The Unfolding Global Crisis: From Careless and Callous to Clueless?

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(Integrated Version of four articles published by the Financial Express in Feb-Mar 2009)

The global crisis of 2007-?? was triggered by global investment banking bonus-eaters who turned silk purses (our money) into sow's ears (trillions of dollars in asset value losses). They thought they were clever and quantitatively sophisticated. They turned out to be careless and callous. Is the crisis now being managed by people who presume to be even cleverer, but may be clueless?

Since September 2008 governments, central banks and regulators around the world have reacted in panic masked as sagacity. They have made and reversed policy on the hoof. Their twists and turns are misportrayed as nimble responses to evolving circumstances. In reality they did not (and still do not appear to) comprehend what's going on. They may have made matters worse by initial negligence (between August 2007 and September 2008), followed by hyperactive interventionism (since September 2008), rather than understanding the unintended consequences of first, their *bank-saving,* and then belatedly, their *world-saving,* plans. G. Brown of the UK comes to mind.

Is such cynicism justified about: (a) how much worse this recession-depression is turning out to be, compared to every preceding month's expectations; (b) how, despite recapitalisation-after-recapitalisation, the global financial system continues to sink rather than float; and (c) increasing uncertainty on the part of a sceptical global public about policies and actions (involving gargantuan fiscal and monetary stimuli implying massive future risks that we are told are unavoidable) to pull the world out of the tailspin it is now in? It is certainly justified and indulged in without apology!

Dangerous diagnoses and prescriptions are being recommended by doom-merchants, Nobel laureates (peculiarly prone to advocating impractical nonsense) and the commentariat. The worst such idea is the temporary nationalisation of major global banks. Yet such notions are being imbibed and peddled by political emperors without any clothes, intent on saving the world, though the ideas smell of rotting globaloney. These prescriptions are not too different in essence from the kind of arrogant, presumptuous thinking about systemic risk that created the mess we are in.

Will taking the medicine now being prescribed in elephantine doses (i.e. even more fiscal and monetary incontinence and overindulgence) cure the patient, or kill him/her altogether, or cripple him/her for decades to come? What governments are doing defies understanding on the part of a global public which seems concerned by a simple question: *"If egregious public and private borrowing and spending, supported by loose monetary policies in the US, UK and EU between 1999-2005 got us into this mess, how is even more public borrowing and spending, and even looser monetary policy in OECD countries and everywhere else, going to get us out of it?".* Unless that question is answered in a way that a moderately intelligent eight-year old can understand, public doubts will persist about the workability of these grandiose stimulus plans.

The implicit answer of stimulus fanatics and hyperactive (unhinged) leaders is "*this problem is difficult for simpletons to comprehend, so trust us; throwing everything at it including the kitchen sink is the only answer. Any other course of action would be disastrous*". But, it is a big ask to trust those who are proving, by the day, to be unstable and untrustworthy.

A series of missteps have been taken since August 2007 when it became clear that the world of global finance was in trouble. They ensured that a containable American financial crisis turned into a calamitous global catastrophe. The financial world, governments, regulators, rating agencies and auditors are unquestionably to blame as much as banks are; just as they were to blame in the first place for what occurred before the collapse. The period August 2007 to September 2008 can be seen retrospectively as a lost opportunity to fix something that should have been fixed. But it was swept under the carpet, by banks and governments alike, in the hope that values would recover and that gaping holes in bank balance sheets would somehow close by themselves.

The casually engineered (or grossly negligent) failure of Lehman Brothers on September 15, 2008 changed all that. It tipped a financial crisis into a global disaster by causing the complete seizure of the credit system. There is no point revisiting the past except to learn from it. One cannot undo it.

One has to live with the consequences. But the various rescue plans being discussed and implemented do not suggest that any real learning is being done.

In contemplating the future, a series of questions are being confused in an unmanageable *melange*. The wrong questions are being asked. So, the wrong answers are being peddled. The three crucial sets of questions to ask are:

(1) What should be done now to stabilise the world's banking system and prevent it from imminent implosion? It is clear that what has been done so far (in the UK and US) has not worked, but probably exacerbated the problem. What must now be done to come to grips with this issue?

