Take stock, this is going to hurt

The economic meltdown in the US will affect every Australian household and business, writes national affairs correspondent **Jennifer Hewett**

SO what happens now? Confusion about the answer is no longer the preserve of the financially naive. All those well-paid investment bankers, sophisticated financial analysts and aggressive market traders are scared to go to sleep at night for fear of what unimagined new horrors the next day may bring. Suddenly, leaving it to the market to efficiently sort out has become a very old-fashioned idea. Instead, the titans of Wall Street are reduced to begging for help from Washington while governments across the world frantically try to figure out how to contain a spreading, unpredictable mess.

Despite a manufactured political argument in Canberra about whether Wall Street is "light years away" from Australia — or somewhat less — the public won't have to wait long to discover financial reality.

There is an intimate connection between every home and business in Australia and whatever happens in high finance brought low in New York or London.

Try rising domestic unemployment, companies closing or not expanding because they can't get credit and continuing pressure on Australian bank interest rates no matter what our Reserve Bank does. When the cost of borrowing money on overseas markets soars, as it is doing right now, the Aussie banks' cost of funding soars, too. None of the standard political rhetoric about excessive bank profits can overcome that basic dilemma and, given the extreme nervousness about the stability of the banking sector, it's probably risky for politicians to even attempt it.

Likewise, the Rudd Government's big investment plans for infrastructure look more difficult to put into practice, as well as far costlier. And forget early retirement for anyone relying on a steadily expanding pool of superannuation money. Poof!

Yes, the Australian economy, as Kevin Rudd keeps firmly insisting, is relatively strong and resilient enough to weather the shocks ahead. The Australian banks, despite their ever-increasing write-offs and plunging share prices, are indeed in much sounder shape than many of their counterparts.

But life is still likely to become a lot tougher for many Australians, whether it's through losing their jobs, their houses, a lot of money on their investments or just the comforting illusion of the "wealth effect". Households borrowed up big during the past decade and, as a strategy, it worked remarkably well to increase the value of their assets. Now all that debt seems much more toxic, just when it's harder and less profitable to sell anything to pay it off.

What is clear is that the worst thing for people to do is panic, as the Government appreciates. Unfortunately, there has been no avoiding the panic of the market. The Australian share market, for all the strengths or tribulations of various individual companies, remains hostage to international investor sentiment, now more than ever.

Think of that sentiment as a kind of giant global mood swing that can change in an instant, depending on the medication available. This weekend's feel-good pill is the idea the US will soon legislate to take over hundreds of billions of dollars of bad debt or problem assets from US banks, perhaps as early as next Monday. It certainly helped the general level of confidence recover from the battering of the past week.

Despite a shocking few days, the Australian stock market also went up sharply on Friday by more than 4 per cent. This was after the world's central banks injected more than $US180 billion ($222 billion) into the global banking system to try to reduce fear and get credit flowing again. But it would be a brave investor anywhere in the world who decides the worst is really over.

Problem shares are shares halved: Share prices light up the board at the Australian stock exchange this week as the world's central banks scrambled to avert a global crisis Picture: AFP

Times change: News of the Lehman Brothers collapse breaks in Times Square, New York

Progressive saver: The US Government came to the rescue of insurer AIG

The optimists have pointed to signs of a flickering recovery at various times during the past year, only to be disappointed as it dies again. And that was before the past week from hell. More stomach-churning slides in share prices are inevitable, as is the likelihood of more famous, supposedly impregnable, institutions abruptly vanishing.

The comparisons with the Great Depression of the 1930s are becoming as frequent as they are ominous. The difference is supposedly that those in charge are more ready and able to take co-ordinated action to try to ward off disaster and prevent systemic collapse.

That's the theory, anyway. And it's true that authorities everywhere — from Russia to China — are trying to mount concerted rescue actions for faltering share markets and any banks in trouble. When and whether this will work effectively remains less obvious. Any sustained fix will have to come out of the US, where it all started, with Britain playing a supporting role, and perhaps some more money from Asian sovereign wealth funds.

Quarantining the bad debt is certainly a start, assuming it is possible. Free market? What free market? These days, it's all about government support and direction, even at the price of increased regulation. A looming financial cataclysm tends to make the most resolute master of the universe quiver. But the odd few billion dollars of support turns out to be chump change. It has to be in the realm of many tens of billions of dollars to even register; presumably much, much more for any type of secure safety net.

The US authorities' preparedness to take on bad debts shows how great the price of not acting is considered to be. Already, the rollcall of the fallen would have seemed incredible just a short time ago. The mighty are indeed humbled.

Two of the big five investment banks in the US, Bear Stearns and now Merrill Lynch, for example, have had to accept marriage proposals that slashed the value of their once-vast dowries. Another investment bank, Lehman Brothers, was far too picky about its possible suitors. With the Federal Reserve unwilling to step in as marriage broker, Lehman ended up left for dead early last week. That meant Morgan Stanley was desperately looking for another marriage of convenience while hedge funds and other speculators relentlessly attacked its share price.

Goldman Sachs is the strongest of the lot, but it knows no one can feel safe in a world where fear and rumour can so brutally destroy reputation and record.

Nor is it just the investment banks. The US, home of unbridled capitalism, had already effectively nationalised its two biggest mortgage brokers, Fannie Mae and Freddie Mac, earlier this month. As house prices kept falling, their financial troubles just kept rising. It was a vicious circle. This also explains why Britain's largest mortgage lender, HBOS, has been taken over by Lloyds for a fraction of what it had believed it was worth, until recently. And it all happens so fast.

As of last weekend, for example, no one was predicting an imminent government rescue of American International Group. After all, AIG was no ordinary company. It was the world's biggest insurer with assets of $US1 trillion. Unfortunately, AIG too had become seduced by the money to be made in all those fancy new financial instruments, none of which the experts apparently understood could turn bad. That convenient self-delusion encouraged AIG to become involved in writing $US450 billion in contracts betting or insuring against the risk of other companies defaulting on their debts. In the jargon of the market, these are known as credit default swaps, which now cover more than a staggering $US60 trillion of debt.

Yet somehow all this seemed safe as houses. . . . which, of course, proved not to be safe at all.

