



RBA ECONOMICS COMPETITION 2009

Policy Responses to the Global Financial Crisis

Best Essay from a First Year Student

VARUN CHHABRA

The University of New South Wales

*Domestic and International Responses
to the Global Financial Crisis*

The Global Financial Crisis (GFC) sometimes referred to as the Great Depression 2.0, has evolved from its origins in the sub-prime loans of the United States to affecting almost every nation in the world. There has been a swift and effective response worldwide to the Global Financial Crisis, and their first priority has been to ensure the stability of the global financial system through a variety of measures. Recently, governments have turned their attention on combating the associated economic downturn by unveiling their fiscal strategies and stimulus packages.

How did we get here?

This whole affair started when in August 2007, when American house prices started falling, exposing certain uncreditworthy homeowners that were lured by the temptation of owning a house. These subprime loans were packaged together in Collateralised debt obligations (CDOs), which were now losing their value as house prices fell and delinquency rates rose. These CDOs were complex securities that provided high returns in the prevailing market conditions, and effectively hid the below-par collateral that was backing the security. Bear Sterns, was the most heavily involved in mortgage-backed securities (MBS), and as the market withdrew its money, it was essentially insolvent. The loss of one institution was not the issue, but the systemic risk that it posed if it went under, threatened to bring other firms down and the widespread use of Credit Default Swaps, ensured the consequences of a bankruptcy would be far reaching in the economy. As such the Federal Reserve and the Treasury were forced to bailout firms, to avoid a systemic solvency situation.

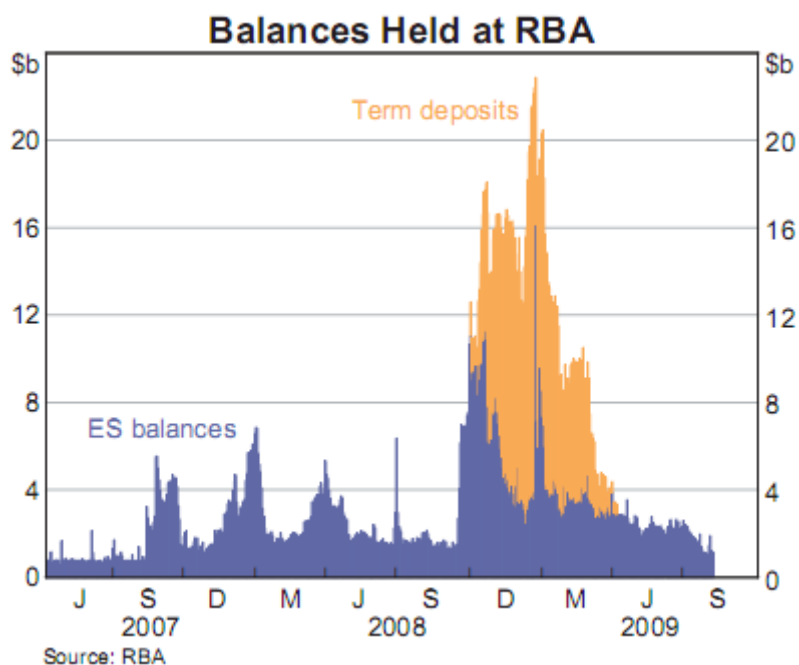
As the financial contagion spread and the perceived counter-party risk increased, demand for liquidity shot up. This is evident in the dramatic increase in the corporate bond spread over government yields, in both Australia (appendix 1.1) and the United States (Appendix 1.2) and a similar effect occurred in markets around the world.

Monetary Policy

Central Banks have many options available with application of monetary policy, and they have devised an effective plan to provide support the financial system with ample liquidity. They must now combat any associated economic downturn as well. They have also teamed up with governments to intervene in markets and provide guarantees.

Supporting the Financial System

In a bid to ease the global credit squeeze, central banks unleashed the monetary policy tools available to them. These measures can be broken down into three distinct categories. The first measure is to provide extended opportunities for the banks to borrow from the central bank¹. In Australia, the RBA significantly increased the Aggregate Exchange Settlement (ES) balances to a peak of \$10billion, which usually runs at \$1 billion. Since lenders were only willing to lend at short maturities, we can see the corresponding demand for RBA term deposits in the graph below.



