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Will it work?

By Jean Pisani-Ferry, published in French on 22 October 2008

Ten days after the launch of the plan to rescue the financial system credit markets are still not back to normal. True, the interbank lending rate has dropped a bit, but liquidity fears are at such a pitch that a loan over several weeks costs considerably more than a loan over a few days, and in particular the volume of interbank credit remains very low. Trust has clearly not been re-established between operators who, until summer 2007, were providing credit to each other on the nod. As for long-term issuance, this is still a non-starter unless it is backed by a state guarantee.

The remedy devised by governments and central banks has been, however, uniquely vigorous. Breaking with their earlier foot-dragging, they decided simultaneously to get to grips with the three problems paralysing financial systems: doubts about the solvency of banks (by injecting public capital), the race for liquidity (by providing central bank money, at a fixed rate and without too many strings attached), and the crisis of confidence (by guaranteeing deposits and loans issued by banks in return for bank lending to the economy at large). As much as the unheard-of magnitude of the sums involved in this campaign, it was its coordinated and systematic approach which reveals well just how necessary it was to think outside the box in order to clear the financial blockage and thus avoid economic depression.

But the devil is in the detail, and the detail is different from one country to another. After long remaining aloof from engaging in ‘financial socialism’, the US administration followed the European example with the zeal of the newly converted. As of 14 October the US announced that the federal government intended to become a shareholder in nine big banks and how much it was injecting into each. In Europe this operation is being carried out country by country and has been more halting – for example it is still not clear which banks are to be recapitalised in Germany, France and Italy. In the meantime everyone is claiming to be in good shape and doubtless that it is only competitors which need help.

Moreover, as governments could not resist the (understandable) temptation to sermonise bankers and accompany the capital injections with conditions relating to lending behaviour, the pay of top management and dividends payable to shareholders, candidates for recapitalisation are thin on the ground. Even in the UK, where Gordon Brown has volunteered names, some banks have turned down the offer. But the lesson to be learnt from past crises, especially in Japan, is clear – in circumstances like these, honour and ethics take second place to survival.

And the race is on. Financial stress is hastening the fall into recession because, with each day that passes, households are becoming more cautious and businesses are trimming investment plans and sharpening the redundancy knife. Likewise financial crashes are very prone to proliferate in a recession and to make lenders more mistrustful. The interplay between financial stress and recession is unfailingly lethal.

More profoundly, the crisis signals the end of the debt economy for a number of years. Even if there is a swift lending thaw and if interest rates go down again and reduce the cost of borrowing, the intensity of the pain will remain in people's memories and leave its stamp on behaviour. This applies to business and to financial institutions themselves: many whose profitability was based on high levels of debt have already disappeared, the others will need to restructure, boost their capital and reduce their debt. This also applies to US households, whose appetite for consumption had never waned: for a few months at least they can no longer expect to prosper without saving.

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Finally, this applies to a number of emerging countries which were financing current account deficits of 5-10% with ease (even 20% in the case of Lithuania): they are seeing an exodus of capital and have come knocking on the IMF's door.

Looking beyond the financial crisis itself, it seems that the halcyon days are over, that debt must be unwound and that this will take years. The question is who will take the place of all those missing consumers. We must hope that in China and the oil-producing countries domestic demand will relieve failing external demand. But this will not be sufficient to maintain global demand at an adequate level.

This raises the fiscal issue. Keynes taught us that it is up to the state to take on debt when no one else in the private economy is in a position to do so. This prospect is obviously causing many to baulk, if only because numerous member states accumulated debt at a time when they should have been saving. But the errors of the past do not justify committing new ones.

It would be most unfortunate, only ten days after the financial rescue plan, to announce a fiscal recovery plan. It is to be hoped we can do without it. But it is time to get to grips with the issue, fast, and with nothing off-limits.

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