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Essays on the Financial Crisis and Globalization

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Introduction

We have certainly been living in interesting times. While avoiding the worst connotations of that concept (no global war or other catastrophe), we have seen the fall of communism, the rise of information technology, and the beginnings of a shift in the global economic balance, back toward the days before the industrial revolution, when Asia carried as much economic and political weight as the West. All three trends – the ostensible triumph of capitalism, the innovations wrought by digital technologies, and the growth of China and (to some extent) India – in some ways came to a head in the current financial crisis. The crisis was sudden, and at one stage seemed that it would engulf the world economy in depression and even chaos. It prompted some fevered writing, by journalists in particular. For my part, writing fortnightly columns for Indian financial dailies (first the Financial Express, then The Mint), I have seen my role as bringing analytical economic thought to bear on understanding current events. A column gives one some freedom to opine, but also imposes disciplines of concision and clarity, beyond the usual requirements of academia. The following dozen pieces were written between September 2007 and April 2009. They comment on the reasons for the crisis, and possible solutions, using economic theory to understand the issues wherever possible, but in relatively non-technical language. What keeps markets working well? What do financial markets accomplish, at a fundamental level? Why do markets fail? Why do scandals arise? What can regulators do to improve matters? I have tried to shed light on these basic questions in the context of current events. Along the way, I have had the temerity to take issue with Alan Greenspan, George Soros and Martin Wolf, all bigger names than I, but less well versed in the core principles of economic analysis. My sympathies lie with other professional economists: George Akerlof, Nouriel Roubini and Larry Summers come out well in these pieces, though I take issue with Summers' implicit politics with respect to globalization. Several essays look at aspects of globalization, and view with optimism the potential of emerging economies. Another underlying theme is that the crisis was not about the collapse of capitalism, but rather arose from some specific failures of institutional design in so-called advanced economies. Getting this lesson right is critical for economies that want to go beyond being just "emerging." Readers must judge if I have made my points clearly and convincingly enough.

Making lemonade out of lemons

Financial Express, September 27, 2007

George Akerlof, in his Nobel prize autobiography, tells the story of his prize-winning paper on “The Market for Lemons”. He wrote it as a first-year assistant professor at UC Berkeley, but revised it while visiting the Indian Statistical Institute in Delhi in 1967-68. In an observation which will comfort many an academic who has been similarly treated, he says the paper “had been rejected two or three times in the course of the year by editors who felt that the issues in the paper were too trivial to merit publication in a serious academic journal”. The “lemons” in the paper are used cars, and the central point of the analysis is that the inability of potential buyers to discern the quality of individual used cars can lead to a collapse of the market. This insight carries over to numerous other markets. One revision during the Indian sojourn involved adding the example of credit markets in India, which could similarly fail to function properly, if at all.

The market for lemons can be rescued if the information asymmetry can be overcome, for example through certification by independent mechanics. In credit markets, rating agencies play the same role, assessing the quality of borrowers, or rather of the debt they seek to issue. The subprime crisis in the US can be seen in the light of Akerlof’s classic analysis. Credit rating agencies did a poor job of looking under the hood when they rated various debt instruments created from the securitisation of subprime mortgages: they were far too optimistic. Since the mortgage-based securities were spread around various financial institutions, based on the over-optimistic ratings, lenders could not assess the quality of asset portfolios that might hold suspect securities—these could no longer serve as collateral for short-term loans, and the credit crunch began. Since holders of suspect securities included non-US financial institutions, the crisis became global.

While the root causes of the mess included low interest rates and lax regulation (permitting too many mortgage loans that should never have been made), the rating agencies contributed to the problem by failing to assess risks accurately and in an unbiased manner. One might forgive these mistakes on the basis that the financial products being rated were too new, and not well enough understood. However, a lack of good information or understanding about the products ought to lead to more conservative ratings—the mechanic can always say that there are features of the car that he could not assess, and warn the prospective buyer accordingly.

It may be that there is a rating bias caused by the desire to keep markets functioning actively, and ensure ongoing demand for quality assessments. Rating agencies may therefore consider the preferences of borrowers in making their judgments. The conflict of interest is not as stark as that of Wall Street securities analysts in the 1990s, who worked for firms that profited from active stock markets and buoyant IPOs, but “independent” credit ratings have often failed to play the role they are supposed to.

Put another way, the market for credit ratings is itself imperfect, subject to moral hazard (as opposed to adverse selection, the consequence of the lemons problem). Moral hazard can be mitigated by concerns for reputation, but those are weaker if there are few alternatives. That is precisely the case in the credit ratings industry, where Moody's and Standard & Poor have a market share of about 80%, while a third, Fitch, has 14%. The three Indian rating agencies have each separately allied with one of these big three to overcome reputational entry barriers in the ratings market.

However, the latest problem of the big international agencies represents an opportunity for the strongest of the Indian agencies. To use a different citric metaphor, this is a chance to make lemonade out of the lemons handed out by the subprime crisis. Essentially, this is a market where two or three firms dominate, without providing top quality. (Think of the US automobile industry before competition from Japan.) Already, Western firms are turning to India for high-quality financial research. For knowledge services, lower costs can lead not only to savings, but also to deeper and better quality analysis. India's rating agencies, removed from Wall Street, may also be in a position to establish a stronger reputation for independence as well as high quality analysis.

Realising this opportunity, like any other, is not a sure shot, but India's rating agencies stand as good a chance as Japan's automobile makers did once upon a time. The strategic intent of those automakers was to take on Detroit, and the Japanese government foresaw the positive spillovers to the rest of the manufacturing sector. India's policymakers are certainly trying to formulate a strategic intent with respect to the financial sector. Forty years after Akerlof's first visit, India's economy is still replete with asymmetries in information, notably in many kinds of financial markets, but also markets for educational and health services. Credit rating in India is in its infancy, but has to develop quickly if the domestic financial sector is truly to become world class. The nature of knowledge services suggests that this domestic development can go hand in hand with becoming a significant force in global finance.

The world according to Greenspan

Financial Express, October 11, 2007

In his new book, and in subsequent interviews, Alan Greenspan has provided a lucid analysis of the driving forces of global economic change during the last two decades. The end of the Cold War, in this telling of the story, freed up savings, lowered interest rates, and fuelled a major, almost uninterrupted global expansion. The disinflationary effects of access to a global labour pool made Greenspan's monetary management task easier, perhaps even trivial, except for pumping in liquidity to stave off the occasional crisis. Greenspan argues that asset price bubbles under his watch were driven more by this global excess liquidity, and could not really be controlled by the US Federal Reserve Board. Perhaps the most intriguing

view expressed by the former Fed chairman is that “Turbulence is, as we get into the 21st century, probably a necessary condition to maintain an economy worldwide as high-powered as the one that now exists.”

