VIII. Conclusion: the difficult task of damage control

The current market turmoil in the world's main financial centres is without precedent in the postwar period. With a significant risk of recession in the United States, compounded by sharply rising inflation in many countries, fears are building that the global economy might be at some kind of tipping point. These fears are not groundless. A powerful interaction between financial market innovation, lax internal and external governance and easy global monetary conditions over many years has led us to today's predicament. Rather than seeking to apportion blame, however, thoughtful reactions must be the first priority.

Looking forward, it is crucial to put emphasis on all these elements, and their interaction, and not just on the recent innovations in financial markets that have received so much attention to date. Too narrow a focus has two dangers. First, it points to remedial policies of limited scope that could prove inadequate to manage a crisis with deep roots in the real economy as much as in the financial sector. In particular, we need to address directly the problem of bad debts and high debt service burdens built up over many years in some major economies. The temptation rather to use still more credit expansion and higher inflation to paper over these problems must be firmly resisted. Second, a focus on shortcomings in recent financial innovations tempts policymakers to address symptoms, not underlying causes, in taking measures to avoid similar problems in the future. It is unquestionably important to identify "what is different" about our current problems, but we must also recognise "what is the same".

It cannot be denied that new developments in financial markets, in particular inadequacies in the implementation of the originate-to-distribute model, have had calamitous side effects. Loans of increasingly poor quality have been made and then sold to the gullible and the greedy, the latter often relying on leverage and short-term funding to further increase their profits. This alone is a serious source of vulnerability. Worse, the opacity of the process implies that the ultimate location of the exposures is not always evident. How then to clear up the debris if it is not even clear where it lies?

These financial innovations have heightened what seems to be an inherent tendency to "procyclicality" in liberalised financial systems. That is, as credit expansion fuels cyclical economic growth, asset prices and optimism rise while perceptions of risk recede. This further supports credit expansion, not least through the provision of more collateral to allow more borrowing, leading to spending patterns that could eventually prove unsustainable. Initial rational exuberance might in this way become irrational, setting the stage for a possible subsequent collapse.

Nor can it be denied, again as seen many times in the past, that there were also deficiencies in both the internal governance and external oversight of financial institutions. Individual firms have suffered huge losses, and forced recapitalisations will dilute future returns for current shareholders. Small wonder, then, that shareholders are outraged at the behaviour of both managements and supervisory boards. Moreover, as evidence has accumulated that the financial system as a whole is no longer functioning effectively, those charged with prudential oversight must also ask themselves what went wrong. How, for example, could a huge shadow banking system emerge without provoking clear statements of official concern? Perhaps, as with processes for internal governance, it is simply that no one saw any pressing need to ask hard questions about the sources of profits when things were going so well. One consolation is that those elements of Basel I that contributed to the excesses, in particular the effective absence of capital charges on off-balance sheet entities related to banks, will no longer play such a role under Basel II. The sooner the new framework is fully implemented the better.

Finally, it cannot be denied that a still more traditional factor was also at work. Real interest rates – globally, and not just in a few advanced industrial economies – have been at unusually low levels for much of this decade. With inflation initially low and stable, policy rates, long-term rates and risk spreads failed to increase commensurately as global growth rose to record levels. The expansion of monetary and credit aggregates surged, while foreign exchange reserves rose by unprecedented amounts as emerging market economies intervened massively to keep their exchange rates from appreciating. Moreover, as with low interest rates, the global trend towards faster monetary and credit growth was seen in almost every major region of the world.

One plausible explanation for this extended period of easy monetary and credit conditions is that central banks have not yet fully adjusted their domestic policies to reflect increasingly important global influences. For many years, global inflation was maintained at low levels, aided by the tailwinds of numerous positive and overlapping supply shocks arising from deregulation and technical progress, but perhaps due even more to the entry of major emerging economies into the global trading system. However, instead of temporarily allowing inflation to drift lower, analogously to the past treatment of negative supply shocks, policymakers interpreted this quiescence of inflation differently. They took it to mean that there was no good reason to raise interest rates when growth accelerated, and no impediment to lowering them when growth faltered. It is not fanciful, surely, to suggest that these low levels of interest rates might inadvertently have encouraged imprudent borrowing, as well as the eventual resurgence of inflation. Similarly, there are dangers in saying that food and energy prices can be ignored in setting domestic policy because they are externally driven. For the world as a whole, these are not external supply shocks, but rather seem to have been primarily demand-driven. These examples indicate that our domestic frameworks for policymaking need to be better adapted to the realities of globalisation.

