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***Michael Borshchevsky:* What is your opinion about the current stage of the crisis? Shall we expect deflation in some countries or are there any other possible scenarios of crisis development?**

Professor Portes: We have passed the really dangerous point. We were in danger of completely falling off the cliff in terms of the world trade and international finance. World trade actually looked worse in the first several months of the crisis than it did in the first several months of the Great Depression, starting in 1929. It is only very recently that the trade has begun to come back, but I think that now it is a well-established trend, and we are not going to see a complete collapse of trade and on the finance side. We were in danger of seeing the entire financial system seize up, and although the way in which it has been done has not been very pretty, nevertheless the financial system has more or less been saved. On these counts, we are past the really dangerous phase. That does not mean that we are starting a vigorous recovery. I don't think we are. I am not going to get into the question of whether it is a V, U, W or L-shaper, but I don't think we will see the standard pattern in the past of a strong V shape. That is to say that in the past the majority of recoveries from severe recessions have been very sharp and very strong. I don't think we are going to see that in any of the vast advanced counties. Of course the situation has been different from the beginning in some of the major emerging market countries. Although China experienced a very significant fall in trade initially as well, it compensated for that by a very vigorous stimulus program, which has been relatively successful at least in maintaining the momentum of demand in the economy. It has not been successful, in my view, as in terms of its efficiency and the way in which it has been directed, but the stimulus to demand has been sufficient. So China is growing; India is doing well; Brazil is doing well — too well in some ways — because its exchange rate has appreciated excessively. Russia, on the other hand, is Russia. Russia I think is a disaster area. It was of course picked up by energy prices and commodity prices boom in 2006/2007 and even in 2008. But Russia does not have the industrial capacity now to make a substantial recovery. However the overall prospects are reasonable for this year. We will not see in the short to medium run any significant recovery in employment and that is very distressing, but that's the way it is.

***M.B. :* Does this mean that we will not see a situation of deflation in the developed countries?**

P.P.: Indeed, I think that we will not see a deflation. The policy-makers are sufficiently concerned about deflation that they will do everything in their power to avoid it. That means even more aggressive monetary policy than actions that have been taken so far if necessary. You may have noticed that the government of the Bank of England in its very recent testimony in the House of Commons said that if necessary they would restart the Credit Easing Program[1] that they had been running and expanded. I think that's what they would do.

***M.B. :* Do they have sufficient funds?**

P.P.: The Bank of England can create the funds, of course. That is not an issue. The policy-makers are still for the most part concerned about the possibility of deflation and they will be vigorous in opposing it. Other people say that the fiscal monetary stimulus will produce inflation — I do not think that's correct. We are in no danger of inflation now.

***M.B. :* What do you think would happen with the American property market as the next stage?**

P.P.: Oh, I have no idea!

[1] In March 2009, the Monetary Policy Committee announced that, in addition to setting Bank Rate at 0.5%, it would start to inject money directly into the economy in order to meet the inflation target. The instrument of monetary policy shifted towards the quantity of money provided rather than its price (Bank Rate). But the objective of policy is unchanged — to meet the inflation target of 2 per cent on the CPI measure of consumer prices. (Herlad of Europe, hereafter HE)

M.B. : You were one of the leaders of the group of scientists who prepared some materials for the G20, where you have proposed some financial measures. In particular, measures for stronger financial rules and regulations for the banks. Which of these measures in your opinion will be taken into consideration by the communities of central bank regulators?