Within a few days, the Federal Reserve had decided that if it didn't quickly lend AIG up to $US85 billion, no one else would help the toppling giant either, and that would reverberate throughout the financial system with consequences too dangerous to contemplate. Lehman Brothers' bankruptcy has already shattered nerves. Allowing an AIG failure would have been like unleashing a whirlwind to knock over those still holding on grimly.

Part of the problem is the need for absolute confidence in financial institutions. When most companies' share prices get mauled, it can be difficult and painful, particularly for those directly involved. But it's not a mortal threat to the whole system. A bank run is. Despite all the esoteric terms being used, that is effectively what is at stake.

Trust is the essential lubricant. Banks don't even trust one another any more. No one knows where the next implosion will take place or where the bad debt stops. That means they are also not lending at all, or at absurdly high rates. It won't take long for that approach to cripple an economy, which is another reason central banks are pushing in money to the banking system as fast as they can. But the immediate concern is trying to bring some semblance of order to an unravelling market.

The other complication is the feverish activity of hedge funds. In a falling market, these hedge funds are ruthlessly targeting the vulnerable, including financial institutions, betting on the fact their share prices can be forced lower.

They help achieve this effect primarily through the magic-pudding technique of short selling; that is, selling shares they don't yet own, known as naked short selling, or shares they have borrowed, known as covered short selling. The idea is to then buy the shares later at a cheaper price and pocket the difference. It's risky business but usually highly lucrative.

In a normal market, short selling by hedge funds and speculators hardly wins popularity prizes. But it can also force companies to own up to problems sooner, increase liquidity and thus make the system as a whole work more efficiently.

This, however is not a normal market. Nothing like it. And in a climate of fear, deliberate rumours of bad news for companies or sectors can become eerily self-fulfilling. Britain has banned short selling in all financial companies until January 16. The US had already temporarily banned the particularly aggressive forms of short selling of 19 financial institutions. It is considering broadening that ban, while New York Attorney-General Andrew Cuomo has announced an inquiry into the spreading of false information that accompanied hefty share-price drops in companies such as Lehman Brothers.

In Australia, the Government has been very cautious in instituting any changes despite lengthy consultations with business.

But by late yesterday afternoon, partly provoked by the actions of Britain and the US, and the seesawing pressures on financial institutions such as Macquarie, the Government finally moved. The Australian Securities and Investment Commission announced an interim ban on naked short selling effective from next Monday. It will also require more disclosure on covered short selling.

For most Australians, this would sound incomprehensible or relatively unimportant. It's neither. We are all market players now, even if we don't quite realise it.

The week capitalism took a battering

The bloodbath on Wall Street will reverberate for a long time, writes economics editor **Michael Stutchbury**

Bailout: The US Government has pulled out all stops to ensure the survival of the financial system

WE have just experienced the most terrifying purge of financial leverage the world has seen. Thirteen months after the US sub-prime mortgage crisis began, the world's economic and military superpower this week threw its fiscal authority at ensuring global financial capitalism survived the ordeal.

Rather than old-fashioned bank runs by depositors, the reckoning has been led by investors, funnelled through Wall Street and the City of London.

The sharemarket collapse of brand-name Wall Street investment banks that had survived the Depression has paralysed global credit markets, adding to the global liquidity crisis. Banks have become afraid to lend to other banks, producing sharply higher costs for short-term finance, including for the funding of Australian mortgages.

With a lame-duck president in the White House, US Treasury Secretary Hank Paulson and US Federal Reserve chairman Ben Bernanke on Monday allowed the system to purge itself, standing by as 158-year-old Wall Street investment bank Lehman Brothers filed for bankruptcy. Fellow investment bank Merrill Lynch got the message and fell into the clutches of Bank of America.

That appeared to draw a line in the sand against further socialisation of Wall Street's losses. In March, the Fed had extended a $US29 billion loan bailout to investment bank Bear Stearns (founded 1923) as part of a fire sale to JP Morgan Chase. And in the first week of September, Paulson effectively nationalised Fannie Mae and Freddie Mac, the two giant US mortgage underwriters, one of which dates back to the 1930s New Deal.

But after letting go of Lehman Brothers, Paulson and Bernanke blinked on Tuesday when the world's biggest insurance company, AIG, teetered under the weight of its highly leveraged corporate default insurance losses. Bernanke lent AIG up to $US85 billion in return for Washington getting 80 per cent ownership of the 89-year-old firm.

On Thursday, Bernanke's Fed led central banks from Europe, Japan and Canada in injecting $US225 billion of liquidity into the seized-up global credit system. And yesterday Paulson started talking about a plan to get to the "root of the problem": falling US house prices weighing on bank balance sheets.

How did it get to this?

The macro story can be traced back to the rise of China early this decade. The surplus capital China built up exporting factory goods to the US was recycled into Wall Street. Smarting from the sharemarket tech-wreck, then Fed chairman Alan Greenspan cut official interest rates as low as 1 per cent.

Armed with modern computing power and sophisticated mathematics, the US investment banks leveraged this cheap and easy credit into increasingly complex financial instruments. Most toxic was the highly geared securitisation of housing loans to low-income Americans.

These bundles of tradeable securities contained a time bomb: the hidden risk produced by separating borrowers from lenders with a vested interest in monitoring the creditworthiness of the loan.

Traditionally, this was the role of the local bank manager. Now this sub-prime risk became buried in unintelligible algorithms of securitised mortgages.

As more money was pumped into low-income housing borrowing, US house prices began to rise, turning into an old-fashioned debt-financed asset bubble. Unlike in Australia, the US central bank turned a blind eye. When the bubble inevitably burst, the US system of non-recourse lending allowed borrowers to simply walk away from their bad dream homes, a financial accelerator that drove house prices down even further.

While centred in sub-prime mortgage lending, complex leveraged products spread throughout the US financial system, again driven by the investment banks. "The sophisticated financial system of the 21st century was supposed to spread risk, but a lot of the risk ended up being concentrated on the books of highly leveraged institutions," Reserve Bank of Australia governor Glenn Stevens said this week. "High risk and high leverage proved to be a fatal combination. It always does."

Will this change the world?

The big immediate question, of course, is whether Paulson and Bernanke's emergency interventions calm the panic and stabilise the market. No one knows, notwithstanding Wall Street's rally on Thursday night.

So far, the world economy has remained surprisingly resilient to the financial crisis, though the US, Britain and Europe could easily fall into recession over the coming year.