(2) What must be done to prevent global consumption from imploding, causing a collapse in private investment as well? Will the stimulus packages being proposed and enacted work?

(3) How can the above two questions be addressed in a way that does not result in greater future problems – of galloping inflation, rampant competitive devaluation, and resort to creeping or racing protectionism, that will change the way the world does business and create a longer night of darkness?

The way things are being handled now risks dissipating if not reversing: the enormous advances that the global economy has made, the gains made by countries like India and China that have benefited enormously from globalisation, and the efficiencies that the world's trading and financial systems, have realised over the last 50 years; especially as *national* rescues inevitably trigger adverse *global* consequences.

We are kidding ourselves that, because markets have failed, governments are the answer. In truth, resorting only to governments to get us out of this mess – especially given the pathetic quality of their leaderships, and their general incompetence, around the world –will lead to an even greater problem. Our assumptions of being safe in government hands may soon blow up in our faces; simply because governments know even less what they are (or should be) doing than bankers once thought they did. Let us deal with these three sets of questions in order

What to do about the Banks? The Good, The Bad & The Ugly (Nationalised) Banks.

The banking system (especially in the developed OECD world*)* has been in intensive care for 18 months. It seems to be getting to a terminal stage rather than recovering. Several theorists have expatiated on this question. Thoughtful answers have been provided by John Taylor*. The issues he identifies were pointed out in *Brown & Tarp* (*Financial Express, 23rd Nov 08*). Since the crisis first broke in August 2007 there has been much discussion about separating out the assets on bank balance sheets into *good* banks (in which performing assets are left untouched) and *bad* banks (into which toxic non-performing and difficult-to-value assets are shifted). The terminology itself has been counterproductive for sensible problem-solving. But, despite endless talk, very little has been done to quarantine toxic assets for a variety of bad reasons. The result: We now confront the prospect of ending up with neither good nor bad banks, but plain ugly (nationalised) ones, as an unintended consequence of poorly thought through rescue measures.

A second problem has been that bank rescues have been undertaken hurriedly on a *national* basis when the solution demands a *global* (multilateral or plurilateral) approach. As a result, national legislatures and taxpayers are left feeling aggrieved that their taxes (present and future) are being used to bail out borrowers in other countries. Recently, there was a hue and cry in the UK about RBS writing off US$ 3.5 billion in loans to bankrupt mining firms owned by a Russian oligarch who was personally solvent and liquid enough to keep buying up homes in Mayfair and Belgravia!

Similarly, British, Dutch, French, German and Japanese taxpayers will end up financing write-offs on sub-prime loans in California and Florida! Icelandic and Irish taxpayers will take the hit as their countries (which were turned into risky hedge funds by aggressive domestic banks) attempt to cover the follies of bankers who lost their shirts financing British homes and department stores! Other absurdities that have arisen concern the British authorities using *anti-terrorist legislation* to seize the assets of Icelandic banks in London to cover payouts to British depositors in these banks. This kind of nonsense (outlandish in spirit if not illegal in technicality) is being perpetrated by governments reacting in panic; disregarding the consequential implications for rule-of-law.

Let's be clear: the ever-changing diagnoses of the problem, half-baked policy responses, premature recapitalisation measures, and hasty actions like bilateral asset seizures, have all been done by *governments* in haste responding to rapidly changing political pressures. All have turned out to be

wrong. It is obvious that we are reposing too much faith in governments who are probably even less astute than bankers were. Because we are convinced that markets have failed, we assume that governments (and the talking heads in financial newspapers and journals goading them) know better. They don't. They just talk louder but make little sense.

As a result of flawed government actions and premature concerns about avoiding moral hazard, what was a *liquidity* problem in 2007-08 has become a major *solvency* crisis since September 2008, with serious secondary and tertiary effects. Bank balance sheets are unwinding rapidly as values of all types of collateral continue to collapse, and as expected revenues to support normal debt servicing fail to materialise. From Q3-2007 through 2008 bank illiquidity has turned to acute capital inadequacy and insolvency. Consequent recapitalisation requirements kept increasing as governments fumbled and asset values kept dropping. It has exploded as government actions turned what started out as an *American* financial crisis into a *global* economic crisis.