Given the variety of the influences underlying current economic and financial difficulties, their interactions and their long-standing nature, we should not expect a quick and spontaneous return to normalcy. Nor should we expect quick and easy policy solutions. The likelihood that cleaning up after past excesses will prove difficult has an important implication: it adds weight to the argument that we need to use policy measures to lean against such credit-driven excesses in the first place. While introducing a new framework for policymaking clearly presents difficulties, surely the massive economic costs incurred in past crises of this sort warrant a serious investigation of the possibilities for change.

How great are the risks to the outlook?

Against this background, while most commentators expect some slowing of global economic growth, there is an exceptional degree of uncertainty as to how severe the slowdown might be. One need only consider the widening dispersion of views in the consensus forecast, as well as the unusual differences between the forecasts of some national authorities and those of the IMF. Divergences in the stance of monetary policy across the major regions, while reflecting many influences, are also consistent with different assessments about how severe the effects of the current turmoil might become for national economies. Nor is there a great deal more certainty with respect to the prospects for inflation, with incoming news increasingly suggesting that it is more likely to rise further than to suddenly fall. As a result, some see parallels today with the early 1970s, when inflationary pressures rose sharply, and others with the early 1990s, when banking systems and the economy were weakened by an overhang of private sector debt. In the end, both might well prove right.

Looking back in time provides some clues as to why such a high level of uncertainty currently prevails. How we got to where we are now was itself highly unusual. On the real side, the impact of globalisation in recent years has already been noted. But consider as well the unprecedented reliance on household spending and debt accumulation in many countries during the last upturn. On the financial side, there has been unprecedented growth in volumes in many markets, a whole host of new instruments and many new players. And on the policy side, the degree of sustained fiscal and monetary stimulus needed to ensure recovery after the slowdown of 2001 was also unprecedented. Against this background, and that of the continuing turmoil in financial markets, it is simply implausible that traditional forecasting models would continue to work well, if indeed they ever did.

Looking forward in time, there is significant uncertainty as to the extent of the damaging effects on growth of a number of interactive processes. There are interactions within the financial sector, within the real economy and between the real and financial sectors, and potential contagion across geographical regions. To these vulnerabilities must be added the inhibiting effects on the real economy of rising inflation, and potential disruptions arising from global trade imbalances. Lurking behind many of these processes is the spectre of deleveraging, after many years of debt accumulation, and the problem of the fallacy of composition. That is, as individual economic actors try to deal sensibly with their own problems, they may only make everyone else's problems worse. Such processes can be highly non-linear, potentially leading to much slower global growth than is generally expected and, for a time at least, also to higher inflation.

Within the financial sector, the most important interaction is that between institutions and markets. Finding it hard to estimate their own future capital and liquidity requirements, as losses have mounted and balance sheets have swollen involuntarily, banks in the main financial centres have already cut back on credit to financial sector borrowers and have tightened margin requirements. This could well intensify. In turn, those borrowers who cannot meet more onerous credit conditions could be forced to sell assets into markets which remain illiquid in spite of extraordinary efforts by central banks to resolve this problem. The impact of such "fire sales" on prices, and on the capital of financial institutions, could be substantial. Potentially, such developments could also do further damage to market liquidity if previous market-makers, starved of funding liquidity, were forced to reduce their activities further.

Within the real sector, the principal concern is that households facing heavy debt burdens, and sometimes falling house prices, will seek to raise secularly low saving rates by cutting consumption quite sharply. The fact that in the United States and some other advanced industrial countries the stocks of houses, cars and other durables already seem rather high could encourage such behaviour. Unfortunately, everyone cannot save more simultaneously, since one person's spending is another person's income. The end result of such a process would be lower economic activity and employment, not only in these countries, but also in those reliant on exporting to them. Nor would higher US investment be likely to fill the gap. In such circumstances, corporations might well judge that the demand for their products was unlikely to recover for some time and would simply hold back spending while cutting costs. Evidently, a related fall in the effective value of the US dollar would create domestic jobs and reduce the US trade deficit, but this would only add to the discomfort of exporters in other countries.