Former International Monetary Fund chief economist Ken Rogoff this week suggested that the debt obligations taken on by the US Government as part of the financial crisis amounted to a manageable $US200 billion to $US300 billion, or about one more year in Iraq.

But Rogoff suggested that the ultimate cost of the taxpayer bailout was likely to rise to $US1 trillion to $US2 trillion. Much like the Vietnam War in the stagflationary '70s, this would push up taxes and encourage an inflationary solution to the debt burden.

In turn, this could further weaken the greenback's role as the linchpin of the international financial system. And it would undermine Washington's fiscal capacity to maintain the military superiority of Western democracies against threats ranging from Islamic fascism to Russian nationalism, Chinese opportunism and North Korean who-knows-what.

On the other hand, investors have disciplined Vladimir Putin more than Europe and US politicians have dared in the wake of Russia's aggressive military incursion into Georgia. It may be a Wall Street crisis, but Moscow boasts the world's worst performing share market of 2008.

When the dust settles, New York and London surely will lose much of their vitality as global financial capitals. The US investment bank model will give way to back-to-basics banking such as the Bank of America, Wells Fargo and — hey — Australia's big banks. In Australia, the Macquarie model of highly leveraged management of infrastructure assets will struggle.

Australia remains cushioned but not immune.

As a big importer of capital, Australia is highly vulnerable. Although our share market has sold off sharply, so far we've been spared the worst for three main reasons.

First, our big banks — Westpac, the Commonwealth, the National Australia Bank and the ANZ — have remained more like traditional British high street or US main street banks than the Wall Street investment banks. With some exceptions, they have not gone deeply into exotic financial products. They remain well capitalised and profitable.

Second, by lifting official interest rates, the Reserve Bank took some of the steam out of our housing price boom. Australia did not indulge in US-style sub-prime lending.

Third, the China boom will keep fuelling demand for Australia's mining and energy exports. Stevens maintained this week that the China boom will not go away, even if it comes off the boil as China's exports to the US weaken.

Nevertheless, Australian households have some bills to pay. Stevens called the end of the big Australian financial story of the past 15 years: the debt-fuelled expansion of household balance sheets.

From the early '90s to 2007, Australia's household debt burden more than tripled as a multiple of household income. Even without sub-prime excess, Australians still lapped up the global supply of easy credit.

Australians felt comfortable going deeper into debt because the value of their assets nearly doubled as the stock market boomed and housing prices soared.

They borrowed against their increased wealth to finance bigger houses, new boats and overseas holidays.

Now the purge of global financial capitalism is making Australians poorer by hitting the share market and housing prices. That's forcing them to pay off debt and to cut back on the good life. Those approaching retirement will have to keep working for a few more years because 20 per cent or so has been slashed from their super funds.

The good news is that the China boom continues to hold up Australian incomes. The potential bad news is that unemployment is set to rise. That could cause mortgage delinquencies to jump and housing prices to turn down sharply. That's when Australia's back yard could turn very nasty.

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G EORGE W. Bush says the US Congress has to understand that the financial crisis has gone far beyond New York and Wall Street and that it is now affecting ''hardworkin' people'' in the US heartland. If only it were that simple ... or that contained.

This crisis may have started in the US, but there's no escaping its effect everywhere — from Reykjavik to Brussels, from Dublin to Bankstown. It's clear that at least some of those people won't be so hardworkin' either because they will be unemployed instead. That's because, beyond the international financial panic of the moment, the broader question is how severe an impending global recession will be.

The dramatic gyrations — sometimes up but still mostly down, down, down — of the stock market are only the most public symptom of this rolling disaster. Think instead of a much less visible, but far more dangerous enemy, the total blockage in the credit markets.

Credit is what makes any modern economy function. It's what consumers use to buy cars and houses. It's what companies use to expand their businesses or just keep them going. It's what provides jobs for employees. It's what banks supply to their customers, big and small. And now it has simply vanished.

Banks everywhere no longer want to lend, even to one another. This has been a problem on and off for the past year. But in the past few weeks, it has become extreme as the tottering financial system keeps losing its balance and the casualties mount.

The immediate result is like a bank run, but of investors rather than depositors. It means the banks are hoarding whatever money they do have as their own version of life insurance in this unpredictable climate. And if financial institutions do lend, they charge rates that are so exorbitant most customers can't afford to borrow. That is if those customers have the nerve to take on any more debt right now. Mostly, the natural instinct is to cut where they can, particularly the longer the chaos goes on.

Official interest rates can become almost irrelevant in this equation. Normally they are only a fraction below the unofficial rates used by bankers among themselves. Not now. Fear begets fear.

Warren Buffett, regarded as the world's canniest investor over several decades (see opposite page), has been happy to spend at least $US8 billion ($10.2 billion) buying shares in the giant General Electric company and Goldman Sachs bank in the past few weeks. But he still insists there's no point in being unrealistic, maintaining that economic problems are going to become worse. What he can't predict, he says, is whether that unhappy situation will last for six months or two years. Or longer.

That's even assuming a skittish US House of Representatives finally does pass a version of the original $US700 billion bailout bill today after failing to do so so spectacularly last week.

Not that it's supposed to be called a bailout any more, particularly not a Wall Street bailout. Sarah Palin strongly attacked what she called ''corruption on Wall Street'' during the US vice-presidential debate yesterday while community disgust at the greed of executives, particularly at those big investment banks, will only grow in intensity. And four weeks from an election, it doesn't help voter sentiment that there's a lot of Republican and Democratic finger-pointing going on about who's most to blame for a system so out of whack.

But aware of the damaging resonance of the Wall Street tag, most American politicians of both parties are trying to recast the bill as a ''rescue package of Main Street''.

They are belatedly desperate to remind voters that the two streets always do intersect. Unfortunately, it looks ever more probable that Congress and the Bush administration have left it far too late to avoid the world's biggest-ever crash at that same intersection. Now it's a matter of trying to limit the carnage.

In that sense, the passage of the rescue bill is increasingly regarded as less a solution than a start. It won't be enough to completely restore confidence or avoid recession. It's more an issue of avoiding still worse: an uncontrollable series of financial panics leading to a longer recession leading perhaps even to, gulp, depression.