¹ (Schwarcz, 2008)

Essentially, as the economy enters a “Systemic Liquidity Stage,” the central banks become the “lender of last resort” (LOLR), as financial institutions refuse to lend to each other; the LOLR is critical to providing liquidity in a crisis. Central banks have also eased collateral requirements e.g. RBA now includes RMBS, ABCP and USD-denominated RMBS and ABCP and extending the term of repos to 6months and 1 year. This provided banks with ample liquidity to support themselves in a period of tough financial conditions.

The second measure was to provide loans or make direct purchases to support certain markets. In Australia, the government directed the Australian Office of Financial Management to purchase a maximum of \$8 billion of residential mortgage – backed securities. Similarly, the RBA also spent \$730mn, to kick-start the MBS market. In the United States, the \$700billion TARP which was rushed through the senate, which attempted to use “complex auctions to buy back mortgage-securities and provide short-term stability.”²

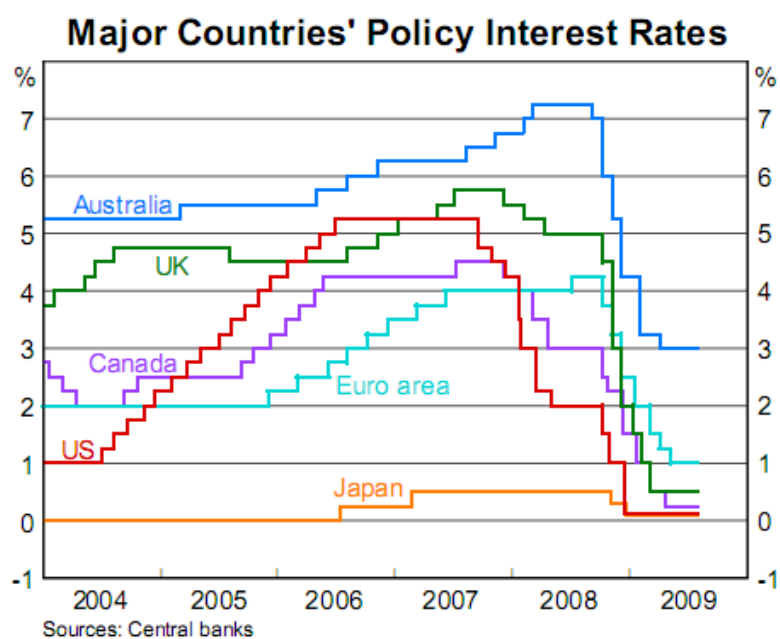
The third measure is the use of guarantees to stabilise markets, support banks in raising debt and to avoid a run on the banking system. After the bankruptcy of Lehman Brothers, losses on Lehman debt in the money market totalled \$700million. Due to the short-term nature of these liabilities and the uncertainty of who held these toxic assets, investors could easily withdraw their funds, which turned into a bank-like run on \$3 trillion industry, which would heavily affect the corporate commercial paper market. To avoid this crisis, the Treasury and Federal Reserve provided deposit insurance for these money market funds. Deposit Insurance was also provided in many countries to re-assure the public and avoid any bank runs. There was no form of insurance during the great depression, which led to numerous bank runs and ultimately the collapse of the banking system. In Australia, the bank guarantees were pushed up to \$1 million dollars, with a fee charged for amounts above that. Further support for authorised deposit-taking institutions, was the ability to use the Federal Government’s AAA credit rating to raise debt cheaply.

² (Roubini, A Bird’s-Eye View, 2009)

Supporting Economic Growth

A financial crisis results in reduced credit flows to consumers and business which when combined with significant declines in major share indexes and house prices. The resulting net loss of wealth reduces the appetite of consumers and business to consume and invest. This can be seen in drop of in consumer and business confidence in the world's major economies (appendix 1.3). Further, a run-down of inventories (Appendix 1.4) was evident as businesses struggled to anticipate consumer demand.