Between the financial and real sectors, there could also be worrying interactions. Of greatest concern at the moment is that still tighter credit conditions will be imposed on non-financial borrowers. While the corporate sector globally is hardly cash constrained, this cannot be said of many large firms that have recently been involved in leveraged buyouts. Moreover, the financial position of the household sector in many countries is not good. Simply losing the ability to withdraw equity from houses has, in the United States at least, already had a significant effect on spending. But even tighter credit conditions could exacerbate such trends, leading to more job losses and bankruptcies, which would again feed back on the financial system.

Given the possibility of such a worsening economic and financial environment, it would not be surprising if asset valuations also came under further pressure, with house prices still of prime concern in many countries. In the United States, the inventory of unsold houses remains particularly high, and could well increase further if homeowners are tempted to walk away when the value of their house falls below their mortgage obligations. This would be another direct charge on the capital of the lenders, and would further increase the downward pressure on US house prices, as well as the prices of all financial instruments backed by such mortgages. In a number of countries, commercial property prices are also beginning to soften, a development which traditionally has been bad news for lenders. Clearly, these real-financial interactions are potentially both complex and dangerous.

Globalisation increases the possibility of contagion across geographical regions. There can be little doubt at this point that the US economy is facing serious difficulties, and has the greatest potential to be hurt by interactions of the sort just described. Moreover, there are suspicions that a number of other countries with low household saving rates might be similarly, if perhaps less significantly, exposed. Nevertheless, there continues to be hope that the slowdown will spread to other countries only in a much attenuated form. In Europe, the centre seems fundamentally strong, though the periphery is another story. Problems in the construction sector in Spain and Ireland are already quite evident, while some countries in eastern Europe have been running remarkably large current account deficits. As well, their dependence on western European banks implies another significant vulnerability, should circumstances force those banks to retrench. Japan still has strong trade links with the United States, and is exposed to that extent, but it seems to have avoided the build-up of private sector debt in recent years that now threatens many other countries.

It is also not clear whether, and if so to what extent, the emerging market economies might "decouple" from setbacks in the advanced industrial countries. On the one hand, their domestic demand does seem to be on an upward trend, and exports are increasingly directed to other emerging market countries. On the other hand, it is notable that much domestic investment, as well as the export of goods for final assembly in other emerging market countries, remains ultimately driven by spending in the advanced industrial countries. Moreover, financial market influences and general confidence effects would seem likely in an increasingly "globalised" environment. Such arguments imply that the linkages and vulnerabilities seen in earlier cyclical downturns have by no means been eliminated.

Rising global inflation provides a further serious and conflicting source of concern. How high could it go, and for how long? Commodity prices have been at the heart of the recent global acceleration, in part because neither demand nor supply react quickly to price changes, but the underlying pressure of strong global demand on near-term supply capacity is becoming increasingly evident over a much broader range of markets. Further, while the quiescence of wages and inflation expectations to date gives solace to some, others see a clear potential for both to rise significantly. Higher prices have already cut real consumer wages almost everywhere, even to the point of triggering social and political unrest in a number of emerging market economies. In turn, this has prompted many governments to resort to administrative measures to hold down prices and restrict exports, measures which imply that underlying inflationary forces are actually stronger than they appear. Evidently, a global economic slowdown would help reduce overall inflationary pressures. Given the inertia in the inflation process, however, this might still imply an uncomfortably long period of high inflation along with slower growth. Moreover, slower growth would also provide an environment in which more generalised and dangerous protectionist pressures might well emerge.

Beyond these global risks to the inflation outlook, the prospects for both growth and inflation in individual regions will also be affected by exchange rate movements. One source of concern is what might happen in the markets themselves. Against the background of a still wide US current account deficit and rising external debt levels, the decline in the effective value of the US dollar has to date been remarkably orderly. However, this need not be a guide to the future. Foreign investors in US dollar assets have seen big losses measured in dollars, and still bigger ones measured in their own currency. While unlikely, indeed highly improbable for public sector investors, a sudden rush for the exits cannot be ruled out completely.

Finally, whatever exchange rate changes might occur, they could have significant costs as well as benefits. Countries like the United States, whose currencies are depreciating, should see growth benefit from trade substitution effects. The United States will further benefit from valuation effects, since most of its debts are denominated in dollars while its assets are measured in appreciating foreign currencies. Conversely, those with appreciating currencies are likely to see growth suffer on both counts.