Government failure has converted what might have been a short recession into a long depression. **The notion, that when markets and banks fail governments automatically succeed, is wrong.** Evidence suggests that governments have failed even more; because of the nature of political (and legislative) processes, bureaucracy, inefficiency, and compromised delivery that is endemic in governments, more than in the private sector! What's the evidence for this assertion?

In August 2007, Fed Chairman Bernanke testifying before the US Congress estimated toxic assets of the banking system to be US$150 billion and manageable. In September 2008,the same Ben Bernanke and then US Treasury Secretary Hank Paulson estimated these to be US$800 billion and intractable; and that was after US$500 billion had been written down! In January 2009, Goldman Sachs and the IMF estimated impaired assets to be US$ 2 trillion. In February 2009, RGE Monitor estimated that 'total losses will peak at US$3.6 trillion and another US$1.5 trillion will be needed to restore the banking system's equity base to pre-crisis levels.'†

The escalation of the problem from US$150 billion to US$3.6 trillion in 18 months does not suggest that government intervention has worked. It has, in fact, made matters worse by conveying signals that hyperactive but clueless governments (especially the UK's) did not know what they were doing, but were intent on doing it anyway just to show that they were in charge and 'doing something'! **The key mistake made was to precipitate a round of premature bank capitalisations around the world before removing toxic assets from bank balance sheets. Another major mistake was that governments ignored the disastrous impact of imploding asset values. Markets will not correct this degree of overshoot by themselves. They will need some form of official support before confidence in asset valuations returns.**

Since September 2008 governments and sovereign wealth funds (SWFs) have put US$500 billion into the shrinking capital of global banks around the world. They have lost $350-400 billion of that! Will they recover it? Most unlikely! And, in March 2009, new cash calls are being made on shareholders by banks previously thought to be safe (e.g. HSBC). Moreover, despite over $5 trillion in additional liquidity being provided by central banks, the global credit tap is barely dripping. Significant blockages remain on both the demand and supply side of the credit picture. With the global economy shrinking at the pace it is, it would be unreasonable to expect bank credit to increase significantly. All these signs suggest that governments have NOT been effective at all.

The fantastic sums mounting in the black hole of bank balance sheets are now resulting in wet diapers and calls for triggering the nuclear option: i.e. **nationalising** global banks in the US, UK and EU! This is advocated by Greenspan (who, with Bush Jr., is probably more responsible than any bankers for the mess we are in), senior members of the US, UK and EU parliaments, as well as 'public choice' academics. Based on experience with nationalised banks around the world over time, and the UK's desultory experience since August 2007, that proposition borders on being insane; even if it is advocated as temporary, for nursing the banking system through intensive care!

Why? Because:

First, it is clear from parliamentary debates and public outrage expressed every day that, when taxpayers take over banks, they cease operating normally. Governments, legislatures and civil servants are terrible micromanagers of banks. They feel obliged to react to political pressures instantly. That stops banks functioning credibly as anything other than inefficient payment utilities.

Second, political pressures oblige governments to make banks do self-harming things (like interest subsidies, delayed recovery of collateral, forced lending to unviable, uncreditworthy households, farmers and businesses) and to direct lending to sectors that scream the loudest for special treatment but are those that should be allowed to die.

Third, nationalised banks give depositors false comfort that their money is safe. It may be in illusory nominal terms, while eventually turning out to be worthless in real terms (cf. Zimbabwe) if governments keep pumping out money mindlessly.

Fourth, nationalisation (which Japan avoided like the plague) will result in massive capital losses to the global pension funds of taxpayers and insurance companies at the worst possible time. They are unlikely to invest in new banks to recover their losses. Such losses will only make asset values decline even further as forced liquidation becomes the norm and confidence in values is lost.

Fifth, nationalising banks in the US, UK and Eurozone, will result in India, China and other developing countries feeling vindicated that their grotesque policy follies, in having nationalised banks dominate their financial systems even in normal times, were alright after all. It just took time and the mother of all crises for the 'backward' West to realise that.