The analogy used by Greenspan is that of millions of computerised adjustments that keep a modern plane flying steadily. Certainly, financial markets can provide that kind of flexibility to the real economy, absorbing shocks, and smoothing their effects so that economic activity proceeds on course. And when financial markets are in danger of seizing up, the role of central banks becomes that of an über-computer, to provide a higher level of adjustments to control lurches. Or perhaps the Greenspans of the world are the human pilots who take over from the computers when necessary.

So there are two key ideas in Greenspan’s book that can frame thinking about the future. One is the impact of long-run demographic trends. The other is the role of financial markets and how to manage them. It does not appear that the potential to absorb the world’s surplus labour is anywhere near its end. Despite the recent increase in China’s inflation rate, and booming commodity prices, the scope for training workers around the world, giving them capital and technology, and raising their productivity remains substantial. As many others have noted, the rapid growth in countries like China and India is being helped by catching up with the technological frontier at a pace not seen before for such large countries. Also, the nature of recent IT innovations has speeded up technology transfer by enhancing communications, and by reducing the minimum efficient scale of many activities.

All this is good. Greenspan’s worries about the US, in this regard, apply to a small fraction of the world’s population, albeit its richest component. Lagging school education, burdensome social security arrangements and political pressures for relaxed inflation targets will put the US at a relative disadvantage, but not slow down the world’s growth appreciably. Pushing this view to the extreme, even terrorism, as long as it is contained in scale and frequency, cannot injure growth. High oil prices mean that Middle East petrodollars are now adding to the global savings and investment mix, and this should keep interest rates low and liquidity high. Even long-struggling countries such as Egypt are seeing investment and growth. Soon, the subprime crisis will fade into the past, as the capitalist juggernaut keeps going for decades.

If the lubricant of this growth is global financial capital, then its continued flow will be crucial to the process just described. Going back to Greenspan’s computer metaphor, however, the problem is that the computer is subject to manipulation by other humans besides benevolent central bankers. And there is not even one computer, but many of them, acting only on parts of the system, with feedback loops that can magnify deviations more than stabilise them. Herd behaviour, seen often in financial markets, is not something that is captured well by the metaphor of computerised adjustments.

Perhaps central banks realise that they may be called upon more and more to prevent or manage panics and crises. This is one explanation for the accumulation of foreign reserves that is gaining favour among

academics. Even developed countries may need larger reserves now that global capital flows and financial trading have skyrocketed. Global market movements can swamp individual countries' abilities to deal with them. In this scenario, the current lull in the demands on the IMF may be temporary: its role as liquidity provider to countries may still be needed on occasion.

Lessons of the credit crunch

The Mint, April 7, 2008

On Wednesday, 26 March, Martin Wolf of the *Financial Times* boldly proclaimed, "The dream of global free-market capitalism (has) died." Three decades of movement towards market-driven financial systems, the core of capitalism, supposedly ended with the US Fed's rescue of Bear Stearns. Wolf sees a reversal of deregulation in the US, and countries such as India and China, being influenced by the "failure" of deregulation. As if to bear him out, a few days later the US treasury secretary proposed the most sweeping overhaul of financial system regulation since the Great Depression.

Martin Wolf gets it mostly wrong. The US treasury proposals are closer to the mark, but they also miss the target in some dimensions. Understanding the variety of financial systems is critical to designing regulations that reduce the chance of further messes. Wolf lumps everything together in his characterization of the liberalized financial system as an "unregulated, but subsidized, casino", but his greater mistake is to neglect the nature of financial systems and their role in the economy.

The fundamental role of financial intermediaries is to channel funds from those who have them to those who can put them to productive uses. Those uses involve risks of failure, and intermediaries also devise ways to pool and spread the risks. So, the financial system increases aggregate risk, but it also increases returns. Along the chain from source of funds to final use, some intermediaries exist only to invent new ways to pool and spread risks, or to look for profit opportunities through arbitrage, which then competes away those opportunities. The whole system benefits from better disclosure, and from clear and enforceable penalties for fraud. It is also subject to risks associated with loss of confidence among the suppliers of funds — this leads to liquidity crises ("credit crunches").

Governments (and international financial institutions set up by governments) have learnt to play a key role as ultimate managers of risk, through their size and ability to provide liquidity as creators of money. Ever since the Great Depression, banks and other retail deposit institutions have been protected by explicit insurance provisions. With each step towards a more unified financial system, the insurance role of government has grown.

In the US, the government stepped in after the savings and loan crisis of the 1980s and the Long-Term Capital Management (LTCM) crisis of 1998, to maintain confidence in the financial system. In the first case, retail depositors were protected, but shareholders sometimes lost. In the LTCM fiasco, the company's investors certainly took a big hit. That is true for Bear Stearns' shareholders as well. The Fed's provision of liquidity to JPMorgan Chase, the acquiring firm, may ultimately cost taxpayers, but this is effectively an everyday cost, collectively borne by society to spread risks in a way that allows greater average returns.

The latest financial crisis, and the Fed's responses, while different in specifics, are very much in character with previous episodes of instability. And, a closer look at the treasury proposals shows they are mostly long-term and overdue adjustments to the regulatory framework. Integrating regulatory oversight of financial exchanges, and broadening the Fed's monitoring of the health of the system beyond commercial banks, are changes required both by previous liberalization, and by the increased complexity and interconnectedness of financial markets. There is no sharp reversal of financial liberalization—instead, just a recognition that regulation needs to catch up with the changes. Catching up is also one aspect of the US proposals to change regulatory oversight of mortgage origination. The problem there has partly been that state-level regulation has been lax and poorly implemented—federal standards and federal scrutiny will help fix this. And, the “small guys” who were duped into unviable subprime mortgages will probably get better protection than the shareholders of Bear Stearns.

The US treasury also proposes more light-handed, “principles-based” regulation and more self-regulation, again expressing confidence in modern financial systems, contrary to Wolf's pessimistic views. This shift may be harder to justify in the current climate, especially politically, but also in terms of economic principles. But that debate is a subtler one than a general condemnation of markets. The issue is the practical matter of how best to control fraud and negligence, not of broad ideology. Ultimately, the financial system will manage most of the risks it creates in the search for higher returns — government regulation provides the enabling environment for this, and the critical role of lender of last resort. Risks are managed and spread, not necessarily reduced.

