

Opinion

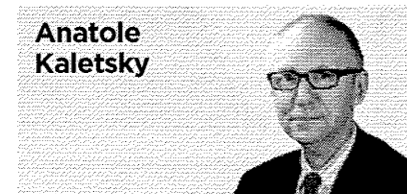
How Guy Ritchie
can advance the
principles of equality

Melanie McDonagh, page 26



Slash interest rates now to stave off depression

More co-ordinated international action will be needed to build on the opportunity created by the bank bailout



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Nobody can dispute any longer, as I rashly did two months ago, that we are living through the worst financial crisis of our lifetimes. Historians can argue about the causes of the near-collapse of almost every bank in the world — a catastrophe never threatened even by the two world wars. Conventional wisdom will no doubt view it as the inevitable consequence of a decade of credit excesses and banking follies.

I will continue to argue, as I have since the chronic credit squeeze turned suddenly into meltdown in September, that it was an avoidable accident, caused mainly by the blunders of one individual: Henry Paulson, the US Treasury Secretary, when he hubristically bankrupted Lehman Brothers and expropriated the shareholders of Fannie Mae.

But there are far more urgent items on the political and economic agenda. The first is how to prevent the recession made inevitable by this meltdown becoming a Japanese-style "lost decade" of economic stagnation and falling prices. The second is how to fine-tune the financial rescue plans announced by all leading governments, to promote economic revival. The third is how to reform regulation and global economic governance to reflect the lessons of both the upswing and the slump.

The second and third issues are

rather technical but, in a nutshell, I believe that Britain has missed a crucially important issue by failing to remove the lethal distortions in regulation and accounting that were have been largely responsible for the boom and bust. Gordon Brown has also been overly punitive to bank shareholders and his terms will have to be relaxed to avoid unnecessary damage to what is still the country's most important industry.

In America, by contrast, Mr Paulson has been far too generous. As a result, there must be a serious risk that his sweetheart deals with the banking industry will unravel if the Democrats win the White House and both Houses of Congress on November 4. One issue that will hang over financial markets is what happens to US financial and economic policy in the three-month hiatus between November 4 and the inauguration of the new president on January 20. But I want to focus on what must be done to prevent this recession turning into depression.

Moderating the recession will require drastic changes in monetary, fiscal, financial and international policy, preferably done in concert in the world's main economies.

Interest rates everywhere must be cut urgently. Central bank base rates must fall to the lowest levels in the postwar era to offset the much wider credit spreads that banks will demand for lending, even to their best customers. Governments must not be intimidated by shock-horror headlines that exaggerate the modest costs of bank rescue packages, which should mostly pay for themselves. Financial policy must ensure that government-led bailouts result in the increased lending promised to

companies and households.

Last but not least, governments must deal with the enormous imbalances in the global economy that have been financed by the credit boom and are bound to reverse. Since the mid-1990s, most of the impetus for global growth has come from the consumer and housing booms in America, Britain and Southern and Central Europe, while the Asian economies and Germany, have relied to a disproportionate extent on export-led growth. This will inevitably change. As previously consumer-driven economies endure a period of belt-tightening, imports will weaken and exports will soar, as is happening in America.

To prevent a global depression resulting from belt-tightening in countries such as the US, Spain and Britain, it is imperative that China, Japan and Germany recognise that they can no longer rely on export-led growth and redirect their economic policies to stimulate domestic consumer spending, infrastructure investment and housing. If they refuse, they will face a protectionist backlash, certainly in the US.

How might these principles be translated into practice in the US and Britain? In America there will be little room for further rate cuts after the Federal Reserve Board reduces its policy rate to just 1 per cent, as it surely will this month. The top priority will be to ensure that lenders pass on the benefits of ultra-low rates to the rest of the economy. There will probably a big role for the US Government in direct lending to homeowners and businesses, and substantial revisions to the bailout deals struck by Mr Paulson this week with the private banks.



Oxford Street consumers: a bout of serious belt-tightening is imminent

The biggest policy stimulus in the US is likely to come from tax cuts and public spending, whoever wins the election. The most effective tax cuts would be directed at low-income households and these are likely after a Democrat victory.

In Europe, and especially Britain, the scope for interest-rate cuts is huge. The European Central Bank is likely to move slowly, because of its federal structure, Germanic traditions and continuing upward wage pressures from powerful public sector unions. But in Britain, there is no such excuse. It is preposterous that Britain, the G7 economy most gravely threatened by the collapse of activity in housing and international finance, should have higher interest rates than the EU and the US.

The Monetary Policy Committee should aim for a base rate of 3 per cent by the end of the year and 2 per cent or below, roughly in line with the US, by next summer. To show that it means business, the MPC should cut by a full percentage point in November. The only alternative would be an explosion in the government deficit, to well over £100 billion. If that were to happen in the year ahead, it would certainly be less of a disaster than increasing taxes or slashing public spending in the recession. Amid a financial crisis of the kind the world is now facing, the litmus test of fiscal prudence is not the budget deficit this year or next, but the credibility of long-term plans to put government finances on a sustainable footing.

In short, Britain needs a steep rate reductions, combined with a fiscal policy that permits much bigger deficits in the short term, followed by big tax increases and spending reductions once the recession abates.

Is such a programme conceivable? Recall what the Major Government did in 1992. Within three months of Black Wednesday, interest rates were cut from 12 to 8 per cent. The government deficit was allowed to expand to almost 7 per cent of national income, but the 1993 Budget set a credible course for bringing finances back into surplus by 1997. The result was a rapid economic recovery, followed by 16 years of uninterrupted growth. In the months after Black Wednesday, only the wildest optimist imagined such a golden future to be possible. In 1992 I was that wildest optimist — and today I believe that, with the right policies, a similar miracle could be repeated in the decade ahead.