Sixth, that erroneous belief will delay the essential opening of Chinese and Indian capital accounts and market determination of their currency values. China is now almost everyone's largest trading partner in manufactured goods. The opening of its capital account and market determination of its currency is at least as important and urgent a step to be taken for the world economy to recover in a balanced fashion as fixing the global banking system.

Seventh, if OECD banks are nationalised, their balance sheets will still have to be cleaned up by having toxic assets removed and parked elsewhere. If that does not happen these banks won't function properly no matter who owns them.

Eighth, and most importantly, nationalising global banks is oxymoronic. Once global banks like Citi, BoA, J P Morgan, RBS, Deutsche, are *nationalised* they cease functioning as *global* banks. The intricate complex intra-bank networks, built up over time within their operational structures to finance cross-border trade and investment, with high level of efficiency at low cost, will unravel.

And there will be other side-effects as well: e.g. India will lose out when OECD taxpayers and their legislatures decide they don't want back-office jobs outsourced to India regardless of cost-efficiency. We will regress to a pre-1960 financial system that was national and controlled, but unresponsive and inefficient. In short, nationalising OECD banks will set us back a half-century. It will introduce frictional losses and additional transaction costs in financing global trade and investment at a time when both are faltering and exacerbating the process of global implosion.

To avoid that disastrous prospect, a different approach is required. At present the problem of removing toxic debt – which remains the key problem to solve -- is stymied by unresolved issues on pricing. To get around that the US, UK/EU and Japan need to set up a plurilateral asset reconstruction company (PARC) with paid-in capital of US$500 billion carrying callable capital obligations in a ratio of 1:10. To reflect the global distribution of impaired assets, PARC shareholding should be: US-60%; EU-20%; UK-10%; Japan-10%. That would provide PARC with US$5 trillion in capital if it needed to call it to acquire, store and eventually revive, toxic assets.

PARC could invite banks to submit bids for selling their impaired toxic assets on a reverse auction basis with an arbitrary price of US0.45 on the dollar as the maximum likely to be received. These assets are impossible to value anyway, so arbitrariness is the only option available. The assets 'bought' by PARC would result in sellers (banks) getting either long-term PARC bonds (which would be AAA rated like World Bank bonds because of the underlying callable guarantee) or cash (with a discount of 33-50% on value agreed). Such bonds held to maturity could be used to bolster Tier 2 capital. PARC could then accumulate, unbundle, rearrange, and re-bundle these assets over time to eliminate their toxicity and increase their marketability. Incidentally, that would be a great outsourcing opportunity for India with real global value added!

That is a broad if skeletal outline of what might work. It would mop up ALL toxic assets once and for all. The devil in the detail could be worked out if governments concerned were so inclined. This scheme would avoid the absurdities perpetrated with premature recapitalisations around the world. These were undertaken on extortionate terms that later had to be amended. Much more remains to be said about what could be done; but time and space in this column are short. What is

crucial to appreciate is that much more can be done to save the banking system without resorting to nuclear options.

Are we over-stimulating ourselves?

Coming to the second set of questions posed earlier: How can we decelerate the downward spiral in global demand implosion for consumption and private investment? Will stimulus packages around the world reverse current trajectory and restore growth? When?

Right now there is only bad news. Economies are contracting everywhere, underlining how coupled the global economy is. Decoupling is a myth. The intricate web of myriad cross-border linkages is invisible. It is chaotic. A butterfly stirs in the US. Trillions of micro after effects of that nano event result in floods in India and China. In this case, a downdraft in the US is shrinking the world in ways not fully understood. Yet, the US accounts for only 23% of the global economy, compared to over 55% in 196o. Then, what happened in the US, affected India and China far less!

All parts of the world are experiencing declines of at least 5% in GDP from 2007-08 levels. In Korea, the rate of contraction is over 21% in Japan it is 12%. In Singapore it is 6%. In the US and EU, growth has fallen from **plus** 2-3% to **minus** 5-6%. In India and China it has dropped from 9% and 11%, to 7-8% this year. It will drop to 5-6% in the next. In Brazil the drop is from 7.5% to 3% and in Russia from 8% to 1%. We have not seen the nadir yet. The loss of world output in the Q3-2008 was US$400 billion. In calendar 2009 it will be US$2.5 trillion. So, global stimulus is needed if the implosive spiral is to be arrested. But, how much stimulus?

