Rescuing Our Jobs And Savings: What G7/8 Leaders Can Do To Solve The Global Credit Crisis

A VoxEU.org Publication

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Edited by Barry Eichengreen and Richard Baldwin

CEPR

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Introduction

We are in the throes of what is almost certainly the most serious economic and financial crisis of our lifetimes. The crisis is no longer a US crisis or even a US and European crisis; it is a global crisis. It has spread from Wall Street to Main Street. It is not just investment portfolios and retirement accounts but jobs that are now at risk. There is a need for urgent action. The policy response needs to be decisive. It needs to be global. The stakes could not be higher.

The G7/8 finance ministers meeting: an opportunity

Global economic and financial leaders are convening this weekend in Washington DC for the annual meetings of the IMF and World Bank. G7/8 finance ministers will meet Friday on the sidelines of the Fund/Bank meetings to craft their response. The global financial community will assemble the next day at IMF headquarters. Unfortunately, it is not clear that they have a clue of what to do.

With this sense of urgency in mind, we have assembled a group of leading economists to offer priorities for crisis response. This is not a homogenous collection of experts. The contributors are from different continents and different schools of thought. Not for the first time, the experts do not entirely agree.

Remarkable consensus: stabilise the banking system

But, that said, there is a remarkable degree of consensus on what must be done. Policy makers must move boldly to stabilise the financial system. To be sure, there are also other urgent tasks for the future. There must be regulatory reform and, more than that, a fundamental rethinking of the financial architecture to prevent an equally devastating crisis from occurring again. Social programs will need to be ramped up to provide assistance to the innocent victims of the crisis. The damage done to pensions, retirement accounts, and the housing market will need to be repaired. But these are tasks for tomorrow. Today, the contributors to this volume agree, the urgent task is to contain the panic and staunch the bleeding in the financial system.

Stabilising the banking system: Options

To be sure, there are some differences of opinion in how to go about this.

Quick bank recapitalisation with global coordination

Our contributors are unanimous in the importance they attach to quick bank recapitalisation. But this is easier said than done. Stijn Claessens, Barry Eichengreen and Charles Wyplosz all point to the free-rider problems and lack of state capacity that discourage and, indeed, prevent countries from proceeding unilaterally. Countries will have to coordinate their initiatives to prevent willy-nilly recapitalisation from only shifting the crisis from one country to another. In cases like Switzerland, where bank liabilities are a multiple of GDP, the burden will have to be shared internationally. Here the IMF can help by opening a special window to provide immediate credits for this purpose.

Given the pervasiveness of cross-border bank liabilities in Europe, no recapitalisation scheme will work, as Luigi Guiso and Marco Pagano, and Daniel Gros emphasise, unless European finance ministers immediately agree on a common plan, for example something along the lines of the 8 October 2008 UK plan. The US Treasury, for its part, will have to quickly shift the focus of its rescue efforts from taking troubled assets off bank balance sheets at "market prices" to using the $700 billion Troubled Asset Relief Program to inject capital directly into US banks, giving the taxpayer an equity stake, as Brad Delong and others noted. Charles Calomiris would insist on injecting capital in the form of straight preferred stock. Barry Eichengreen would settle for warrants, notwithstanding their problems, insofar as time is of the essence.

Guarantees of deposits and/or loans with global coordination

Some like Klaus Zimmerman hope that the panic can be quelled by international agreement on a higher level of insurance for bank deposits. Others like Alberto Alesina, Guido Tabellini, Daniel Gros, Avinash Persaud, Douglas Diamond, Anil Kashyap, and Raghuram Rajan, Roger Craine argue for going further and guaranteeing not only bank deposits but also bank loans. In effect, they are arguing for a time-out to let passions cool and regulators determine which banks should be wound down and which ones should be recapitalised. The device they propose is a guarantee of all short-term bank liabilities to remove the incentive for investors to flee.

It is clear that these measures will have to be harmonised and implemented simultaneously around the globe if they are going to solve more problems than they create. This is most obviously true in Europe, where banks in different countries are often on the two sides of interbank transactions. But the problem extends beyond that. It extends across the Atlantic. Increasingly it extends around the globe. Only a global solution, therefore, will work.

Utmost urgency

With these two priority measures, then - a blanket guarantee on bank liabilities and quick recapitalisation, both coordinated internationally - there is a hope that governments can finally get a handle on the problem. It is of the utmost urgency that they do so this weekend.

The essays collected here speak directly to the finance ministers and leaders assembling in Washington, DC on the second weekend in October. They are designed to offer specific instructions about what those finance ministers and leaders should do to rescue our jobs and savings.

Origins of this book

This E-book sprang from an email sent in the early morning of 8 October 2008 by Barry Eichengreen to VoxEU.org. The call from Vox for essays went out the same day, primarily to US and European economists as this is where the crisis is currently burning most strongly. We hope that there will be Asian, Latin American and African analogues to this initiative, and sooner rather than later.

The production of the book was organised by CEPR's capable staff and Team Vox (especially, Anil Shamdasani, Jonathan Dingel, Pierre-Louis Vezina and Melanie Sawaryn under the guidance of CEPR's Chief Executive Officer, Stephen Yeo). We are staggered by their speed and dexterity and, above all, grateful for their efforts.

Barry Eichengreen and Richard Baldwin
Berkeley, CA and Geneva

October 9, 2008

Coordinating International Responses to the Crisis

Klaus F. Zimmermann
Bonn University, IZA, DIW and CEPR

Governments need to adopt a mixed strategy of short-term and long-term measures to handle the crisis. The key is worldwide concerted action, based on similar policies executed by national governments. Some of the measures necessary have already been undertaken - but without the international coordination essential for their effectiveness.

It is obvious that dubious practices in the financial sector have gravely damaged the global financial system, with consequences for the rest of the world economy that are still hard to foresee. The Federal Reserve's excessively low interest rates and the US government's policy overactivism have contributed to an enormous loss of trust. European banks have been part of the problem, including public banks in Germany. Europe's failure to provide early systemic responses has fuelled the fire. The reactions of the markets over the last ten days suggest that attempts to calm the markets and restore trust will not be effective in the short term. Therefore, the authorities need to adopt a mixed strategy of short-term and long-term measures to handle the crisis.

I believe that the key is worldwide concerted action, based on similar policies executed by national governments. In the short run:

- Unsecured interbank lending has to be re-established by guarantees provided by the central banks and substituted by direct supply of liquidity and credits to the business sector by the Fed, the ECB, and others.
- Providing a harmonised level of insurance for bank deposits is also essential.
- Measures to recapitalise the banking system need to be taken - state funds might be one useful means to this end.
- Central bank interest rates have to remain low and should be reduced further in Europe.
- Banks should be allowed to value their assets at their purchase price and not their current market value.

Some of these measures have already been undertaken but without the necessary coordination.

- The nationalisation of banks is a last resort to stop the crisis.

It is also essential to dampen expectations of an oncoming recession, since these have detrimental effects on consumer demand and investment spending. Higher public spending or lower taxes will not help to restore trust at this stage. Any fiscal stimulus needs to be timely, temporary, and targeted at those who are inclined to spend the money provided by the government. This is unlikely in the face of the current fear and distrust in the markets.

