



WHAT NEXT? An exasperated trader on the floor of the New York Stock Exchange.

Meltdown

Tough decisions are needed to rescue the global financial system, writes **BRUCE MCKERN**.

THE Australian share market's reaction to the rejection by the U.S. Congress of the financial bailout plan shows we are facing a problem of global dimensions.

The big fall in financial indices worldwide underscores the scale of the crisis.

With breathtaking speed, we have seen the knockdown sale of venerable Wall Street institutions, government-brokered sales of others, and the seizure of two huge mortgage financiers, Fannie Mae and Freddie Mac.

What are the causes of this crisis? How serious is it? What can be done to resolve it? And why did the financial rescue Bill before the U.S. Congress fail?

The causes of the crisis lie in the long period of easy credit enjoyed in the U.S. and elsewhere. Low interest rates, coupled with easy mortgages

for low-income (sub-prime) borrowers in the U.S. led to a bubble in real estate markets around the world.

U.S. financial institutions invented innovative ways to package mortgages and create dicey debt instruments which were sold to institutions. Credit rating agencies, whose job it is to evaluate the risk of these instruments, didn't look at the whole picture.

When the U.S. Federal Reserve started to raise interest rates amid concerns about inflation, and the artificially low initial rates of mortgages were reset much higher, mortgage holders began to default and started to sell.

Quickly, mortgage debt held by financial institutions declined in value and these institutions had to report substantially lower asset values. Some of them became the targets of sellers, driving down their share prices.

Many of these institutions had borrowed heavily and were then forced to report losses and seek injections of capital to strengthen their balance sheets.

The effect was twofold. Investors began to pull out their money and other institutions stopped lending to them.

This liquidity crisis has virtually frozen the financial system, the channel through which funds flow to the economy's enterprises, and this, in turn, threatens the whole economic system.

With no apparent end in sight, how serious is this crisis? In the last couple of hundred years, the U.S. has suffered 16 credit crises and it has taken an average of two years to purge the system of the excesses and return to normality.

As yet, this crisis is probably not worse than the one of 1974-75. Nevertheless, con-



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fidence has been badly shaken and the degree of government intervention has been greater than in the past. There is need for strong action to restore confidence and avoid a panic.

So what needs to be done? A full solution should do three things:

STABILISE the markets. **NOT** have significant cost to taxpayers.

AVOID setting up incentives for similar crises in the future.

RESTORE confidence in the system.

The first concern is to recapitalise the financial institutions. Their assets are no doubt worth a lot more than the distressed valuations currently in the market. So one option is the U.S. Administration's proposal to buy these assets through a \$840 billion government fund.

A critical question is how these assets will be valued. A weakness of the Bill sent to Congress, the Emergency Economic Stabilization Act of 2008, is that it is not specific about the actions the U.S. Treasury should take, but gives it sweeping powers to acquire "troubled assets" and dispose of them over time.

One approach would be for the treasury to acquire assets

either at the original value of the loans, or a discounted price roughly 20 per cent below the decline witnessed so far in the mortgage market. If the assets are purchased at too low a price, there will be insufficient funds to save the institutions.

The treasury could require institutions agreeing to these purchases to guarantee the government would receive no less than the purchase price upon the ultimate sale of the assets, putting potential future losses on to shareholders.

Because the functioning of the fund was not clearly spelt out in the Bill, there was room for voters and politicians to see it negatively. When members of the House of Representatives face re-election in November, with vociferous voter opposition to what is seen as a taxpayer cost, it required a degree of courage to vote for the Bill.

Congressmen were flooded by letters and emails opposing the Bill and it was rejected by 228 votes to 205. Significantly, of the 205 congressmen voting in favour, only two are facing difficult re-elections.

A second option is for the government to lend funds to the troubled institutions or

invest directly in them, effectively a bank nationalisation. Taxpayers would essentially become the owners and would bear the costs of future losses. This option flies in the face of the free market philosophy of the U.S.

A third option would be to allow the banks to continue to hold the "toxic assets" but relax accounting rules. Since many mortgages are producing cash flows, the financial institutions could continue to operate, provided they weren't required to write down their equity.

GIVEN the urgency of the situation - which is likely to get worse - and the need for firm action to be seen to be happening, the best course would be for the Congress to pass the Bill.

However, it should include modifications which make clear that there will be stronger regulation of U.S. financial institutions.

Regulation is the price U.S. institutions will have to pay for the financial system to be restored to health.

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FORCES AT PLAY

■ The U.S. Congress smack-down of the \$US700 billion bank bailout plan sent fearful investors scurrying for the exits and markets plunged across the globe.

■ With just five weeks to go before elections, not enough lawmakers were willing to take the risk of backing a deeply unpopular measure that many U.S. voters see as an undeserved bailout for Wall Street fat cats.

■ The people power sentiment was captured by angry demonstrators outside the New York Stock Exchange carrying posters declaring: "Bail out people, not the banks", "No free ride for Wall

Street", "Bail out workers and the poor" and "No taxation without representation".

■ The proposed legislation was voted down by more than two-thirds of Republicans and two in every five Democrats.

■ The failed Bill was aimed at allowing the U.S. Government to buy bad mortgages and other sour assets held by troubled banks and other financial institutions.

■ Getting those debts off their books was meant to boost those companies' balance sheets and make them more inclined to lend, easing one of the biggest choke points in the credit crisis.