P.P.: One correction — it is not central bank regulators. In some countries central banks regulate the banking system, but in some countries they do not. In the UK that is the FSA[2]. It is a matter of controversy right now in the US who should be doing that. Generally, there are not just regulators, but there are also legislators and governments, who set the framework of regulations, which the regulators then implement. The regulators have some degree of discretion, for example in capital requirements or leverage requirements on the banks that legislators do not have. The idea is to try to agree those internationally in the so-called Basel Committee[3] and the Financial Stability Board[4]. Surely there will be higher capital requirements and probably some formal constraints on leverage of the financial institutions. I think most of these will be inadequate. If you look back 20 — 30 years, the leverage was much less and the capital base was much greater and that's what we have to go back to. I do not think that the banks are lobbying very hard to avoid any serious constraints and they will probably be successful. As I say, there will be somewhat greater capital requirements, new leverage requirements, probably maximum leverage requirements, but I do not think these would bite to any significant extent. They may impair the banks' profits somewhat, but not hugely. They also will not be sufficient to deal with broader systemic problems. What else could be done? There are the proposals — the Volcker Rule[5] for the US — of separating proprietary trading from commercial banking. I think that it is not likely to get through the US political process in a very effective form. In my view, even if it does go through, it will not be enough. It is not what is needed. It was not the combination of proprietary trading and deposit taking that was in the root of the financial crisis. The institutions that really caused the problem were not deposit taking institutions. I do not think that proprietary trading should be allowed to go on the back of public deposits in the banks. But I do not think that stopping that would make a major difference. What needs to be done is to break up the banks to make them much smaller. If we look back again 10 — 15 years, the banks were indeed much smaller and relative to the economy and the financial system. I think that is what we need to go back to, but that would require a degree of conscious intervention that might have happened if it would have been done very early in the process, but this is not going to happen now. So what could you do? You could tax size and that would be my preferred option. Actually, put a tax on the banks in proportion to the size of their asset base. That would have been better than having to intervene and break them up. That's one way of getting them back down to a reasonable size. But the lobbying against that would be very strong, but it still does have a chance, because it depends on political reactions over the next several months. The politicians are beginning to realize that the people are very angry about the banks. The bankers can say what they like, but nobody believes them and rightly so.

[2] The Financial Services Authority (FSA) is an independent non-governmental body, given statutory powers by the Financial Services and Markets Act 2000. This is a company limited by guarantee and financed by the financial services industry. The FSA is accountable to Treasury Ministers, and through them to Parliament. The FSA has been given a wide range of rule-making, investigatory and enforcement powers. The FSA regulates most financial services markets, exchanges and firms. It sets the standards that they must meet and can take action against firms if they fail to meet the required standards. (HE)

[3] The Basel Committee on Banking Supervision provides a forum for regular cooperation on banking supervisory matters. Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. It seeks to do so by exchanging information on national supervisory issues, approaches and techniques, with a view to promoting common understanding. The Committee's Secretariat is located at the Bank for International Settlements in Basel, Switzerland. (HE)

[4] The FSB has been established to address vulnerabilities and to develop and implement strong regulatory, supervisory and other policies in the interest of financial stability. Mario Draghi, Governor of the Banca d'Italia, chairs the FSB in a personal capacity. The Board is supported by a small secretariat based at the Bank for International Settlements in Basel, Switzerland. (HE)

[5] The Volcker Rule implies that deposit-taking banks will not be able to engage in proprietary trading or owning, investing in or sponsoring hedge funds or private equity funds. (Paul Volcker — the chairman of the US Economic Recovery Advisory Board) (HE)

M.B. : When you were saying about the taxation you reminded me that some politicians recently came up with the idea to tax some banking transactions. From my point of view it's just bizarre!

P.P.: You mean the Tobin tax[6]. It would not be necessarily just banking transactions. It could be foreign exchange transactions, security purchases and sales etc. This is a bad idea. This is probably the only bad idea professor Tobin ever had because he was a great economist. It could not have been effectively implemented because there would always be ways to get around it. Besides it would not stop speculation because they could never put it at a rate sufficiently high to stop speculation. The profits that come from betting on a currency are just potentially too great that a quarter of a percent tax would not have any effect on that at all. It would probably impair liquidity — reduce liquidity in the financial markets, and if it will reduce liquidity in the financial markets, it will probably rise volatility in the financial markets — exactly the opposite of what people think is going to happen. This is just an idea, which has been pushed very hard by the Development Community as it were and I understand why. They think that if you put on this tax it would raise hundreds of billions of dollars and you could devote it to financing the poor countries. Even if they did it, even if you could collect it, it still would not go to the poor countries anyway, you might as well just forget about that. It will go to deal with budget deficit that the advanced countries are getting into right now, and it is not going to happen.

M.B. : What is the role of the so-called "bad assets"[7] in the banks in the current crisis? What can banks do about it?

P.P.: It was of course these assets and their weak qualities, which started the crisis in the first place. They were overvalued by the rating agencies, sold as AAA[8], when they were actually very weak assets. However, we are discovering that the market is actually in some cases raising the value of these assets very considerably from their deeply discounted levels. So in that sense the banks' books will not look as bad as the IMF[9] forecast a year or so ago or even more. They had a series of these forecasts deliberating on how much losses the banks could take from the portfolios they have been holding. I think that these are overestimated losses and the market is suggesting that I am right. The market prices of these assets are rising, and investors are getting more interested in them. However, there are a lot of people, who have given up their mortgage and houses that have been foreclosed and sold for much less than they were bought for etc. A lot of the mortgage assets should realistically be valued much less than their original prices. What will be done with these assets? They will be partly written off and partly sold off, and the banks will have to generate more capital. It is hard to say how much more, but not impossible levels, so that the banks will be able to do it. The worst period here has passed us again. The more dangerous securities are the Credit Default Swap contracts[10]. I have a very clear position on that, which some people are just coming around to. I have been saying for over a year now — two years actually — that CDS contributed significantly to the downwards spiral that we saw in the financial system. Originally, when credit default swaps were created there was a simple way of hedging a few bottom bonds — it was taking the insurance on the value of that bond effectively. But people on the markets quickly learned that you could use those things to speculate on them — you did not have to buy the bond, you could buy a CDS contract

