly, the financial systems were responsive to government policies that to stabilize them, they recovered more quickly, and they were able to fill in, to some extent, for the troubled foreign lenders who withdrew from making loans and credit available in the emerging market economies.

Stronger financial systems are especially important in the face of a large inflow of capital. This was a lesson we all thought we learned from '97 and '98, in which the U.S. lectured emerging market economies about a lot, didn't they? And in the ensuing years -- and we forgot it or we didn't pay any attention to it. We neglected to apply the lesson to ourselves.

A current account deficit is not a necessary or sufficient condition for a financial crisis. Think about Japan in the 1980s. But persistent deficit and associated capital inflows, I think, are a warning sign, especially when the deficit is at least partly a response to distortive government policies and not a natural outgrowth of private sector decisions based on comparative rates of return.

I think there were two types of distortive policies that produced this current account deficit and capital inflows into the United States. In particular, one was exchange rate inflexibility and associated reserve accumulation in the emerging market economies. But the other one was government deficits, housing policies. In the advanced economies, policies that encouraged the accumulation of debt and borrowing.

A third lesson: good macroeconomic policies going into recessions and financial crises greatly expand the room to run simulative policies when problems hit. I think both the advanced economies and the

emerging market economies had good monetary policies focused on keeping inflation and inflation expectations at low levels. And that enabled us, the central banks of the world, to act very, very aggressively once the problems hit without endangering the -- without running the danger that there would be an increase in inflation expectations.

But that wasn't true. As this sort of matching monetary policy focus, wasn't true in the fiscal area. Where the emerging market economies in Asia were in much stronger position, they could use fiscal policy very aggressive to cushion the decline in demand. Whereas in the advanced economies, of course, we went into the crisis in a deficit position. And being in that deficit position and already having debt levels that were fairly high, in many cases rising relative to GDP, has constrained the response to the crisis. So, having a stronger fiscal position is necessary for a lot of reasons. But one of them is, it gives you more room to maneuver when something bad happens.

Emerging market economies have experience with macroprudential policies, which can be useful to the advanced economies. A good use of macroprudential policies can help limit damages to financial intermediaries from an asset bubble when it bursts. Think about lowering loan to value ratios as real estate prices rise in a hot property market and maybe, by those macroprudential policies such as changing loan to value

or capital requirements, could help cool the market itself. I'm a little -- I think that's yet to be seen. But at a very minimum, good macroprudential policies can make the systems more resilient when bad things happen.

I think another lesson is banks need to have good lending outlets for their deposits. Asian banks and Asian emerging markets stayed out of trouble in large part because they were fully occupied in their own economies. And a lack of opportunities at home can drive banks into riskier and ill-understood credits.

Think about the Landesbanks in the U.S. subprime market, for example. Think about U.S. regional banks, particularly in the Midwest and Northern Midwest, who reached out to lending in Florida and Arizona in property markets. At a minimum, when banks venture on unfamiliar turf, risk management must be up to what is then a very, very more difficult task.

I think it's important to keep in mind also that as Kemal and others point out in their essays, that the longer-term increase in prosperity in Asia and other emerging market economies was built on openness to technology, capital inflows, and shifts to market-oriented policies. Markets don't always get it right. There was widespread mis-pricing of risk, poor risk management, problems of asymmetric information, agency, moral hazard, et cetera, in the financial markets before the crisis.

But market determined outcomes, especially when appropriately overseen, beat all the alternative ways of allocating credit and promoting growth. And oversight -- additional oversight, additional regulation, capital controls, which we've heard some about this morning -- putting more of that in place, fully justified. But we shouldn't lose sight of the importance of allowing markets to work, allowing innovation to occur, allowing failure to occur. Stability and growth are usually complements, but at some point protecting against instability -- against these externalities, downside risk, can impair productivity if we make markets too stable.

I think one lesson from the experience of the U.S. for the emerging markets goes to this issue of access and inclusion that Eswar was talking about. I think a sub-theme of many of the -- a number of the essays in that book was the necessity for reaching out in emerging market economies and banking systems. This is an important public policy goal. Bringing services to more people down the income and wealth scale is absolutely necessary and desirable. Getting them away from unregulated, very expensive black market/grey market-type economy lenders into regulated banks is highly desirable.