When it comes to the impact on inflation of exchange rate changes, the calculation of costs and benefits is both more complex and, for some countries, more worrisome. For example, should the dollar and sterling continue to depreciate on an effective basis, inflationary pressures in the United States and the United Kingdom would be expected to increase. While "pass-through" from exchange rate changes has been relatively weak in these countries in recent years, this has been associated with shrinking margins in exporting countries, and enhanced efforts to keep margins up by increasing productivity relative to wage growth. However, with time, both processes become increasingly painful and the likelihood of an inflationary outcome correspondingly greater. Conversely, in most of the countries whose currencies might appreciate, particularly in Asia and western Europe, inflation is higher than desired and the disinflationary implications of an appreciation against the dollar would be clearly welcome.

In this last respect, Japan remains a significant and worrisome outlier. With the effective value of the yen close to a 30-year low, a large current account surplus and massive exchange rate reserves, the yen could eventually rise further. In this case, against a backdrop of sagging trade and continuing sluggish growth, a return to deflation could by no means be ruled out. While the Japanese economy today seems to be less exposed than many others to the various damaging interactions described above, its room for manoeuvre on the policy front has become almost non-existent. The country has a huge government debt, and policy rates are almost zero. In fact, this is the lingering heritage of Japan's long having relied almost exclusively on macroeconomic instruments to deal with the aftermath of the bubble that burst in the early 1990s.

Together with a decade or more of sub-par growth, this continuing downside exposure in Japan suggests two policy conclusions that might be pertinent to other countries today. First, if the Japanese authorities had leaned against the bubble earlier and more vigorously than was actually done, the worst of the excesses of the "boom" might have been avoided. Second, their failure to restructure corporate and financial sector debts in a timely and orderly way made the ultimate costs of the subsequent "bust" much greater than they would otherwise have been.

How to cope with conflicting risks?

The fundamental cause of today's emerging problems was excessive and imprudent credit growth over a long period. This always threatened two unwelcome outcomes, although it was never clear which would emerge first. One possibility was a rise in inflation as the world economy gradually approached its near-term production potential; the second was an accumulation of debt-related imbalances in the financial and real economy which would at some point prove unsustainable and lead to a significant economic slowdown. In the event, the global economy now seems to be experiencing both unwelcome phenomena at the same time, albeit with different countries often having significantly different degrees of exposure to these common threats.

This presents a considerable complication for policymakers. Not leaning vigorously against inflation pressures, which are currently rising almost everywhere, threatens an increase in inflation expectations that might prove very costly to rein in. But not leaning vigorously against the interacting processes described above threatens a cumulative downward momentum in the economy that could all too easily get out of hand. Yet these threats also differ in their immediacy, in that inflation is actually rising, while significantly slower growth remains only a possibility in many parts of the world. In general, this should imply a bias of global policy towards being much less accommodating.

This global bias agreed, the need to evaluate conflicting risks means that monetary and fiscal policies in individual countries cannot be recommended on the basis of "one size fits all". Each central bank must carefully assess a number of issues whose relative weight varies from country to country. First in importance is the strength of existing inflationary pressures and the risk of inflation expectations ratcheting upwards. Second, policymakers must assess the likelihood of other potential shocks to inflation going forward. Here considerations pertaining to commodity prices, exchange rates and terms of trade would loom large. Third, they must evaluate the extent to which potentially large changes in asset prices and perceptions of wealth might affect the outlook, particularly against a backdrop of elevated debt levels. And fourth, they must make a related judgment on the health of the financial system and the likelihood of a credit crunch emerging.

Given the need to make difficult judgments about all these considerations, the path of interest rates seems bound to differ across countries. While rising inflation is a clear danger everywhere, it is already a reality in most emerging market economies. There, food counts for more in the consumption basket, the track record of price stability in some regions is less well established, and the threats to growth from balance sheet excesses and a tightening of credit standards seem generally less in evidence than in some key advanced industrial countries. Of course, if monetary policy were to be tightened relatively more in the emerging market economies, this would also imply a greater willingness to allow their exchange rates to rise in consequence. The latter is in any case to be recommended, both as an inflation-fighting tool and as an instrument for reducing global trade imbalances. Since, within the advanced industrial economies, similar considerations seem to warrant a tighter set of policies in continental Europe (relative to the United States, where the threat of recession seems greater), higher emerging market exchange rates would also help alleviate upward pressure on the euro.