The stock markets are and will remain crazy and unpredictable until the architecture of a reinvented financial system comes into view. Regionally decentralised regulatory authorities are needed to supervise the entire financial sector including the hedge funds and the rating agencies. This would create incentives to compete for the best regulatory practice and to recognise systemic risk. It is necessary to refocus regulations on judging the global strategies of financial institutions. The regulatory authorities must also be enabled to supervise all aspects of the market participants' activity including off-balance-sheet positions and the protection of investors. There is a need to abolish shareholder value as an indicator of success for the compensation schemes of managers. It is important to enforce the provision of sufficiently homogenous and transparent assets. New financial products should be examined by the regulatory authorities and tested in a local market before they are accepted for general use.

About the Author

Klaus F. Zimmermann *is Full Professor of Economics at Bonn University and Director of the Institute for the Study of Labour (IZA Bonn) since 1998, President of the German Institute for Economic Research (DIW Berlin) since 2000. He is also Honorary Professor of Economics at the Free University of Berlin Renmin University of Peking. Previously, he taught at the University of Pennsylvania, Dartmouth, Humboldt, Kyoto and the University of Munich where he was Dean of the Faculty of Economics. He studied economics and statistics at the University of Mannheim, where he received his degree as Diplom Volkswirt, his doctorate and his habilitation.*

Founder and Secretary of the European Society for Population Economics (ESPE), 1986-1992, he was CEPR Programme Director for "Human Resources" (1991-1998) and "Labour Economics" (1998-2001). He is Editor-in-Chief of the Journal of Population Economics and was a Managing Editor of Economic Policy. He has been a CEPR Research Fellow since 1990.

Calming the Panic

Alberto Alesina and Guido Tabellini

Harvard and CEPR; Bocconi University and CEPR

The current crisis is a case of financial panic that risks a self-fulfilling nightmare. Governments should guarantee bank loans to end the panic.

The last few days look more and more like a case of financial panic.

Some markets have stopped operating because nobody seems to be willing to lend for fear of solvency of the borrowers. The fears seem exaggerated, even taking into account the reduction of growth forecasts and the exposure to the losses originated by the subprime real estate market in the US. The real economy shows signs of slowing, of course, but no sign of deep recession. The IMF predicts positive growth for the world next year (3%, slower than previously predicted but certainly not a depression). About half of the losses of banks, estimated to be about $1400 billion, have been already covered by some sort of government intervention. A panic is extremely dangerous because it could bring about self-fulfilling worsening of fundamentals. If credit to, say, the real estate sector stops, housing prices would keep falling in vicious circles of self-fulfilling expectations.

Monetary authorities have tried injecting liquidity and cutting rates, but this has not fully worked because these measures have not restored faith in borrowers. The Federal Reserve has expanded its role as a direct lender to additional institutions in the market for commercial paper, but it is not clear that the European Central Bank could do the same, and there is a limit to which kind of institution could directly borrow from central banks.

Here is a proposal. The central banks should guarantee not only deposits but also bank loans, especially in the interbank market. This measure could be temporary until the situation is stabilised. These guarantees would in large part not be used to the extent that the problem is panic rather than fundamentals. The basic idea is similar to the one underlying the need to guarantee deposits so as to prevent depositors from abandoning their role as lenders to banks. With this proposal, we would avoid banks abandoning their role as lenders to other banks.

This proposal should not be viewed as a substitute for others already discussed, like bank recapitalisation, purchase of depreciated assets like the Paulson plan, or direct intervention to subsidise borrowers in the real estate market.

About the Authors

Alberto Alesina *is the Nathaniel Ropes Professor of Political Economy at Harvard University and was Chairman of the Department of Economics (2003 - 2006), having obtained his PhD in Economics from Harvard in 1986. He is a member of the Econometric Society and of the American Academy of Arts and Sciences. He has published extensively in all major academ-*

ic journals in economics and written books and edited many more. His two most recent books are The Future of Europe: Reform or Decline published by MIT Press (2006), and Fighting Poverty in the US and Europe: A World of Difference, published by Oxford University Press. He has been a Co-editor of the Quarterly Journal of Economics for eight years and Associate Editor of many academic journals. He obtained his Ph.D. from Harvard in 1986.

His work has covered a variety of topics: political business cycles, the political economy of fiscal policy and budget deficits, the process of European integration, stabilization policies in high inflation countries, the determination of the size of countries, currency unions, the political economic determinants of redistributive policies, differences in the welfare state in the US and Europe and, more generally, differences in the economic system in the US and Europe, the effect of alternative electoral systems on economic policies, and the determination of the choice of different electoral systems. He is a CEPR Research Fellow.

***Guido Tabellini** is Professor of Economics at Bocconi University, and President of IGIER at Bocconi University in Milan. Previously, he taught at Stanford University and UCLA. He is a foreign honorary member of the American Academy of Arts and Sciences, a fellow of the Econometric Society, and a joint recipient of the Yrjo Jahnsson award from the European Economic Association. He is President of the European Economic Association, and an associate editor of the Journal of the European Economic Association. He has been associate editor of the Journal of Public Economics, the European Economic Review, and other international journals.*

He has acted as an economic consultant to the Italian government, the European Parliament and the Fiscal Affairs Department of the International Monetary Fund. The main focus of his research is on how political and policymaking institutions influence policy formation and economic performance. Much of his recent research is summarised in two books co-authored with Torsten Persson - "Political Economics: Explaining Economic Policy", MIT Press, 2000; and "The Economic Effects of Constitutions", MIT Press, 2003. He earned his PhD in Economics at UCLA in 1984. He is a CEPR Research Fellow.

How to Save the European Banking System

Daniel Gros

Director, Centre for European Policy Studies (CEPS), Brussels

To save the European banking system, we need a coordinated approach by all EU member countries under which the large banks are re-capitalised and each government guarantees the lending of its own banks to other EU banks.

A severe banking crisis has developed in Europe. Why? And what could be done to address it?

There are two related reasons for the problem in Europe. The large money-centre banks that provide the backbone for the inter-bank lending market are undercapitalised. With their low capitalisation, they are vulnerable to even small swings in market conditions. Any liquidity problem thus turns almost immediately into a solvency problem. Because of this vulnerability they do not trust each other, thus paralysing the inter-bank market.

A two-pronged approach is thus needed:

- Recapitalising the large banks, and
- Restarting inter-bank lending.

The recent measures of the UK government go in the right direction as they contain both elements: bank re-capitalisation and support for the liquidity management of banks. The Italian government has also decided to offer its banks public funding if they are in need of recapitalisation, and it is likely that other European governments will follow.

This leaves as a key problem the dysfunctional state of the euro area money market. This problem cannot be solved by the UK government, even if a large part of that market happens to be in London.

What is needed (and has been proposed by the UK) is a coordinated approach, by all EU member countries under which each government guarantees the lending of its own banks to other EU banks. The impact is stronger, the larger is the number of countries that participate in this approach,

The principle of this approach could be quite simple. Each participating government guarantees its own banks' reimbursement of inter-bank loans, including cross-border loans to banks in other participating countries. The guarantee would presumably be valid for a limited time and available against a fee. Given current levels of the cost of protection against counterparty default in the banking system, this fee could be substantial enough to provide a comfortable insurance premium without choking off the market.

Of course, finance ministers will object that this exposes them to an unacceptable risk. In reality, this risk will be quite limited because all governments have already announced that they will not let any large bank fail. Hence most governments have implicitly already guaranteed the liabilities of their own large banks.