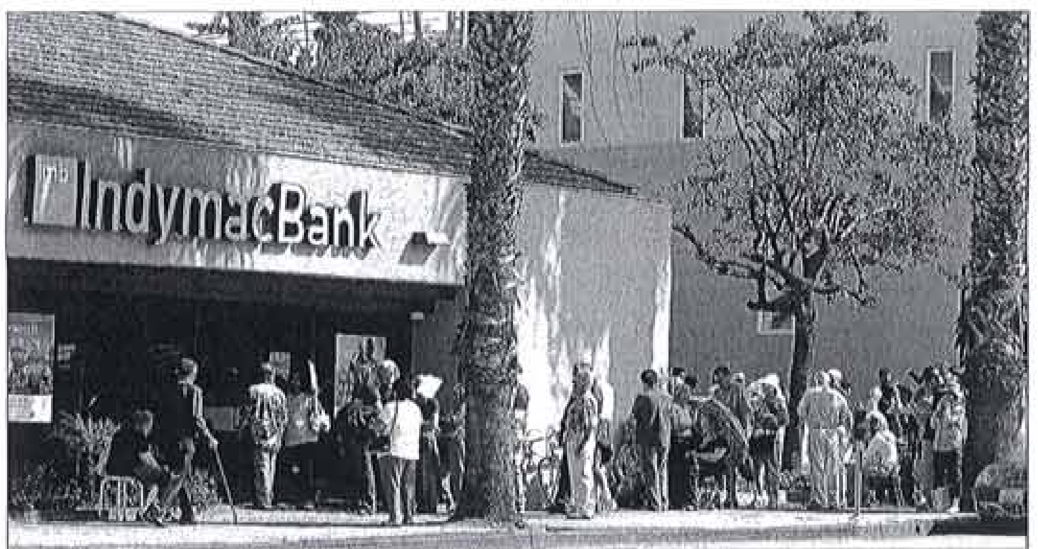
As he voted for the bill in the Senate, Barack Obama described it as preventing ''crisis from becoming catastrophe''. Here's hoping.

The world usually does manage to muddle through eventually. Governments, despite the US congressional fiasco, are far more willing to act to try to ward off disaster. But with each new day, confidence is waning about the ability of the whole system to manage even that more modest manoeuvre.

Europeans have stopped being quite so vehement in their denunciations of American capitalism as they struggle to save their own financial institutions, for example. It turns out that most European banks are more highly leveraged than most modestly sized American ones. In Ireland, the decision by the Irish Government to guarantee bank deposits and debts from its six biggest banks for the next two years has attracted ire from the British Government and banks because it's encouraging British depositors to switch to Irish banks.

In Iceland, a government that had been thrilled to embrace the benefits of the free market for the past decade has now bought 75 per cent of Glitnir, its third-largest bank. Outbreaks of panic have hit banks in Hong Kong, India and Russia before being calmed by government assurances.

The significance and sensitivity of this international drama will overwhelm the political argument in Australia about whether the big banks should pass on in full the expected Reserve Bank of Australia reduction in official rates next week. Malcolm Turnbull points to still healthy Australian bank profits and says yes. Kevin Rudd has suddenly become far more cautious about what he now refers to as the need for ''maximum pass-through''.



Now for the good news: Customers line up at the IndyMac Bank in Santa Monica, California, as the federally seized bank was set to reopen

Credit crunch is here to stay

Now that the US has caught pneumonia, can we still get away with just a cold? That is the question for us, writes national affairs correspondent **Jennifer Hewett**

Final frontier: An advertisement for home loan modifications in Moreno Valley, California

The bad news is that what's at stake is far more serious and damaging than this surface political rhetoric. It's more an issue of how best to survive the threat to every part of the economy that comes from all banks becoming hoarders rather than lenders as they find it ever more difficult to borrow themselves.

Even the vast amounts of money being injected into the global financial system by central banks, and the likelihood of more cuts in official rates to come, haven't altered that. And no matter what the Australian banks choose to do next week, they too remain captive to the much bigger forces at work internationally. Prime Minister Rudd pointed out yesterday — again — that Australia's big banks constitute four of the 20 double A-rated banks in the world.

''It's really important in terms of the future of credit arrangements worldwide because when credit unfreezes — and that's why the passage of this package before the US Congress is so important — then lenders will look at credit ratings of major banks around the world,'' he declared.

When will that be? No one can be certain of the answer.

The theory behind the US bill is to put a floor under falling housing prices and all those complicated derivatives and insurance products linked to them. The US Government is trying to provide a circuit breaker by buying these distressed assets at prices that are better than anything the market can provide. That still means the banks have to account for big losses on their balance sheets, and possibly return to Washington (don't tell anyone) for even more injections of capital as a result. It's just that the even more insidious fear of the unknown would supposedly be kept at bay in the meantime.

And it's that great unknown that is haunting the market and keeping all banks on edge. So while declining US housing prices may remain at the centre of this deadly vortex, the sub-prime mess has sent out ever-widening alarm signals that continue to reverberate around the globe.

Companies everywhere will be the victims of this pathology whatever their markets or the wealth of their customers. They can't really raise money. Neither can their clients. Luxury carmakers such as Porsche in Europe are suddenly unable to predict their normally robust growth, for example. Sales of Ford Motor cars in the US dropped more than 30 per cent last month on the previous September — as did car sales in Spain. The overall effect is a large bucket of sand being thrown into the engine of the whole world economy.

Although the Rudd Government remains keen to emphasise that the Australian economic and financial systems are well placed to manage the problems, ministers always add the caveat that no country can remain immune.

Of late, that caveat has been much more pronounced. The optimists still insist that the resources boom will continue to drive Australia through the worst of any downturn. And it is true that the prices for Australian exports of commodities, particularly iron ore and coal, have given the country the equivalent of a giant economic airbag against any sudden braking.

But despite the optimism of companies such as Rio Tinto and BHP Billiton that China will need and be willing to pay for ever larger quantities of Australian resources to support its mass-scale urbanisation, many others are becoming far more apprehensive about the pace of China's growth in the future. Even a few months ago, the expectation was the Chinese economic growth rate, hit by the decline in its exports, would fall by a couple of per cent at most — down to a still surging 9 per cent or so. That's looking like a brave prediction these days. The big falls in the shares of all Australian resources companies, along with the global prices of most commodities, reflect that suddenly more sombre assessment.