The ultimate lesson for countries such as India and China is that financial liberalization is here to stay. The US is moving to correct the specific mistakes it made, as well as allowing regulation to catch up with previous structural changes in the financial system. Emerging economies can learn from US mistakes without panicking, and build vibrant financial sectors.

Brave New World

The Mint, May 19, 2008

Economist Larry Summers, in a two-part argument in the *Financial Times*, offers a strategy for “healthy globalization”. What is the disease he diagnoses, and the cure he offers? He argues that increasing numbers of Americans can “legitimately doubt whether the success of the global economy is good for them”. In this argument, the middle and working classes in the West are losing out as developing nations compete in product markets with increasingly sophisticated goods, compete for resources, and compete for footloose capital. The result is erosion of political support for openness to the rest of the world or, more grandly, “economic internationalism”. Summers’ prescription for health is international coordination of policies to prevent races to the bottom in financial regulation, labour standards and tax rates.

Responses to Summers’ argument have included further emphasis on the distributional concerns he raises for developed country populations and suggestions that the “liberal international economic order” is losing intellectual support, with Summers as the “canary in the intellectual mine”. The concerns have been around for a long time, though expressed more often by those who do not have as firm a grasp of economic principles as Summers. The argument is subtle, involving both distributional and efficiency issues, combined in a non-obvious manner. Essentially, he makes a case that uncoordinated national policy choices with respect to tax rates, financial regulations and labour standards — none of which pertains to conventional aspects of international openness (freedom of movement of goods, capital and, occasionally, labour) — may not only be inefficient from a global perspective, but have distributional impacts that favour wealthy owners of financial capital over unskilled labour (basically, workers) and many types of skilled labour, or owners of human capital (typically, the middle class).

Clearly, Summers is not advocating a retreat from trade or capital openness. Fixing the problems, he identifies, requires a completely different set of policy responses. His point is that failure to deal with international policy coordination where needed will lead to second best policy responses such as trade restrictions in the face of political demands for greater income security. Yet, the most important policy tools in the face of global competition are domestic. Workers earn rents from skills that cannot be supplied perfectly elastically.

Large global supplies of unskilled labour have been harnessed at previously unimaginable scales and even the not-so-rich countries have seen the impact: Consider the effect of China’s expanding manufacturing prowess on Mexican workers. The only long-term answer for those whose rents are being competed away is to increase their productivity through skill acquisition, i.e., education and training. This does not require international policy coordination. The short-term policy response has to involve some form of adjustment

assistance, essentially a form of insurance in the face of accelerated change. Again, this is a domestic policy tool.

But what about the funding of education and insurance schemes? Traditionally, governments played a major role in this, via tax revenues. If these are being eroded by a race to the bottom, then we have a problem. Summers' prescription of avoiding this race seems to have value, then. On the other hand, education and training that have private returns may be supported by well-functioning capital markets — one should not rule out such options. It may also be that the need for tax coordination is overstated. Within the US, California and New York are high-tax states. This has certainly led to some movement of capital and jobs to other states. Yet, they both retain important economic centres and have high average incomes: They have avoided a race to the bottom. Nor is there any call for (and no constitutional possibility of) protectionist policies at the state level, even when automobile manufacturing jobs have moved from Detroit to southern states.

In fact, no one argued that the economic rise of the American South was a political problem for the free movement of goods, capital and labour within the country. No one seems to have made the case that the rise of Europe was an economic or political problem for the US, or for the case for economic openness. Even the expansion of the European Union to include many significantly poorer countries has not been an issue. But Japan was more of a concern to the US when it began to produce and export very sophisticated products in the 1980s. And now it is China and India.

Towards the end of Shakespeare's play, *The Tempest*, the young woman Miranda, seeing a group of people for the first time after a life of near-isolation, exclaims, "How many goodly creatures are there here! How beauteous mankind is! O brave new world that has such people in't!" International policy coordination may be a good thing in its own right. It should not be justified by being linked to economic openness, nor is it necessarily a precondition for healthy globalization. That precondition may instead be an acceptance of Miranda's perspective, applied to our entire world.

The Ostrich and Dr. Doom

The Mint, September 22, 2008

On 14 September, Alan Greenspan, once a figure of mythic proportions as chairman of the US Federal Reserve, observed that the US was in a "once-in-a-century" financial crisis. As if we hadn't already noticed. What started all this was, of course, the housing bubble, which was associated with fraudulent

mortgage loan practices and shoddy credit rating techniques, unsuitable for the complex securities that were being created and pushed by financial firms of all types.

In May 2005, Greenspan acknowledged that there were a lot of local housing bubbles, but he didn't see a national housing bubble, and said that the economy was not at risk. He was Fed chairman then, and maybe his position did not allow him to be more forthright. But in October 2006, several months after he stepped down and could speak freely, he said of the housing market, the "worst of this may well be over". And he still seems to miss the essence of what happened. He has recently said that the problem was not in the mortgage loans themselves, but in their securitization and sale to a wide range of investors. This denies the core problem, of dishonest, unsustainable loans. Ultimately, Greenspan was the Ostrich, with his head in the sand. He had the opportunity to be more forceful about the risks and needed regulatory responses at the time, but chose not to be. Now, with the storm at full blast, he looks up and acknowledges the reality.

Contrast all this with the position of Nouriel Roubini, a professor at New York University's Stern School of Business, and head of Roubini Global Economics. In August 2006, he wrote, "The scariest thing is that the gambling-for-redemption behaviour...are not the exception in the mortgage industry; they are instead the norm. ...If this kind of behaviour is — as likely — the norm, the coming housing bust may lead to a more severe financial and banking crisis than the S&L crisis of the 1980s. The recent increased financial problems of...sub-prime lending institutions may thus be the proverbial canary in the mine — or tip of the iceberg — and signal the more severe financial distress that many housing lenders will face when the current housing slump turns into a broader and uglier housing bust that will be associated with a broader economic recession."

Roubini went on to say, in 2006, "One cannot even exclude systemic risk consequences if the housing bust combined with a recession leads to a bust of the mortgage-backed securities market and triggers severe losses for the two huge GSEs (government-sponsored enterprises), Fannie Mae and Freddie Mac." Talk about prescience. In August this year, the *New York Times* (*NYT*) dubbed Roubini "Dr Doom". This was after the failure of Bear Stearns, which he had also foreseen. Three weeks after the *NYT* piece, Fannie Mae and Freddie Mac bit the dust, effectively being nationalized.

A bit earlier, in July, Roubini had said that Lehman Brothers would need a buyer: it soon did, but didn't find one, and is now bankrupt. He didn't stop there. He predicted in July that Merrill Lynch, Goldman Sachs and Morgan Stanley would also not survive as independent firms. Lo and behold, Merrill Lynch is now set to be owned by Bank of America. Forget the Ostrich. When Roubini talks, people should listen.

