

## **ANZ Chief Economist, Saul Eslake shares his thoughts**

### **How did the financial crisis begin?**

Well, the financial crisis began in the middle of last year with the meltdown in the American sub-prime mortgage market, and as a growing proportion of people who had taken out these loans in earlier years when interest rates were much lower began defaulting on them.

As of early this month, those losses had reached some \$650 billion US dollars. When banks are forced to write down their capital by orders of magnitude such as this, it inhibits their ability to lend and undermines the faith which others have in them. What this eventually led to, in part accelerated by the ad-hoc and inconsistent response of the US authorities as to whether institutions would be allowed to fail or not, it became a wholesale run on banks. And in the weeks leading up to the final meltdown on the 10<sup>th</sup> of October, it was becoming increasingly difficult for banks to access wholesale financing at all. And there was a very real danger that the entire global financial system could have seized up.

### **What is it going to take to repair this situation?**

There is more scope in Australia in particular, and to some extent in New Zealand for Governments to cut taxes and increase Government spending to offset weakness in the private sector. We saw an example of that in Australia in early October when the Government announced a \$10 billion fiscal stimulus package, most of which takes the form of cash handouts to pensioners, carers, low-income families and others who are most likely to spend it quickly rather than use it to pay-down debt and thus provide timely stimulus to retailers who might otherwise have been facing a fairly bleak Christmas.

And although that package is by definition one-off, it will be sufficient to prevent negative growth in the December quarter and by the time we get into the first half of 2009, interest rates are likely to be lower; sufficient to provide growth from the monetary side. Almost certainly the Australian Government will be doing more on the fiscal policy front, either cutting taxes, or more likely and more usefully, bringing forward planned infrastructure spending.

And because Australia entered this downturn from a position where the Government was running a large surplus and it had no public debt, Australia has far more scope to use these kind of economic policy responses than, for example, America, which has entered this downturn with a budget deficit of half a trillion dollars and counting, and public debt equivalent to about 40% of national income. Most European governments have even higher public debt than that. Unfortunately, none of those measures can, nor was intended to, prevent the impact that what had been happening up until the 10<sup>th</sup> of October is going to have on the world economy. We are now looking very much at the prospect of a global recession for only the third time since the end of the Second World War.

### **What will this mean for property prices?**

There are some important differences between Australia's housing market and the housing markets of the US and the UK. In the first place, both of those countries saw

building booms in the early years of this decade, which have left both of them, and particularly the US, with more housing than is actually required by the number of people who want to live in them.

There are perhaps three areas of the property market where there could be perhaps some risk of falling prices. One is areas where non-traditional lenders have had a much bigger share of the market than the country as a whole, and that's relevant because non-traditional lenders have typically targeted more marginal borrowers and are much more quick to foreclose in the event of a borrower getting behind on his or her payments than the banks and building societies are. And western Sydney is a good example of that, and that is the main reason why prices are falling there at a greater extent than anywhere else in Australia.

The second category of property prices that's at risk is ironically the top end of the market. Where very often in Australian's most exclusive suburbs, what people are prepared to pay for housing has little to do with the value of the housing itself, but rather how much the people who want to live in it are prepared to throw at it in exchange for the privilege. And as a result of the financial crisis there are fewer people around with enough money to push the prices of houses up into the \$15 to \$20 million dollar range.

The third area of risk is in suburbs or areas where investors are a disproportionately large share of the market because investors, unlike owner-occupiers who after all have to live somewhere, do have the option of selling.

Speaking about property prices in general, I think the majority of would-be vendors who discover they can't get the price that they would hope to and are not forced sellers, will simply take their properties off the market and wait it out.

### **What can individuals do?**

I think for individuals, the important things to do are, first of all not to panic. Second, to where possible and prudent, reduce debt and ensure expenditures are sustainable given the amount of income available.

### **What would you say to people who are concerned about the safety of Australian banks?**

There are now only fourteen banks in the world with a double-A credit rating or better, and four of those are the four major Australian banks. Not even in the Great Depression did banks fold in a way that caused losses for depositors. More recently of course, the Government has issued a blanket guarantee of all deposits in banks, building societies and credit unions. And although that wasn't objectively necessary in Australia, once the Irish government offered a guarantee of deposits in Irish banks and we saw people in Britain moving savings out of British banks and into Irish banks, it became obvious that every country had to offer this guarantee for fear that money would flow out of banks in countries whose governments didn't guarantee deposits, towards banks in countries whose governments did offer that guarantee.

So now there is a government guarantee for the next three years of all deposits in banks, and people should have absolutely zero concern about the safety of their money in an Australian bank.