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Shifting the balance

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More than a new capitalism, the world needs a new multilateralism

Illustration by Belle Mellor

JUST under ten years ago, during the emerging-market financial crises, *Time* magazine ran a cover headlined "The committee to save the world". It showed Alan Greenspan, then chairman of the Federal Reserve; Robert Rubin, the treasury secretary; and Larry Summers, his deputy. Inside was a breathless account of how this trio of Americans had saved the world economy from calamity by masterminding IMF rescue packages for cash-strapped Asian countries through weekend meetings and late-night conference calls.

Today the threats facing the global economy are graver than they were a decade ago, yet it would be hard to know whom to put on such a cover. Wall Street is at the centre of the mess, so America's stature and intellectual authority has plunged. Rather than staving off defaults in Asia, Mr Paulson, today's treasury secretary, and Ben Bernanke, chairman of the Federal Reserve, are battling to prevent the implosion of their own financial system. Instead of dictating tough terms to Asian governments, they have been begging Congress for public money to deal with Wall Street's most toxic securities.

But even as the crisis spreads far beyond America, few others have so far shown much sign of leadership. Europe is rife with *Schadenfreude* at America's travails but its politicians have been slow to recognise the scale of their own problems. China, the biggest, most resilient emerging economy and the one with the deepest pockets, has stood quietly on the sidelines. The IMF provides useful analysis but has no political clout.

The only institutions that have co-operated, and creatively so, are the rich world's central banks. Even as many politicians have grandstanded and pointed fingers, the ECB, the Fed, the Bank of England and others have tried to stem panic by flooding financial markets with liquidity, lending eye-popping sums of money against all manner of collateral.

Unfortunately, central bankers—however creative—cannot sort out this mess with injections of liquidity alone. That is because it is a crisis of solvency as well as liquidity. The bursting of the biggest housing and credit bubble in history has caused a banking bust that will probably turn out to be the biggest since the Depression, affecting many countries simultaneously. Across the rich world banks are short of capital; many are insolvent. As they deleverage, they will force down asset prices and weaken economies that are already stumbling, so the mess will only worsen. Uncertainty and panic have already amplified the problem as banks hoard cash.

The urgent task is to prevent a grave multi-country banking crisis from becoming a global economic catastrophe. That ought not to be too hard. Thanks to the growing importance of emerging markets, the world economy has become more resilient to trouble in its richer corners. Capital is plentiful outside Western finance. Now that commodity prices have tumbled, the rich world's central banks have plenty of room to cushion their weakened economies with lower interest rates. And although public-debt burdens are already heavy, notably in Italy, Europe's governments, like America's, have enough public funds to prevent a capital-starved banking system dragging their economies down.

This has already started to happen, most strikingly with the American government's $700 billion plan to take over mortgage-backed securities. But other governments too are stepping in. Five European banks were nationalised or bailed out with public funds in the last week of September. Several European governments have guaranteed the deposits and in some cases the debts of their banks.

Yet these disparate rescues are likely to be more expensive and less effective than a more co-ordinated policy that reaches beyond the financial system alone. The panic in the markets would be stemmed if the rich world's governments agreed on a common approach for stabilising and recapitalising banks. Equally, a co-ordinated interest-rate cut would boost confidence and make economic sense: the inflation threat is receding simultaneously across the rich world.

Any such policy co-ordination must include the big emerging markets as well. By boosting domestic spending and allowing its currency to appreciate faster, China could counter deflationary pressures in the rest of the world economy and help support growth in Europe and America just when this is needed most.

There are precedents for high-profile international economic co-operation, notably the Plaza and Louvre Accords in the 1980s. Designed, respectively, to push the dollar down and to prop it up, these agreements met with mixed success. Today's problems are deeper, and the number of parties is larger. But if there were ever a time for a new multilateralism, this, the biggest financial crisis since the 1930s, is surely it.

Learning the right lessons

A successful multilateral strategy to staunch the crisis would also make it more likely that the world will rise to the second challenge: learning the right lessons. Too many people ascribe today's mess solely to the excesses of American finance. Putting the blame on speculators and greed has a powerful appeal but, as this special report has argued, it is too simplistic. The bubble—and the bust—had many causes, including cheap money, outdated regulation, government distortions and poor supervision. Many of these failures were as evident outside America as within it.

New-fangled finance has its flaws, from the procyclicality of its leverage to its fiendish complexity. But the crisis is as much the result of policy mistakes in a fast-changing and unbalanced world economy as of Wall Street's greedy innovations. The rapid build-up of reserves in the emerging world fuelled the asset and credit bubbles, and rich-world central bankers failed to counter it. Misguided monetary rigidity caused financial instability. Much though people now blame deregulation, flawed regulation was more of a problem. Banks set up their off-balance sheet vehicles in response to capital rules.

It is the same story with the spike in food and fuel prices over the past year. To be sure, commodities markets can overshoot—but rather than pointing the finger at speculators, governments should look in the mirror. Rich countries' biofuel policies pushed up the cost of food. Poor countries' food-export bans and fuel subsidies compounded the problems. In many ways today's mess is a consequence of policymakers' misguided reactions to globalisation and the increasing economic heft of the emerging world.

If markets are not always dangerous and governments not always wise, what policy lessons follow? In the aftermath of the crisis the battle will be to ensure that finance is reformed—and in the right way. The pitfalls are numerous. Banning the short-selling of stocks, for instance, makes for a good headline; but it deprives markets of liquidity and information, the very things that they have lacked in this crisis. Even if the easy mistakes are avoided, improving supervision and regulation is hard. Financial regulators must look beyond the leverage within individual institutions to the stability of complex financial systems as a whole. Wherever the state has extended its guarantee, as it did with money-market funds, it will now have to extend its oversight too. As a rule, though, governments would do better to harness the power of markets to boost stability, by demanding transparency, promoting standardisation and exchange-based trading.

Over-reaction is a bigger risk than inaction. Even if economic catastrophe is avoided, the financial crisis will impose great costs on consumers, workers and businesses. Anger and resentment directed at modern finance is sure to grow. The danger is that policymakers will add to the damage, not only by over-regulating finance but by attacking markets right across the economy.

That would be a bitter reverse after a generation in which markets have been freed, economies have opened up—and prospered. Hundreds of millions have escaped poverty and hundreds of millions more have joined the middle class. As the world reconsiders the balance between markets and government, it would be tragic if the ingredients of that prosperity were lost along the way.