Of course, policy should in principle be conducted not only with a view to resolving current problems, but also with an eye to the longer term. Again, conflicts present themselves that offer further scope for policy divergences. On the one hand, it is not impossible that the unwinding of the credit bubble could, after a temporary period of higher inflation, culminate in a deflation that might be hard to manage, all the more so given high initial nominal debt levels. Such considerations have led some, not least in the United States, to argue for a particularly vigorous use of monetary easing as "insurance" against this low-probability but high-cost outcome.

However, others, notably in continental Europe, have voiced different concerns about the future. In addition to near-term worries about higher inflation, many suspect that significantly easier monetary policies will only stimulate another unsustainable credit and asset price bubble – perhaps a partial explanation for developments in commodity markets today – and that current spending and trade imbalances will only tend to be exacerbated. Those espousing this view would note the historical experience of serial bubbles, particularly in the United States, and what seems to have been the need for an ever more vigorous monetary response to successive downturns. Another, closely related concern is that, in the end, monetary easing might even cease to stimulate real growth at all and would only produce higher prices. Indeed, many prewar theorists warned of just such a possibility. In failing to recognise this possible limitation of monetary easing, the great danger is that policymakers could delay too long in turning to other policy actions that could prove more effective in mitigating a cumulative economic downturn.

Perhaps the most obvious policy alternative would be stimulative fiscal policy. In most advanced industrial countries, slowdowns activate some degree of automatic stabilisation, though this is less common in emerging market economies. It also seems a political reality that, given the prospect of a serious downturn, discretionary fiscal policy would be used more actively. Indeed, an element of this has already been seen in the United States, where concerns about a serious downturn were used to justify a fiscal stimulus package in early 2008 that was "timely, targeted and temporary".

At the same time, however, certain downsides must be recognised. One is that pre-emptive fiscal stimulus, like monetary easing, might encourage an upward shift in inflation expectations given an initial absence of excess capacity. Another is that, in many countries, the explicit and implicit debts of governments are already so high as to raise doubts about whether all non-contractual commitments will be fully honoured. Further fiscal stimulus could then lead to a rise in risk premia, which might cause interest rates to back up. Moreover, for countries with large external deficits or debts, the exchange rate might also be severely affected. And, of course, the fiscal room for manoeuvre would be further restricted given fears that taxpayers' money might eventually have to be used to help resolve problems of overindebtedness in the financial or household sectors.

Principally in the United States today, but also prospectively in a number of other countries, there has been a build-up of debts that cannot be serviced on the originally agreed terms; US subprime mortgages are a good example of this. In such circumstances, creditors and debtors should in principle restructure the debt in an orderly way so as to maintain residual value to their mutual benefit, while limiting moral hazard going forward. However, one reason why governments might have to get involved in this process is that existing private sector workout and liquidation procedures, and their supporting infrastructure, could prove incapable of ensuring speedy and effective resolutions on the scale required. Moreover, new financial instruments and players in the world's major financial markets constitute a further significant impediment to private sector solutions. It is not clear where the losses are, how they should currently be valued, or how large they might grow given ongoing declines in the prices of underlying assets. Similarly, it is often not clear who retains the legal authority to initiate procedures to seize what value is presumed to remain.

Yet another complication, in sharp contrast to recurrent sovereign debt crises, is that there are now millions of troubled borrowers, particularly US households, as well as a myriad of lenders. And equally troubling, given the widespread use of credit risk transfer instruments, is that the interests of investors are no longer aligned in seeking to minimise losses by avoiding bankruptcies. In sum, orderly private sector workouts are not going to be so easy. Perhaps the most useful role of governments might be to see how this state of affairs could be quickly improved.

Should governments feel it necessary to take direct actions to alleviate debt burdens, it is crucial that they understand one thing beforehand. If asset prices are unrealistically high, they must eventually fall. If saving rates are unrealistically low, they must rise. And if debts cannot be serviced, they must be written off. Trying to deny this through the use of gimmicks and palliatives will only make things worse in the end. Against this background, it seems worthwhile to lay out some principles, based on the handling of previous crises in Japan, Sweden and elsewhere, while recognising at the same time that turning principles into practice raises its own set of difficult problems.

