

## Contact:

Thomas D. Higgins, PhD

Chief Economist

ph: 213 830-4302

email: [thiggins@payden-rygel.com](mailto:thiggins@payden-rygel.com)

## Highlights

- The Federal Reserve, European Central Bank, Bank of England, Bank of Canada, Sweden's Riksbank, and the Swiss National Bank each reduced their benchmark policy rate by 50 basis points.
- The interconnectedness of the world financial system and concerns about counterparty risk internationally required collective action.
- There are no silver bullets to resolving a banking crisis, but past experience in Scandinavia, Japan, the United Kingdom and United States indicates successful plans have several elements in common.

## Unprecedented Action By Global Central Banks

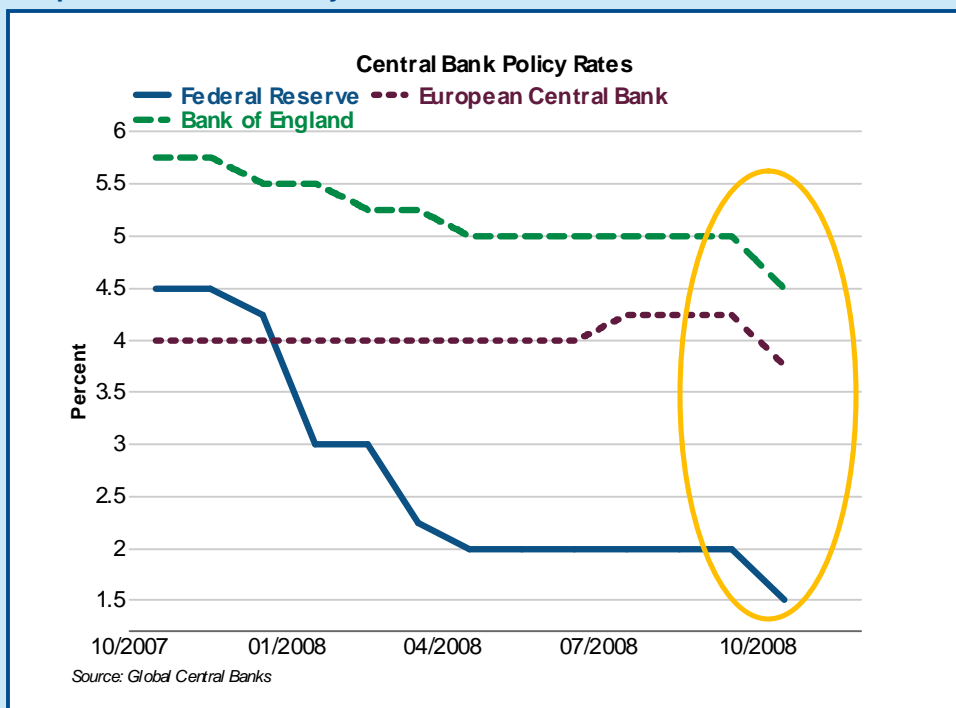
The sharp declines in world financial markets during the past few weeks prompted a coordinated response from global central banks this morning. The Federal Reserve, European Central Bank, Bank of England, Bank of Canada, Sweden's Riksbank, and the Swiss National Bank each reduced their benchmark policy rate by 50 basis points. The People's Bank of China followed suit by lowering its one-year lending rate by 27 basis points. In a joint statement, policymakers said, "The recent intensification of the financial crisis has augmented the downside risks to growth and thus has diminished further the upside risks to price stability." Consequently, they concluded that some easing of world monetary conditions was warranted.

Global policymakers appear to have finally accepted that the credit crisis is not just a US problem. The interconnectedness of the world financial system and concerns about counterparty risk internationally required collective action. Although world equity markets may remain under pressure as investors price in a global recession, I believe that the recognition by policymakers of the magnitude of the problem is the first step on the long road to crisis resolution.

## What Has Worked in the Past?

There are no silver bullets to resolving a banking crisis, but past experience in Scandinavia, Japan, the United Kingdom and United States indicates successful plans have several elements in common. First, policy responses must be rapid and involve the early recognition of losses by financial institutions. Second, bad assets must be removed from bank balance sheets and banks must be recapitalized. Third, the adverse impact of the credit contraction on the real economy must be addressed through fiscal and monetary stimulus. And fourth, the regulatory infrastructure must be updated to avoid a repeat of past mistakes and limit the risk of moral hazard.

## Unprecedented Action by Global Central Banks



## Contact:

Thomas D. Higgins, PhD

Chief Economist

ph: 213 830-4302

email: [thiggins@payden-rygel.com](mailto:thiggins@payden-rygel.com)**Highlights**

- The recognition of bank losses globally has totaled nearly \$600 billion with more than half of these coming from US financial institutions.
- The US policy response from both the Fed and the US Treasury has been swift. Most recently, the Fed began paying interest on reserves which effectively eliminates constraints on the central bank's balance sheet and allows it to print money to fund its new facilities.
- Although European leaders have thus far rejected calls for a pan-European rescue plan, sentiment may be shifting.

