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Wanted urgently: a comprehensive and global solution

*di Dominique Strauss-Kahn **

Some weeks ago, I published an appeal for a comprehensive policy solution that spanned the core problems in the financial sector (i.e., lack of liquidity in markets, doubts about the value of troubled assets and a clear shortage of capital) and spanned financial markets around the world (ie, not just a few money centres). Although a great many policy actions have since been taken, they have been neither comprehensive nor global. Indeed, the approaches taken have been so varied and inconsistent, especially with regard to deposit guarantees, that they are intensifying problems for other countries. It should come as no surprise then that market confidence has not been restored.

What is the underlying problem? In a nutshell, financial institutions are holding a large volume of securities of falling and doubtful value, and which imply large losses for them. There are also potentially further losses from having insured asset values through credit default swaps and other derivative instruments traded in not-so-transparent over-the-counter markets. But even if a bank 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). In this febrile environment of distrust and capital shortage, standard macroeconomic policy instruments are blunted and a strategy that relies mainly on liquidity provision by central banks – while essential – will not suffice.

What more must be done? I would highlight five sets of actions.

First, as some governments have concluded, the fragility of public confidence has now reached a point that some explicit public guarantee of financial system liabilities is unavoidable. This means not only retail bank deposits but probably also interbank and money market deposits, so that activity may restart in these key markets. Of course, such a step would need to be temporary, and include safeguards against the risk-taking that comes with such guarantees, such as heightened supervision and limits on deposit rates offered.

Second, the state needs to take out troubled assets and force the recognition of losses. Asset purchases must be done transparently at fair market value. The reasons are not moralistic, though there is such an imperative, but pragmatic. If prices are inflated, then banks will inevitably have to make good the losses that fall on the taxpayer – in the US case, they would have to issue shares to the government, thus diluting other shareholders. But losses deferred to the future prevent new private capital from flowing into banks. If such capital is to be attracted, it is better to pay a lower price now, recognise losses, and give banks an upside if the implied loss turns out to be smaller.

Third, private money is scarce in today's environment, and loss recognition alone may not be sufficient to induce fresh injection of private capital. One strategy that has worked in past crises is to match new private capital subscriptions with state capital, which imposes a market test for the use of public funds.

Fourth, a high degree of international co-operation has become urgent. Unfortunately, recent measures have been taken with national interests in mind, and not enough has been done to prevent unintended "beggar-thy-neighbour" consequences that only exacerbate problems for others. If one country credibly offers a blanket guarantee (say, Ireland), investors may move out of countries that do not (say, the UK). If asset purchase schemes are very different, institutions will go to the most generous buyer. Financial institutions now span many countries and credible rescue plans must be consistent across many jurisdictions. More fundamentally, and looking beyond the immediate crisis, it is clear that the international community needs to work to close the many loopholes in the global regulatory architecture that allowed financial institutions to minimise capital even as they concentrated risk.

Fifth, it is now becoming clear that emerging market countries are likely to be hit hard by financial turmoil, despite stronger fundamentals and policy frameworks. Lest a sudden stop of capital bring their progress to a sudden halt or, worse, bring down their financial systems, some form of large and rapid financing should be kept ready. There should be no doubt that the Fund is prepared to deploy its emergency procedures and flexibility in rapidly approving high access financial programmes, based on streamlined conditionality that focuses on crisis response priorities.

As bleak as the situation now looks, I am convinced that there is a way out of our shared predicament. The trick is to get policymakers around the world to pull in the same direction.

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