Moreover, losses from housing-related activities seem relatively minor in Europe (except Spain and Ireland). This implies that the key issue in Europe is not how to make up massive losses but how to resolve a coordination problem. The European governments amongst the G7 should agree rapidly on such a scheme to get at least the euro-area inter-bank market moving again.

About the Author

Daniel Gros *is the Director of the Centre for European Policy Studies (CEPS) in Brussels. Originally from Germany, he attended university in Italy, where he obtained a Laurea in Economia e Commercio. He also studied in the United States, where he earned his M.A. and PhD (University of Chicago, 1984). He worked at the International Monetary Fund, in the European and Research Departments (1983-1986), then as an Economic Advisor to the Directorate General II of the European Commission (1988-1990). He has taught at the European College (Natolin) as well as at various universities across Europe, including the Catholic University of Leuven, the University of Frankfurt, the University of Basel, Bocconi University, the Kiel Institute of World Studies and the Central European University in Prague.*

His current research concentrates on the impact of the euro on capital and labour markets, as well as on the international role of the euro, especially in Central and Eastern Europe. He also monitors the transition towards market economies and the process of enlargement of the EU towards the east (he advised the Commission and a number of governments on these issues). He was advisor to the European Parliament from 1998 to 2005, and member of the Conseil Economique de la Nation (2003-2005); from 2001 to 2003, he was a member of the Conseil d'Analyse Economique (advisory bodies to the French Prime Minister and Finance Minister). Since 2002, he has been a member of the Shadow Council organised by Handelsblatt; and since April 2005, he has been President of San Paolo IMI Asset Management.

He is editor of Economie Internationale and editor of International Finance. He has published widely in international academic and policy-oriented journals, and has authored numerous monographs and four books.

What Is To Be Done - and by Whom? Five Separate Initiatives

Avinash Persaud

Chairman, Intelligence Capital

Five separate national and international initiatives are needed to contain the crisis, reverse some of its effects, and prevent its reoccurrence.

There are five separate initiatives the authorities need to follow to contain the crisis, reverse some of its effects, and prevent it from happening again. National authorities are best positioned to respond quickly to contain the crisis, international initiatives are required to avoid repetition, and some combination of the two is best suited to reversing its effects.

National authorities can best contain the crisis through two measures.

First, as Willem Buiter has argued, they must revive inter-bank markets by providing a temporary guarantee for short-term unsecured lending between regulated institutions. Central bank disintermediation of inter-bank markets is more costly and less sustainable.

Second, national authorities should also inject preference share capital to institutions that need it on condition of a partial swap of "old" debt for equity. Such involvement by government is best carried out at arms length - in Europe's case, the European Investment Bank may be a good vehicle.

A critical part of the current crisis is that write-downs of asset prices have so depleted bank capital that many banks are close to insolvency on a mark-to-market basis. These write-downs are caused by the distress prices obtained when selling instruments today that the market cannot easily value because of their complexity and uncertainty over their rating. This leads to the next necessary initiative.

The third thing the authorities should do is to support a more immediate reversal of this process by facilitating the creation of long-term liquidity pools to purchase assets - rather like John Pierpont Morgan's 1907 money trusts. These pools are best managed by those with long-term liabilities like insurance companies and funds with investor lock ups, but the authorities could capitalise these liquidity pools by issuing ten-year government bonds. Under existing rules, these pools would not mark-to-market, and it is better that long-term investors, not governments, buy assets on a strictly commercial basis. These liquidity pools need to operate internationally and therefore need to be capitalised and organised internationally. The IMF may perform this co-ordination role.

Looking ahead to the next crisis

This is the seventh international financial crisis I have lived through. At the end of each, the focus on avoiding the next one has always been the same trinity: more transparency, more disclosure, and more risk management. This is an inadequate response to systemic crises. At the heart of new, internationally co-ordinated regulatory initiative, there must be counter-cyclical capital charges (*a la* Goodhart and Persaud 2008). Crises do not occur randomly; they always follow booms. That is my fourth policy initiative.

But there also needs to be a shift in the focus of regulation, away from sensitivity to the market price of risk and notions of equal treatment for all institutions to a greater sensitivity to risk capacity and a better appreciation that diversity is the key to liquidity. This is the fifth step.

Systemic resilience requires different risks being held in places where there is a natural capacity for that type of risk. In the name of risk-sensitivity and equal treatment we ended up with institutions that had no liquidity holding liquidity risk and those with little capacity to hedge or diversify it owning credit risk.

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About the Author

Avinash Persaud*'s career spans finance, academia and public-policy in London and New York. He is currently Chairman of Intelligence Capital, a financial consultancy and a Member of the Board of three investment boutiques. Previously, he was managing director, State Street Corporation; global head, currency and commodity research, J. P. Morgan and Director, fixed income research, UBS. His analytical innovations led him to be ranked in the top three of currency analysts in global investor surveys for over a decade.*

Persaud was elected, Member of Council, Royal Economic Society and is Emeritus Professor, Gresham College. He is Governor and Member of Council, London School of Economics & Political Science, Co-Chair, OECD Emerging Markets Network and Deputy Chair, Overseas Development Institute. He was Visiting Scholar at the IMF and ECB, and was elected a director of the 65,000-strong Global Association of Risk Professionals. In 2000, he won the Jacques de Larosiere Prize in Global Finance from the Institute of International Finance, Washington.

What Next?

Douglas W Diamond, Anil K Kashyap and Raghuram G Rajan

University of Chicago Graduate School of Business

If the panic of the second week of October 2008 worsens, governments need to be prepared to stop it using auditing, recapitalisation, and liquidation. A stopgap stabilisation plan would be to guarantee all banks' short-term liabilities, audit their assets, and then clean up the mess.

We are in a midst of a banking panic caused by concern over the quality of bank assets and the adequacy of bank capital. Interbank lending has stopped and lending to non-banks is grinding to a halt. We need intermediaries to begin functioning again to avoid a deep recession.

The historical recipe for stopping a panic is an automatic stay (or suspension of convertibility) that freezes the ability of creditors to withdraw their money. This buys time so that authorities can audit the banks, decide who is solvent, wind down or recapitalise the shakiest banks, and stop the panic. Today, however, short of failing a bank, such a stay on short-term debt or deposits is impossible.

Perhaps the various guarantees made over the last couple of days will end the panic. But we must prepare for the alternative. If the panic continues, it can be stopped with the traditional tools of auditing, certification, recapitalisation, or asset liquidation. The challenge is to be ready with a plan to accomplish this within the law and without increased incentives for short-term creditors to run.

Our plan is for regulators to buy time by guaranteeing all banks' short-term liabilities for a brief period. This would amount to saying that all securities maturing in the next three months would be federally guaranteed and could be rolled over up to five months. To prevent gaming, asset growth would need to be limited to normal lending growth. Dividend payments would be stopped.