The progress on each of these fronts has varied by country, but there are some encouraging signs. The recognition of bank losses globally has totaled nearly \$600 billion with more than half of these coming from US financial institutions. Though the International Monetary Fund (IMF) just upped its estimate for total losses from the global credit crisis to \$1.4 trillion, this figure includes the losses of pension funds, insurance companies and hedge funds. Banks themselves have already written off approximately three-quarters of their bad debt.

The US policy response from both the Fed and the US Treasury has been swift. The Fed has aggressively slashed the fed funds rate from 5.25% to 1.5% in the past 13 months and sought to provide liquidity through several new credit facilities. Most recently, the Fed began paying interest on reserves which effectively eliminates constraints on the central bank's balance sheet and allows it to print money to fund its new facilities. In the process, the Fed's balance sheet has exploded from roughly \$900 billion at the beginning of September to \$1.4 trillion last week! Looking ahead, I expect the Fed to reduce rates again before year end, bringing the benchmark interest rate to 1% by its December meeting.

At the same time, the Treasury is working on removing bad assets from bank balance sheets and recapitalizing the US banking system. To this end, the Treasury has launched a \$700 billion plan to purchase illiquid assets from financial institutions. There are few details on exactly how the plan will work, but Treasury Secretary Hank Paulson has suggested that the government may pay a "hold to maturity" value for the assets it acquires which would get the bad assets off banks books while simultaneously boosting their capital. However, past experience suggests it may be wiser to simply pay a market price and then make a separate preferred equity infusion into the banks.

This is the approach the United Kingdom is taking with its £250 billion plan to recapitalize the British banking system. Seven leading banks and the Nationwide Building Society will initially apply for £25bn in permanent capital with a further £25bn available as a stand-by and for other eligible institutions. The hope is that the government backstop will make it easier for the banks to go out and raise capital in the market. The Treasury has insisted that the banks conclude their recapitalization by the end of the year.

Although European leaders have thus far rejected calls for a pan-European rescue plan, sentiment may be shifting. The Spanish government has already independently announced a €30 billion fund to purchase illiquid assets from banks. In addition, the Irish, German and Dutch governments have each announced blanket guarantees on all domestic bank deposits to prevent a run on deposits. However, with European investors clamoring for a more comprehensive and unified approach, policymakers may have no choice but to implement bank rescue package to restore confidence.

## Contact:

Thomas D. Higgins, PhD

Chief Economist

ph: 213 830-4302

email: [thiggins@payden-rygel.com](mailto:thiggins@payden-rygel.com)**Highlights**

- Even with such action, it will take a long period of time to unwind the massive amount of leverage in the financial system and to restore investor confidence.
- The deleveraging process is disinflationary and will act as a restraint on global economic growth in the coming quarters.
- The extraordinary measures they have adopted will take time to work, but the amount of liquidity flooding the system will gradually help the financial markets turn the corner.

**Global Recession Likely, But Central Banks Have Plenty of Ammunition Left**

Even with such action, it will take a long period of time to unwind the massive amount of leverage in the financial system and to restore investor confidence. The deleveraging process is disinflationary and will act as a restraint on global economic growth. Asset liquidation, debt repayment and increased savings rates will put downward pressure on prices across the industrialized world. We expect headline inflation rates, which were pushed up by rising food and fuel prices earlier this year, to converge with core inflation rates, which exclude food and energy and have been much more benign in recent months.

Meanwhile, the traditional banking system is in the process of reintermediating the debt that was previously borrowed through the credit markets. However, regulations prevent traditional banks from leveraging up by more than 10:1 on their capital, which compares with leverage ratios of 30:1 amongst the investment banks during the latter stages of the boom. As a consequence of the reduced amount of leverage in the financial system, global economic growth rates will be more subdued for the next several years.

The good news is that global policymakers are finally all on the same page recognizing that this is a global credit crisis. Fears that they will run out of ammunition are grossly exaggerated. Both the Bank of England and the European Central Bank have ample room to lower interest rates and have finally showed a willingness to do so.

Furthermore, as Fed Chairmen Ben Bernanke outlined in a 2002 speech titled, "Deflation: Making Sure 'It' Doesn't Happen Here," the Fed still has plenty of other tools at its disposal even if it were to reach the zero bound on interest rates. In fact, the Primary Dealers Credit Facility, which opened the discount window to non-bank broker dealers last March, was straight out of this playbook. Given the severity of the crisis in the US, the Fed may even choose to pursue a quantitative easing in the coming months as a means of getting cheap money to where it is most needed. Under such a strategy, the central bank purchases long-dated Treasuries or perhaps even mortgages to bring down market interest rates.

Most importantly, the willingness of global policymakers to work together toward a solution to the global credit crisis represents a sea change in attitude. The extraordinary measures they have adopted will take time to work, but the amount of liquidity flooding the system will gradually help the financial markets turn the corner.