First, in principle, the government's actions should be quick and decisive, with the clear objective of removing all uncertainty about future private sector losses. This happened in the Swedish banking crisis of the early 1990s, whereas in Japan the government took too long to act decisively. In practice, however, it will always take some time to determine the severity of the problem to be faced and to decide what to do about it. Second, in principle, losses should fall heavily on those who incurred them in the beginning: first the borrowers and then those who lent unwisely to them. In practice, however, the possible implications of widespread household bankruptcies (including resulting litigation) would also have to be seriously considered. Third, if the public sector chooses to socialise the losses, it should be done explicitly and transparently, without shifting potential losses onto the balance sheets of central banks. In practice, however, as was seen in Japan in the early 1990s, inadequate legislation pertaining to deposit insurance gave the central bank very little alternative to providing emergency assistance to insolvent institutions. And fourth, the moral hazard associated with the use of government money should be counterbalanced by the introduction of forward-looking measures to prevent similar problems arising in the future. The practical problems this raises are discussed in the next section.

Most of the more specific suggestions for government involvement have been directed to alleviating the likelihood of a full-blown credit crunch in global financial markets. What is sought are ways to mute the potentially powerful interaction between uncertainty about the solvency of borrowers, primarily households, and the solvency of lenders. In fact, steps have already been taken in the United States to use government and quasi-government agencies to support mortgage markets, and thus indirectly house prices, homeowners and lenders as well. In a number of countries, there have been calls for direct government purchases to put a floor under the prices of a variety of financial instruments. Of course, this conflicts directly with the need for the market to find its own level if it is eventually to function normally again, and exposes the government to future losses should prices continue to fall regardless. Another approach to the problem focuses not on households' assets but on their liabilities, and suggests that there should be a form of blanket reduction based on certain principles established by governments. The downsides of course are evident: the potential direct cost to the government, the moral hazard involved, and the political outrage as "prudent" borrowers and taxpayers are forced to subsidise the "imprudent".

How might governments help in reducing uncertainties about the solvency of banks and, in turn, the threat of a credit crunch? Evidently, the first step would be to encourage self-help. Both dividends and bonuses should be cut in order to increase capital cushions. The private sector, whether through rights issues or appeals to outside investors, should also be turned to for further capital injections. This process would clearly be facilitated by greater clarity as to the need for capital, in the light of prospective losses and also possible involuntary increases in balance sheets. The problem, however, is that the valuation of many structured products is difficult, because there is effectively no market for them, and valuing them using models has many drawbacks. The suggestion that banks might agree on a common "template" for valuations, recognising these shortcomings, nevertheless has significant merit.

Of course, such an evaluation might also reveal that the losses are uncomfortably large, a possibility for which the authorities should make preparations in advance. One response, if the regulatory authorities were able to determine that the estimated "fair value" losses were much greater than seemed likely to be realised in the end, might be a temporary degree of regulatory forbearance. Conversely, and perhaps more likely, if the regulators felt unable to do this, then the government should not hesitate to intervene directly subject to the principles laid out above. Mergers, takeovers, the establishment of a "bad bank" to house bad assets, recapitalisation using public funds and even nationalisation are all procedures that should be contemplated depending on the circumstances.

When direct public sector intervention seems required, the domestic legal framework and the potential need to involve foreign authorities will be important factors constraining what might in practical terms be done. In such circumstances, it is likely to become evident quite quickly that not enough effort has been put into preparing for the possibility of a financial crisis of some sort. If the authorities must muddle through regardless, the experience will at least provide some indications of what preparations might have been better made in advance.

Improving crisis prevention and crisis management

To be realistic, there have been financial crises with significant economic costs since time immemorial, and we should not think they can ever be eliminated. Nevertheless, steps can be taken in advance both to mitigate the excesses in the expansionary phase of the credit cycle and to further reduce the costs in the downturn through better crisis management. With the costs of the current turn in the credit cycle becoming increasingly apparent, there should be a corresponding political will to proceed with such improvements. Moreover, a commitment to do so would help reduce the moral hazard likely to arise from direct government involvement, both actual and potential, in response to the current difficulties.

As noted in the Introduction to this Annual Report, the roots of the present turmoil are both different from and similar to earlier such occurrences. A number of study groups have already identified "what is different" in financial markets today and have made many sensible suggestions for changes that would reduce the dangers these factors now evidently pose. At the same time, and again sensibly, these suggestions also seek to maintain wherever possible the benefits these new developments offer. Not least, ways must be found to turn the theoretical benefits offered by the originate-to-distribute model into a practical reality.

