Mere words will not restore confidence in the markets

Sunday, 12 October 2008

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It was only on Wednesday that the Government announced a £400bn package – the largest single intervention in the financial industry in the last half-century – intended to calm the markets and restore the willingness of the banks to lend to each other. Two days later, it looks just small beer. The stock markets have gone into freefall, both here and all around the globe. The all-important interbank rate – the rate at which financial institutions lend to each other – has steadily refused to budge. Indeed it has actually gone up. And the share prices of the eight banks involved have all plummeted. And to add insult to injury, a swath of charities and local governments have been caught out by the collapse of the Icelandic banks, leaving their clients bereft of funds and the government helpless to assist them.

As the traders surveyed the wreckage on the dealing room floor and the US President, George Bush, appeared on television to calm the fears on increasingly anxious public, two points became clear at the end of this wracked and woeful week. One is that governments have lost control of the markets. It's not that they haven't tried. Almost every government in the developed world has acted in the past fortnight to save individual banks, pouring more liquidity into the banking system and, only this week, taking concerted action to reduce the interest rate by a full half point. And yet nothing, not the American $700bn (£400bn) bailout, the British measures of this week, the takeover of banks in Europe and forced mergers in France and Germany, the injection of short-term funds nor the interest rate reduction have restored market faith. Confidence in government and their ability to control events, put bluntly, just isn't there.

The other factor influencing the market and now dominating the thinking of governments as much as players is the gathering gloom in the real economy. After the traumas of this week it is no longer possible to keep the events in the financial markets separate from the contraction of most of the major economies. A good deal of the problem does stem from the banking crisis. Unable to borrow money themselves and hoarding what cash they have, the banks have cut back sharply on loans to their customers. The result is that businesses, unable to finance themselves, have in turn started to draw back, laying off staff and delaying expenditure. This in turn has clamped down on an economy that was already starting to contract as house prices fell and consumers started to draw in their horns. Which factor is the cause and which the effect no longer matters. The financial crisis has collided with a gathering recession and the two are now inextricably joined.

Which is not to say that nothing can be done. At the heart this is a crisis of confidence. If that can be restored and money starts to flow again between banks and therefore to their customers, and if the markets can be persuaded that the next step is up not down, then there is some hope of preventing this retreat from turning into a total rout. A recession in terms of a year or so of non – and even falling – growth is probably inevitable. The bubble of house prices and consumer credit was bound to be pricked sooner or later. But recession need not deep into a long-term depression. The question is what ought and indeed what can be done at this stage.

After the failures of the past few weeks, it is clearly going to take more than words to move the markets but this weekend at least provides a pause in which government and players can reconsider. It also provides an occasion with the annual meeting of the International Monetary Fund and the pre-summit gathering of economic ministers of the G7 group of major industrialised nations. This is a global crisis and it requires a sense of global action from governments. Already central banks have done a huge amount in flooding the markets with money. But they still need to do more. Banks require more capital as well as more funds. Governments have to be prepared, as the British are now promising, to inject this capital in return for shares. Call it "part nationalisation" or whatever, it needs to be done if banks are to start lending again. And finance ministries also need, as the UK has done, to start talking in terms of guaranteeing loans made to banks. It may be expensive in terms of numbers but there is now no alternative.

There are also things that shouldn't be done. Having done well early in the week, the British Prime Minister has ruined his own standing by his obsession with "punishing" banks for past misdeeds and, even more, by his outrageous and ill-considered action to seize the assets of Icelandic companies in the UK in retaliation for the collapse of their banks here. His frustration is understandable. His actions are unstatesmanlike, foolish and futile. The only result of this declaration of near war on a neighbouring friendly country has been to drive it into the hands of the Russians, who are now seeking a military base in Iceland in return for bailing it out.

Getting governments to act in concert is not easy. Asking them at this point all to introduce all of these measures may well be a bridge too far. But there is still much that can be done in the meantime short of the nuclear option of finally nationalising the financial industry. The central banks can keep acting in the money markets. They should certainly keep pulling down interest rates. China, India and the newer countries should be brought into the international economical institutions. It is a disgrace that they are not already full members of the G7. But in the end this is a crisis that has arisen in America and it is to Washington that the world looks for leadership. And America, to the world's frustration, is in the middle of an election. We may well have to wait for a new president before the markets, and governments around the world, can start to feel real confidence that the US is back in the saddle again.----------The Independent