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OP-ED COLUMNIST

## The Widening Gyre

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Economic data rarely inspire poetic thoughts. But as I was contemplating the latest set of numbers, I realized that I had William Butler Yeats running through my head: “Turning and turning in the widening gyre / The falcon cannot hear the falconer; / Things fall apart; the center cannot hold.”

The widening gyre, in this case, would be the feedback loops (so much for poetry) causing the financial crisis to spin ever further out of control. The hapless falconer would, I guess, be Henry Paulson, the Treasury secretary.

And the gyre continues to widen in new and scary ways. Even as Mr. Paulson and his counterparts in other countries moved to rescue the banks, fresh disasters mounted on other fronts.

Some of these disasters were more or less anticipated. Economists have wondered for some time why hedge funds weren’t suffering more amid the financial carnage. They need wonder no longer: investors are pulling their money out of these funds, forcing fund managers to raise cash with fire sales of stocks and other assets.

The really shocking thing, however, is the way the crisis is spreading to emerging markets — countries like Russia, Korea and Brazil.

These countries were at the core of the last global financial crisis, in the late 1990s (which seemed like a big deal at the time, but was a day at the beach compared with what we’re going through now). They responded to that experience by building up huge war chests of dollars and euros, which were supposed to protect them in the event of any future emergency. And not long ago everyone was talking about “decoupling,” the supposed ability of emerging market economies to keep growing even if the United States fell into recession. “Decoupling is no myth,” The Economist assured its readers back in March. “Indeed, it may yet save the world economy.”

That was then. Now the emerging markets are in big trouble. In fact, says Stephen Jen, the chief currency economist at Morgan Stanley, the “hard landing” in emerging markets may become the “second epicenter” of the global crisis. (U.S. financial markets were the first.)

What happened? In the 1990s, emerging market governments were vulnerable because they had made a habit of borrowing abroad; when the inflow of dollars dried up, they were pushed to the brink. Since then they have been careful to borrow mainly in domestic markets, while building up lots of dollar reserves. But all their caution was undone by the private sector’s obliviousness to risk.

In Russia, for example, banks and corporations rushed to borrow abroad, because dollar interest rates were

lower than ruble rates. So while the Russian government was accumulating an impressive hoard of foreign exchange, Russian corporations and banks were running up equally impressive foreign debts. Now their credit lines have been cut off, and they're in desperate straits.

Needless to say, the existing troubles in the banking system, plus the new troubles at hedge funds and in emerging markets, are all mutually reinforcing. Bad news begets bad news, and the circle of pain just keeps getting wider.

Meanwhile, U.S. policy makers are still balking when it comes to doing what's necessary to contain the crisis.

It was good news when Mr. Paulson finally agreed to funnel capital into the banking system in return for partial ownership. But last week Joe Nocera of The Times pointed out a key weakness in the U.S. Treasury's bank rescue plan: it contains no safeguards against the possibility that banks will simply sit on the money. "Unlike the British government, which is mandating lending requirements in return for capital injections, our government seems afraid to do anything except plead." And sure enough, the banks seem to be hoarding the cash.

There's also bizarre stuff going on with regard to the mortgage market. I thought that the whole point of the federal takeover of Fannie Mae and Freddie Mac, the lending agencies, was to remove fears about their solvency and thereby lower mortgage rates. But top officials have made a point of denying that Fannie and Freddie debt is backed by the "full faith and credit" of the U.S. government — and as a result, markets are still treating the agencies' debt as a risky asset, driving mortgage rates up at a time when they should be going down.

What's happening, I suspect, is that the Bush administration's anti-government ideology still stands in the way of effective action. Events have forced Mr. Paulson into a partial nationalization of the financial system — but he refuses to use the power that comes with ownership.

Whatever the reasons for the continuing weakness of policy, the situation is manifestly not coming under control. Things continue to fall apart.

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