But as Eswar said, the U.S. subprime lending was a form of expanded inclusion, which was applauded by the authorities; some cases,

encouraged by regulation, affordable housing requirements, and Fannie and Freddie. And there was resistance to even the small steps that U.S. regulators took to put constraints on these markets ahead of the crisis, because people saw the advantages of the greater inclusion, of having mortgages available to more and more people.

But we need to keep in mind this brings less-sophisticated users into contact with more complex financial instruments. Do they understand the nature of the contract and the risk they're taking? Are those risks appropriate for their level of education, the amount of resources they have? How can the instruments be made clearer and more transparent even to less-sophisticated people? And are there instruments that are -- even if they're totally transparent, aren't really suitable for some users. So, we need to be careful that way.

The other point is that greater inclusion shifts the credit supply curve. One other reason for increase in real estate prices in the United States was that folks who had been credit and liquidity constrained and couldn't enter the housing market now could enter the housing market. That shifted out the demand for homes, and it was one of the things that led to the rise in prices of homes. And then when they couldn't support, that higher price wasn't sustainable, people who bought the homes couldn't support the mortgages. Then things began to collapse the

other way.

But greater inclusion can contribute to macroeconomic stability. So inclusion is an important, worthy objective, but it needs to be managed so it doesn't endanger financial and economic stability.

Finally, I'd like to say a word on global imbalances. It's an important theme in the Asian policymaking book of Kemal and others. I'd like to underline several points that actually come out in the book.

One is I think the global imbalances is a serious problem. We did not face the disaster scenario that we probably would have been talking about if we had had this panel four or five years ago, which was a flight from dollar assets that drove down the dollar, drove up dollar interest rates. That was the scenario lots of people were concentrating on.

But I think the global imbalances did contribute to the crisis in the United States, certainly to the build-up in the United States, by lowering the natural rate of interest. Building -- helping -- contributing to the buildup of debt in the United States, the increased demand for safe dollar assets that our financial system was so eager to supply. And those assets turned out to be, in many cases, not so safe.

Going forward as the United States gets back to full employment, we need to be less debt-financed, less dependent on consumption, on real estate construction, on government spending, than

we were a few years ago. We need more investment and more net exports. The United States needs to have a relative decline in domestic demand as compared to net exports.

The downshift in domestic demand in the United States must be matched by an increase in domestic demand in the rest of the world if the global economy is going to get back to full employment. In one of his essays, Kemal emphasizes that this is a level shift. It doesn't necessarily affect growth rates, but it's a level shift that we're having trouble, I think -- the global economy is having trouble making, judging from the persistent high unemployment in advanced economies.

There are a lot of policies and demand propensities that need to change, including in the advanced economies, fiscal policy, et cetera. But a change in relative prices is part of the equation that will encourage a shift in resources between tradable and non-tradables, from surplus to deficit countries, and constraints on -- just a few seconds -- constraints on exchange rate appreciation are not helping in that regard.

Exchanging -- constraining exchange rates means to you do import the monetary policy of your trading partner that you're tied to. When cyclical positions differ, that monetary policy is not appropriate for both countries.

It is not reasonable to expect the United States, Europe, Japan to

run monetary policies that are sub-optimal for them in order to hold down inflation or asset prices in emerging market economies. I often get this question traveling in Asia. Why doesn't the Fed run a monetary policy appropriate for us? That's not going to happen. There's no way that the United States, Europe, Japan is going to sacrifice the welfare of their own citizens for the welfare of other citizens. That's not the way the world works.

What can happen -- and it doesn't need to work. The -- with flexible exchange rates, each country can pursue the macroeconomic policy that's best for it. And that's the way we should be working.

Advanced economies are emerging from recessions slowly and face fiscal contractions. And in the current circumstances, short- and long-term policies, prescriptions are aligned, it seems to me. Emerging market economies need to run tighter monetary policies, allow exchange rates to appreciate. That will fight inflation in the long-run and promote global -- better global balance. Fight inflation in the short-run, promote better global balance in the long-run.

Thank you.

MR. LOMBARDI: Thank you very much, Don. I think we are a little bit late with the time, so I would just suggest that we jump directly into the Q&A session.

May I remind participants if they want to ask a question and identify themselves. They will be provided with a microphone from the staff. And also may I remind just to speak clearly into the microphone for audio recording, please.

Okay. So, on the first row here.

MR. FONACHMAL: I'm Anton Fanatical, Emerging Markets Management.