[6] Tobin Tax is the tax proposed in 1970 by the Nobel prize-winning US economist James Tobin that reduces the volatility of currency exchange rates by stopping speculative trading on foreign exchange. In November 2009 Gordon Brown suggested that Tobin tax as a way of building up a reserve to insure against further big banking losses in the future, among a range of solutions. (HE)

[7] "Bad asset" is an asset that is worth less than the owner says it is worth. (HE)

[8] AAA is the highest credit quality rating (HE)

[9] The International Monetary Fund (IMF) is an organization of 186 countries, working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world. (HE)

[10] Credit Default Swap (CDS) is a swap designed to transfer the credit exposure of fixed income products between parties. The buyer of a credit swap receives credit protection, whereas the seller of the swap guarantees the credit worthiness of the product. By doing this, the risk of default is transferred from the holder of the fixed income security to the seller of the swap. (HE)

on the bond, which was an effective way of speculating against the reference editing. This became a vehicle for pure speculation. There is a column by Wolfgang Munchau[11] in FT-Monday saying that the so-called "naked CDS" (the ones that are used purely for speculation) should be banned. So that I think is the major reform that might just happen because the politicians of Germany and France are actually saying that they have found a good villain. Well, this time it is the right villain. This is not just running up the usual suspects; this time it is the right suspect and they should shoot him in my view. I am actually against capital punishment of any form, so lock him up forever. These things should be locked up and not allowed to go into circulation.

M.B. : ***To what extent can the European countries and their financial regulators and legislators cooperate to produce more compatible rules of banking?***

P.P.: I am very sceptical about the ability of regulators to cooperate without being forced to cooperate, and I don't see a real prospect of that. The De Larosiere report[12], which you may be familiar with, recommended new committees and regulators with stronger powers etc. I believe it is not going to make much difference. These committees will be very big; they will find it very hard to make any decisions; they will find it even harder to implement any decisions. The regulators of the individual countries do like power like anybody does; and they do not like to be told what to do by anybody else. On the whole, these committees will not tell them what to do. So the bottom line is that the new structure is a very weak one. It is maybe marginally stronger that the one we have had until now, but it is not going to make any significant difference. We have hundreds and hundreds of so-called memorandums of understanding among regulators. When the crisis came what happened? No cooperation. And worse — the regulators fought with each other. Let's take a look at the case of the Fortis Bank[13]. You would think that Benelux — Belgium, Netherlands, Luxembourg — the three countries which are the closest to each other in the EU — would cooperate. However, they not only could not agree, they fought with each other very bitterly about the disposition of the Fortis Bank. Memorandum of understanding turned into a memorandum of misunderstanding. I am afraid, I am negative about that. I think that the only serious prospect for regulatory cooperation is for some central body to tell all of them what to do. The only possible source of that realistically is the Financial Stability Board. We shall see if it can develop enough power. For now it is unclear.

P.B. : ***I hope you will not find my question a rhetorical one. To what extent is the academic research, thought, the opinion of specialists taken up by the governments? Is it sufficient or is there any room for this cooperation to grow? If we look at other spheres like chemistry, biochemistry or drug use regulations we will see a significant contradiction between scientific opinion and implementation. What is the situation here?***

P.P.: I think that the politicians and the officials, regulators, finance ministry people, central bank staff and even governors do listen to academics. They certainly listen to me, and they listen to my colleagues as well. Whether they take our views and how far they take our views does not matter, but in many cases there have been demonstrable effects on the policies coming from academic research and views the academics support. If you look at the G20 process for example, I think that we have had a very significant input there. The scientific opinion has had some weight there. Of course I would like to see them do exactly how I say, but I am not going to do that and you could see why. We — academics — do not contribute to political campaigns. We — academics —

[11] Wolfgang Munchau is an associate editor of the Financial Times, where he writes a weekly column about the European Union and the European economy. (HE)

