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 and the IMF had estimated that eventually the losses that banks and other financial institutions will incur from not only mortgages and mortgage backed securities and other forms of consumer debt could total as much as one-and-half trillion dollars, of which close to one trillion US dollars would be borne by banks. Now whereas institutions such as pension funds and insurance companies, when they suffer losses that's passed through in effect to their clients, 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 10th 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.

By injecting capital into weak banks in Europe and the US, Governments have allowed those banks to write down to some appropriate value the unreliable and damaged assets they have on their books as a result of the sub-prime mortgage market crisis, without in the process becoming insolvent. And it would appear that those measures are now slowly restoring faith of wholesale investors in the global financial system.

Many of the stressors that were evident in the months leading up to the 10th of October are now starting to slowly unwind, and given time, I think those measures will work.

Unfortunately, none of those measures can nor was intended to prevent the impact that what had been occurring up until the 10th of October is going to have on the world economy, and we are now looking at the very real threat of global recession for only the third time since the end of the second world war.

How might different industries fare?

One shouldn't overplay comparisons between industries that did well or badly during the previous recession with whatever might be about to occur on this occasion because the courses are different.

We're not for example going into this as the result of a period of double-digit interest rates as we did in the early 1990s, and before that in the early 1980s, nor are we necessarily going into this as the result of excessive wage claims and strikes as we were in the recession of the mid-1970s or the early 1980s. But I'm generalising; the areas of the economy that are likely to experience the greatest pressure at the moment are those catering to discretionary consumer expenditures, in the retail sectors for example, sectors that are selling high–end consumer goods such as electronic appliances, household goods, motor vehicles and the like.

On the other hand, I think the resources sector will continue to do well even though the prices that we will be receiving for many of our commodity exports won't be nearly as high as had been hoped as recently as three months ago. The volume of mining production and exports will continue to increase; exploration for new sources of energy will continue to increase and I think non-residential construction will do well because State Governments already have a lot of infrastructure projects underway, and the Federal Government's response to the risk of economic downturn is going to include increased federal spending on infrastructure, so engineering construction, non-residential building and the like will do pretty well.

On the down side, one should mention residential property development. Given that residential property development companies are among the more highly geared businesses who have been exposed to the credit crunch and have had more difficulty obtaining finance than other sectors of the economy, the likelihood is that at least some major residential projects will be deferred or cancelled and there will be fairly subdued conditions in that sector for a while.

People are going to become more careful about borrowing and spending. That's probably a good thing from a long-term point of view, but it does mean that prospects for growth in the financial services sector will be rather more subdued than they had appeared to be 15 months ago.

What's the employment outlook?

First of all, I don't think that a recession is the most likely scenario for Australia. The way things stand at the moment, Australia is unlikely to have consecutive quarters of negative economic growth. The unemployment rate is going to rise, probably to around or slightly above 6%, although that's mainly because employment growth with no longer be sufficient to absorb all the new entrants into the labour force, including immigrants.

Most businesses haven't been confronted with rapidly rising labour costs as they have been prior to each of our past three major recessions. Instead, employers have become increasingly aware that over the medium term one of their biggest challenges will be shortages of labour as a result of demographic change. So I think unless the economy takes a marked downturn for the worst, which I don't foresee at the moment, they will tend to be reluctant to let go of valued employees for fear that they won't be able to get them back when the recovery eventually comes, as it will.

I don't think unemployment will rise significantly, although it will probably get to close to 6%, but I don' think that's enough to induce defaulting and hence downward pressure on house prices on the same scale as we've seen in the US or the UK.

What about the Australian dollar?

Part of the fall in the Australian dollar is a reflection of the rise in the US dollar against almost every other currency, bar the Japanese Yen, over the last couple of months.

At first it seems surprising that the US dollar would be going up, given that:

- the US is the epicentre of this financial crisis,
- that interest rates in the US are falling,
- that the US has a budget deficit of half a trillion dollars and counting.

The reason the US dollar is going up despite those factors is because people are hoarding US dollars for fear that they will need them themselves, or that if they lend them to someone else they won't get them back. So, to some extent, the weakness in currencies like the Australia dollar reflects an artificial shortage of US dollars that I expect to unwind as stressors in the global financial system are gradually unwound. The bottom line out of all of this is that the AUD and NZ dollar may see a short-term bounce as the US dollar loses some of its current artificial scarcity, but the longer-term trends on commodity prices and interest rates suggest that the AUD will settle at somewhere in the mid-60s against the US dollar over the medium term, that is say through 2009.

How will Asia fare during this crisis?

Asian economies for the most part haven't been as exposed to the upheavals in the western financial system as they would have been a decade ago. A good deal of the growth that Asia has enjoyed over the last decade has come through exports. With most of Asia's export markets now in recession, exports are slowing.

Korea and Taiwan among others are now running trade deficits; Singapore has experienced consecutive quarters of negative economic growth and even China's economy has slowed from almost 12% annual growth two years ago to 9% over the year to the September quarter which, high though that sounds, is for China the weakest since the SARS epidemic of 2003.

As it happens, not only has China been hit by a slow-down in its exports, but it has also experiencing a slump in its own property market, which over the previous couple of years the authorities in China had been seeking to consciously dampen down by raising interest rates, increasing taxes on property transactions, and restricting the flow of credit to it. That in turn has had a flow-on effect on demand for steel and other commodities, which we're experiencing here in Australia.

But China does have considerable capacity to use economic policy to ward off some of the negative international forces that are now bearing down on it. They have considerable capacity to cut interest rates because they raised them a fair bit over the previous three years, and they have ample capacity to use fiscal measures, to cut taxes and to increase government spending including on commodity-intensive infrastructure to ensure their growth rate does not fall below 8%. We think it will fall to 8% in 2009, but that the authorities will succeed in putting a floor under China's growth rate at that level. Asia is not immune from this crisis, but it's in a better place to whether it that it was a decade ago, and it will continue to be the fastest growing region in the world.

What will this mean for property prices?

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, lent to them at higher rations of loan-to-valuation 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 to 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 in order to avoid further capital losses, or because they no longer expect to make a capital gain, and or because they are unwilling to incur the continued cash-flow costs of a negative-geared investment positions.

Speaking about property prices in general, I think the majority of would-be vendors who discover they cant 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.

That means that turnover will fall a lot, real estate agents will be doing less business, state governments will be collecting less stamp duty revenue, but house prices will tend to be stagnant rather than fall.

The corollary of all this of course is that it will be along time before house prices go up again, and that won't happen until house prices, interest rates and incomes have moved in such a way that the average new buyer can afford to by the average-priced new house.

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.