The beauty of Roubini's predictions is that they are based on crystal clear economic analysis. He argues that the independent broker dealer model (epitomized by the former big four firms) is fundamentally

flawed. These firms use the same business model as banks: they borrow short and lend long. But they borrow on even shorter time frames, use more leverage, and do not have explicit government backing (as banks have had since the Great Depression). If one accepts this analysis, then the last quarter century, after a spate of deregulation, has been a transitional phase, and the new institutional model for the sector will involve more diversified financial intermediaries, more careful regulation, more explicit lender-of-last-resort provisions, and a different risk-reward trade-off. More specifically, Goldman Sachs and Morgan Stanley will also (within a few years, according to Roubini) need saviours.

But this is nothing like the end of financial capitalism, as some windy observers have claimed. Fraud (lending practices that created toxic financial products) and incompetence (rating methods that helped diffuse them all through the global financial system) are not necessary consequences of capitalism. Greed does flourish under such a system, but greed always has to be managed (for example, safety rules, liability laws, disclosure provisions and requirements to honour contracts).

One might even go further, and argue that many of the Western financial institutions are vestiges of a time when financial products were idiosyncratic, liquidity could be fragile, informal trust and social networks mattered, and information was hard to come by. Information technology may offer opportunities to replace some old-style intermediaries with automated exchanges for a broader range of financial products than hitherto possible. Financial markets may actually become more efficient.

Fixing the financial mess

The Mint, October 6, 2008

The financial mess in the US, with its global spillovers, has prompted a great deal of commentary — some of the same quality as the mortgages that started it all. I don't think the current situation heralds the collapse of capitalism or of global finance. If anything, it involves a sweeping away of some inefficient incumbents and poor organizational practices. The problem has not arisen due to deregulation, but from a failure to enforce regulations, and mismatches in the pace of innovation in different parts of the financial value chain. In breaking down the causes of the mess, fixes, and even new opportunities, become clear. Dishonest lending practices began the problem. Mortgage loans to buyers who could never realistically pay up, with terms that were deliberately confusing or misleading, represented the creation of new capital (when new houses were built) with inadequate rates of return, or paper wealth that unsustainably relied on flipping existing houses. Securitization increased the moral hazard (making it easier to pass on the bad assets), but the basic cause was failure to enforce existing laws — regulators allowed a lot of

straightforward consumer fraud to flourish. The fix at this part of the value chain: Enforce basic consumer protection laws.

The creation of bad loans presented challenges for the securitization of mortgages. Here, there was collusion between the sellers of the securitized loans and the credit rating agencies. Again, there was failure to enforce existing regulations — the Securities and Exchange Commission (SEC), as regulator, had the authority to question the credibility and reliability of the ratings awarded for mortgage-backed securities of dubious quality. A charitable view is that the rating agencies and the regulatory staff were out of their depth in assessing the risks of the new financial products, and just went with the flow. That would be a case of one part of the financial services value chain not keeping up with innovations elsewhere. More probably, individuals knew or sensed the problems, but had no incentive to blow the whistle. In the case of SEC, regulation was poorly enforced, rather than absent. The fix again: Enforce existing regulation, in this case by not letting shoddy rating practices slide by.

The buyers of the questionable securities spread the problems. They could have exercised due diligence — after all, US court rulings say credit ratings are opinions, and the rating agencies have no liability. A homeowner who bought a house where the building inspector was paid by the seller and accepted no responsibility for his inspection report would be foolish indeed. The investment banks in the US that bought without sufficient care constitute an old-fashioned, oligopolistic, old-boy network. These are the institutions that have gotten away with charging 7% of the proceeds for handling initial public offerings, and collecting millions in individual bonuses for being toll-takers and matchmakers for large financial transactions. They thrived by being few and non-transparent.

Perhaps deregulation gave them the rope to hang themselves. Or one can argue that, like the credit rating agencies, they were not up to the task of managing the new complexities of finance. The internal incentive model also proved deficient since individuals could capture large rewards while their employers bore the risks. The fix: Let the old model die, and be replaced by one with more competition, and greater transparency. In a slightly different setting, this is what happened when the Internet and electronic trading destroyed the toll-taking oligopoly of the old-style stockbrokers. The change requires a somewhat different approach to regulation to ensure transparency through disclosure and monitoring, even without an organized exchange.

This is not difficult or new: Indian bonds are not exchange-traded, but trades still clear through a central organization, allowing better regulatory knowledge of holdings and market conditions.

Finally, the regulators of last resort in the US, after lesser regulators had failed to do their jobs, responded too weakly. They tried to create greater overall market liquidity, but did not allow for the fact that, in the

case of financial intermediaries, there is a short step from illiquidity to insolvency. Intermediaries without liquidity in borrowing lose liquidity in selling, and their assets can collapse in value. Even hinting at liquidity problems can start the downward spiral. So tackling liquidity alone did not work. Then, a firm-by-firm approach to fixing insolvency failed, and the result was the massive, inchoate bailout plan now being passed. The fix: A smaller, clearer, firmer plan to shore up the capital of threatened financial institutions could and should have been worked out a year ago.

All of the above may seem like easy hindsight, but these recommendations could have been extracted from well-understood economic principles. Ideology got in the way here. Lurching to opposite ideological extremes will not help either. Instead, policymakers can work with known principles of market design, and create financial market infrastructures that support more efficient new entrants and more effective regulation.

Are we facing the abyss?

The Mint, October 20, 2008

Through the unfolding of the financial crisis, I have been an optimist, looking at the situation in technical terms, and seeing light at the end of the tunnel. Since late last summer, that seems to have been the attitude of US policymakers, as they have taken one measured step after another to defuse the crisis. But it seems that the rot keeps spreading ahead of the fixes. European governments and multilateral institutions are now dealing with their pieces of the financial fallout. Real economic activity is starting to plummet.

The immediate problem is the lack of short-term liquidity. Credit markets that are normally the lifeblood of every modern economy are frozen with uncertainty. The uncertainty is coming from not knowing if the institution that wants to borrow can be trusted to repay. Not even the potential borrowers know the state of their own balance sheets. Perceptions of risk have gone through the roof.

