

The Big Picture

To the rescue

For the past year, parts of the global financial system have operated under severe pressure. In this edition of The Big Picture we look at the policies undertaken to relieve that pressure both in Australia and around the globe.

The US situation

As the US global financial crisis unfolded there were stages in their policy response. The first stage saw cuts to official interest rates. Moves were then taken to deal with the problems faced by specific institutions such as the investment Bank Stearns, the mortgage finance providers Fannie Mae and Freddie Mac and the insurance giant, American Insurance Group.

The failure of US investment bank Lehman Brothers signalled a new phase in the unfolding crisis. It sparked a further sell-off in share markets and heightened the growing reluctance of banks to lend to each other. It was the reluctance of banks to lend to each other and to their own clients that was undermining the normal operations of the economy.

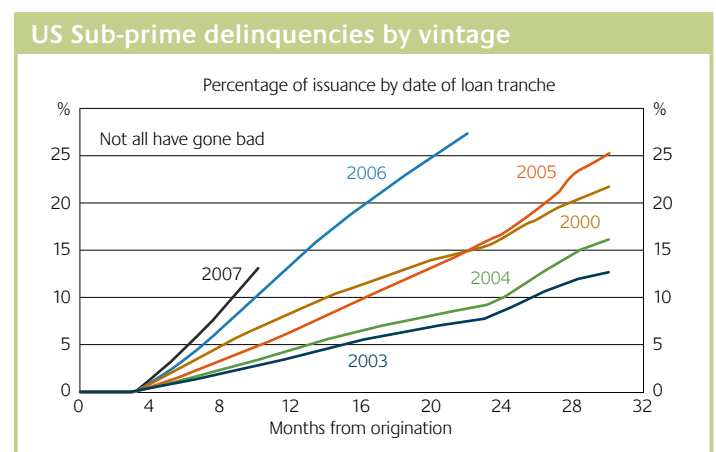
Several intertwined problems were emerging. Falling share prices saw the underlying capital of banks shrink as were losses on bad loans and poor investments. These problems were magnified by the amount of leverage or borrowing that had been undertaken to purchase assets whose value was evaporating.

The US Troubled Asset Relief Program (TARP), finally passed in early October 2008, sought to resolve some of these issues.

The reluctance by banks to lend to each other was based on the fear of bank failures due to over exposure to 'troubled assets' mostly backed by sub-prime mortgages. The market value of these assets fell to virtually zero as no one was prepared to buy them. With some asset values falling to zero, banks began reporting large losses and confidence in the banking system waned. The US\$700 billion Troubled Asset Relief Program (TARP) rescue package aims to purchase these troubled assets. This process in itself will establish a 'market price'.

After troubled assets are purchased by the government, they will be managed to maximise returns to their new owner. Not all sub-prime mortgages are in default and part of Troubled Asset Relief Program (TARP) will be directed towards helping borrowers avoid moving into default.

The chart below shows that not all sub-prime mortgages are in default. The lines show the year the sub-prime loans were made. These loans defaulted at differing rates. The horizontal axis shows the months since the loan was made and the vertical axis shows what portion fell into default. None of these loans are at 100% default and as since some people are still making their repayments the sub-prime loans would still continue to earn some income.



Source: RBA: Statement on Monetary Policy August 2008. BIS.

By moving the troubled assets out of the banks, the probability of further bank failures declines and this should reduce the fear banks have of lending to each other. In turn, this should lift the availability of finance to normal 'main street' business that need bank finance to conduct their normal business operations.

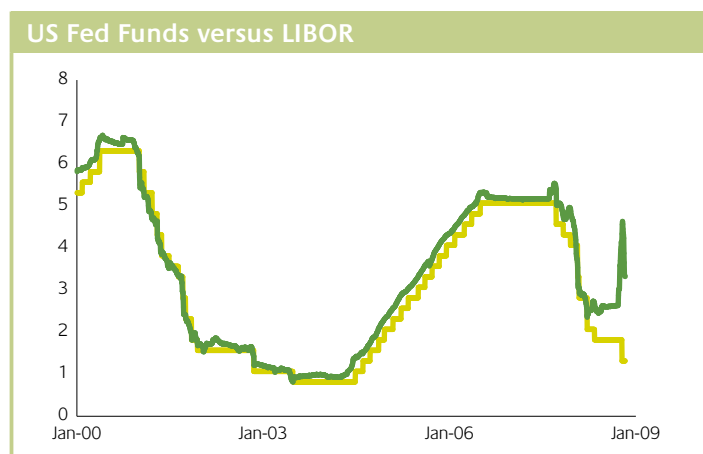
As with the Savings & Loan crisis of the late 1980s, the final cost of the rescue package is unlikely to be the full US\$700 billion. It is even possible that the government will make a profit on the exercise.