As the link between financial crisis and a possible economic downturn became more apparent, central banks cut rates very quickly. In Australia the overnight cash rate was cut 425 basis points to an "emergency level" of 3%. A similar situation was played out in major economies around the world, see graph below.



The ability to modify rates at any time provides the central bank with flexibility to stimulate in a downturn and prevent overheating in boom. Thus in the current situation, a decrease in the interest rates reduces the cost of borrowing, increasing planned aggregate expenditure and thereby raise the short-run equilibrium output. It also increases a household's discretionary income and results in increased spending. A big driver of discretionary spending is the not the interest rate set by the central bank but as specified in home loan

contract. Mr. Stevens, points out that our “transmission channels are still working: interest paid by borrowers has fallen when the cash rate has been reduced.”³ Because the vast majority of Australian loans are variable, they track the cash rate as can be seen in Appendix 1.5. However in the UK and U.S. mortgage rates didn’t decrease for an extended period, instead margins rose as policy rates fell. Therefore, the transmissions channels have worked more effectively in Australia allowing a sudden increase in disposable income, to help fight the downturn.

Fiscal Policy

It is generally accepted by mainstream economists, that government intervention in a downturn is essential in shortening the duration of the recession and also to support demand in short-term, essentially a Keynesian approach. Since government spending is autonomous, any increase in spending will work its way around the economy, having the multiplier effect, thereby increasing planned aggregate expenditure. It also works to fill output gaps in the short-term as private consumption dips.

In Australia, we have seen two stimulus packages delivered in quick succession, as the government wanted to act quickly and decisively. The \$10.4 billion Economic Security Strategy package is just under 1% of GDP, and was the first stimulus package. After the Christmas break, the government came back to parliament with a “\$42 billion Nation Building and Jobs Plan, providing a boost to the economy of around ½ per cent of GDP in 2008-09 and around ¾ to 1 per cent of GDP in 2009-10.”⁴

The government’s strategy for its discretionary fiscal policy was to provide a mix of short-term and long-term incentives. The cash handouts helped the Australia economy narrowly avoid a technical recession with growth in the March quarter at 0.4%. The unemployment rate has risen from its record lows to stabilise around 5.8% over the past few months,

³ (Stevens, 2009)

⁴MP, H. W., & Hon. Lindsay Tanner, M. (February 2009). *Updated Economic and Fiscal Outlook*. Australian Government, Treasury.

however the increasing incidence of under-unemployment was evident in the aggregate monthly hours worked, which fell 0.43% in seasonally adjusted terms to 1515.2 million in July. The expansion of the first-home owner's grant was effective in stimulating demand for new homes; however it also served to make existing homes more expensive, serving no economic benefit.

Globally, there has been a wave of stimulus packages, with the largest being in China and the United States. In China a 4 trillion Yuan (\$586bn, 12% of GDP) stimulus largely focused on infrastructure. China's stimulus was large enough to have a significant impact, but it is fading quickly because it was projected at building capacity in the economy, when instead should have been focusing on reducing its reliance on exports and focusing on stimulating domestic consumption to drive its economy. In the United States, the Congress passed the US\$787 billion fiscal stimulus package in February 2009, amounting to 5.4% of GDP. The package includes significant tax breaks, benefits for unemployed, aid for the states, infrastructure and an ambitious green agenda. The United States, the epicentre of the Global Financial Crisis needs discretionary fiscal stimulus to support the economy, but it can ill-afford it, as its budget deficit balloons to US\$1.8 trillion, and is completely reliant on foreign savers to finance its debt.

Robert J. Barro, is critical of the Keynesian approach evident in many stimulus packages designed by governments around the world. The flaw he suggests in the Keynesian theory is that it "implicitly assumes that the government is better than the private market at marshalling idle resources to produce useful stuff." ⁵Barro suggests that more focus should present on "incentives for people and businesses to invest, produce and work."⁴ Essentially, saying stimulus packages should provide tax relief and allow the private sector to be more efficient, instead of throwing money at people. The Australian stimulus packages were not effectively targeted and failed to provide effective tax relief.