It struck me from listening to all of you that we are now in a new environment that has a -- which you could call a new moral hazard and a new health hazard. The new moral hazard -- and I think it's described both in what Kemal said earlier and in the summary -- is that in addition to banks that are too big to fail, we seem to have a new category, which is countries that are too big to fail. And what's -- that our being treated rather gingerly and softly in terms of what many economists believe actually needs to be done.

When I look at this question of the persistent imbalances, I think it was called, in the G-20 dialogue, and also at the Asian financial stability dialogue, they seem to be kind of timid, backdoor efforts to deal with it. But they do seem very timid. And I just wanted to comment from all of you on how timid they are.

And then the second hazard, which is the health hazard --

and I'm sorry to be so negative here; I'm not usually negative about emerging markets -- is what Kemal, I think, referred to already as, you know, the potential environmental gridlock. What else -- water, whether it's global warming, et cetera. And so the question is, in the dialogues that are coming about, what attention is being focused on this second, longer-term hazard?

MR. LOMBARDI: I would suggest that we group the questions in groups of three -- yeah, two or three. There is someone in the second row. And then in the third. Yeah.

MR. HAGEUS: Thank you. Abdula Hageus, Turkish Industry and Business Association.

The panel addressed some important issues, and it is clear that most -- to effectively deal with these issues, we need to have global collaboration. And some of the speakers have already hinted at that. Mr. Kawai, for instance, when talking about how to deal with the currency appreciation and capital controls in Asia, he hinted that Asian countries should come together and come up with a common policy.

So my question is, is there any global institution to deal -- to effectively deal with these issues that you have been talking about? G-20, IMF, or is there any other one on the horizon? And secondly, even if we identify one body institution, do you think it's likely to secure a global

collaboration on these issues?

Thank you.

MR. LOMBARDI: Okay, perhaps one more question. In the third row? And then Nancy Alexander on the fourth.

MR. KATZ: Sherm Katz, Center for Study of the Presidency.

Thank you all very much for your comments. I was particularly struck, Dr. Derviş, when you mentioned the very limited contribution that you think exports -- that you find exports are making, net exports, to Chinese growth. We often hear from Chinese authorities and our own that there are constraints on their capacity to appreciate their currency because jobs are so key and they need exports for jobs, et cetera. So I wonder if you'd care to comment on that at all.

And very briefly, a second question. China itself is, some would argue, an enormously influential lesson to other Asian countries in terms of the much larger than capitalistic society role for the government in producing growth. And particularly, you look at Vietnam where I've been a couple of times recently. They've had 6, 7, 8 percent growth. They continue to move toward a more open market-drive society, but the economy still has major impact -- the government still has major impact on the economy. And it's largely, from their point of view, following their own instincts. But it's also -- they wouldn't admit this -- the Chinese lesson.

Thank you.

MR. LOMBARDI: Okay, and one more question from Nancy Alexander. And -- the lady in the third row. Yeah.

MS. AMAD: Hi, my name is Sawai Amad and I'm an MBA student. And I was curious about the lessons for emerging markets in terms of why -- I understand like in the U.S. and Europe, Japan, we've moved away from sustainable industries such as agriculture and stuff, which used to be a huge part of the economic trade and stuff, before -- why that has -- is that a focus that you see that coming up for emerging countries?

MR. LOMBARDI: Okay. So, Nancy Alexander?

MS. ALEXANDER: Thank you. I've been introduced. I'm with the Heinrich Böll Foundation.

Thank you for the presentations. I especially appreciated the remarks on financial inclusion in the last two presentations, and the need for good management and oversight of that process given the vulnerabilities that have been shown.

To some extent, the G-20 is establishing the discourse around financial inclusion, given its major emphasis on this topic. And at least from materials I've reviewed, it seems as though the G-20 has a very significant bias against the state role in the financial inclusion processes.

And I'm wondering two things. One, whether my perception is accurate based significantly on IFC materials for the G-20. And secondly, is that justified? Or, put better, what is your advice to the G-20 in terms of their financial inclusion initiative, particularly with regard to small- and medium-sized enterprises?

Thank you.

MR. LOMBARDI: Thank you, Nancy. I would suggest for the first round of discussions three minutes each panelist. If you want to react and pick up the questions.

MR. DERVIŞ: Yeah. Well, I tried to --

MR. LOMBARDI: Your preference first.