Policymakers have finally been dealing with the problem, by offering to have governments insure such transactions. But meanwhile, the credit crunch has set off the second stage of the crisis. The uncertainty about repayment is coming about because many institutions hold assets that may have been seriously mispriced. The original source of this mispricing was securitized subprime mortgages, but large amounts of derivative securities, ostensibly designed to improve risk sharing, have been piled on top of this rotten foundation. Liquidity problems can force the selling of overvalued assets — as their true value is revealed, the holders of the assets may become technically insolvent. This sets off a chain reaction across the web of interdependent holdings of financial assets. Markets can also overshoot in this situation, so that artificial,

temporary insolvency is created. Restoring liquidity can help, but meanwhile the need for liquidity has grown.

Even without insolvency, asset holders across the economy see their wealth reduced as assets prices fall to new, more realistic levels. Wealth reductions cause pullbacks in real spending. As consumption and investment fall, production and real economic activity follow them down. As reality becomes bleaker, of course, realistic asset price levels decline. Animal spirits give way to panic.

Recessions are not new, nor are financial crises. We have had our share in recent decades. What seems to be different right now is the scale of the problem. Governments are spending to buy bad assets, and taking on new contingent liabilities, such as insuring short-term borrowing and increasing deposit insurance. Their fiscal positions will become more fragile. Real economic growth can help reduce this fragility by generating tax revenue to pay for the borrowing, but growth will be lower in the short run. Another way to pay is to tax everyone through inflation, which can also hurt growth. Again, the challenge is the size of the problem — some governments may run out of room to operate if they cannot borrow enough in the short run to make good on their increased insurance commitments and finance their asset purchases.

Global coordination may be essential to manage the financial crisis, but so far has been mostly lacking. Without coordination, if one moves on from financial institutions going under to countries going to the wall, or being forced to borrow from multilaterals with stringent conditionalities (taxing their constituents to pay back their loans), the political consequences may be ugly. The financial crisis comes on the heels of (and maybe was a result of) an unprecedented economic boom but unfortunately, not political stability. Political fragility may ultimately be a greater threat than the financial crisis itself.

The world can step back from this abyss if there is globally coordinated action and a sense of leadership. The US is in the process of replacing a lame-duck, miserably unpopular president who seems to be at a total loss. New leadership may help there. Other global leaders will also have to step up. The US and Europe still account for a large fraction of global GDP, but Asia's economies, with their high savings, large reserves and robust growth, will have to play a role. Exchange rate policies may need to move away from keeping currencies low to boost exports. Boosting domestic demand may once again be a good idea, especially as key commodity prices have deflated remarkably, and that source of inflation has receded as a threat.

India is still a tiny fraction of the world economy, but an even more aggressive cutting of the cash reserve ratio, and quickly starting to bring down interest rates seem to be called for, even just for domestic reasons. The global deleveraging is going to happen, it is going to be severe, and it is going to lead to a significant slowdown in real growth. Indian monetary authorities should act boldly in staying ahead of this process.

Acting decisively with the right accompanying words would signal that policymakers are in charge in this difficult time. All major governments need to do the same.

The anatomy of scandals

The Mint, January 12, 2009

B. Ramalinga Raju invented \$1 billion in cash, which never existed. Satyam, his firm, has lost close to \$4 billion in market value, wealth that never had a firm foundation, it turns out. The Satyam scandal has shaken corporate India, and damaged its reputation with investors, domestic and foreign. Meanwhile, of course, Bernard Madoff had evaporated tens of billions of investors' dollars in the US. And the subprime crisis of fraudulent and misrepresented mortgage-backed assets triggered perhaps \$30 trillion in losses of wealth worldwide. It is tempting to see all these scandals as symptoms of the same disease—unchecked capitalist greed—and look for a fix through greater government control. We seem to have come full circle since the heady days following the collapse of the communist model across eastern Europe. But capitalism is a complex beast, and the scandals that have been piling up have multiple causes and require multiple cures.

Private negligence: Financial capitalism needs monitoring and disclosure. The basis of modern limited liability corporations is high standards of accounting and disclosure, which allow markets in ownership shares to function well by increasing certainty and trust. Auditing of accounts to verify disclosure is a basic check in the system. Several years ago, Enron perpetrated a massive accounting fraud. It failed, and so did its auditor. Satyam's accounting fraud appears to be much less complex, and the auditing failure all the more shocking. Madoff used a tiny auditing firm to help hide his Ponzi scheme; Satyam's auditor is one of the big four global accounting firms. Unlike Madoff, Satyam also had a high-profile board of directors, whose job it was to monitor and guide. What were they doing? Numerous officers of the firm should also have had some inkling of what was going on, even if they were not involved in the fraud. Enron did have a whistle-blower, whereas Satyam relied on a Madoff-like ending when hiding the fraud finally became impossible and the perpetrator confessed. Negligence can be punished, but raising standards won't help if the problem is failure to detect violation of standards.

Public negligence: Financial markets or financial systems rarely thrive with self-regulation alone. It is too tempting to gang up on the outsiders and cheat them. Corporate outsiders can be insiders through public action, helping create government regulation. The Satyam scandal is being seen as indicating weaknesses in India's corporate governance, which is based on government regulation, but structural weakness was less important in this case than sheer negligence. On the other hand, the Madoff scandal seems to have involved

public negligence on the part of the Securities and Exchange Commission (SEC), which failed to pay attention to numerous warning signs. And the subprime scandal was allowed to develop and spread because of the SEC's apparent negligence in supervising investment banks, as well as the Federal Reserve's seeming failure to do its duty with respect to monitoring the soundness of the banking sector.

Private institutional failure: In the case of Satyam, the surrounding institutional structures were sound—the actions taken were not. Even in the Madoff scandal, the requirements for due diligence by institutional investors existed, but were just not followed. On the other hand, the subprime scandal was magnified and spread because the institutional structure itself was unsound. Numerous financial innovations of great complexity had taken place, including derivatives built on top of securities carved out of asset pools containing toxic mortgages. Yet the trading system for these complex derivatives was poorly developed: bilateral deals, no transparency, and no clearing mechanism for large gross positions on different sides of the market. Modern institutions used for trading more basic financial assets (shares of firms) were not adopted for trading a wide array of complex derivative assets. The investment banks operated in a 19th century manner.

Public institutional failure: This is the most talked-about cause of the scandals we have been seeing, usually in the form of criticizing deregulation. But the old regulations were obsolete long before they were repealed. The public institutional failure was in not forcing the market participants to design and implement new institutions for trading new financial instruments: Public action could have substituted for the lack of private institutional innovation. There are numerous public institutional failures in India (e.g., regulations for corporate governance, bankruptcy, and maintenance of competition), but they did not cause the Satyam scandal. The much bigger subprime mess, however, was compounded by public failure to update key institutions.