The timeout would be used to verify asset quality and establish capital adequacy. This would start with rapid audits of bank assets, marking to market using common pricing assumptions across banks (above fire-sale values), with the goal of establishing the relative net worth of the banks. Banks would be invited to raise additional capital, with the understanding that any capital raised would be senior to existing capital (except perhaps recently raised capital). If the banks subsequently needed to be liquidated or required government capital infusion, these new investors need the assurance they will be protected (their seniority respected) - otherwise they will not participate. The banks that emerge with higher capital could use the funds to buy weaker banks. The weakest banks, which no one wants to buy, would be wound down. If it turns out that a number of banks are insolvent, even though their core capabilities such as local knowledge have value, they could be failed and recapitalised by the government (without imposing any losses on the short-term creditors).

This plan should be viewed as a stopgap measure. It is possible that the asset purchases under the Troubled Asset Relief Program will eventually help, both to allow banks to sell without depressing prices and to allow the market and regulators to value banks. Likewise, schemes aimed at stabilising home prices, if done on a massive scale, could influence the value of bank assets. But these types of solutions are infeasible in the short term and helpful only if investors believe that they will stop the bank run and make banks solvent. With the number of at-risk institutions growing every day, stabilising the banking system must be the first priority.

About the Authors

Douglas W. Diamond *is Professor at the University of Chicago's Graduate School of Business having previously taught at Yale and the Hong Kong University of Science and Technology. He specializes in the study of financial intermediaries, financial crises, and liquidity, and worked for the Board of Governors of the Federal Reserve System as a graduate student. He is a visiting scholar at the Federal Reserve Bank of Richmond. He is a former president of the American Finance Association and the Western Finance Association, a fellow of the Econometric Society, the American Academy of Arts and Sciences, and the American Finance Association.*

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Raghuram G. Rajan *is a Professor at University of Chicago's Graduate School of Business, having served as Chief Economist at the International Monetary Fund (2003- 2006). He has taught at Northwestern University, MIT, and the Stockholm School of Economics. He has been a consultant for the Indian Finance Ministry, World Bank, Federal Reserve Board, Swedish Parliamentary Commission, and various financial institutions. He is the author, along with Luigi Zingales, of the book, Saving Capitalism from the Capitalists. He received the inaugural Fischer Black Prize in 2003.*

A Strategy Emerges: The Right Policies to Deal with the Crisis

Richard Portes

London Business School and President of CEPR

The UK strategy to recapitalise banks and unfreeze the term funding markets is the right approach. It should be the template for international coordination by the G7/8 and others.

The acute phase of the crisis was triggered by the failure of Lehman Brothers. This and the associated confusion in the markets about government policies caused a sharp rise in perceived counterparty risk, which completely blocked the short-and medium-term money markets. The pervasive uncertainty brought a widespread realisation that many commercial banks are undercapitalised and that further dumping of assets at fire-sale prices, with associated marking-to-market, would eliminate their capital base.[1]

The Paulson plan (US Emergency Economic Stabilisation Act, EESA) focused on creating a market for impaired securities. This is important, although there may be better ways of doing it. But the urgent issues are the *recapitalisation of banks* and *re-liquefying the term funding markets*.

Secretary Paulson has emphasised that the EESA does enable the Treasury to "inject capital into financial institutions". This is the direction that the US and European countries should take. Funds invested in bank equity are leveraged, because bank creditors and depositors are then willing to put more into the bank; this will then reduce by a leveraged amount the excess supply of distressed securities. And *recapitalisation with public funds can be tied to underwriting the money markets*.

New measures to unblock the wholesale markets include the ECB's commitment to supply unlimited funding at the fixed policy rate (now 3.75%) in its weekly refinancing operations, and the Fed's new Commercial Paper Funding Facility, in which a Fed-backed special purpose vehicle will purchase three-month secured and unsecured paper. These are useful but *ad hoc* measuresand unrelated to recapitalisation.

The UK Package: The right policies and hopefully not too late

The UK proposals announced on 8 October provide a detailed template that links the two urgent objectives. The government has offered to inject equity (as preference shares or PIBS) into a wide range of "eligible institutions", and the major banks have already confirmed their participation. There are safeguards for the public interest. In

1 The evidence is clear: TED and Libor-OIS spreads and the VIX at record levels; spikes in CDS spreads, even for the top names; no unsecured interbank lending, even overnight; banks borrowing from the ECB and then redepositing the funds (at a lower rate) with the ECB, rather than lending them on, because they want liquidity above all; plummeting bank share prices.

addition to the prerogatives of a significant equity stake, there will be specific conditionality in regard to dividend policies, executive compensation, and lending policies. Although taxpayers take a risk, there is an upside risk too. Bank price-earnings ratios are now extremely low, so it is not unreasonable to think the value of the equity will appreciate in the longer term.

Banks that do raise appropriate additional capital either from the government or from other sources will be entitled to a government guarantee (on "commercial terms") of new unsecured debt issuance "to assist in refinancing maturing wholesale funding obligations as they come due". This should go far in eliminating the counterparty risk that has frozen the term funding markets.

These are the right policies, finally, and perhaps not too late. Other countries should consider seriously how to adapt them to national circumstances. It would be worse than unfortunate if preconceived ideas or politics were to block similar initiatives elsewhere in Europe - only for countries to find subsequently that they have to reverse themselves yet again or follow ill-designed alternatives.

The dangers facing the European financial system - and the real economy - are now clear and present. They call for a focused strategy rather than the *ad hoc*, mainly uncoordinated reactions we have seen so far in the UK and elsewhere. The new British proposals provide the basis for a strategy that the G7 and the international institutions should endorse and promote.

About the Author

Richard Portes *is Professor of Economics at London Business School and Founder and President of the Centre for Economic Policy Research (CEPR), Directeur d'Etudes at the Ecole des Hautes Etudes en Sciences Sociales, Secretary-General of the Royal Economic Society, and Senior Editor and Co-Chairman of the Board of Economic Policy. He is a Fellow of the Econometric Society and of the British Academy. He is a member of the Group of Economic Policy Advisers to the President of the European Commission, of the Steering Committee of the Euro50 Group, and of the Bellagio Group on the International Economy. Professor Portes was a Rhodes Scholar and a Fellow of Balliol College, Oxford, and has also taught at Princeton, Harvard, and Birkbeck College (University of London). He has been Distinguished Global Visiting Professor at the Haas Business School, University of California, Berkeley, and Joel Stern Visiting Professor of International Finance at Columbia Business School. His current research interests include international macroeconomics, international finance, European bond markets and European integration. He has written extensively on globalisation, sovereign borrowing and debt, European monetary issues, European financial markets, international capital flows, centrally planned economies and transition, macroeconomic disequilibrium, and European integration.*

The Need for a Comprehensive and Global Solution

Stijn Claessens
IMF, University of Amsterdam and CEPR

On top of more transparency, guarantees, and capital injections, international policy coordination is urgently needed to restore confidence in markets.

We are facing a global financial crisis and bold steps by policy makers gathering this week in Washington are urgently needed. It has become clear that the policy interventions to date have not restored confidence in markets. Rather, at times, by being ad-hoc, interventions have actually created more turmoil. A comprehensive and global approach is needed. It should address the core problems in the financial sector - lack of liquidity in markets, doubts about the value of troubled assets, and a clear shortage of capital - address the underlying losses (notably in housing markets), and cover all markets around the world.

What is the problem today? In a nutshell, lack of confidence. Financial institutions are unsure where the losses are. Even if a financial institution knows that its own balance sheet is intact, it cannot be sure that its counterparty is in the clear (or in some way exposed to a third party with problems). Underlying the lack of confidence is the problem of large losses in US and other countries' housing markets, and the risk of economies spiralling down leading to massive corporate defaults. In this environment of distrust, uncertainty, and capital shortage, standard approaches will not suffice. What must be done?