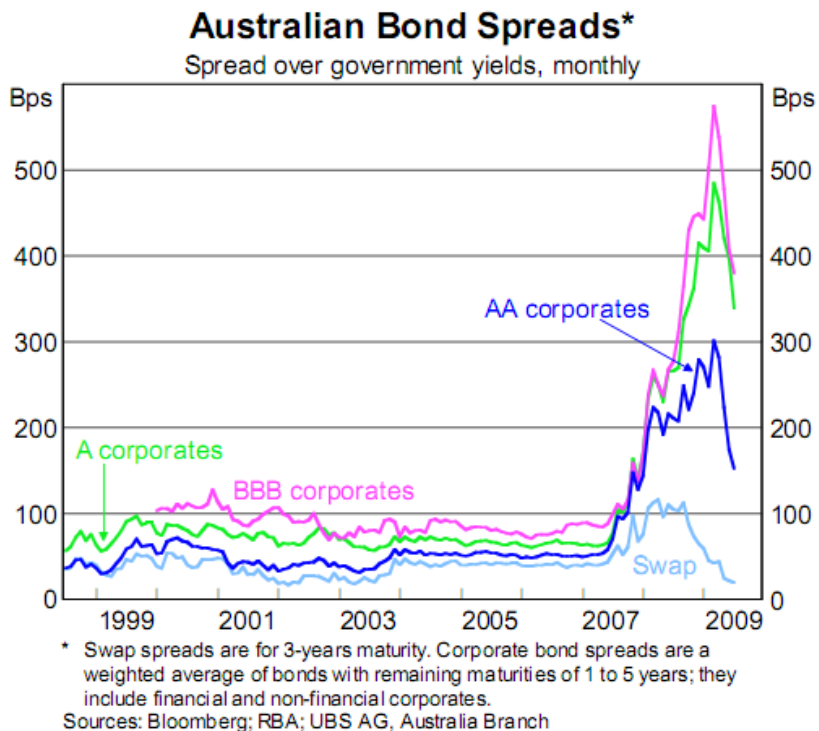
⁵ (Barro, 2009)

Conclusion

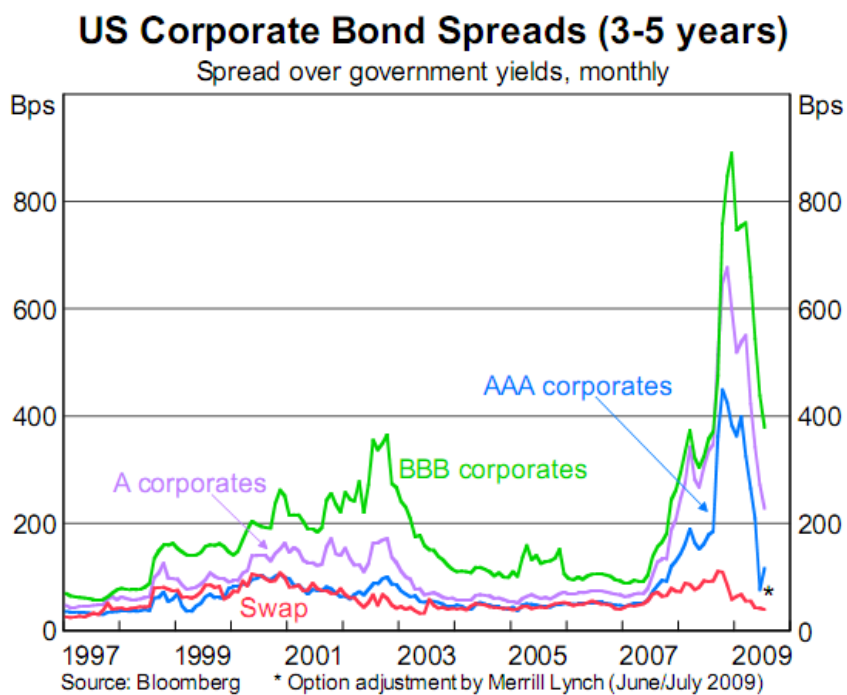
The Global Financial Crisis has rigorously tested the very institutions that were setup to prevent such events from happening. Monetary policy and three distinct policy measures have provide targeted and effective support for the financial system. The resulting economic downturn is being targeted through monetary and fiscal policies. Fiscal policy has helped sustain short-term demand but a more targeted stimulus could be provided. To ride out the global financial crisis, we need to sustain our efforts in supporting the financial system, but also to empower the private sector to ensure maximum efficiency is achieved.