MR. DERVIŞ: We can't deal with all the good questions, but on the net export. You know, I think it's very hard to be a centrist moderate on this question. I think the global imbalances are an important issue. I agree with Don and I agree with much of the analysis. But sometimes it's overblown. I mean, it seems like, you know, everything is due to global imbalances. And I wouldn't go as far as that.

Second, exports have been very important in terms of market discipline, incentives for firms to look at the global economy rather than just the domestic economy. There have been challenges for foreign inward investment that then creates export capacity, technological

change, and all that.

But if you look at the net export numbers kind of mechanically, decomposing where demand goes, you know, they are not huge. In the Chinese case, many years they are negative. There have been 3 years where they've been significantly higher -- 3, 4 -- between 2 and 4 percent. 2005, 2006, 2007. And that's when the global imbalances kind of reached a peak in a sense, okay?

But I don't think that from there, one can argue that getting the Chinese trade balance to zero, for example, will necessarily mean a major slowdown in Chinese growth, okay? So, I think one has to get that balance of the argument right. In India's case, net exports have generally been negative because India has actually been running a trade deficit.

On the other point -- on Anton's point on the environment and natural resources. I really think that this is very, very important and could well -- you know, we always tend, unfortunately -- not always. But often, economists kind of fight the last war instead of, you know, looking forward. And I think the kind of growth which we're projecting for the world economy -- I think with good reason. Because the dynamics of globalization are so strong, because investment rates are so strong -- are creating a kind of potential growth path that -- with huge environmental and climate-related problems and constraints.

I think if technology shifts -- if there really is a major shift to a low carbon provision of energy, that can be handled. But if there isn't that shift, if incentives and things don't work out that way, if there is no decent price on carbon and if these technologies are not encouraged by the price system and the policy system, I really do believe that we face a major problem here. That's why I very much agree with you. It's climate, but it's also natural resources: food, water, and related things.

We've never had the world economy growing at this rate over sustained period in world history. And we've never had the huge emergence of a global middle class that we're now facing. So, this has implication -- very serious implications, I think, for the management of the environment and of climate.

And here, you know, markets can be very helpful and, in fact, have to be helpful. Provided public policy creates the incentives that markets can work in such a way that investments that lead to the low-carbon economy can be made. I think we're very far from that. We're still actually providing fossil fuel subsidies in much of the world and we're still shrinking from putting a price on carbon and dealing with that externality. So I do believe -- and I agree with Anton that this is one of the big health hazards for the world economy.

I leave the other points to my colleagues.

MR. LOMBARDI: Hiro?

MR. KAWAI: Yeah. On the first question, new moral hazard. I think the reform for following the global financial crisis has been to limit this too big to fail problem for banks. I think the most important tool would be to make sure that very effective resolution mechanisms would be in place.

But I think the problem is that for big banks, they are operating internationally. So there has to be an international agreement on the resolution process. And that's what's lacking.

On countries which are too big to fail, you may be referring to Greece, perhaps. Okay? Maybe. (Laughter)

MR. PRASAD: I thought he meant the U.S., actually. (Laughter)

MR. KAWAI: Oh, the U.S. I see, okay. Then I shut up.

MR. DERVIŞ: Huge to fail.

SPEAKER: You're thinking bigger.

MR. KAWAI: Okay. The global cooperation may be difficult. The G-20 is trying to do it, the IMF has been trying to do it. But perhaps at the regional level, perhaps it will be a bit easier than at the global level. Therefore, my suggestion.

On China's issue, net exports, I agree with Kemal. If net

exports become zero, that doesn't necessarily mean that growth rate is going to go down.

If, say, for example, consumption goes up in China, and the result is that imports would rise and net exports can narrow. But still, the economy can continue to grow. So, the size of net exports is not the most important factor.

MR. LOMBARDI: Thank you. Thank you, Hiro. Eswar?

MR. PRASAD: On the financial inclusion agenda, I believe there is what you might characterize as a bias towards private sector. But I think the fundamental question there is, what market friction is it, or what market inefficiency is it that prevents lending from taking place to small- and medium-sized enterprises that prevents more people from being brought into the formal financial system? And I think once you phrase it that way, it forces you to confront more directly what the problems are in the financial system in terms of the incentives facing financial institutions. And also, the level of comfort that the regulator has or the sense that he or she has about the capacity of the regulatory system to deal with different types of institutions. And virtually every emerging market you see this issue coming forward.