- First, as some governments have concluded, the lack of confidence means that some explicit public guarantee of financial liabilities is almost unavoidable.

But make no mistake here, such guarantees just buy time and can be very costly for governments. Besides being temporary, such guarantees need to include safeguards against risk-taking, such as heightened supervision and limits on deposit rates offered, and be well coordinated in integrated markets such as the Eurozone.

- Second, in some markets, given the size of the problem and the difficulty in valuing assets, the state needs to take troubled assets off banks' books and force the recognition of losses.

Asset purchases done transparently at fair market value would set a price floor and thus help clarify the value of financial institutions, opening up scope for recapitalisation.

- Third, more capital is needed in all types of financial institutions but especially in banks.

Clearly, private money is scarce in today's environment and loss recognition alone may not induce any fresh injection of private capital. Many governments have already signalled support for their systemically important financial institutions. But governments should not just rescue defunct financial institutions, they should be pro-active in their support. As already announced in some markets, public capital on a large scale is needed. It should support those financial institutions that are systemically important and that have franchise value.

One strategy that has worked in past crises is to match new private capital subscriptions with state capital, which imposes a market test. And governments should be properly compensated for taking on this role and safeguard their interests with strict control rights.

- Fourth, much more international cooperation is needed.

Too many recent measures have been taken with largely national interests in mind, and not enough has been done to prevent the negative consequences for others, especially in Europe. Greater policy coordination will be the necessary starting point, but it will have to be backed up by concrete joint actions. A multilateral pool to support systemic banks with large cross-border activities can be such a mechanism to achieve this coherence.

About the Author

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The Content of Coordination

Barry Eichengreen
University of California, Berkeley and CEPR

Now is the time for action, as empty promises will only exacerbate the panic. We need coordinated measures to help banks - international policymakers led by the US should emulate the UK's recapitalisation plan.

If the events of the last week have a silver lining, it is that they have driven home the fact that we are all in this together. The crisis is global. We will sink or swim together. The hurried decision of G7/8 finance ministers to meet in Washington on Friday is belated recognition of this fact.

But one thing we have learned from recent unsuccessful attempts to right the ship is that empty words of reassurance are not enough. Indeed they can be counterproductive if not accompanied by deeds. Seeing only empty words, market participants will conclude that national leaders cannot agree on what is to be done. And the downward spiral will accelerate.

This is the danger that may arise when G7/8 leaders issue a communiqué later this week on their coordinated response to the crisis. If they simply say, "we will work together to unclog credit markets and restart the interbank market," they will only be repeating the obvious. Their empty platitudes will further demoralise the markets.

So on what specific actions should they agree? The priority should be a coordinated programme to immediately recapitalise banking systems. The UK has shown how this can be done in a matter of days. But there is an urgent need for the G7 countries, together with the other Europeans, to immediately implement an analogous plan. Failing that, the problem will only be shifted, not solved. Now that British banks are stronger, funding will flow there from other countries. The UK's unilateral recapitalisation of its banks is superior to Ireland's unilateral guarantee of all bank deposits in that it addresses the root causes of the current problem and not simply its symptoms. But it creates the same beggar-thy-neighbour dangers.

In addition, in the case of cross-border banks there is the question of whose taxpayers should bear the burden of recapitalising them. This creates a dangerous free-rider problem that urgently needs to be addressed. But as our friends in Iceland will remind us, the issue goes beyond fairness to taxpayers. It goes to the capacity of the state in cases like UBS and Credit Suisse, whose assets are both substantial multiples of Swiss GDP. Even if countries like Switzerland try to do something, the fiscal implications may be so alarming that investors flee. The capital that the government pours in through the top of the jar may then just leak back out through these holes in the bottom. This is essentially what brought down the Austrian and German banking systems when those countries were denied foreign help in 1931.

As Fortis and Dexia have shown, burden sharing is not an insurmountable problem, but the need for it should be addressed explicitly in the communiqué announcing the joint recapitalisation scheme. And to assist countries for whom even a share of the burden may be too heavy, the IMF should be instructed to announce a special low-cost lending facility making available funds for the specific purpose of bank recapitalisation. Switzerland, Sweden, Iceland, and Korea may be among the first customers when the markets reopen on Monday.

While the UK has supplied the blueprint, the US must provide the leadership. The Paulson Plan, everyone now agrees, failed to reassure the markets because it did not directly and credibly address the need for bank recapitalisation. Recapitalising the banks without taking an equity stake would have required overpaying for bank assets, and this is not something that a Congress facing a general election in three weeks was prepared to allow - quite reasonably on its part. Moreover, by the time US Treasury assembles its team of rocket scientists and designs an efficient set of auctions, the financial system and economy will have suffered yet more financial damage. We cannot wait for the next administration. We cannot even wait for this administration to call the Congress back into session in order to hold hearings on Plan B.

The Bush administration should therefore abandon the idea of buying toxic assets. It should use the wiggle room under the TARP, which includes language about equity warrants, to directly inject capital into the banks. Done expeditiously - tomorrow - this may require less than the full $700 billion. But notice the weasel word "may." Even if the US follows with British-style alacrity, scaling up the British plan still implies injecting $500 billion of new capital. Either way there is no reason to waste money on incidentals like reverse auctions. And US participation is critical to the success of and even agreement on an internationally coordinated bank recapitalisation plan.

These measures will have to be supplemented with others. Regulators will have to immediately seize insolvent financial institutions to prevent them from gambling away taxpayer funds. The need for such steps is coming in any case. Their pace will now have to be stepped up.

To be sure, there will be political hell to pay. There will be a firestorm of criticism that Secretary Paulson is running roughshod over the separation of powers and putting taxpayer money at risk. The last time we had a financial crisis of this magnitude, Franklin Delano Roosevelt shut down the banking system, took the country off the gold standard, and abrogated the gold clauses in private contracts, all in a matter of days. He was target of vituperation. But he exercised what we call leadership. It is not too late to see if there is a repository of the same left in the United States.

There are other creative ideas out there. Central banks could cut another 50 basis points. They could guarantee interbank deposits. They could emulate the Fed in putting a floor under the price of other unsecured paper. But central banks have pushed pretty much as hard as they can on the available strings. This is now a problem for governments and their treasuries. It is the latter who now urgently need to coordinate concrete steps.

About the Author

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Why Government Responses Need To Be Comprehensive and Coordinated

Charles Wyplosz

Graduate Institute, Geneva and CEPR

Various governments are moving to absorb toxic assets, recapitalise banks, restart the interbank market, and guarantee deposits. They should do all four in a comprehensive plan and coordinate internationally.

The Lehman Brothers story has shown two things - banks cannot be simply allowed to go bankrupt and a piecemeal approach will not bring banking systems back into minimal functioning condition. The lesson is that there will have to be a bailout. The contagion from the US to Europe and now to most other parts of the world further shows that the bailout will have to be global. The question is how to do it and who will bear the cost.

Four measures are jointly necessary to clean up the financial mess:

1) Absorb significant amounts of toxic assets (and each day's fall in stock prices widens the definition of toxicity);
2) Recapitalise banks;
3) Restart the interbank market;
4) Prevent bank runs by guaranteeing all deposits.