Certainly, no one is going to feel sympathy for Fortescue Metals' Andrew Forrest, least of all Forrest, over the fact that his reign as Australia's richest man has been so shortlived. But apart from the odd $5 billion of his personal fortune that has suddenly evaporated, the broader sharemarket concern is that the would-be iron ore giant can no longer rely on getting international financiers to fund the company's expansion. The ever-resilient Fortescue insists it can still manage to increase its production as planned using its own cashflow. Still, with general confidence sagging so badly, there's a lot less willingness to give any individual business the benefit of the doubt.

And while much of corporate Australia actually has relatively low debt levels, the same can't be said of consumers. On average, our household debt is 158 per cent of household income, largely thanks to still expensive Australian house prices. Then add in the more urgent requirement to pay off credit card debt. That makes consumers a lot less prone to show forgiveness or flexibility when things go wrong.

How wrong? Despite hot spots such as western Sydney, Australia does have a very small percentage of mortgages in arrears. This is thanks to generally tighter lending practices than the US. And that difference, by the way, is not just the fault of the laissez-faire Republican administration. The Democrats in Congress during the Clinton presidency were the most enthusiastic about encouraging loans to poor households, often through the good services of the now nationalised Fannie Mae and Freddie Mac. With rising asset prices, why not?

But now that is all history and the immediate future looks bleaker for everyone, the surprise booby trap hidden in the march of globalisation.

As Treasury Secretary and former Goldman Sachs head Hank Paulson noted before he gagged himself, there's a lot of blame to go around. That blame is likely to spread over all governments as well as investment bankers. Consumers can only hope it doesn't bury them as well. Pay now. Buy later.

Banking on the rescue squad

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funding vulnerability highlighted by the International Monetary Fund. As investors, Australians have lost faith in banks, suspecting they continue to hide toxic assets on their balance sheets. Banks don't trust other banks.

But, in the middle of a global banking crisis, Australian savers trust the banks with their money. Many Australians still believe that the Government guarantees bank deposits, just like the formal guarantee announced by the Irish Government this week.

In fact, there is no explicit government guarantee in Australia. And depositors cannot buy deposit insurance. However, governments have form in protecting policyholders (the HIH failure) and depositors (the state banks of South Australia and Victoria) from failed insurance companies and banks.

''The long history of depositors not suffering losses in bank failures, in part due to government intervention, creates the impression that there is an implicit government guarantee of deposits,'' the IMF concluded in a confidential part of its 2006 review of Australia obtained by *Inquirer*.

The risk of deposit guarantees is the ''moral hazard'' of drawing savers to high interest rates offered by risky banks. Instead, Australian bank depositors are protected by depositor preference. They come first, ahead of creditors and shareholders in the case of a bank failure, which all but guarantees their deposits are safe.

However, the Reserve Bank's Stevens and APRA's Laker watched in alarm at the depositor run on Northern Rock in September last year, the first run on an English bank in more than a century.

Britain's depositor guarantee did not prevent the run, in part because depositors figured it would take months to get their money out of a collapsed bank.

Stevens and Laker responded by dusting off a proposal previously put to Peter Costello following a review by University of Melbourne finance expert Kevin Davis.

In June, Swan announced a so-called financial claims scheme, which would guarantee early payment of up to $20,000 to depositors and policyholders of failed banks and insurers. It would make sure families got their mortgage repayment and supermarket money if their bank went under. It's a form of household liquidity guarantee.

For the past two decades, Australia has been keen to undercut the market power of its big banks. Paul Keating let in the foreign banks. Under Costello, the mortgage securitisers took market share. Both sets of competitors are now in retreat.

With a once-in-a-century financial crisis at the door, even a Labor Government figures it has no alternative but to rely on the bastard banks to keep the Australian economy afloat.

THE ARRANGEMENT

A memorandum of understanding on financial distress management

OBJECTIVES:
- Protect depositors, policyholders and superannuation fund members, with view to avoid or minimise losses.
- Maintain stability in, and confidence of, the financial system.
- Resolve distress situations effectively and quickly.
- Ensure owners, directors and managers of distressed or failed institutions bear appropriate responsibility.
- Minimise economic and budget impact of distress and maintain market disciplines.

RESPONSIBILITIES:

Glenn Stevens, governor, Reserve Bank of Australia:
- Maintain stability of financial system, including the payments system.
- Assess systemic impact of financial stress and advise Treasurer of emerging stress.
- Provide liquidity support for the system and distressed institutions.

John Laker, chairman, Australian Prudential Regulation Authority:
- Protect interests of bank depositors, insurance policyholders and superannuation fund members.
- Monitor and prudentially supervise banks, insurers and superannuation funds.
- Assess distress in supervised institutions and advise Treasurer.
- Appoint statutory manager to distressed institutions.
- Manage the Financial Claims Schemes guaranteeing $20,000 a depositor.

Tony D'Aloisio, chairman, Australian Securities and Investments Commission:
- Enforce corporations and financial services laws, promote market integrity and consumer protection across financial services payments system.
- Monitor financial service providers and advise on emerging vulnerabilities.
- Assess regulatory implications of distress for financial markets and investors.
- Supervise public disclosure by distressed institutions subject to Corporations Act.

Ken Henry, secretary, Treasury:
- Advise Treasurer on policies promoting a sound financial system, including managing financial distress.
- Advise Treasurer of economic and budget implications of threats to financial system.
- Advise Treasurer on the exercise of his powers.

Businesses here are plagued by the same anxiety and blockages in the banking system as their counterparts overseas, writes national affairs correspondent **Jennifer Hewett**

Taking action: Pedestrians pass in front of the Reserve Bank of Australia building in Sydney; the RBA has cut its rates by 1 per cent Picture: Bloomberg

Crisis needs a global solution

KEVIN Rudd keeps saying that Australian banks are strong, well capitalised and well regulated. And he's absolutely right. They are. It's just that even impeccable logic isn't quite so reassuring when the rest of the world's banks are hostage to rapidly rising panic.

Not that there's been any suggestion of a substantive run on the banks in Australia. Anything but. Sure, there are plenty of individual instances of people taking their money out to pad their mattresses.

But in general, Australian banks are still regarded as the safest place for customers to keep their cash.

At the Commonwealth Bank in particular, it's like the revenge of the cardigans. Retail depositors are proving extremely keen on putting their funds in the CBA as the ultimate safe haven.