In these circumstances all governments feel political heat to support growth. No electorate wants to lose jobs and income. Paradoxically, households and firms around the world must tighten their belts. They have to deleverage and adjust expenditures to falling incomes and increasing risk of job losses. Those *natural* adjustments cannot be counteracted by fiat. They will occur no matter what. Attempts to arrest the ebb and flow of that tide will fail. But, in letting such adjustments happen, how can the risk of overshooting and damaging national and world economies be avoided?

Precipitate contraction of consumption and investment leaves only one option: i.e. increase public expenditures to spend our way out of recession in the hope that, when the anticipated inflexion arrives, policy can be tightened without killing recovery. Theoretically that's fine. In practice it is almost impossible. That balancing act is beyond the capacity of most governments to perform. It needs luck more than acuity.

The current depression has spawned a new generation of neo-Keynesian Stimulus Maniacs (NKSMs). To them, the lesson of 1929-39 is that we must go from what was done then to the other extreme. NKSMs want governments to run absurdly loose fiscal and monetary policies. They want to prevent a slide back into protectionism that would reverse the gains of the last two trade rounds. But those courses of action do not necessarily reinforce each other. Often, fiscal stimuli (e.g. bailouts and producer subsidies) lead to creeping or galloping protection.

When the US taxpayer bails out US banks, or the US auto industry, the expectation is that Americans will 'buy American'. The British, French, Germans, Japanese, Indians and Chinese then follow suit in ways that might make sense nationally but lead to disaster globally. When Americans call for American jobs (whatever that means in a globalised world) to stay in the US, they forget that it is the Chinese, Indians, Japanese, Singaporeans, Arabs and Russians who are financing the US deficit that enables them to indulge in nationalistic idiocy leading to global harm.

There is a fallacy of aggregation in assuming that global demand will revive by reviving *national* demand through fiscal stimulus. That will not automatically result in revival of global demand. Instead, beggar-thy-neighbour fiscal stimuli may have the opposite impact. Right now, the fiscal stimuli being designed represent the domestic pork-barrel politics of each country. They are resulting in bad policy favouring special interests. It is difficult to see what stimuli aimed at supporting industries (autos, steel, airlines, etc.... where do you stop?) will do to revive consumer demand. In most cases they will delay death (e.g. of the US auto industry) at great expense. There is little point in filling every square inch of space with cars or steel or flat-screen TVs that no one wants to buy. Even if justified on the grounds of saving jobs, such subsidies will end up as a waste, resulting in these and many other jobs (not protected by unions) being lost over time.

Some say it would be better to reduce taxes and leave more money in people's pockets for them to spend as they please rather than have government spend it for them. The problem is that, at times like these, people will save not spend; except for the poorest, whose subsistence consumption will not revive demand for cars or steel. The difficulty with fiscal stimuli in places like India (which is as determined to stimulate as the OECD world although its growth rate is >5%) is that its central and state governments cannot deliver the goods with budgeted expenditure. Expenditure of authorised funds occurs with a long lag. That delay may actually prove to be pro-cyclical rather than counter-cyclical at that point in time. So what should be done?

National recovery packages do not add up when aggregated globally. Reviving demand in the US and EU right now is like Sisyphus rolling a juggernaut uphill with no traction. On the other hand, spurring demand in Asia (with an economy of US$12 trillion), and encouraging it to grow at 10+%, could create useful global demand of US$1.2 trillion next year. But, oddly and unwisely, Asians prefer to finance US and EU fiscal deficits with their reserves rather than financing the credit they need for themselves to invest, consume and grow. As in 1997-2000, this crisis shows that Asia has learnt few lessons to protect its own regional/continental interests, other than building reserves as a bulwark. It has just not grown up politically. Asia still invites external intrusion to arrange its economic and political affairs. It is incapable of doing so by itself in its own interests. Permit me to digress a bit on this crucially important issue.