What has received less attention are potential cures for "what is the same" in the current turmoil: the inherent procyclicality of the financial system and excessive credit growth. This lack of attention is surprising for two reasons. First, recognising excessive credit growth as the underlying problem helps explain not only the current financial turbulence, but imbalances in the real economy and rising inflation as well. This is truly parsimonious. Second, it could well be that the tendency for rapid credit expansion to have dangerous side effects is actually growing. The trends towards globalisation and consolidation, as well as securitisation, increase not only the likelihood of excessive behaviour in the upturn but, arguably, the costs of downturns as well.

In the light of all this, what seems needed is a new macrofinancial stability framework to resist actively the inherent procyclicality of the financial system. By using macroprudential regulatory instruments as well as monetary tightening to lean against the upturn, the worst excesses could be avoided. Indeed, faced with the anticipation of resistance from the official sector, private sector behaviour might itself be tempered. Note, for example, how the new focus of central banks on inflation is said to have affected the inflation expectations process. And fewer excesses on the way up would probably imply less damage to clean up afterwards, as well as more room to ease policy since this would have been tightened more systematically beforehand.

The first salient feature of such a framework would be a primary focus on systemic issues. Attention would be placed on the dangers associated with many institutions having similar exposures to common shocks, for example a turn in the property cycle. This would be complemented by the recognition of endogenous interactions among and between institutions and markets that could lead to highly non-linear outcomes. While such an approach would not imply paying less attention to the good health of individual institutions, it would certainly imply significantly enhanced oversight of firms that were very large or had complex relations with other parts of the system.

The second feature would be a much more "symmetrical" or countercyclical use of policy instruments. They would be tightened in the expansionary phase of the credit cycle and eased in the downturn. In this regard, the new framework would simply mirror what is now the accepted wisdom for fiscal policy: namely, that the good times should be used to prepare for the bad. Currently, in an upturn, neither monetary nor regulatory instruments tend to respond systematically to emerging imbalances of the sort described above. Moreover, regulatory instruments are commonly tightened only when things turn bad, potentially making the downturn worse.

To be more specific, monetary policy might be tightened even with projected inflation under control, given a sufficiently worrisome combination of rapid credit growth, rising asset prices and distorted spending or production patterns. In focusing on a combination of systemic indicators, this proposal is quite different from simply targeting asset prices. Macroprudential instruments would be used with a similar bias, either on a discretionary basis or following some rule-based criteria, to ensure that risk spreads, loan loss provisions and capital provisions all moved so as to reduce the amplitude of the credit cycle. A technical challenge would be ensuring that the regulatory requirements for individual institutions reflected their own behaviour, while at the same time responding to system-wide developments. Fortunately, the flexibility provided by the various pillars of Basel II eases the task of finding a solution.

A third feature would be still closer cooperation between the central banking and regulatory communities in trying to identify the build-up of systemic risks and in deciding what to do to mitigate them. What is needed is a means of better integrating the particular insights of each community and their respective analytical strengths. Increased clarity about the individual responsibilities of cooperating agencies, and formal agreements to ensure that timely decisions are taken when needed to foster systemic stability, would also be of great practical usefulness.

There are many practical impediments to making a macrofinancial framework operational. The first is that not everyone accepts the hypothesis that excessive credit growth is the root of the problem. Nor is everyone agreed that it might prove difficult to clean up the mess after such periods of excess. While hopefully it will not come to that, if the costs of the current turmoil continue to mount and policy measures prove largely ineffective, such beliefs are more likely to be re-evaluated. A second problem is the practical one of recognising when resistance to the upswing becomes necessary. And a third problem is mustering the will to act, to take away the punch bowl at the party, when the time is right. These problems are real but they should not be insurmountable, and they pale against the difficulties likely to be encountered when an unresisted boom turns to bust.

A framework designed to reduce the amplitude of credit-driven cycles will not eliminate them. Periods of turmoil and outright crisis will then still have to be faced and managed, and such events should also be prepared for through the introduction of a coherent set of "safety net" measures. The adequacy of deposit insurance schemes should be evaluated and shortcomings dealt with. "Off-the-shelf banks" should be set up to allow crucial functions of bankrupt banks to be maintained. Legislation should be enacted to give the authorities the powers they need to cope with unfolding difficulties. Memoranda of understanding, both domestic and international, need to be agreed. And war games need to be played by those who would actually manage problems in real time. Admittedly, there is an element of moral hazard in all efforts of this sort. But if history is any guide, failing to make such efforts will eventually entail recourse to still more expensive and dangerous measures during the crisis itself. Businesses and banks are expected to undertake business continuity planning in advance of trouble. Surely we should expect as much from policymakers.