There are many ways of proceeding with each measure. For example, debt-for-equity swaps can achieve the third and fourth measures. Effectiveness is a key consideration, of course, but it is not the only one. The cost of the bailout, likely to amount to many percentage points of GDP, matters greatly. Nor can we ignore the moral hazard component since it matters greatly for the future and, more ominously perhaps, since the long-run political implications of the crisis will be deep.

The Paulson plan deals with the first measure. The British plan deals with the second and third measures. Decisions taken in Ireland, Germany, Greece and Austria deal with the fourth. Most European countries seem to be determined to operate on a case-by-case basis. A comprehensive plan remains to be adopted anywhere in the world.

An essential ingredient is that taxpayers get a fair share of the upside. The British plan achieves this but in a modest way, as preferential shares limit both the up and the down sides. The Paulson plan is likely to take off only if the toxic assets are bought above current market value, which limits the upside and increases the downside. European-style case-by-case bailouts mostly involve regular shareholding, with significant up and down sides.

One reason why governments adopt partial measures is that they fear their costs. This is a mistake. The cost of the sum of the four measures is most likely to be significantly lower than the sum of each measure's potential cost. Importantly, a comprehensive plan that includes all four measures raises the probability of success and therefore the odds that the upside will materialise. Thus, a comprehensive plan should encourage governments to emphasise measures that increase the upside.

It is very unlikely that one country will be able to salvage its banking system if others fail. Indeed, if some significant countries fail to respond adequately, the crisis may well worsen and, at the very least, raise the cost of the bailout for those countries that got it right.

Banks, which have been so good at regulation arbitrage, will indulge enthusiastically in bailout arbitrage, further increasing the costs. This means that comprehensiveness is not enough. All countries with systemically important banks need to closely coordinate as central banks have done so far. They do not need to adopt exactly the same plan, but plans that correctly include all four measures.

In addition, as the world tips into a global recession, macroeconomic policies are urgently needed to dispel the risk of depression. Central banks have been extraordinarily active in providing liquidity. They must shift to also supporting the economy. Fiscal policy too must contribute. It may be difficult to contemplate larger deficits at a time when huge fiscal commitments must be made. Again, a prolonged recession would cost considerably more than a shorter one.

About the Author

Charles Wyplosz *is Professor of International Economics at the Graduate Institute, Geneva; where he is Director of the International Centre for Money and Banking Studies. Previously, he has served as Associate Dean for Research and Development at INSEAD and Director of the PhD program in Economics at the Ecole des Hautes Etudes en Science Sociales in Paris. He has also been Director of the International Macroeconomics Program at CEPR. His main research areas include financial crises, European monetary integration, fiscal policy, economic transition and current regional integration in various parts of the world. He is the co-author of a leading textbook on Macroeconomics and on European economic integration. He was a founding Managing Editor of the review Economic Policy. He serves on several boards of professional reviews and European research centres. Currently a member of the Group of Independent Economic Advisors to the President of the European Commission, and of the Panel of Experts of the European Parliament's Economic and Monetary Affairs Committee, as well as a member of the "Bellagio Group", Charles Wyplosz is an occasional consultant to the European Commission, the IMF, the World Bank, the United Nations, the Asian Development Bank, and the Inter-American Development Bank. He has been a member of the "Conseil d'Analyse Economique" which reports to the Prime Minister of France, of the French Finance Minister's "Commission des Comptes de la Nation" and has advised the governments of the Russian Federation and of Cyprus. He holds degrees in Engineering and Statistics from Paris and a PhD in Economics from Harvard University.*

A Proposal to Tackle the Crisis in Europe

Luigi Guiso and Marco Pagano

European University Institute and CEPR; University of Naples Federico II and CEPR

While the US is trying to attack the bank solvency crisis with the Paulson Plan, no comprehensive response is emerging in Europe. Finance ministers must agree on a common set of rules to recapitalise European banks and establish a European institution to manage this recapitalisation.

While the US is trying to attack the bank solvency crisis with the Paulson Plan, no comparably comprehensive response is emerging in Europe. No single political institution in Europe can enact a comprehensive rescue package comparable to that of the US. European governments are proceeding in a piecemeal, disorderly way to attack the problem at a national level, while its scale far exceeds that of their national boundaries. The Ecofin meeting this week effectively abandoned any attempt to set up a coordinated action plan and gave the green light to country-by-country intervention in the capitalisation of intermediaries.

This decision was wrong, for two main reasons.

- First, case-by-case, *ad hoc* intervention weakens the chances of success, especially if it concerns large banks with considerable cross-border operations, which are precisely those that pose the greatest challenge to systemic financial stability.
- Second, the differences in the form of interventions that will unavoidably emerge put at risk the process of financial integration in Europe, for instance tearing up large intermediaries along national boundaries (as in the case of the Fortis group) and distorting competition.

Ministries of finance should reverse this decision immediately and agree on a common set of rules to recapitalise European banks and establish or appoint a European institution to manage this recapitalisation. Of course, such an institution would have to be based on mutually agreed rules for burden sharing in case of bail-outs of large banks with cross-border operations. National governments wanting to strengthen the capital of domestic banks should do so through this agency, which should:

1) Make new equity capital available to financial institutions mainly through preference shares, so as to allow EU taxpayers to share in the eventual recovery of the banks that are rescued;
2) Commit to sell these shares as soon as the financial crisis is over and in any event not after a predetermined number of years (say, three years);
3) Appoint new management, whenever required for the effective rescue of a bank.

This proposal is a second-best solution to Europe's lack of an institution capable of a coordinated response on the US scale. Of course, designing the rules to determine when to bail out a cross-border bank and how to share the implied costs across EU member states is no easy task. Their design will have important implications for the incentives of bank managers and bank regulators, as well as for European taxpayers. Yet, however technically and politically thorny, these issues can no longer be dodged.

So far we have been blessed by lucky circumstances - none of Europe's largest cross-border banks have become insolvent or seriously distressed. But if this were to happen, the limitations of Europe's policy response would become tragically apparent.

About the Authors

Luigi Guiso *is professor of economics at the European University Institute in Florence and Scientific Coordinator of Ente 'Luigi Einaudi' for Monetary, Banking and Financial Studies in Rome. His path-breaking work has been published in the best international journals and recognized with international prizes such as the 2005 award of the Fondation Banque de France for Financial, Monetary and Banking Research ("The Cost of Banking Regulation", with Paola Sapienza and Luigi Zingales) and the 2002 World Financial Association "Nasdaq Award" for the best paper on capital formation: "The Real Effects of Local Financial Development", with Paola Sapienza and Luigi Zingales. He is a CEPR Research Associate.*

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Governments Should Buy Straight Preferred Stock in their Banks

Charles Calomiris
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To give banks capital and liquidity while protecting taxpayers, governments of the G7 should buy straight preferred stock in their banks.

The G7 needs to follow the UK's plan, and do so on a coordinated basis. That plan has two parts. First, the governments must work together to share the burden of standing behind interbank borrowing in the LIBOR market for a brief time (probably not to exceed a month), and also continue to support the commercial paper market. This burden sharing follows from the fact that these banks are international entities. But this is not a long-term solution, and without a long-term solution this kind of support could encourage very risky behaviour by the banks.