The lesson of the scandals is that there are multiple things that can go wrong in modern economies built on complex financial systems. Negligence needs to be distinguished from structural failure. And it needs to be recognized that these problems can arise in the private and the public sectors. Solutions have to be matched to the nature of the cause and its institutional location. Bleeding the patient cannot be the treatment for every disease.

What is finance for?

The Mint, February 9, 2009

The global financial crisis has been providing economists with an opportunity to present the old basics of finance as new insights. Non-economists often seem to misunderstand the functions of financial markets—the current mess reinforces a prior view that finance is just a complex way of stealing people’s money. What is finance really about?

Stripping to the essentials, financial transactions are motivated by individuals’ desires to change their pattern of income or wealth across different states of the world, or across different time periods. If two individuals have complementary desires (e.g., one wants to save now and spend more later, and another the reverse), they can engage in mutually beneficial trades (the current saver lends or extends credit to the borrower). Trading across different contingencies allows individuals to adjust the riskiness of their patterns of income to suit their preferences better. These are the most basic financial transactions, and they could potentially be conducted directly by individuals—if they always were, there would be no financial services sector. Instead, finance is all about various kinds of intermediation between individuals, groups or institutions. What roles do financial intermediaries play? Here are seven examples.

- *Economizing on the costs of completing and implementing transactions.* Digital technology has made the form-filling aspects less important. Complex contracts require lawyers as intermediaries, but that is not strictly a financial service. In general, technology has reduced the importance of this role for intermediaries.
- *Matching buyers and sellers.* Financial exchanges serve this role very well. What is surprising is how many financial assets are still not traded on exchanges, so intermediaries get to play the matching role in a non-transparent manner, which hinders efficiency. Exchanges do not work for every kind of financial asset, but greater transparency could be achieved for non-exchange financial transactions, using clearing houses for example.
- *Economizing on search costs.* Search can be a precursor to matching, with or without an intermediary. Financial intermediaries provide information for buyers and sellers of financial products. Much of this is basic financial data and news. The crisis has shown that simply having easy access to large quantities of information does not ensure successful market functioning, but still, more information is generally better to have.

- *Providing expertise.* One area where this expertise provision failed was in rating the quality of newer types of securities, such as those derived from bundling mortgages. This was partly because the experts were not really experts, and partly because their pay scheme eroded their neutrality. In general, information availability increased in financial markets, but expertise has lagged considerably.
- *Smoothing the market.* Financial intermediaries can carry inventories of financial assets, using those to manage fluctuations and make sure buyers and sellers can carry out plans, providing liquidity as a result. This role broke down in one phase of the crisis, partly because large volumes of new kinds of financial assets were being traded without the kinds of inventory requirements that govern stock exchanges or banks.
- *Providing reputation.* When buyers and sellers are not long-run market players, intermediaries become crucial sources of trust. Both sides of the market will trust intermediaries who have strong reputations that they seek to protect from damage or erosion. Reputations can be falsified (Bernard Madoff), so disclosure and external monitoring may also be required, but they can also be very powerful. The US' reputation is keeping its financial system going, even after negligence and incompetence has been revealed in many of its components.
- *Transforming products.* With physical products, transformation can go only so far. Distributors change the products' locations. Wholesalers and retailers may tinker with packaging. In the case of financial products, however, there is seemingly no limit to the transformations possible, and derivative securities are completely "new" financial assets created on top of existing ones. Transformation used to mean simple cases of bundling individual assets into securities that would reduce the risk borne by any single asset holder, but now has gone far, far beyond that.

Discussions on how to improve regulation of the financial sector often are limited by starting from current institutions, and thinking of adjustments to these institutions. Boundaries between institutional categories, determined by historical legacies, are often taken as given. A more productive approach to considering regulatory reform could be to first answer the question, "What are the economic roles of financial institutions?" (invariably some form of intermediaries), as I have done here. This framework can be used to identify what has not been working well, and why not. It can be used to examine how different roles fit together, and if systems are becoming unbalanced. As transformations of financial products exploded, Alan Greenspan argued that incentives to maintain reputation were all that mattered, but meanwhile, expertise and matching functions were lagging far behind. In financial markets we have to accept self-interest— even greed—but we do not have to accept inefficient institutions.

Relationships and markets

The Mint, February 23, 2009

As global capitalism goes through its greatest crisis in seven decades, a robust new debate on the role of the market versus the state has begun. Much of it focuses on perceived failures of markets, and the need to reassert state action through regulation of markets. Certainly, in an economic crisis, effective governance is a crucial guarantor against total systemic meltdown. Market fundamentalists in the US seem to be having a difficult time accepting this fact. At the same time, I would argue that the right way to think of the long-run solution to the problem is to frame it in terms of redesigning and modernizing market institutions, not just regulating or constraining them.

The shortcoming of much of the market versus state debate is that it deals in abstractions rather than the institutions that underlie each concept. Going deeper, it is people and their relationships that underlie or precede the institutions, and relationships may be the starting point for thinking about market design. Relationships, and the trust embedded in and supported by them, allowed international trade to span continents centuries ago in the absence of government regulation and effective legal remedies. Avner Greif, an economic historian at Stanford, is famous for having argued that the Maghribi traders of the 12th century succeeded in international trade without relying on governments or formal legal systems. More recently, the concept of Guanxi, describing complex personalized networks of influence and social relationships, has been used to explain the success of China in international trade and investment early in its economic reform process and before developing anything like standard property rights and other legal protections for contracts.

Yet markets that rely on relationships and trust have limits; “trust but verify” might be a good rule instead. Greif also points out that the Genoese traders ultimately outdid the Maghribis, using more formal, legalistic institutions for governing transactions. Indeed, Jeremy Edwards and Sheilagh Ogilvie of the University of Cambridge re-examine the historical evidence and find that for their trading success, the Maghribis relied on legal backup more than Greif admits. Arguably, China is also struggling with the constraints placed by its lack of legal frameworks and property rights. Very recently, Sankar De and Manpreet Singh of the Indian School of Business have empirically tested the benefits of informal relationships among small and medium enterprises in India, and found that these benefits are weak or nonexistent. There is no getting away from the fact that complex market economies need formal legal institutions and governments to back them up: This point is well recognized. Less well understood is the importance of the market institutions themselves.

In many cases, market institutions are chiefly shaped by the underlying legal institutions. Retail stores must post prices clearly for customers, for example. In some cases, maximum and minimum prices may be legally mandated or enforceable. But in other cases, stores may go below posted prices if they choose. The products themselves must satisfy certain disclosure requirements, which can affect how buyers search and choose among sellers and products. In formal retail markets, relationships start to recede to second-order importance: personalized discounts or credit arrangements, extra service and so on.

