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OP-ED COLUMNIST

Moment of Truth

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Last month, when the U.S. Treasury Department allowed Lehman Brothers to fail, I wrote that Henry Paulson, the Treasury secretary, was playing financial Russian roulette. Sure enough, there was a bullet in that chamber: Lehman's failure caused the world financial crisis, already severe, to get much, much worse.

The consequences of Lehman's fall were apparent within days, yet key policy players have largely wasted the past four weeks. Now they've reached a moment of truth: They'd better do something soon — in fact, they'd better announce a coordinated rescue plan this weekend — or the world economy may well experience its worst slump since the Great Depression.

Let's talk about where we are right now.

The current crisis started with a burst housing bubble, which led to widespread mortgage defaults, and hence to large losses at many financial institutions. That initial shock was compounded by secondary effects, as lack of capital forced banks to pull back, leading to further declines in the prices of assets, leading to more losses, and so on — a vicious circle of “deleveraging.” Pervasive loss of trust in banks, including on the part of other banks, reinforced the vicious circle.

The downward spiral accelerated post-Lehman. Money markets, already troubled, effectively shut down — one line currently making the rounds is that the only things anyone wants to buy right now are Treasury bills and bottled water.

The response to this downward spiral on the part of the world's two great monetary powers — the United States, on one side, and the 15 nations that use the euro, on the other — has been woefully inadequate.

Europe, lacking a common government, has literally been unable to get its act together; each country has been making up its own policy, with little coordination, and proposals for a unified response have gone nowhere.

The United States should have been in a much stronger position. And when Mr. Paulson announced his plan for a huge bailout, there was a temporary surge of optimism. But it soon became clear that the plan suffered from a fatal lack of intellectual clarity. Mr. Paulson proposed buying \$700 billion worth of “troubled assets” — toxic mortgage-related securities — from banks, but he was never able to explain why this would resolve the crisis.

What he should have proposed instead, many economists agree, was direct injection of capital into financial firms: The U.S. government would provide financial institutions with the capital they need to do business, thereby halting the downward spiral, in return for partial ownership. When Congress modified the Paulson plan, it introduced provisions that made such a capital injection possible, but not mandatory. And until two days ago, Mr. Paulson remained resolutely opposed to doing the right thing.

But on Wednesday the British government, showing the kind of clear thinking that has been all too scarce on this side of the pond, announced a plan to provide banks with £50 billion in new capital — the equivalent, relative to the size of the economy, of a \$500 billion program here — together with extensive guarantees for financial transactions between banks. And U.S. Treasury officials now say that they plan to do something similar, using the authority they didn't want but Congress gave them anyway.

The question now is whether these moves are too little, too late. I don't think so, but it will be very alarming if this weekend rolls by without a

credible announcement of a new financial rescue plan, involving not just the United States but all the major players.

Why do we need international cooperation? Because we have a globalized financial system in which a crisis that began with a bubble in Florida condos and California McMansions has caused monetary catastrophe in Iceland. We're all in this together, and need a shared solution.

Why this weekend? Because there happen to be two big meetings taking place in Washington: a meeting of top financial officials from the major advanced nations on Friday, then the annual International Monetary Fund/World Bank meeting Saturday and Sunday. If these meetings end without at least an agreement in principle on a global rescue plan — if everyone goes home with nothing more than vague assertions that they intend to stay on top of the situation — a golden opportunity will have been missed, and the downward spiral could easily get even worse.

What should be done? The United States and Europe should just say "Yes, prime minister." The British plan isn't perfect, but there's widespread agreement among economists that it offers by far the best available template for a broader rescue effort.

And the time to act is now. You may think that things can't get any worse — but they can, and if nothing is done in the next few days, they will.