But there's no doubting the fragility of confidence as the bad news keeps washing in from offshore. Every day, it seems there's a higher king tide. And every day, as none of the bigger and bigger "rescues" appear to be working, the nervousness in Australia becomes more pronounced.

Ironically, the moves by other governments to either buy direct stakes in their banks or provide unlimited guarantees for deposits are actually increasing the pressure on local banks. "The question now is whether Australian banks are at a competitive disadvantage because they don't have (or need) a government guarantee," one banker says.

"What a paradox. The good banks are now relatively weaker because they are not government-owned."

It's also why Opposition Leader Malcolm Turnbull is suddenly demanding that the Government increase its proposed deposit guarantee scheme in financial institutions from a maximum of $20,000 to $100,000.

This scheme has been in the works for months, an additional insurance cover in response to an earlier recommendation from the Financial Stability Forum operated by the Group of Seven leading industrial nations.

The legislation is still to be introduced to parliament, evidence of the lack of urgency about it, given the strength of Australian banks. It was seen more as an example of Australia's willingness to work with international systems and regulators. Yet, suddenly, events have more than caught up.

That's despite the fact that even at $20,000, the guarantee would cover the overwhelming majority of Australian depositors — 80 per cent to 85 per cent.

Australia has also long had a "depositors' first" approach whereby depositors have first call on the assets of any bank that gets into trouble. But what do the the facts matter in a climate like this? Fear begets fear. It's now rampaging everywhere.

Of course, the call from Turnbull won't help settle the public's nerves. Just the opposite. But it reflects the reality: growing apprehension will lead to demands for more solid guarantees. It is a truly vicious market circle.

As the CBA's new move on BankWest and Westpac's planned takeover of St George Bank demonstrate, the bigger Australian banks are betting on their ability to grow, including by taking advantage of others' current problems.

Treasurer Wayne Swan, who's in the US for the Group of 20 emergency meeting on the global financial crisis, declared yesterday from Washington that there was a "world of difference" between Australia's banking and financial system and those elsewhere.

But even the relative stability in the Australian banking system can't avoid being rocked by the scale of the disaster offshore. The dizzying fall in the banks' share prices over the past year is only part of that. Likewise the big four banks' much celebrated AA rating is fine as far as it goes — but that's not so far any more. The horizon is no longer visible.

Still reassuring: Prime Minister Kevin Rudd and Treasurer Wayne Swan

The larger issue is the confidence in the banks being able to borrow — either from each other or the wholesale markets. Australian banks rely heavily on their borrowing offshore to supplement the money they get from Australian retail depositors.

Right now, the experience is more like having the door slammed in their faces. No funds available, go away.

That dilemma is compounded by the banks' own reluctance to lend money. The banks are hoarding whatever cash they do have, just in case. It almost doesn't matter how long their clients have been clients or how good their record is. Safety first.

The reaction is getting worse because the international crisis of confidence in the credit markets shows no sign of ending.

That is despite governments everywhere throwing money at the financial system in amounts and ways that would have seemed inconceivable even a few weeks ago. The succession of bleak and bleaker days on the global stock markets is terrifying enough. The Australian market closed down by more than 8 per cent yesterday — the second biggest one-day fall on record and 40 per cent down on a year ago.

What is more terrifying, although less obvious, has been the fact that the cost of borrowing has still been going up for everyone. There has been some slight relief in overnight borrowing rates between banks — but not for anything longer term.

The result is the total failure to get credit flowing through the financial system. Without it, everything just shuts down. And that is just what's happening now.

The central bankers and finance ministers gathering in Washington this weekend will be desperately trying to find a circuit breaker. What has been so remarkable is their total inability to do so.

Instead, the government-backed responses have constantly been outpaced by what is happening on the market. Their reaction always seems too little, too late. Actions by individual governments just haven't been convincing.

In some cases, such as the Irish Government's initial decision to guarantee bank deposits, attempts at stability have only destabilised the efforts of its neighbours to maintain a semblance of control.

And clearly, having central banks cutting interest rates and pumping hundreds of billions of dollars into the system is important, but not nearly enough.

The world's main central banks have already taken unprecedented and co-ordinated action to cut interest rates last week, shortly after the 1 per cent reduction from the Reserve Bank of Australia.

Nor is the rate reduction cycle confined to the developed world. China has cut its interest rates. India followed suit on Friday with a 1.5 per cent reduction.

From next week, the European Central Bank will also offer European banks as much money as they need at its relatively low benchmark interest rate.

But just look at what has happened in response.

Nouriel Roubini, professor of economics at the New York University School of Economics, says that investors have totally lost faith in the ability of policy authorities to control the meltdown.

"This disconnect between more and more aggressive policy actions and easings and greater strains in the financial market is scary," he says in his well-read newsletter, *RGE Monitor*. "You know that you are one step away from a market crash and a systemic financial sector and corporate collapse."

That means this weekend will represent a critical new attempt for governments to achieve agreement on a co-ordinated plan that is dramatic enough to impress the global market. And just what would that be? For all Rudd's commendable emphasis on developing measures to improve international financial regulations and transparency, the focus is far more immediate. Help needed — yesterday. One possibility may be a global government guarantee of bank deposits, at least temporarily, to replace the mish-mash of individual guarantees in place at present. But incredible as that seems, it is still likely to be inadequate to break the cycle of panic.

British Prime Minister Gordon Brown, for example, is calling for other governments to follow Britain's example of a much more co-ordinated approach.

The British Government initiated its own drastic remedial action plan last week. This involved a proposal to take £50 billion ($128.4 billion) of direct equity stakes in its banks, massively increasing its own lending to banks and guaranteeing another £250 billion of new bank debt.

Brown said it was the first program to simultaneously address "the three essential components of a modern banking system — sufficient liquidity, funding and capital".

"But because this is a global problem, it requires a global solution," he said.

The US, after the fiasco of the congressional brawling delaying passage of the $US700 billion ($1.056 trillion) bailout package to buy up bad assets from banks, has also realised it needs to do much more — and quickly. The US Treasury, unwilling to wait for the purchase of various bank assets to take effect, is planning to use some of the money to take direct equity stakes in banks.