Financial markets are the most challenging to organize and maintain. The products that are bought and sold are abstract, they are assets whose returns are uncertain, and the choices are almost limitless. The best functioning financial markets rely on strong explicit rules to improve information flows and transparency of trading, and the nature of price agreement and trading itself, thereby allowing market participants to trust the rules rather than just individuals or individual firms. Modern electronic stock exchanges are relatively anonymous, but transactions and intentions are well documented and disclosed.

The failures we have seen have been failures of the old relationship model of trading, rather than a failure of modern markets. Investors who follow a Bernard Madoff or an Allen Stanford based on reputation and trust, do so in a misunderstanding of well-functioning markets, which strips away easy advantage from individuals, no matter how clever (that cleverness being distorted towards fraud instead). The US investment banking industry had also persisted as a relic of a pre-modern era of relationships and secrecy, ultimately bilking the entire world with its pretence of knowing something special. They were all too good to be true in a competitive market economy. There was too much trust, not enough verification, unlike other financial markets where verification is continuous and pervasive.

Relationships can substitute for weak market institutions. They can also subvert market institutions, as in the Satyam case, where Ramalinga Raju used relationships with those who should have been monitoring and verifying to undermine those necessary functions. Relationships can also be important where markets cannot work well, or where market transactions would be deemed to be ethically or morally indefensible. But the failings of markets based on relationships cannot be used as a justification for condemning, constricting or shutting down those markets—instead, better market design is the correct prescription.

Is George Soros Right?

The Mint, March 9, 2009

George Soros is a financial titan. He beat the Bank of England in 1992, and has since cemented his billionaire status with his financial dealings. Yet he also lays claim to the status of societal thinker: He has

written several books critiquing the workings of financial markets. He departs from the academic consensus of efficient markets, instead arguing in a December article: “First, financial markets do not reflect prevailing conditions accurately; they provide a picture that is always biased or distorted in one way or another. Second, the distorted views held by market participants and expressed in market prices can, under certain circumstances, affect the so-called fundamentals that market prices are supposed to reflect. This two-way circular connection between market prices and the underlying reality I call reflexivity.”

Reflexivity, in Soros’ analysis, leads to bubbles and crashes in markets. Soros argues that the current crash is the end of a superbubble that had been developing since the 1980s. The superbubble was created by a combination of financial innovation and regulatory negligence. Soros favours more active regulation, using a variety of policy tools, to control bubbles. At the same time, he warns against “punitive reregulation”.

Soros contrasts his views with the idea that markets always tend to be in equilibrium. In fact, the notion of market equilibrium, as developed by economists, is quite broad, and includes the idea that the equilibrium state can be influenced by market participants’ expectations. At any time, there can be more than one equilibrium, depending on whether people are pessimistic or optimistic. In some cases, small external shocks can lead to dramatic changes in the equilibrium, as both expectations and actions follow an upward or downward spiral. The shortcoming of the equilibrium view of the world is that it does not give us a clear understanding of the process of adjustment from one equilibrium to another. Often, there is no model of how people’s expectations are formed, making it impossible to understand how expectations adjust. Another weakness of the equilibrium perspective is that often the term is used in a narrow sense, referring to a lack of short-term incentives for any individual to deviate from what he or she is doing, rather than a long-term alignment of actions with underlying fundamentals.

But it is hard to be sure what the fundamentals really are. Much of the prevailing thinking during the long boom was that the fundamentals had changed: The collapse of Communism, the rise of emerging economies in Asia, the impact of information technology, and the increase in international flows of goods, services and capital, all could be adduced as factors supporting higher global growth. One could argue that this was a virtuous cycle that could have continued without the severe collapse we are now seeing.

What went wrong then? Soros identifies inadequate models of risk assessment and risk management, and financial innovations that outstripped the capacity of regulators to regulate effectively. These are different reasons than his argument that there is a natural tendency for financial markets to bubble and crash, but they explain why neither the financial industry nor the government controlled the bubble in time to prevent the crash. Soros also blames “deregulation”, but that is a somewhat different cause than lack of regulatory implementation. In any case, the heart of the argument is that markets are not inherently stable and do not

self-correct without pain. But as I have suggested, Soros' view on this is not something that the vast majority of economists would argue with.

However, there are four things that Soros misses. First, sufficient regulatory authority with respect to commercial bank supervision and regulation of investment banks was clearly available to Alan Greenspan of the US Federal Reserve and Christopher Cox of the Securities and Exchange Commission. Neither did his job properly: That is different from deregulation. Second, ideology and politics interfered, beyond a simple market fundamentalism. The same processes and attitudes in the Bush administration that distorted economic policy led to a disastrous foreign policy that had its own high costs. Leadership matters, and poor leadership can be calamitous. Third, markets are not abstractions. The design of market institutions matters, and the regulatory problem was not just deregulation or lack of enforcement, but an abdication of regulators' responsibility to update the design of market institutions to keep up with innovations in financial instruments. One could call this lack of regulation, but it is a different enough issue to deserve separate treatment.

The fourth additional point deserves emphasis. Soros focuses on the failings of financial markets in describing the cycling of the world economy. He notes that lower risk tolerance is going to affect future growth negatively. But, despite the chaos in the world economy caused by high-level greed, incomprehension and incompetence in the US, the world is fundamentally different since the 1980s, in a way that has not been the case since before the Industrial Revolution. Asia can still drive the world's economic growth if it follows the right policies.

AIG: Talent or toll-taking?

The Mint, March 23, 2009

American Insurance Group (AIG) was saved from collapse by \$170 billion of government funds. The government rescued the company because it feared that the failure of the insurance giant would reverberate through the financial system, and further damage the real economy, already suffering its worst downturn in almost 80 years. The problem was caused not by plain vanilla insurance, but by complex derivative contracts (now estimated at \$1.6 trillion), which suddenly generated tens of billions in losses when rosy assumptions about the future turned out to be false.

Now, it turns out that the members of the AIG Financial Products group, which created the mess, are receiving hundreds of millions of dollars in bonuses. Individual amounts of at least \$1 million went to some 73 employees. The company has offered various defences: These are contractual obligations (agreed on

before the crisis), and, according to the current CEO, they are necessary to “attract and retain the best and the brightest talent”. In fact, the claim (note the irony) is that only these executives can clean up the mess they created, by unwinding the various positions taken in different complex financial derivatives, since they know best what they did.

I want to put aside all the moral, ethical and legal dimensions of this situation, which has elicited outrage from across the spectrum of society. What was agreed upon by the firm, what the government knew, what can be done now, all this will be sorted out over the next weeks and months. I’d like to look, instead, at the market for talent, and the economics of high pay.