An Asian Digression: Why does Asia find it so difficult to get its act together in becoming the locomotive that would get the world out of trouble?

Despite the obvious lessons that this crisis holds for Asia let me ask: Can anyone imagine India, China, Japan, Korea, Pakistan, and the Asean countries agreeing on anything constructive in their own collective interest? Yet, Asian economic and financial integration is crucial to the economic security and well-being of the world for getting out of this crisis and for the rest of this century. But no one is even focusing on that issue as being relevant for crisis resolution and moving beyond that.

China is busy encircling India; containing it to prevent it from emerging as a possible strategic competitor on the regional and global stages. The autonomy of Tibet and other unresolved border disputes continue to act as irritants preventing normalisation of the relationship between these two giants that is so crucial to the safety and prosperity of Asia. Instead of being covertly antagonistic, Indian and Chinese economic and security strategies ought to be focused on building each other up rapidly through intensified cross-border trade and investment. It is in the interests of the US and EU to foster and encourage that process instead of seeing it as threatening to their own immediate, myopic interests (i.e. attempting to pre-empt Asian reserves to finance their burgeoning deficits).

India and China need to build up trade and investment linkages with Asean countries as their largest future trading partners and neighbours. The prosperity and security of both countries and the region for the rest of this century can be guaranteed only through that route. That approach would: (a) build the foundations for an economically and financially integrated Asia that can prosper on its own, without being coupled with the US or EU; (b) make Asia less dependent on US and EU consumer markets for exports of Asian goods and services; or (c) on their financial centres for the flow of trade, investment and infrastructure finance that Asia needs; and (d) create a new and dynamic Asian market for absorbing US and EU exports to rebalance the global economy.

Pakistan, a palpably failed state has become a danger to itself and every one of its neighbours. It is now the epicentre of the global terrorism industry. It is much too preoccupied with diminishing a powerful India in any way imaginable to keep alive its fragile but defunct *raison d'être*. If it were not anti-Indian, Pakistan would cease to have any meaning or cause for independent existence. Though the US has belatedly learnt its lesson in creating monsters in the Pakistani military establishment that have survived to bite it back hard, China is a long way from learning the same lesson. It is surreptitiously supporting Pakistan's anti-Indian proclivities by encouraging its warped military intelligence establishment to continue with its disastrous bungling. To avert the prospect of Chinese influence becoming dominant in Pakistan, the US is locked into a 'support' relationship that is ambiguous and probably self-defeating. What China does not appear to realise is that its support will cause Pakistan's ISI to eventually turn on China by working up discontent in China's own Islamic communities.

China and Korea, for understandable historical reasons, have a deep basic instinctive distrust and fear of Japan; in the same way that Europeans still have about Germany and Russia, while refusing to acknowledge or admit it. Japan, an aging closed society that is a demographic time-bomb, distrusts and condescends patronisingly to everyone except the US. *Bumiputras* in all the Asean countries resent overseas Chinese. Asian Muslims across Asia distrust Asian *kaffirs*. Even the problem of terrorism in Asia needs US intervention to resolve.

In short, Asia, despite its immense *economic* success, has not shed the *political* inferiority complex imprinted on its genes by former colonial masters. It divides and misrules itself. It prefers to route its funds through London and New York back to itself, rather than use its own considerable capacity to do that. It prefers to listen to Washington and London for policy advice about what to do when Asia has found its own answers to what works better in Asia and possibly even elsewhere! That may suit US and EU policy-makers in the short run, by preserving their global influence and dominance well past its sell-by date. But it does not suit the interests of US and EU populations.

So, global stimulus would be more effective if Asians diverted their resources to Asia from financing deficits elsewhere to create the impetus to invest, consume and grow. Asia should use the opportunity this crisis provides to lessen dependence on US and EU markets. It should focus on widening, deepening and strengthening its own.

In India and China the cause of stimulus would be better served if instead of heeding calls from every special interest for fiscal sops (a) urgent reforms were accelerated in land, labour, financial and product markets; (b) these countries weaned themselves away from price supports and producer subsidies; and (c) they made all markets work across the board.