The Federal Reserve has also doubled the amount of money available to banks on a short-term basis to $US900 billion. It is now lending directly — and unsecured — to companies for the first time because corporate borrowers simply can't raise funds in any normal way. Treasury Secretary Henry Paulson is still warning that some financial institutions will undoubtedly fail.

Limiting the carnage will include governments becoming far more heavily interventionist, reversing the trend of decades. They will become the lenders of first resort, in ways that will transform government finances for decades to come.

Who would have thought that the 21st-century banking model would involve partial nationalisation, for example?

Certainly, the highly leveraged investment banking model of financing is dead — along with all those clever ways of reinventing and recycling debt.

But not before it seduced all commercial banks — including those in Australia, to some degree at least. Now only the most traditional banking, in all its dull sobriety, will be considered acceptable.

But that is assuming the emergency meeting in Washington works out an effective remedy for a very sick system. The world has a proven ability to struggle through various financial crises. But right now, you wouldn't bank on it.

Only thing to fear is rhetoric

FRANK FUREDI

PROBABLY the two most overused words in the present economic crisis are panic and fear. The word panic has been used so routinely it has been emptied of meaning. So a headline in a newspaper asks "World economy: is now the time to panic?" as if an overwhelming fear and anxiety is the normal way to react to bad news.

Others tell us that "panic grips Europe" or that it strikes, spreads, escalates, even "rules the markets". The rhetoric of panic is mobilised to promote the idea that we are all scared and, if we are not, we should be.

Past fears are regularly recycled to lend weight to the claim that being scared is the default option.

One German analyst warns of the danger of a "banking tsunami", while British Liberal Democrat treasury spokesman Vince Cable demands that interest rates should be slashed to prevent the "bank tsunami".

The language of environmental catastrophism is recycled to dramatise our predicament. The metaphor of pollution is deployed to describe the workings of the financial system: we have toxic debt, toxic assets and toxic funds. The Arctic icecap may not have yet melted but banks face a physical meltdown. "This week the crash went nuclear," a columnist from *The Guardian* warns before predicting "Britain will feel the worst of the fallout".

The world may have changed since the crisis of the banking system but the way the public is instructed to respond to a threat has not. Scaremongering has become a normal dimension of our lives.

Warnings about the future continue to escalate and the usage of terms such as human extinction and destruction of the planet has become commonplace. The present crop of warnings about "fear gripping the markets" continue a 21st-century tradition that was initiated with alarmist statements about the millennium bug and the threat it represented to human survival. At the time Morris Cerullo, a Pentecostal healing revivalist, prophesied a catastrophe of biblical proportions. "This panic that will sweep the nation will translate into a global depression," he warned. Some would like us to believe our predicament vindicates his prediction.

Since the turn of our century there has been a veritable epidemic of the rhetoric of fear. Scaremongers today constantly transmit the idea that we ought to be scared. Like therapists who tell us "not to be afraid to cry and show your emotions", fear entrepreneurs invite us to live our lives as passive and scared individuals. So Cable insists "panic is the all-too-human reaction" before noting that so is fear. Fortunately, the good news is that people panic only in rare and exceptional circumstances. The vast majority of humankind refuses to play the role assigned to actors in a Hollywood disaster movie. People may be angry and apprehensive about their savings and economic security, but their response has little to do with panic.

But how does the dramatisation of global threats affect our lives?

Research carried out for last month's World Social Summit in Rome suggests that at least until recently most people perceive the problem of everyday survival as far more threatening than the big global fears. The WSS report Fear in the Mega-Cities attempts to capture the experience of fear in 10 key cities across the world. Based on a survey carried out in July this year, it provides important insights into the way the public perceives and feels about threats in London, Paris, Rome, Moscow, Mumbai, Beijing, Tokyo, Sao Paulo and Cairo. The study suggests that while a large majority of the respondents (90.2 per cent) acknowledge they have day-to-day worries or serious anxieties (42.4 per cent) about an important dimension of their lives, only a minority (11.9 per cent) feel overwhelmed by a sense of fear. Most state they have a positive orientation towards life (55.3 per cent) and almost one-quarter (24.3 per cent) define themselves as optimistic.

One key point that emerges from this study is that the rhetoric of fear is far more pervasive than fear-led behaviour.

It is always difficult to ascertain how people's beliefs and behaviour are influenced by scaremongers. Most people are exposed to a wide variety of views and claims about problems and threats. Such claims often conflict with other statements and opinions transmitted through the media. People often ignore warnings or at least try to respond to them in light of their experience and circumstances. Many of the mega-scares are far too impersonal and abstract for people to visualise and imagine. For example, warnings about population growth rarely lead people who desire large families to cut down on having children. However, that the big global and apocalyptic scares do not directly influence behaviour does not mean they do not influence our lives. Such scares provide us with a ready-made story about what to fear and their cumulative effect is to make us more anxious about the future.

It is not hope but fear that excites and shapes the cultural imagination of our times. Indeed, fear has become a caricature of itself. It is no longer simply an emotion or a response to the perception of threat. It has become a cultural idiom through which we signal a sense of growing unease with the workings of the world. To acknowledge fear is to demonstrate awareness. This self-conscious affectation does not mean people are more scared than before. It merely signals the idea that they ought to be.

Although, fortunately, most people are able to refuse the invitation to panic, the constant repetition of fear appeals distracts people from engaging with the problems they face. At a time of global economic insecurity, society needs to draw on its reserve of strength and steady its nerves. Instead of treating the crisis as a drama, we need to turn it into an opportunity for learning from our experience.

Frank Furedi is professor of sociology at the University of Kent in Britain.

Calls for international community to flush the system

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Reserve Bank as a sign that global policy-makers were bit-by-bit putting together the preconditions to calm the financial market mayhem. By Wednesday night, the US Federal Reserve led other central banks in a co-ordinated 50 point cut. Stevens's Reserve Bank may have suspected it was about to gazump other central banks, but it was not let in on the secret.

That's because the co-ordinated cut was delivered by the Group of 10 inner circle of central banking: the G7 countries plus Switzerland, Sweden, The Netherlands and Belgium. With its low 1 per cent official rate, G7 member Japan did not take part in the co-ordinated cut. But, in a sign of the new order, China soon joined in off its own bat.