Who earns large sums of money in modern society? Doctors, pilots, scientists, and others like them are highly skilled and talented, and definitely get paid much more than average. But they typically do not earn millions of dollars annually. Successful business entrepreneurs can earn much larger amounts. They are rewarded for satisfying wants better than others can, perhaps by designing new products and services, or simply being more efficient. Entertainers and sports stars can earn in the millions. Mass entertainment (including sports) has increased the earning power of the most popular actors and singers, and best-performing athletes. There are limits to the number of slots that are available at the highest levels of performance, both because of limits to natural abilities (only a few cricketers are good enough to play for their country), and limits to the audience’s loyalty and attention span. There can be only one national team, and only a certain number of teams in a professional sports league.

Mass markets and competition can, in some cases, produce highly skewed earning distributions, where the top performers earn phenomenal amounts. Is that what happens on Wall Street? Are hundreds of financial sector employees so valuable that they are worth being paid over a million dollars? Economic theory says that workers will be paid the value of their marginal product. If their skills are rare, and cannot be duplicated, they will earn “economic rents”— amounts greater than what they could earn elsewhere—but their marginal value is determined on the demand side. So scale helps increase the value of such skills; thus recording and broadcasting technologies boosted the earnings of the top singers, actors and athletes.

Certainly Wall Street’s top performers are able to generate large sums of money for their employers, since they engage in large-scale financial transactions. That is supposedly why they earn such large amounts. But what are they really doing? Are Wall Street’s top earners really earning economic rents for skills that are in very short supply? Are they super smart, or do they have nerves of steel that few can match? I don’t think so.

Most of the high incomes on Wall Street (excluding CEOs and the like) are earned by traders. Their jobs are stressful, and there are likely few people who can do such jobs, but what really boosts their earnings are

barriers to entry and market imperfections. Some of the barriers are necessary: Even traders have to be trained and certified, though clearly they are not being trained well enough. But there are restraints to competition in these markets that inflate earnings, in the form of a small, tight network of firms and people.

The situation with many financial products reminds me of that of common stocks 30 years ago. Commissions were regulated and high. Brokers controlled information, and kept it from retail investors. They claimed special expertise, and earned incomes that were basically a form of toll-taking for buying and selling stocks. With deregulation and new technologies that increase market access and transparency, commissions have plummeted, and the old stockbroker model is dead.

Bonds, complex financial derivatives and other more esoteric securities are not as easy to trade as stocks, and their markets will never be as efficient, but we have to move away from a situation where 21st century financial products are being traded in 18th century-style institutions that collect tolls and misallocate talent.

G20: A global new deal

The Mint, April 6, 2009

In 1932, Franklin Roosevelt, the US Democratic Party nominee for president, promised “a new deal for the American people”. The US government under Roosevelt would go on to enact stimulus and redistribution programmes that set the economy’s course for decades. Other individual governments also stepped up to the challenge of the Great Depression, but collectively, they failed to halt a collapse of world trade and a slide into a global war hastened by the economic turmoil.

Now, we have the global economy’s greatest challenge since the 1930s, and the G-20 summit has, remarkably and unexpectedly, produced a significantly positive response from a heterogeneous group of national leaders. What did they achieve? Not anything revolutionary, perhaps, but certainly the beginnings of a global new deal. And this was done, I think, through a new kind of global leadership from the US. By all accounts, Barack Obama listened, he kept leaders talking to each other, he charmed and he compromised. This is exactly what he promised in his campaign, when the focus was on conventional foreign policy and the failure of the previous administration’s unilateral approach.

His first success has come in the economic arena. No doubt, many of the G-20’s other leaders played significant roles, but the US’ new president scored a major triumph.

What was agreed and what might be achieved? Despite Obama's and British leader Gordon Brown's remarks that the "Washington consensus", which they associated with unfettered globalization and deregulation, is outmoded, the G-20 agreement preserves the essence of free movement of goods, services and capital. There is \$250 billion to finance global trade; there is a statement reaffirming a commitment "to refrain from raising new barriers to investment" as well as trade in goods and services. Nevertheless, the statement outlines a sequence of measures designed to improve global coordination of regulation of financial markets and flows, and the overall quality of such regulation. In some ways, this change parallels the revamping of financial regulation following the manipulation of stock markets in the 1920s, but has to apply on a much larger scale and in more complex situations.

It might seem that the failure to achieve a globally coordinated fiscal stimulus undermines the parallel to the New Deal of the 1930s. However, there are strong statements about global fairness, new "resources for social protection for the poorest countries" and a half-trillion dollar increase in the International Monetary Fund's (IMF) resources, to be used to aid poorer nations and emerging market economies. Significantly, IMF's approach will further depart from its old fiscal orthodoxy, at least in the short run, and flexibly support growth. "Emerging markets and developing countries" are no longer bad boys or basket cases, but are recognized as "the engine of recent world growth". Perhaps I am reading too much between the lines, but the language and emphasis of the G-20 statement, as well as the structural reforms previously on the table and reaffirmed by the summit, all point towards the beginning of a major shift in global power, including an inevitable change in the workings of international financial institutions.

In this context, the reluctance of Europe to increase its fiscal stimulus or to take part in a globally coordinated fiscal effort becomes a minor failure. The action will be in the developing world, with private capital flows restored and increased IMF backing for counter-cyclical policies to combat the downturn. This seems to me a far cry from the old "structural adjustment" approach.

Of course, things will not change instantly. The US and Europe, with less than an eighth of the world's population, still account for 40-50% (depending on how one measures across countries) of global output. Leaders of global NGOs expressed disappointment that not enough was being articulated to help the global poor. One claimed, "What's missing is a global green new deal that puts the interests of poor people and the environment at the heart of international trade and finance." But that may be an ideal that is unattainable in any realistic world. And the G-20 statement certainly kept environmental sustainability and human development on the global agenda, even while acknowledging the importance of markets and trade.

Instead of utopias, it is 10% growth—which China has demonstrated and India may still be capable of with the right policy reforms—that will change the global economic balance. The leaders of individual European countries—the UK, Germany, France—all received disproportionate media attention, but their concerns

often seemed petty and parochial. They have even failed to address the problems in their eastern backyard. The new global game of cooperation will be between the US and the emerging economies. Brazilian President Luiz Inacio Lula da Silva, who has demonstrated an ability to pursue policies pragmatically, summed it up. According to him, rich countries had engaged with emerging nations on “equal terms” to achieve a good result. That may be the essence of a global new deal.