The second part of what must be done immediately -- government purchases of straight preferred stock - also copies the UK plan. Why should the governments of the G7 buy straight preferred stock in their banks? This adds capital and liquidity immediately to give banks the room to manage their asset quality and liquidity problems, while ensuring that common stockholders are in a first-loss position, not taxpayers.

The details of how the preferred stock is designed are crucial to its success. Since taxpayers are not in a first-loss position (as in asset purchases) there is no need to add upside warrants or other options, and these are not helpful. The governments should not attach warrants or convertibility options to the preferred stock, since doing so would dilute common stock and make it harder to raise common shares, which would be counterproductive.

Coupons on the preferred should be set very low (zero would be fine with me, or the treasury bill rate) for the first two or three years, and then the coupon should jump to market rates (indexed to some benchmark) subsequently. The initial low coupon will provide an immediate limited up front subsidy that will help to recapitalize banks. The preferred shares should be callable so that banks can exit the arrangement as soon as they are back on their feet.

Government should select banks on a broad basis of availability, but should decide immediately and in advance which banks have to be merged out of existence, and disqualify them from receiving any funds. The remaining banks would receive funds on a pro rata basis relative to assets under management (as in Finland in 1992).

Common stock dividends should be set to zero for all banks receiving assistance for the duration of their use of the preferred shares. Banks receiving assistance should have to devise and defend a capital plan (for raising common stock), and must grant veto authority over major corporate decisions (e.g., mergers and acquisitions) to the government (to prevent asset substitution risk).

Both aspects of this plan could be announced immediately and implemented very quickly (within a week, giving time to the FDIC or other similar authorities) to determine which banks will not qualify. Note that this process is virtually identical to the successful implementation of the Reconstruction Finance Corporation's preferred stock program in 1933.

About the Author

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An Efficient Rescue Plan

Roger Craine
University of California, Berkeley

Policies are needed to unfreeze the credit market and recapitalise banks. Here is a plan to do both.

Financial events moved like a firestorm during the last three weeks, easily jumping the firebreaks put in place by the Federal Reserve and US Treasury. Saving most financial institutions requires a quick and decisive responsive programme that strikes at the source of the financial implosion.

Problem: The credit market is frozen; most financial institutions are illiquid but solvent

Financial institutions borrow short and lend long. Lenders to financial institutions – other financial institutions and outsiders – fear that they may default. The fear is based on facts - Lehman, Bear-Stearns, and Wachovia failed. The spread between the three-month Libor (interbank lending rate) and the three-month T-Bill rate hit a 25year high of 3.87% after the House passed the Troubled Assets Relief Programme (TARP) on Friday of last week. More importantly, the outstanding value of short-term interbank debt plummeted. Financial institutions don't know the value of other institutions and a premium of $4 per one thousand doesn't make it worthwhile to investigate opaque assets and complicated counterparty obligations. The "risk premia" cannot clear markets with asymmetric information.

To restore the interbank lending market and control moral hazard, the government should:

- First, guarantee the short maturity debt (Fed Funds and CDs) of the financial institutions that join the plan and impose a capital requirement on all financial institutions in the plan.

The guarantee eliminates counterparty risk. Government-guaranteed financial institution short-maturity debt is default-free. The capital requirement eliminates, or at least mitigates, the moral hazard problem introduced by the guarantee. With no capital requirement, financial institutions have an incentive to borrow at the default free rate and buy risky assets with higher average returns. Financial institutions that are close to insolvent have the greatest incentive to buy the riskiest assets. If the risky investment pays off, then they are solvent. If not, they likely would have failed anyway. This happened with a vengeance in the S&L fiasco in the 1980s.

In contrast to this plan, TARP focuses on buying toxic assets. Unloading toxic assets doesn't eliminate counterparty risk and will not thaw the market in a time of crisis. The TARP would have to guarantee financial institutions against default to assure lenders. To control moral hazard TARP would have to regulate all financial institutions' behaviour, i.e., nationalise them.

The debt guarantee plan is similar to the Futures Exchange Clearinghouse guarantee that makes trading among anonymous agents feasible. The Futures Exchange

Clearinghouse guarantees delivery and payment on futures contracts so that traders don't have to worry about counterparty risk. To give traders an incentive to perform, the exchanges require that they post margins, i.e., capital requirements. Banks now have risk-based capital requirements. These should be extended to all financial institutions that want the debt guarantee (and maybe all capital requirements should be increased because the world got riskier - margin requirements depend on price volatility.)

If a financial institution fails then the government takes control of it. The Futures Market Clearinghouse takes control of a client's account if he or she cannot meet the margin call.

- Second, the government should offer to provide capital to the financial institutions that join the plan for some interval - say, three months - in return for an equity share.

The capital requirement forces the financial institutions to have a stake in the outcome. Undercapitalised financial institutions benefit most from the guarantee. But, undercapitalised financial institutions must give up a share of equity ownership to participate in the plan.

The plan should be similar to theWarren Buffet model, but probably less demanding on the banks. If taxpayers put their funds at risk, then they should get a warrant that gives them a share in the appreciation if the financial institution prospers. They should also get some interest on the capital they provide, but Warren Buffet's 10% seems like a lot. Remember that the goal is to restore a vibrant private financial market at the minimum cost to taxpayers.

About the Author

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The Wrong Financial Crisis

J. Bradford DeLong

University of California, Berkeley

Catastrophic failures of risk management throughout the entire banking sector multiplied a relatively minor collapse in housing prices into a paralysis of the global finance system not seen since the Great Depression. To fix it, governments should embark on a coordinated fiscal and monetary expansion and a coordinated bank recapitalisation.

All of us from Lawrence Summers to John Taylor were expecting a very different financial crisis. We were expecting the 'Balance of Financial Terror' between Asia and America to collapse and produce chaos. We are not having that financial crisis. Instead we are having a very different financial crisis. Catastrophic failures of risk management throughout the entire banking sector caused a relatively minor collapse in housing prices to freeze up global finance to a degree that has not been seen since the Great Depression.

The first good thing about this situation is that it does not call for different central banks and Treasuries to do different things, but rather for them all to do the same thing in unison without fouling each other's oars. That should be relatively easy to arrange.

What we need right now are:

- Coordinated fiscal expansions across the globe.

If the world economy is not now in something close enough to a liquidity trap to make no difference, it soon will be.

- Coordinated monetary expansions across the globe.

A bank is any organization that borrows or accepts investments short and lends long; the durations of its assets and liabilities are deliberately mismatched; when the entire banking sector is insolvent at current market prices, anything that reduces interest rates all along the yield curve helps reduce the magnitude of the insolvency.

- Coordinated banking sector recapitalizations across the globe.

Since at least 1844 there has been broad consensus that the short-term price of safe liquidity is too important to be left to the market; now there is growing consensus that the price of risk is too important to be left to the market as well. For the government to operate on the price of risk through Operations Twist on a Galactic scale is infeasible. That means that the aggregate degree of capitalization of the banking system must become the object of policy choice. Call it socialism in one sector.

- What we need in the longer term are:

Global rules to make outsized compensation incentive-compatible.

The Princes of Midtown Manhattan and Canary Wharf need to know that their fortunes will be lost if their institution blows up within a decade of their handing over operational control - only in this way can you make them truly long in the fortunes of their firms and of the global economy rather than simply long in volatility.

