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How to save the financial world

The challenge is to bring the world through the crisis and not prove the point about responsible financial behaviour

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THE calamities on the global financial markets have reached a point where a global summit is about to be convened to deal with the problems. It seems like good news, but there is a caveat. Such a summit raises expectations of leadership and ideas about how to turn the boat around. If these expectations are not met, it may prove counterproductive.

Keep it stable: A currency trader at a dealing room in Tokyo; the last thing that the world needs right now is fluctuation between the US dollar, the euro, the yen and the yuan so world leaders should hold the currency rates at more or less the level where they are today

Here are some ideas that world leaders could put on the agenda to extricate the global financial system and the world economy from the present predicament while at the same time lay down some tracks for a future system.

The first step should be to consolidate the global financial system and prevent the crisis from spreading further. With luck, we can see an end to the financial problems - even if risks are still ahead. But the onslaught on the real economy is still to come.

The last thing that the world needs right now is fluctuation between the US dollar, the euro and the yen, plus a couple of other important currencies such as the yuan. Therefore, world leaders should decide that they stand ready to hold the currency rates at more or less the level where they are today.

Potential 'speculators' have been so busy hoarding cash to escape the credit crunch that they have not had time to think of moving funds around, but this luck will not last. If speculation arises, the central banks must swing into action to assert their authority. In itself, currency rate stability conveys that the crisis is getting under control and its positive impact may help radiate confidence.

Obviously, China and some other Asian countries with total currency reserves above US$3 trillion will have to be partners in such a scheme. The time has come to invite them inside as members of the small group of countries, which control the global economy. No one can be less interested in seeing the crisis develop further than China, which needs a growing global economy to sustain its own domestic growth. The price for Chinese contribution may be a stop to recrimination about Chinese cheap products undercutting production in industrialised countries.

Consequently, currency stability must be accompanied by a strong pledge that protectionism is not the way ahead. No country can solve its problem by shifting the burden to others. The best would be an agreement about the stalemated Doha Round trade negotiations, but that may be too much to ask for, so a pledge not to go protectionist will do. The presidential campaign in the US gives rise to worries in that regard and a policy shift away from free trade under a new president would be disastrous. Recall how the US in the 1930s with the protectionist Smoot-Hawley Bill led the world into depression.

This time, the risk may focus more on capital movements and less on goods and services. If the US and/or Europe starts to block direct investment in industries, severe doubt would be sown about the system itself. How can you expect countries to accumulate reserves and play according to the rules if other countries break the rules and put barriers and/or conditions on how they can invest their reserves?

Some of the weaker developing countries may collapse financially. Economically, that has been seen before and is manageable; but if it takes place at the same time as the system itself is in deep crisis, it may undermine any attempt to get the global financial system back to work and the global economy going again. The richer countries need to set up contingency plans to bail out weaker countries regardless of all the arguments that can be forwarded - that it is financial irresponsibility that led these countries into difficulties. Exactly the same can be said about the US. This is no time for self-righteousness.

The challenge is to bring the world through the crisis and not prove the point about responsible financial behaviour. That can be done afterwards.

The problem here is that the money to save these countries, of which we may see more than a few, does not lie with the US and/or international institutions such as the International Monetary Fund (IMF) and the World Bank, but with some of the Asian countries and the oil exporting countries in the Middle East.

They need to be mobilised in a global effort. The difficulty is to convince them that it is in their interest. The second step should relaunch the global economy on a growth track. The solution is not difficult to spot. The oil price was instrumental in turning the financial crisis into a recession. It rose from about US$60 to about US$140 in less than two years. Now, it has fallen to about US$70. If it is kept at that level or ideally steered towards an even lower level, the risk of a deep recession or even a depression would be reduced. It may be too much to ask from the oil exporting countries, but there is no real alternative than convincing them of the need for a lower oil price to tow the global economy through these stormy waters.

The US has very little leverage to increase demand in view of the growing federal deficit and public debt. Europe may have some, but not so much, and countries such as China and Japan might pitch in with an effort. Again, the political problem is that the US can contribute very little to find the way out of the problems it has led the world into. Many countries ask the simple question: Why should we do it? The answer is age old and sounds like this: you may be right, but that is not the point. If you do not do it now, you may teach the US a lesson and rub your hands in joy, but it won't last long before the bill comes home to you and it will be higher.

We are living in a global economy and those countries being asked to make sacrifices now are those who benefited from the US consumer boom over the last 10 years. The US must deliver its pound of flesh by promising to put its house in order after the end of the crisis by running its debt down and reducing its deficits.

If the crisis has proved anything, it is that we no longer live in a world where there is one rule for economic behaviour for the world and another rule for the US, allowing that country to run an irresponsible economic policy.

The third step is the most difficult one, but also the least pressing one: reforming the system. The unanswered question is: what to do and how to do it? In any case, reform cannot be achieved as long as the present system is in ruins and fighting for its life, it can only be done when it is up again and running.

As with many other models or systems caught off balance, the basic problem is not the model itself but how it was applied. The special edition of capitalism growing out of Wall Street may not survive unscathed, but there is no viable alternative to capitalism. We should not forget that capitalism has brought about a tremendous economic growth over the last decades and lifted hundred of millions of people out of poverty.

The model may need retooling, but this is not the time for jumping into the unknown or already known alternatives such as socialism or protectionism, which has been tried and proved unworkable.

Capitalism supposes a market and a market supposes competition. What happened before the crisis and is about to strike roots is lack of competition because of the concentration of capital in a few hands. Compare the number of financial institutions in Wall Street 25 years ago with the situation today. Mergers & acquisitions have put many financial institutions together under same ownership and same management. Institutional investors have pushed individual investors aside and now account for about two-thirds of all shares in the US. It may sound old-fashioned, but even if authorities have fallen back on some of the big banks to help bail out the weaker ones, the 'reward' should be to break them up afterwards. If not, the next crisis is only a bus stop away.

There has been much talk about more international regulation. What needs to be done is establishing a higher degree of transparency which forces financial institutions to reveal the risk the creditor runs by buying assets. International rules stipulating that the issuer of financial assets be required to know who the ultimate debtor is and being able to explain that to national regulatory bodies would help to prevent similar incidents from happening again.

It is good to look at the future global economic system, but let us repair the present one first before we venture into an uncertain world.

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