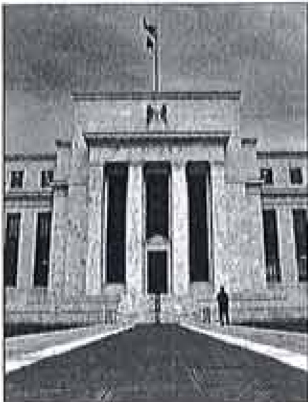
The Reserve Bank has more room to cut because, until just over a month ago, it had interest rates at a high 7.25 per cent to fight the full-capacity inflation threat from an economy that had been overcooked by the China boom.

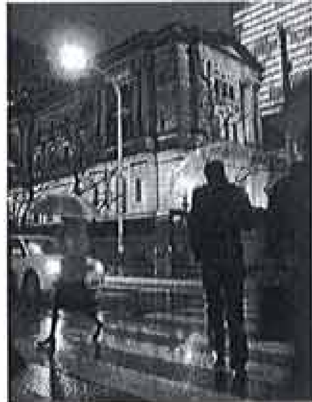
"The RBA got caught with its rates up," says Macquarie's Robertson. So far, the Reserve Bank's two cuts have taken 125 points off its cash rate, translating into 105 points of mortgage lending rates. Robertson predicts that Stevens will continue to aggressively cut, taking down the cash rate to 4.25 per cent within two years. Mortgage rates will fall at least another 50 points before Christmas.

3. Take advantage of the dollar's slide to boost exports. They may be at loggerheads, but BHP Billiton's Marius Kloppers and Rio Tinto's Tom Albanese will continue to deliver strong export growth that will cushion the domestic spending crunch.

The Government, the Treasury and the Reserve Bank so far remain comfortable with the sharp currency depreciation. The Reserve Bank did not even mention the Australian-dollar sell-off in its Tuesday rate cut decision. It could be the economy's secret weapon, just as the lower Australian dollar helped cushion the economy from the 1997 Asian crisis and then the US tech-wreck recession, where the currency fell below US50c.

At US67c, the dollar will stimulate all the trade-exposed parts of the economy, from manufacturers that compete with imports, to farmers digesting a fall in US dollar export prices, to foreign tourist operators to universities that have been priced out of the foreign student market.





Global watch: The European Central Bank, left; the US Federal Reserve, centre; and the Bank of Japan, right Pictures: Bloomberg

The Australian dollar is falling in part because it is a liquid proxy for a range of other national asset classes — ranging from New Zealand to Brazil — that are tied to the downturn in the commodity price cycle.

As well, the crisis has unwound the so-called yen carry trade, which encouraged foreign investors to borrow in low-interest yen and invest in high-interest Australia, which drove up the local dollar.

The potential good news is that the currency markets may have over-reacted and the Australian dollar stimulus may even offset the hit from lower commodity prices.

The much-awaited expansion of mining exports is now coming on stream in a big way. Coal export volumes jumped 15 per cent in August alone, producing the month's stunning $1.36 billion trade surplus. And, while most commodity spot prices are falling, Australia will get breathing space until BHP Billiton's and Rio Tinto's big contract price hikes for iron ore and coal exports expire in April next year. The contracts are written in US dollar terms. So the lower Aussie exchange rate translates into bigger profits, dividends, corporate taxes and royalties in Australian dollar terms.

And, according to the IMF, China will be the one big economy not to be badly hurt by the global financial crisis. After expanding by 11 per cent in each of 2006 and 2007, the IMF tips still rapid growth of 9.7 per cent this year and 9.3 per cent in 2008.

BHP's Kloppers and Rio's Albanese have put their money on it. "The Chinese economy is slowing for breath," Rio's chief economist Vivek Tulpule yesterday told *The Australian* from London. "We expect that the Chinese economy will remain resilient, perhaps surprisingly so, to the troubles in the West."

Tulpule suggests Chinese growth will slow from nearly 12 per cent last year to 10 per cent this year to 9 per cent in 2009, partly as a result of tight monetary policies which are now being relaxed.

A rich-country recession would clip Chinese exports. But trade only adds 10 per cent to China's gross domestic product, delivered mainly from the coastal regions. China's populous interior continues to attract rapid investment growth. And China's financial system appears more or less insulated from the credit crisis.

To take advantage of China's resilience, however, the lower Australian dollar has to be locked into the economy's competitiveness. That requires higher import prices to be quarantined from the domestic wage cost system. Otherwise, the inflation threat might limit the scope for the Reserve Bank to aggressively cut interest rates.

Rising unemployment should keep a lid on union wage demands. Melbourne Institute deputy director Mark Wooden suggests that today's labour market is a lot more flexible than in the early 1990s recession, let alone the early '80s recession. The award system and the unions are weaker, restrictive work practices have been freed up and enterprise bargaining is the norm. And that should limit any unemployment rise to no more than 6 per cent, up from today's 4.3 per cent.

Nevertheless, Wooden cautions that the Australian dollar's inflation risk will put more pressure on Industrial Relations Minister Julia Gillard to resist union demands to return to multi-employer bargaining rather than enterprise-by-enterprise negotiations. "The union movement might be starting to ramp up their dissatisfaction with Work Choices-lite," he says.

4. Prepare for a fiscal stimulus in 2009. Only two weeks ago, Swan revealed that last financial year's federal budget surplus came in at $19.7 billion, nearly $3 billion more than forecast in May. The budget forecast a healthy $21.7 billion surplus this year.

Rudd this week referred to this as a "buffer for us to use in future". The Government and the Treasury at the least are prepared to allow the budget surplus to fall naturally as a weaker economy slows revenue growth and lifts spending on areas such as the dole. These are known as the budget's "automatic stabilisers" that help cushion economic downturns. The Reserve Bank would not object, even if this pushed the budget into deficit.

Government ministers also say an added "discretionary" budget stimulus is a likely option. The IMF says that, for both Australia and NZ, "sound fiscal positions provide scope for allowing automatic stabilisers to operate in full and for judicious use of discretionary stimulus if the outlook deteriorates".

But this is unlikely to be delivered by infrastructure spending, as demanded by the state premiers. The conventional wisdom is that the infrastructure focus of Paul Keating's 1992 One Nation fiscal stimulus could not be put in place fast enough to work when needed.

Instead, any Rudd-Swan fiscal stimulus would likely come in the form of tax cuts or transfers — perhaps even a pensioner down payment — that would be spent quickly.

But, hold on, there's a lot to get through before we get to that point.