Growth would be faster if Asian countries opened their capital accounts and floated their currencies (especially vis-à-vis each other) rather than insist on living in a suboptimal world of residual controls that do not work and manipulated currencies that invite retaliation.

In short, global stimulus is needed. But the present approach to providing it is too partial and too local to do the world economy any good. So, the depression will last longer than it should. A turnaround that could have occurred by Q3-2009 will be delayed beyond Q3-2010.

Back to the Future

This crisis will end as crises always do. But when and how remain indeterminate. What will happen when recovery resumes? What lessons for economic and financial management will have been learnt? What will be the prospects for recovery, growth, inflation, financial system restructuring and regulation?

The consensus now is that the money being thrown (wasted?) at reviving global demand and repairing bank balance sheets in the three years 2008-2010 will exceed: (a) US$9-10 trillion in *incremental* **fiscal deficits** around the world; and (b) US$ 12-15 trillion in aggregate **monetary loosening** by global central banks, some of that going to finance incremental public deficits. With global GDP shrinking to a nominal US$50-52 trillion by end-2009, those are not trivial sums. It is difficult to imagine markets absorbing the full amount of additional public debt that governments will issue. Much of it will be monetised through direct central bank purchases.

That may not show up in inflation now. But it must in the not-too-distant future; despite those who mock such a prospect by accentuating the imminent risk of deflation. Allowing for a proportion of new money being absorbed by value losses in bank balance sheets, there will be an overhang of liquidity waiting to circulate in the global economy with increasing velocity as consumption revives. Excess liquidity will not be quite as easy to withdraw as it was to emit. The timing of monetary and fiscal tightening will be crucial. Too soon and recovery will be compromised. Too late and high inflation will be unleashed. What timing would be exactly right? No one knows!

But all that is theoretical. The crisis will be prolonged indefinitely if:

- governments around the world keep fumbling, indicating to markets that they are clueless and helpless;
- fiscal stimuli are as poorly designed and misdirected as they are;
- toxic assets, whose value cannot be determined, remain on bank balance sheets, without being transferred and quarantined in a plurilateral asset resolution corporation (PARC) of some kind, on appropriate terms;

- the drift towards *de facto* or *de jure* **bank nationalisation**, resulting from relentless 'de-capitalisation', continues unchecked, resulting in global banks ceasing to function, shrinking their operations, and being run by emotional legislatures instead of professional managers; and
- urgent economic, financial, institutional, and regulatory, reforms in OECD countries and Asia (especially India and China) are deferred, using the crisis as an excuse.

Unfortunately, all five of these trends/conditions look like they will continue rather than being contained or reversed.

But, justifiable concern aside, it seems unlikely that the world economy can continue contracting at the extraordinary pace of Q4-08 and Q1-09. That implosion has taken even the most pessimistic analysts by surprise. No one expected Japan to *contract* at an annual rate of 12% or Korea at 21%. Following the vicious wring-out that has occurred, the world economy is likely to contract more moderately from Q2-09 to Q4-09. As supply chain de-stocking, cutbacks in corporate investment, and household consumption deferral/compression, all run their natural course, seriously flawed fiscal stimuli will begin to take weak effect, with the global economy bottoming by Q1-2010. But the recovery will be so fragile as to be almost indiscernible until Q3-2010.

While that trajectory may apply to the world, India's growth will probably slow further from 5.3% in Q4-08 to 4.5% in Q1-09 before recovering to 5% in Q2-09. What happens thereafter depends on the outcome of the general election. If the UPA resumes power, growth will recover to around 6% for the rest of 2009. The BJP's leadership indulges in the bizarre belief that India's economic crisis is piffle compared with the importance of building a Ram Mandir at Ayodhya. That gives faith a new dimension which rational economists remain unaware of. If the election outcome results, improbably but not impossibly, in a Third Front victory, a growth rate of **minus** 5% might be in the cards – because private investment and confidence in India will evaporate.