[12] Report of the High-Level Group on Financial Supervision in the EU chaired by Jacques de Larosière, Brussels, 25 February 2009.The mandate primary covered the issues of how to organize the supervision of financial institutions and markets in the EU; how to strengthen European cooperation on financial stability oversight, early warning and crisis mechanisms; and how EU supervisors should cooperate globally. (HE)

[13] Fortis bank is a Beligian-Dutch bank, which was bailed out by the governments of Holland, Belgium and Luxembourg to the tune of €11.2bn (£8.9bn) after investors deserted it. (HE)

do not run lobbying operations. The banks are spending millions of dollars a day in Washington on the lobbying effort. How do you fight that? Well, you can fight by saying things as loud as you can, use the best arguments you can, but this does not mean that you are going to win. Still, the policy-making community, broadly speaking, has been listening partly because they know that they do not understand a lot of what is going on out there. We do not understand it entirely ourselves. But we — academics — have been able to explain some things. Take for example the case of the so-called macro-prudential supervision[14,8] which tries to look at the financial system and in particular at the banks as part of the interrelated network, where you have to look at the system and the systemic properties and not just at individual banks. Whether this bank is healthy or not depends on whether lots of other banks are healthy, what the overall macro-economic situation is etc. That idea came across very clearly. The academics made this point very strongly; and this idea has come across very clearly in the policy community, which now understands it. The second idea that I have been involved with is the overall role of macro-economic imbalances — the so-called global imbalances — in generating the conditions that led to the financial crisis. Again, it was not something that was immediately apparent to people, the policy makers and etc. But I think it has become clear — now there are a lot of people in the policy community who understand it very well.

***P.B. :* So you could say the general dynamics of the last three decades has been positive? Is the listening getting better?**

P.P.: Policy makers were always ready to use academic ideas when they suited them. Sometimes they used these ideas for the wrong purposes, sometimes for the right purposes. But, as I say, there is a difference between listening and coming to the right views and seeing implementation under the conditions of strong, powerful, well-financed opponents to some of these ideas.

***M.B. :* Looking at the world economy from a birds point of view, do you think that after this crisis the proportion of power between Euro — Atlantic countries and East Asia (in other words, countries with the economy based mainly on technology, on natural sources, on demography– like China for instance) will change?**

P.P.: I would say right from the beginning — I don't think that China's economy is based on demography. Indeed, if it is, and to the extent that it is, they are in a very deep trouble because the demographic picture of China is not a very pretty one. If you look at the demographic profile of China, the one-child-policy does not look advantageous. But I do not think that it is the right way to characterize the Chinese economy.

There is no doubt that the very lightly regulated, very open economy model of capitalism has become in part discredited. From that point of view, the countries that have had a stronger regulatory environment and more interventionist policies in the economy (like China and India) feel justified that they have opened up their economies to the rest of the world economy very slowly in many ways and that they have not encouraged or even permitted the kinds of so-called financial innovation that were not just encouraged, but from which many people profited in the advanced countries. It has an effect on people's perceptions about economic power — about soft power more generally — and in a sense there is some change already in the balance between Europe and the US on the one hand and the emerging market countries on the other. It is wrong to say there is a decisive shift in world's power, and that America is going to disintegrate in the face of the Chinese advance and similar things, which are largely overstated. There are some popular historians out there who are making these claims, but I do not think we are likely to see this in the next 30 — 40 years. These countries still have a lot to do to catch up. And as they catch up, they will find different kinds of economic

[14] The European Commission proposed in May 2009 a set of ambitious reforms, including notably the creation of a new European Systemic Risk Board responsible for macro-prudential oversight. The European Council in June 2009 supported the Commission proposal. (HE)

problems, possibly different kinds of domestic political problems that affect their exercise of power. In the international system they are still relatively powerless, and that should change. You cannot sort out some of these problems without a significant input from the major emerging market countries. A lot of the problems we are talking about are global problems; they are not problems of the US or Europe or the G7, who can sort them out by themselves, because they do (especially with the global imbalances) involve the interactions between the emerging market countries and the advanced countries, and the huge accumulation of foreign exchange reserves by the emerging market countries, and the sovereign wealth funds that have been generated etc. Although there are two opposing things there — one is that you cannot solve the major international financial issues simply with the EU and the US, but on the other hand the EU and the US will remain the dominant financial powers for many years to come. It will take in my view at least one generation for China to have a reasonably advanced financial system.

***M.B. :* Thank you very much for your time and attention!**