

## Learn it again, Uncle Sam {U.S.A.}

Annus horribilis. **Year of the great recession. Year of shattered myths. Year 2008 has been described in many ways, most likely unkind.** However, posterity is likely to judge it more kindly if the events of the year finally compel the much-needed reform and lead onto a better and more equitable global economic order. Like Chairman Mao's Great Leap Forward 50 years ago that laid the basis for China's subsequent emergence as an economic superpower, 2008 could then lay claim to fame as the year of the great relearning that laid the foundations for the great recovery in 2009 and beyond.



But that can happen only if 2009 builds upon the key takeaways from last year; so it might be useful to recount them. The first of these is that while the western model of development has much to commend it, there is much to condemn as well, especially in the realm of the financial sector and macro-economics. The invisible hand of the market works best only when there is the very visible hand of the government to restrain it. This means better regulation, closer oversight, greater transparency and accountability. The fundamental rule - till the world forgets it a gain - is, if an institution is systemically large enough or important enough to warrant bailing out with taxpayer money when it fails, it must be seen as important enough to be subjected to thorough public scrutiny (read tight regulation).

The next takeaway is about the perils of standalone investment banks with their penchant for taking absurd risks. Though such banks have all but disappeared into the bear hug of humdrum commercial banks, it is important they are not resurrected under some other guise. While a return of the Glass-Steagall Act that ensured a separation of commercial and investment banking might be excessively restrictive, there is a strong case for financial conglomerates with Chinese walls separating different activities.

The third relearning is about credit rating agencies and their feet of clay. Even as the failure of these agencies to do a proper due diligence led to inflated ratings in the first place, they made matters worse when, in their haste to make amends, they publicly threatened to downgrade those in

trouble, making it tougher for them to raise capital regulated and their wings clipped so that they can ransom again.

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If I-banks and rating agencies have been knocked off rocket scientists who thought all the nuances of human behavior could be reduced to cold numbers. Hopefully, rocket scientists will be relegated to the sidelines of economic policymaking. The last major lesson to be relearned, though this is one where many in the western world are still in denial, is that the events rocking the world are a consequence of imbalances in the global economy. The US twin deficits, budget deficit, and the corresponding Chinese surpluses are only a symptom of this deeper malaise. Unless these are addressed, nothing that Ben Bernanke and all the other central banks or their governments do, will be able to save the world from a similar convulsion a few years hence.

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Related to this and, perhaps, in some ways the answer to ensuring we do not see a repeat of the events of 2008 is the realisation that the present global financial architecture will not do. This is an extremely painful realisation, especially for the US, given the favoured position of the US dollar as the international reserve currency in the present order. But the November meeting of the G20 heads of state in Washington has tacitly recognised the need for fixing, if not re-doing, the plumbing. Better still, it has set a deadline of April 2009 for coming up with an alternative framework so the ground has been laid for some far-reaching changes.

The way forward will not be easy. The dollar's position as global reserve currency gives the US enormous clout. So US authorities will try their best to ensure status quo. But unlike the Bretton Woods conference (that laid down the framework of the current global financial architecture) where the US could call the shots, the balance of global economic power has now shifted.

Globalisation is a two-way street. The US needs the rest of the world as much as the latter needs the US. The US recognises this but is loath to follow through with any action that entails ceding the dollar's preeminent position, such as the acceptance of an alternate international reserve currency. There's no doubting the US Fed's ability toward off deflation. Fed chairman Ben Bernanke is on record that "sufficient injection of money will ultimately always reverse a deflation". But can it deal with 'the morning after'?

As growth returns, chances are, so will inflation. And with a vengeance!  
Many of our present problems can be traced to former Fed chairman, Alan  
Greenspan's inability to claw back the excesses of his loose monetary policy.  
Bernanke's solution, to let forth an even looser one, virtually sets up the  
world for a much bigger crisis in the years ahead.

The problem is compounded by the fact that the US dollar today is not the  
same as it was in Greenspan's time. The US Fed's balance sheet is bloated  
beyond recognition and is stuffed with assets of dubious quality.

It is only a matter of time before the dollar loses credibility and with that its  
acceptability as the international reserve currency. Today that might seem  
unlikely: despite being the epicentre of the crisis the dollar's special status  
has enabled the US to raise billions of dollars of debt at record low cost to  
bail out its financial system and organise a Keynesian reflation of its  
economy. But it is only a matter of time as the recent fall of the dollar has  
shown. The problem with quantitative easing is that the currency falls as  
investors lose faith in its future value. A free fall of the dollar could be  
catastrophic for the global economy. But a managed fall calls for global  
cooperation on an unprecedented scale at a time when protectionist  
tendencies are rising. So it's not going to be easy; not unless the global  
community takes the lessons of 2008 to heart. But there is hope; for as

Francis Bacon put it: 'Prosperity doth best discover vice, adversity doth best discover virtue'