Whatever happens, it will take monetary management of extraordinary intuition and brilliance to avoid a global inflation rate of over 10% between 2011-2015; bringing to mind a period in 1981-84 when Paul Volcker had to raise the Fed rate to over 15% to bring inflation back under control by 1986. The crisis has, understandably, resulted in more words being written than ever before examining every aspect of it's unfolding in minute detail. Yet, the question remains: what lessons will we have learnt? None that will prevent the next crisis from occurring!

There are serious lessons to be learnt about financial system regulation. But if one analyses what is being said it seems likely that the wrong lessons will be imbibed, not the right ones. This crisis makes a powerful case for: (a) unified systemic financial regulation by an authority independent of the monetary authority, *and* (b) for principles-based regulation, properly and rigorously enforced.

It was in the US with fractured, uncoordinated rules-based regulation that the worst excesses and damage occurred. The crisis also makes a case for seamless, high-level coordination across fiscal, monetary and regulatory authorities; especially when it comes to bolstering financial firms experiencing liquidity distress, without heeding concerns about moral hazard in the midst of a crisis. Yet, the retrospective musings of the UK Chancellor about regulation, as well as the reactions of traditionalists opposed to any financial regulation other than that imposed by central banks (which are incapable of regulating capital, insurance, derivatives or commodity trading markets), suggest the opposite impression. Much can be said about this. But it is not the place to indulge in technical detail; except to hope that sense will prevail over obduracy.

Similarly, one would hope that lessons will be learnt from the credit default swap (CDS) market i.e. a clearing counterparty is urgently needed for intermediating such instruments to maintain the integrity of counterparty performance. Lessons need to be learnt about adopting counter-cyclical capital build-up policies for banks, and for risk weighting of capital requirements for bank portfolios.[‡] Basel-2 was a failure despite the monumental effort that went into it. Similarly, we need to revisit implicit policies permitting banks or any type of financial institution to become too big to fail thus escaping the normal discipline of a competitive marketplace. By now we should have learnt that asset prices matter. Permitting the build up of asset price bubbles is a dangerous risk for central banks to take. Greenspan was wrong about that. We need to learn (from the Euro and EU) that a unified fiscus with seamless intra-regional fiscal transfer mechanisms, along with a unified financial system regulatory authority, are essential concomitants for maintaining the credibility of a synthetic currency, especially in times of acute stress.

But the most important of lesson of all may be one that is obscured; i.e. that issuers of global reserve currencies need to be subject to tougher global surveillance over their fiscal and monetary policies and to rigorous monitoring, enforcement and sanctions by significantly empowered (rather than defanged) multilateral agencies like the IMF, BIS and OECD groupings.

Another lesson that won't be learnt is that world needs India and China to put their currencies on the world stage as prospective reserve currencies. That is to avoid the future concentration of global reserves in currencies whose long-term credibility is suspect. At present, the issuers of those reserve currencies (i.e. principally the USD, EUR, JPY and GBP) are focusing their emission policies on meeting domestic political exigencies and concerns, rather than acknowledging the legitimate concerns of those who hold those currencies around the world as mediums of exchange and stores of value.

These and countless other lessons are waiting to be learnt. But until the crisis is over and recovery resumes there will be no appetite for learning or applying them. Moreover, in countries like India, traditionalists will use the crisis to reinforce entrenched biases, argue against much needed reform, extol their continued faith in a perversely counterproductive rather than constructive heterodoxy, and in retaining the illegitimacy of unworkable command-control regimes (in which those same traditionalists make the crucial decisions), rather than learning from experience and changing their views as facts and circumstances change. Their unshakeable prejudices will remain more important than evidence. The lesson to be learnt there is to ignore their views and their advice!

[**] John Taylor, *The Financial Crisis and the Policy Responses: An Empirical Analysis of what went wrong;* NBER Working Paper 14631, January 2009 (Chicago, USA

[†] Nouriel Roubini, *Time to Nationalise Insolvent Banks*, Business Standard, Feb 18th, 2009.

[‡] Markus Brunnermeier, Andrew Crockett, Charles Goodhart, Avinash D. Persaud and Hyun Shin, *The Fundamental Principles of Financial Regulation,* ICMB International Center for Monetary and Banking studies, Geneva, 2009