Time for Europe and the US to Unite with One Stance - October 8, 2008
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During the last few days the world economy has taken a turn for the worse: numerous commercial banks in Europe have been bailed out, Iceland has virtually declared bankruptcy, the UK announced a major bailout of banks, and the US government and Federal Reserve have dedicated well over 10% of GDP in funding for the financial system. In particular, three recent developments raise concern and mean both the upcoming recession is going to be more painful and there is far greater need for international coordination of policies, even compared with a week ago.

First, there are worrying signs that the credibility of the US authorities is on the decline. Despite passing the $700bn TARP program last Friday, and the Fed announcing it will potentially purchase even more in unsecured commercial paper, plus the provision of $450bn of additional liquidity to banks, credit and equity markets continue to decline. This pattern is reminiscent of the Asian crisis in 1998, when successive IMF programs provided briefer and briefer respite from market routs in emerging economies. It is important to take steps to prevent further loss of credibility.

Second, the ramifications of Iceland's misery are probably more serious than people realize. With bank assets in the country at ten times GDP, and the banks obviously insolvent, the country clearly cannot afford to bail them out. This is going to be a large default, with many counterparties impacted. There are 300,000 account holders in the UK alone who faced sudden loss of access to their funds, and the process for claiming deposit insurance is not completely clear.

There is a broader concern here. When the Icelandic Prime Minister returned empty-handed from Europe on Monday, he commented that it was "now every nation for itself." This smacks of the financial autarchy that characterized defaulters in the 1998 crisis. When Argentina defaulted on its debt in 2001-2002, the politicians faced enormous pressure to change the rule of law to benefit domestic property holders over foreigners, and they changed the bankruptcy law to give local debtors the upper hand. In Indonesia and Russia, local enterprises and banks took advantage of the confusion during default to grab property, and then found ways to ensure that courts sided with them. This is a natural outcome of chaotic times. Iceland's promise to guarantee domestic depositors while reneging on guarantees to foreigners may just be a first step. Gordon Brown's decision to sue Iceland over this issue potentially escalates the crisis.

In some specific instances, such a "financial war" can lead to reasonable outcomes for everyone. For example, we welcomed Ireland's decision to guarantee all bank liabilities, although it could have been handled better, since it forced the hand of other European nations which had, until that moment, refused to face their domestic financial crises. However, in most instances financial war is painful and costly. It will lead to decades of lower international capital flows, and could have other far reaching impacts on global politics. Unless the leading industrial countries take concerted actions, there is a very real danger we will all suffer more.

Our third concern is that we seem likely now to see substantially more defaults and credit panics in smaller countries and emerging markets. After Iceland's fall, all creditors to other nations with large current account deficits and substantial external debt must be trying to reduce their exposures. Much of Eastern Europe, Turkey, and parts of Latin America are obvious risks. The difficulties in Russia show that seemingly solvent countries can be high risk: while the central bank has reserves of $556bn, the non-public sector has recently built up an estimated $450bn of debt. Creditors don't want to roll over this debt, so the government is using its reserves to do this. The government has already ordered $200bn to be channelled through state banks to companies repaying debt. If the oil price falls further, a seemingly highly solvent country could quickly look near insolvent. Some other rising stars, such as Brazil, and even India, may have similar problems.

We believe there is now a risk that continued corporate and bank defaults within nations, matched by large shifts in capital flows across nations, will lead to a chaotic series of national and local defaults. If policy responses are not sensible and coordinated, there is risk of financial war: "each nation to itself" must be avoided, at all costs. Here are six steps that would help, particularly if implemented together:

1. The world's leading financial powers (at a minimum the United States, the United Kingdom, France and Germany) should jointly announce national plans to require recapitalization of banks such that they have sufficient capital to weather a major global recession. The manner in which this is achieved can be left to national politics, and it can be done so that taxpayers can benefit from upside when their funds are used, but there should be a common goal of achieving this outcome in all nations so that populations and companies can again trust their banks. The UK bank recapitalization plans announced today seem in line with this goal, but one nation is not enough.
2. In conjunction with the announcement of a plan to recapitalize banks, a temporary blanket guarantee on all existing deposits and debts of the banks should be announced. This will in effect promise creditors that they can safely expect the institutions to function until the recapitalization takes place, and it will help prevent the large flows of funds that could occur as some banks or countries conduct recapitalizations earlier than others. This blanket guarantee should only be temporary (e.g., for six months).
3. The monetary authorities of these countries need to dramatically lower interest rates. As we write this, a coordinated 50 basis point (half a percent) reduction in rates has been announced in Europe, Canada and the US. This is a good start, but it is only a start. More will be needed and it will not stop the credit crunch within or across countries. Many companies today are shut out of markets, and companies pay far more than official discount rates, so lowering these rates will not in itself have large impact on the credit crunch. The events of the last nine months have set us on course for a global recession, where commodity prices will

continue to fall, and demand will remain weak. Inflation will be low and deflation (falling prices) is a risk. More interest rate cuts will be needed.

4. The monetary authorities of these countries also need to remain committed to pumping liquidity into the financial system so long as credit markets and interbank lending remain weak. This should be promised for at least one year.
5. Every nation should commit to a sizable fiscal expansion (at least 1% of GDP), structured so as to work within the local political environment, to offset the coming large decline in global demand.
6. Many families around the world will have negative equity (i.e., mortgage larger than their house value) due to declining home prices. There are going to be large scale recriminations against lenders and politicians. The most harmed nations in this regard, including the US, UK, Ireland and Spain, need urgently to develop programs to provide relief for homeowners both to offset real hardship, and to prevent a vicious downward cycle in home prices.

It is important to prepare properly: partial and piecemeal actions will no longer work. We are concerned that actions by one country alone, and the current pattern of small steps announced frequently, are no longer credible enough to change the tide: markets need to be jolted out of their panic. So, it is worthwhile bringing along a sufficient mass of economic power, in a very comprehensive program, to move decisively in unfreezing the markets. If the major powers of Europe and the US were to implement such a program, we can be sure other countries would follow suit, and it would dramatically relieve fears of bank failure within these countries.

The G7 finance ministers meet on Friday at the US Treasury; that would be a good time and place to announce such a program. If six of the G7 do not want to cooperate, as was the case two weeks ago when they were approached by Mr. Paulson, then the US should seriously consider implementing these measures by itself. This would be far from ideal, but it might shake the Europeans out of their current reactive mode.

Even in the best case, there is also a need to let asset prices move to values where they are supported in the market, and unfortunately this means wealth is likely to fall further. The events of the last six months will almost surely cause a recession and large downward revisions in earnings estimates are a near certainty. The crisis has surely changed investors' perception of the risks when investing in equities and real estate. As we saw after the Asian crises, this can mean that equities and other assets become very cheap compared to history, and it may take a long time for values to recover. The fiscal expansion and help to homeowners will reduce the pain from these losses, but it is important to be clear that the success of the program should not be measured by rising asset prices.

Finally, it is important for everyone to recognize that we are well past the days where even dramatic steps could have stopped the repercussions of the panic and prevented a major recession. A successful program will not prevent recession, and we will still see many personal, corporate and perhaps even national bankruptcies. Once the genie of panic and great uncertainty is unleashed, it takes years to put it back in the bottle. We need to prevent this coming recession from being ever more difficult due to a chaotic, uncoordinated collapse arising from incomplete policy steps, lack of credibility, and international financial warfare.

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