‘Plenty of bumps before we’re out of this mess’: a roundtable discussion published in the Weekend Australian Financial Review, 11 October 2008

(Responses from Saul Eslake, ANZ Chief Economist)

1) We have seen a number of measures used by governments and central banks to fix the credit crisis. They seem to inject billions of dollars into the system, cut rates yet stocks can only rally for a day. We still are in this crisis. What can fix the credit crisis? What measures can actually work?

Although, in my opinion, the Federal Reserve under Ben Bernanke has done a pretty good job in responding to the financial crisis (drawing upon the lessons learned from Ben Bernanke’s lifetime of studying the causes of the Great Depression), the same cannot be said of the Bush Administration, the European Central Bank or European governments.

It’s becoming increasingly apparent that the dramatic intensification of the financial crisis in recent weeks has been in no small way due to the US Administration’s inconsistent approach to handling the failure of different financial institutions. Investors who subscribed equity capital or loans to institutions in some difficulty after the semi-rescue of Bear Stearns, in the belief that the Fed’s actions in that case represented a precedent, have suffered significant and in some cases total losses. As a result, banks and other institutions in severe need of capital cannot raise it, and the reluctance of investors to lend to banks, or of banks to lend to other banks, has been massively heightened.

Henry Paulson’s TARP plan, as initially conceived, was too easily portrayed as a request to hand over an enormous some of money with no accountability or oversight to people who contributed to the problem in the first place and among whom Secretary Paulson used to work. That contributed to its initial rejection.

Although the ECB has been as willing as the Fed to provide liquidity to its banking system, it has (until this past week) been unwilling to cut interest rates; indeed it actually raised them shortly after a quarter in which the euro area economy had contracted. Even this week, the interest rate cuts by European central banks have been timid, compared with those in Australia or even in the US (which has less scope to cut rates than Europe). And the actions of European governments to the unfolding crisis have been incoherent and unco-ordinated, adding to the erosion of confidence in their ability to respond effectively to it.

The restoration of confidence is made more difficult when governments are unpopular and the public can’t wait to see the back of them (as in the US and UK – and as was the case in Victoria in the early 1990s). Fortunately that isn’t the case in Australia. At least in the US there will be a new Administration in office by the end of January – but it might take until then before the public has any confidence in those who are seeking to resolve the crisis.

2) Do the current packages need more time to work their way through the banking system?

Some of them do. The Paulson TARP program, in particular, requires the establishment and staffing of a new agency, devising a credible method of valuing assets to be acquired from banks, and banks to decide whether they are willing to accept the conditions associated with selling assets into the program.

Others, such as the injection of government capital into banks, or the provision of blanket deposit guarantees, can take effect immediately – although they have to appear both adequate and credible in order to be effective. It would seem that, so far, these two conditions haven't always been fully satisfied.

3) What more can govt/central banks do?

Some central banks – notably in Europe – should follow the example of the RBA and be bolder in cutting interest rates and making it clear that their primary concern is no longer containing inflation but in averting recession. To the extent that their fiscal position allows (which in some cases is, unfortunately, not much), Governments should be drawing up plans increased spending to support growth if and when required – as it is increasingly likely to be in Europe and the US.

Governments need to co-ordinate their actions better, and make it clearer to the public that they are actually working together, rather than looking only after themselves oblivious to the consequences of their actions for other nations.

They need to start work, convincingly, on addressing the deficiencies in regulation and prudential supervision which the crisis has exposed.

And they need to draw up a more coherent and convincing script for shoring up public confidence, and (to the extent that circumstances permit), stay 'on message'.

4) Has an Australian recession already been priced in to the sharemarket? What's your outlook on GDP/growth for Australia over the next 12 months?

No, I don't think it has. It's increasingly pricing in a global recession, as evidenced for example in the large falls in the share prices of resources companies. But analysts' earnings estimates appear to reflect a general belief that Australia's economy will slow but not contract. And at this stage, I think that's the right view – although I suspect that, even so, there is room for further downward revisions to earnings estimates.

5) What are the chances of slipping into a a global depression?
What are the prerequisites for a depression?

Nobody has ever formally articulated widely accepted criteria by which a depression can be distinguished from a recession, although the general sense is that depressions involve much larger contractions in output, last much longer and are also characterised by extended and significant declines in the general price level (ie deflation). They used to be more common when currencies were pegged to the gold standard (as they generally still were until the 1930s) and before the emergence of contemporary thinking about the roles of fiscal and monetary policy. Falling asset prices alone – no matter how severe – don't, on their own, constitute a depression.

The Great Depression of the 1930s was a severe and protracted as it was in large part because of massive policy mistakes by central banks, totally misguided competitive devaluations and tariff increases by national governments, and the general lack of awareness of the role that fiscal policy measures could play in circumstances where monetary policy proved to be ineffective (indeed economists' understanding of the role of fiscal policy emerged during the Depression).

It's not at all inconceivable that major policy mistakes could turn the current financial crisis and what now looks like the inevitable global recession into something much more serious. However, the fact that we do have such a stark example of the consequences of major policy mistakes will, I hope, mean that its far less likely that those mistakes will be repeated. We also have to hope that the current generation of policy-makers don't make equally bad but different ones.

6) What are your thoughts on the outlook for equities in Australia?

I'm not a stockmarket analyst, and the bank I work for doesn't own a fund manager or a full-service broker, so I'm no expert on equities. But my instinct is that we haven't seen the bottom yet.

7) What's your view on the Australian dollar over the next 12 months? What will be the effect of a reduction in terms of trade?

The extraordinary decline in the A$ over the past few weeks is partly the mirror image of the rise in the US$ against most major currencies apart from the yen (and that is in turn the result of the same hoarding of US dollars which has caused interbank borrowing rates to spike upwards despite reductions in official rates); it is partly due to sharp falls in commodity prices and expectations of further narrowing in the interest rate premium on A$-denominated assets; it is partly the inevitable result of heightened risk aversion around the world; and it has been exaggerated by the lack of liquidity in the A$ market.

If and when the arteries of the global financial system are unclogged, and the hoarding of US$ starts to unwind, the US$ will probably fall substantially, and the A$ could then retrieve a good deal of its recent losses. The A$ could easily trade in a range between US55¢ and 75¢, or even wider over the next few weeks,

But the deterioration in Australia's terms of trade, which is likely to be sustained beyond the end of the current crisis, is an unambiguous negative for the A$, so that when the current episode has faded the A$ is still likely to finish up somewhere in the mid US60s.