The problem of LIBOR

The reluctance of banks to lend to each other is a global issue. Many banks borrow funds on international money markets. The benchmark or standard interest rate against which funds are borrowed is known as LIBOR – the London interbank offered rate. Companies generally borrow at a rate above LIBOR depending on their credit rating.

Normally LIBOR for US dollar borrowing hovers a little above the US Fed Funds rate, its official cash rate. In recent months, due to the reluctance of banks to lend to each other, LIBOR has moved much higher than the Fed Funds rate – meaning that borrowing rates for companies have increased despite the US cutting its official interest rate.

The Troubled Asset Relief Program (TARP), combined with actions by other governments is beginning to see LIBOR fall back towards the US Fed Funds rate. This is good news for the world economy.



Source: RBA: Statement on Monetary Policy August 2008. BI

The global response

In mid-October 2008 a meeting of finance ministers from major economies, known as the G7 and the G20, agreed to work together to achieve the 5 points listed below. At the same time, many of the nations reduced their official interest rates.

1. Take decisive action using all available tools to support struggling financial institutions and prevent their failure.
2. Take all necessary steps to unfreeze credit and money markets.
3. Ensure that banks can raise capital from public as well as private sources, in sufficient amounts to re-establish confidence and permit them to continue lending to households and businesses.
4. Ensure that savers' deposit insurance and guarantee programs are robust so savers have confidence in the safety of their deposits.
5. Take action, where appropriate, to restart the mortgage securitisation¹ markets.

¹ Securitisation is a process where financial institutions turn a large number of loans (such as mortgages) into bonds. The value of the bonds depends on the capacity of people to repay their loans. The bonds are sold to investors who want a flow of income.

² Address given by Glenn Stevens, Governor of the Reserve Bank of Australia to the Trans-Tasman Business Circle Business Luncheon, Sydney - 21 October 2008 entitled Australia, New Zealand and the International Economy (http://www.rba.gov.au/Speeches/2008/sp_gov_211008.html).

In attempting to achieve these aims, European nations have leant towards guarantees of bank deposits and providing capital directly to the banks. Governments have become major shareholders in banks. A foretaste of this approach occurred when the UK government effectively nationalised the UK bank, Northern Rock.

The Australian response

Australia was in the fortunate position of having a well regulated and profitable banking system. Our financial system was not highly exposed to US sub-prime mortgages. However, a number of companies had levels of debt that became a problem when credit markets dried up.

Steps taken in Australia include:

- The Reserve Bank of Australia ensured money was available to keep overnight Australian interbank interest rates close to the target for the official interest rate.
- Official interest rates were cut.
- Bank and some other financial institutions' deposits were guaranteed as was interbank lending.
- A \$10.4 billion government spending package was announced.
- A government agency will purchase mortgage-backed securities from non-bank mortgage lenders. These securities are backed by Australian mortgages but are currently difficult to price or sell in the current environment.

Will the rescue packages work?

The rescue packages will keep the global financial system from falling apart.

The key issues of providing capital for banks and ensuring that banks can lend have been addressed. The various rescue packages have also restored a degree of confidence back into the global financial system. As the Governor of the Reserve Bank of Australia noted, "the likelihood of a global catastrophe has in fact declined over the past couple of weeks".²

There is still much to be done. The details and the mechanics of the multiple rescue packages have not been fully worked out. But help is on its way.

What the rescue packages cannot do is guarantee ongoing economic growth in the short-term. Australia is relatively well placed to ride out the economic turmoil but the same cannot be said of the US. If credit from US banks remains in relatively short supply, economic recovery will be slower than in past.

Consumer debt in the US was at very high levels and appears set to contract. Given that consumption makes up 70% of the US economy, a recession in the US appears virtually impossible to stave off – indeed many suggest the US is already unofficially in recession.

This is not the case in Australia but nonetheless, economic growth is likely to slow for a while given the disruption to global economic activity. Stronger economic growth will re-emerge after a period of adjustment. We cannot be sure how long these adjustments will take but like crises of the past, they will come to an end – especially given the size, scope and determination of the rescue effort.

Risks remain. Businesses and consumers are de-leveraging or reducing their debts. In many cases this requires the sale of assets. In the mean time, interest rates are falling; government spending packages are increasing and the currently announced packages are being implemented.

(1) Address given by Glenn Stevens, Governor of the Reserve Bank of Australia to the Trans-Tasman Business Circle Business Luncheon, Sydney - 21 October 2008 entitled Australia, New Zealand and the International Economy

Some background reading:

1. The cost of US Savings & Loans rescue package.

http://www.fdic.gov/bank/analytical/banking/2000dec/brv13n2_2.pdf

2. The stability of the Australian financial system

http://www.rba.gov.au/PublicationsAndResearch/FinancialStabilityReview/Sep2008/Html/financial_stability_review_0908.html

3. The cost of previous rescue packages

<http://www.bankofengland.co.uk/publications/fsr/2001/fsr10art5.pdf>

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