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ECONOMIC NEWS UPDATE

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One thing is certain in this uncertain world: once the currently roiled financial waters have calmed, the world of finance will not be as it was before the storm broke.

John Maynard Keynes' famous statement, "In the long run we are all dead," was followed by the less famous, "Economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is long past and the ocean is flat again." Keynes was right. Fortunately, we can tell everyone more than that -- in addition to a flat ocean, there will be new rules governing the use of the seas.

The first drafts of such new regulations are already on the drawing boards of legislators in America. The sub-prime fiasco has revealed an important market failure: those granting the mortgages sell them off so quickly that they can be more than casual about the about the borrowers' ability to repay -- or even to make the first interest payment due. Soon, mortgage brokers will have to retain some of the risk they have created. This will be forced on them either as a result of new regulations or the insistence of the

investors that ended up holding these mortgages. We have probably seen the last of NINJA loans -- no income, no job, no assets.

More fundamentally, for better or worse it will be far beyond any length probably ascribed by Keynes to the "long run" before the presumption in favor of deregulation reasserts itself. For decades now the vast majority of economists have argued that deregulation of financial markets has contributed to economic growth and to increased stability of the US and other economies. That they are broadly right is no longer relevant. The hunt is now on for regulatory fixes -- expanding the power exercised by the Fed to supervise banks and intervene in their affairs if necessary; more power for regulators to limit the ability of banks to conceal risks with a variety of off-balance sheet gimmicks; limitations on the ability of rating agencies to, in effect, "sell" AAA ratings pursuant to a system under which they are paid by those they are rating. Defenders of light-handed regulation will not be able to dismiss the new regulations with the usual, "If it ain't broke, don't fix it." Instead, they will

have to fight for the least counter-productive fixes.

Nor will major financial institutions emerge from their current troubles unchanged. For one thing, their desperate need for new equity to offset the write-downs they have taken has thrown them into the arms of sovereign wealth funds, non-transparent investment vehicles of national governments that might have other than purely commercial motives for intervening in the management of companies in which they are substantial shareholders. This is making the US government sufficiently nervous that even President Bush, who has welcomed what he calls the return of our money, felt compelled to act. Late last week he issued an executive order requiring tighter review of the national security implications of foreign investments, and empowering the Secretary of Commerce to "compile and evaluate data on significant transactions involving foreign investment in the United States." Thin edge of what will become a rather large wedge.

As a consequence, the sovereign wealth funds will find that the short-run problems the economies of the West now face will produce a long-run change in how they themselves are required to do business. At the gathering of the great and good in Davos last week, executives from Western institutions urged the governments that control these funds to make their governance procedures and investment goals more transparent so as to avoid a political backlash. My guess is that so long as the US and world banks badly need capital infusions from the sovereign wealth funds, they will not insist on such changes, and even such as Chuck Schumer -- the New York senator who

opposed the Dubai ports deal -- will swallow hard and allow his Wall Street constituents to take the money and run. But once balance sheets are in order, and the need for cash less urgent, pressure on these funds will become irresistible, and at least token bows made to the demands of host countries.

The rules governing monetary policy will also change. In recent years there has been a debate over whether central bankers should focus solely on inflation in the prices of goods and services, or consider also prices of assets such as shares and houses. Those who object to basing monetary policy on share price and house price movements argue that it is impossible to tell when there is a bubble that needs pricking, and even harder to do the pricking; it is better, they say, to leave to the market any corrections that prove to be needed.

They have lost. The fact that the bursting of the so-called house-price bubble is complicit in the current, spreading problems means that in the future attention will be paid to house and share prices. Central bankers, now convinced that movements in asset prices affect consumer spending, job creation and inflationary expectations, won't stand idly by while asset prices reach levels they consider unsustainable, but will raise interest rates or restrict credit to bring prices off the boil. How they will know when investors have had too much of a good thing, and whether they can have any effect on prices, I am not certain. But having been asked to clean up the debris left by the recent share price collapse, and watching the social and economic consequences of the housing bubble's collapse, they will feel justified in intervening to dampen price rises, just

as they are now called upon to moderate price plunges.

Robert Brand, a banker-friend of Keynes, warned the great economist against relying “on the skill and economic knowledge of bankers harassed by politicians.” Substitute “regulators” for “bankers” before cheering the new round of regulations that is in our future.

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