So I think ultimately there is a fair burden on us academics also to think about the analytical frameworks. Because as Don pointed

out, there isn't -- I mean, we all in our gut feel that the broader the financial system is, the more access people have to it, the more stable it must be. But actually, it turns out that it's very difficult to show this analytically. And the book that Dean Kawai and I did, we have a couple of chapters that try to grapple with this issue. We haven't fixed it yet.

There was a set of questions on global governance, on China's sustainable growth, exports, and so on. And they are all very related, I think, to the model of development that emerging markets undertake. China, of course, is sui generis and in China, the issue is that much of the growth over the last decade has actually come from investment with investment accounting for somewhere between 50 and 55 percent of GDP growth. During the crisis, in fact, the trade balance made a negative contribution to growth. It was investment that powered the economy along.

For an emerging market with a lot of labor investment, this is in principle a good thing. The question is whether this investment that is being intermediated by a banking system that is not quite doing it's job but is really leading to the right sort of investment. And it also feeds into this broader question about whether a physical investment heavy model is actually good for these broader considerations related to the environment and so on.

And the Chinese understand all of this. The 12th Five-Year Plan, which was put our or ratified by the National People's Congress in March very clearly views these as shifting the balance of growth towards domestic demand. And more importantly, towards consumption rather than investment. It's not that investment isn't bad, but in an economy where the consumption to GDP ratio is falling, where the share of labor income and national income is falling, something is not quite right.

In many other emerging markets, the issue is how to get more investment. In India, infrastructure investment is going to be critical for growth. But there again, there is a real concern about what sort of damage is being done to the environment.

And ultimately, the reason many of these debates get framed in the context of exports is because of a reality that the export sector tends to be pretty good at generating jobs. This is true in China, this is true in India. It seems to be true in the U.S. After all, President Obama has this notion of doubling exports in five years as part of his employment strategy. And that, I think, sets things up ripe for conflict because you can't all be exporting and using that to rely on employment.

And I think this is where we go back to this issue of framing things in the context of global imbalances. Because a trade imbalances ultimately have an implication for employment. And if policymakers start viewing

things from that prism, it's going to be very difficult to come up with a cooperative outcome.

MR. DERVIŞ: May I just add one little thing on this one, because I forgot and it's quite relevant.

You know, if you look at net exports globally, on China you get one story. If you look at the bilateral China-U.S. picture, you get a different story. Bilaterally, there is a much bigger problem. But I don't want to -- yeah, okay.

MR. LOMBARDI: Don?

MR. KOHN: So I think on the inclusion aspect there's a definite push-pull here. One wants to include more folks in the financial sector, but it does run the risk of putting people into situations they don't understand, and runs the risk of financial instability. And I think that's holding things back.

In the U.S., the pendulum is swinging back, right? And the reaction, then, becomes one of we need to restrict what kinds of instruments people can get. We need to put more controls on how banks sell things to people who perhaps aren't as sophisticated. And finding that right balance, as Eswar said. You need to identify the market failure, the -- what incentives are in place. And getting that balance right is very, very difficult. And it doesn't all go in one direction or the other.

I think on the imbalance issue and the timidity at addressing this issue, there are a lot -- as Domenico points out, in his chapter if I remember correctly, there are a lot of incentive problems in the global financial system. There isn't -- you were obviously hinting about the U.S., and Eswar said that. So the reserve currency country has less pressure on it, perhaps, to make adjustments than it otherwise would have if it weren't a reserve currency country. But I would say that's true for the surplus countries as well.

So, I don't know what too big to fail means. I don't think you can talk about failure in the sense of global imbalance. You have to talk about moving from imbalance to balance, and people are wrestling with this problem that a lot of the components of the system aren't being incented by the markets to take the kinds of actions that they need to take to deal with these. And you do get the problems Eswar was just talking about. Everybody wants export-led growth and not everybody can have export-led growth.

People need to be -- countries need to be convinced that it's in their self interest to move in a stabilizing way. That's not always easy and not always possible. There are probably some collective action problems here that could be addressed by global institutions, but countries are not going to easily give up sovereignty. And they are going to have to justify

the choices they made in terms of their own economies, making their own economies better.

So it's a very, very different problem to move from this very timid -- I think that's a good word -- very -- let's just talk about some more and publish some more studies about it -- to something more forceful. I think it's going to be very, very hard.