- More progressive global tax systems.

We wish we could build a better global economic system, but we do not know how to build one that does not contain a solid safety net for plutocrats, and the systems we do know how to build are politically unsustainable unless all voters know and believe that from those who have much will be taken away. The global market economy continues to evade all our attempts to make it foolproof - in large part because our greater fools are so ingenious. But there is not yet any requirement that this global economic downturn reach the magnitude of 1982, or even 1975.

About the Author

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He is author of the widely read blog 'Grasping Reality with Both Hands'.

What Europe should do in the shadow of the financial meltdown

Michael Burda

Humboldt University and CEPR

European fundamentals are in good shape, but its banks are suffering from contagion. To avoid further real damage, EU leaders should guarantee intra-bank lending and recapitalise the banks.

As Europe's financial markets spin down into the vortex created by the US credit crisis, every new day will contain new surprises. Only a few months ago, the real economy looked solid, with the euro providing an impressive shield from financial disruption (imagine last year *without* the ECB!).

Now Europe is in negative play despite its solid fundamentals. What can Europe do to change this?

Guarantee unsecured intra-bank lending, re-liquefy and recapitalize creatively

The payments and credit systems are essential for the working of the real economy and cannot be left to a "workout". The ECB must provide leadership by guaranteeing unsecured intra-European interbank lending. But Europe may have to do more.

Banks need recapitalization but may not get takers soon. If they don't, the only solution will be - as we already seen in Iceland and in the UK - full-blown nationalizations of the banking system and the credit and payments system that goes with it.

The US government has already nationalized one of the largest insurers in the world, half of the mortgage industry, and has taken stakes in banks unthinkable a few years ago. The partial or total nationalization of the banking sector should be temporary and for purely pragmatic reasons – and the EU and its members should develop careful contingency plans.. The ECB is a natural agent for this type of action - assuming the national governments will allow it.

Don't punish the financial sector

Don't listen to the rhetoric of economic fundamentalists, who rejected the Congressional bailout and similar interventions. They want to put investors' feet to the fire - their talk is eerily reminiscent of those who wanted to punish the moneymen and stock speculators following the Great Crash of 1929.

Because of the web of derivative securities and insurance they have created, banks have - purposefully or not - made themselves "too big to punish." We punish them, we punish ourselves. It will probably take decades to work out the international collateral damage of the Lehman bankruptcy. Europe can learn from this costly mistake.

Discuss openly the meaning of a European support fund

The go-it-alone strategy of Ireland, Germany, and Denmark could hasten the collapse of the monetary union unless quantitative minimal and maximal standards for depositor protection are set. Certainly redistribution is involved but letting the system go down will have more serious consequences.

Each country in Europe is too big to fail. I am convinced the German rejection of a common front has the same roots that forced the Maastricht criteria - the fear of sudden redistribution across member states. It was also driven by the fact that Germany is more highly banked than many other countries, with households holding more wealth in bank accounts. Let's not be coy - the crisis is much worse in some countries than others. Put these issues on the table and talk about maximal losses - in complete discretion, of course.

Personally I was convinced a crisis like this would visit Europe, but in another decade's time - following a national government default, not a credit crisis from abroad infecting the EU members in an asymmetric fashion.

If Europe can't handle this mess, which is not even of its own making - heaven help us when the home-grown variety comes along.

About the Author

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No more dithering

Angel Ubide

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There are three steps that must be applied quickly and decisively: close the bad or small banks; recapitalize the good or too big to fail banks; and remove the bad assets from the system so that banks can return to lending.

Ten years after the 1997-98 Asian banking crisis Western authorities have only now understood the gravity of the 2007-8 Western banking crisis. Policy has been reactive and reluctant, and politics have trumped efficiency and common sense.

In a rapid deleveraging process where confidence in the financial system has been broken, the multiple displays of policy confusion, reversals and wrong priorities have severely worsened the outlook for the global economy in the last several weeks.

Time is of the essence. It is critical to stop the dithering and present and united and decisive front, once and for all.

There is no excuse. The best practices are well known, they have been applied successfully in the past, and there are thousands of pages of literature for politicians to read and learn (among them the excellent IMF Occasional Paper "Financial Sector Crisis and Restructuring: Lessons from Asia,"). Unfortunately, they have been ignored.

There are three steps that must be applied quickly and decisively:

- Close the bad or small banks;
- Recapitalize the good or too big to fail banks; and
- Remove the bad assets from the system so that banks can return to the business of lending and restore the vital flow to the economy.

In addition, and to ensure confidence in the system while the restructuring and failures take place:

- Adopt a blanket deposit guarantee before proceeding with the major actions, with some conditionality attached to ensure banks right themselves.

And, above all:

- Present a coherent policy line that can be understood easily by citizens and market participants.

The list of policy mistakes is by now long but it is not time for recrimination.

The UK has today led the way with a package that matches the best practices, with guarantees, capital injections, removal of bad assets, and conditionality, and a global, concerted action should follow. A temporary global guarantee on interbank lending should be a priority.

The EU should stop the sad political show and prepare a package similar to the UK at the EU level. There is no reason why the EU can't create a fund that is endowed by individual countries and can be used to restore the confidence of the European banking system - and the EIB is ready for this mission if needed.

Many banks are too big to be rescued at the national level but no bank is too big to rescue at the European level. European leaders have stubbornly refused to put in place a crisis management framework over the years; they want the benefit of a pan-European financial system without the cost. Now is the time to set apart old national issues and act for the sake of financial stability.

The US has the TARP at its disposal, and must start using it as soon as possible. Capital injections are badly needed at many banks, and MBSs can be purchased at any time. Central banks need to ease policy aggressively to ease funding conditions and restore confidence in the economic outlook. With the system in a liquidity trap, liquidity injections no longer work.

A final advice to policy markers. Please don't over-regulate.

The temptation to fight the last war will be strong. This crisis has mostly been the result of badly applied regulation, not of bad or lack of regulation. This crisis was created by regulated institutions: banks and insurers were allowed to boost their leverage in a procyclical fashion and with very poor risk management systems. Supervisors allowed the expansion of off balance sheet activities. Best practices like Spain's statistical provisioning were ignored. Please focus on improving the incentive structure and don't engage in populist scapegoating, which will only hamper the healing process.

Banks and insurance companies must choose whether they want to be banks and insurers or investment companies. Limit their leverage and gross positions so that they are forced to choose and enforce sound risk management practices. Convince the accountants and adopt statistical provisioning, easier to apply and better for governance than higher or time varying capital ratios. And the EU must, once and for all, create a European supervisory body that has authority over and comprehensive information about systemically important banks.

About the Author

Angel Ubide *is the Director of Global Economics at Tudor Investment Corporation, a leading global funds management company. He is an active member of several international economic policy organizations, including the Euro50 Group, the ECB's Shadow Governing Council, the Atlantic Council of the United States, the Reinventing Bretton Woods Foundation and the Centre for European Policy Studies. He writes a bi-weekly column on international economics for El Pais. Dr. Ubide has written numerous papers on international macroeconomics, banking, and exchange rates, and his work has been published in major international journals and leading newspapers. Dr. Ubide was formerly an economist at the International Monetary Fund and a management consultant with McKinsey and Co. He holds a Ph.D. in Economics from the European University Institute in Florence (Italy).*