MR. LOMBARDI: Thank you, Don. I think we have a few minutes left and we can take some more questions from this side of the audience. Yeah, two more. This lady on the second row? And then we have another lady on the fifth row, I think.

MS. WINN: Thank you. I'm Jeanie Winn with Voice of Vietnamese Americans. We are talking about emerging markets, and you also talked about -- a lot about changing in the environment, the environment, and health hazards. Where do we put the human capital in this equation globally? And where do we put the safety nets?

Because big countries such as China, if all these workers who get sick and have issues, epidemics, you know, other problems, then who would come in to support them? It used to be the U.S. and many other countries who have the surplus. But now China is actually having the surplus, and their surplus goes into their space programs and other defense programs.

So, where do we put the human capital equations into this global economy? Thank you.

MR. LOMBARDI: Thank you. Another question from the lady in the fifth row, yeah.

MS. JOHNSON: Good morning. My name is Allison Johnson. I'm an international political economist.

And I actually wanted to do a very important correction from the beginning presentations because, surprisingly, right here at Brookings, they had a very powerful discussion about mortgage and housing development earlier this year where some of your Brookings colleagues actually debunked the myth that Kemal and Donald were sort of talking about: that it was the lower classes taking on mortgages in the United States of America that caused a tremendous crash in the mortgage and financial mortgage market.

Brookings will have a report on the conference probably at some point this year. But in fact, it was the lower middle classes and the middle classes that were providing -- were given provisions of higher levels of financing by Freddie Mac and Fannie May and so forth that caused the collapse because they were over leveraged. And these were not unsophisticated buyers, as you mentioned. They were actually educated folks, professionals, who over leveraged themselves. And of

course, Wall Street flipped their mortgages.

So I think that's a very important precedent because you don't want to have those studying financial inclusion for the 7 -- well, 5-, 6 billion people on the planet who are not included to think having programs like those are going to destroy their economies. So I really would appreciate comments to correct those misgivings.

Thank you.

MR. LOMBARDI: Okay, so I think we have time for a brief reaction from the panelists.

MR. DERVIŞ: Well, I think I'll leave to Don the reaction to the last one. I don't think I talked about it, actually, but I think it's a multidimensional story that led to the U.S. crisis. And I think Raghuram Rajan's book, for example, has some very good analysis.

I think there were -- I mean, if you want my take, I think the ultimate -- if you want to put blame somewhere, I think it's on the financial regulators more than on any part of the system as such. But you know -- and this is a whole thing we didn't get into today.

But when you -- except by saying that income distribution is an issue. And if income distribution gets more and more skewed and more and more unequal, all kinds of social policy pressures and all kinds of, you know, things will happen that I think can threaten a well-functioning

economy. And I think I'll just leave it at that.

MR. LOMBARDI: Don?

MR. KOHN: So, I agree that the outward shift in the credit supply occurred, importantly, among people who had access to credit but that access was limited. And that may be -- you're defining this as lower middle class, middle class. And that was part of it. That was part of the subprime thing. But I also think it probably went down.

I'm not familiar with the studies you're showing. The studies that I've seen certainly hold open the possibility that this whole increase in credit, wherever it was happening, was an important part of the bubble in the real estate market. And I just think whether we're increasing the amount of credit that people already have access to some, but not as much as they want to have, or whether we're bringing it to new people, we just need to be very careful about that intersection.

MR. LOMBARDI: Thank you, Don. Hiro wants to react.

MR. KAWAI: Just on the question of human capital and safety nets. I think the question is related to international aid issues, I thought. The international commitment to increasing aid to .7 percent of national income has not been, you know, realized. And I don't think it's going to be realized because of difficulties -- fiscal difficulties in developed economies.

So, perhaps international aid should really focus on the real needs, so supporting education, health in developing countries, and, also, many developing countries would also have to mobilize their domestic resources. So, a combination of external financing and then domestic resources would be needed. And a focus in education and health would be, I think, very essential.

MR. LOMBARDI: Well, thank you very much, Hiro. I think that it's noon so we have to wrap up. Just want to thank the panelists for joining this event and, of course, the audience. And I would like also to mention that the books that have been referred to throughout these presentations are for sale outside of this room.

Thank you very much. And of course, the biggest hands to ADBI for supporting these projects.

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