Appendix

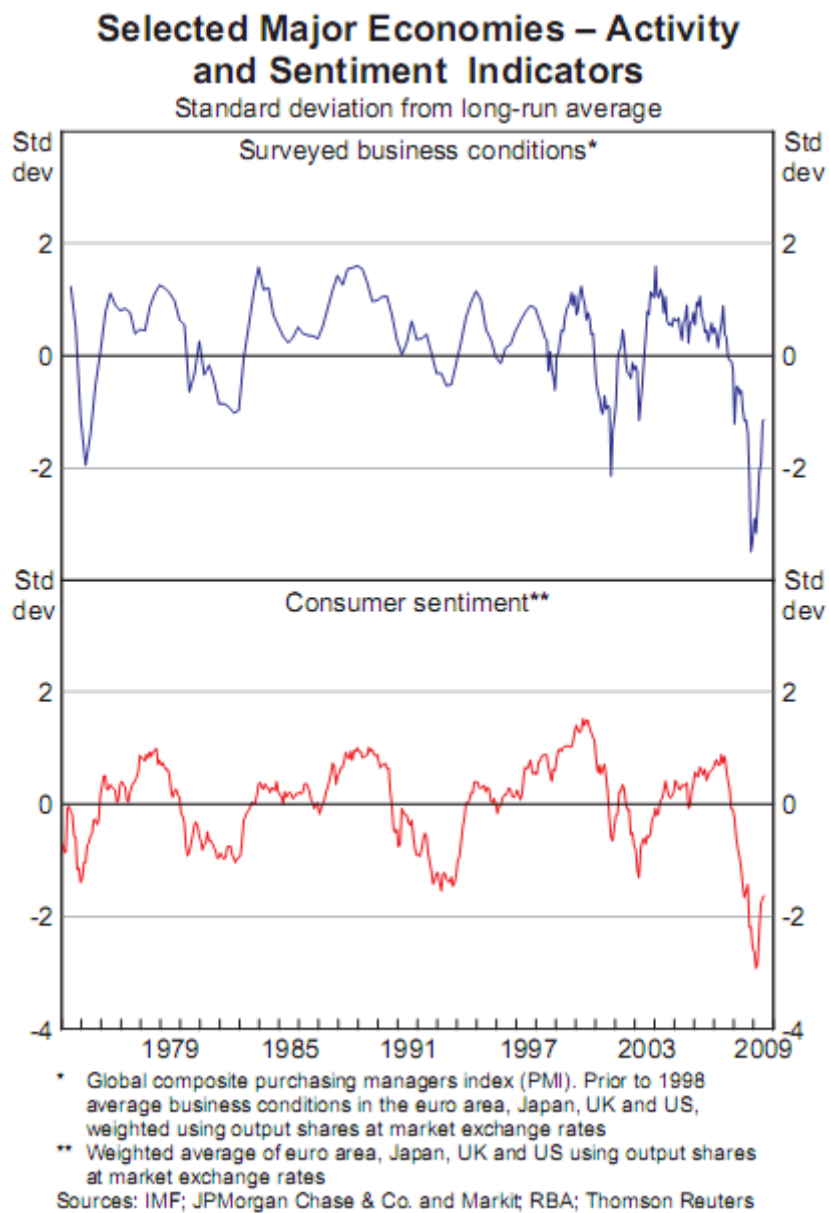
Appendix 1.1



Appendix 1.2



Appendix 1.3

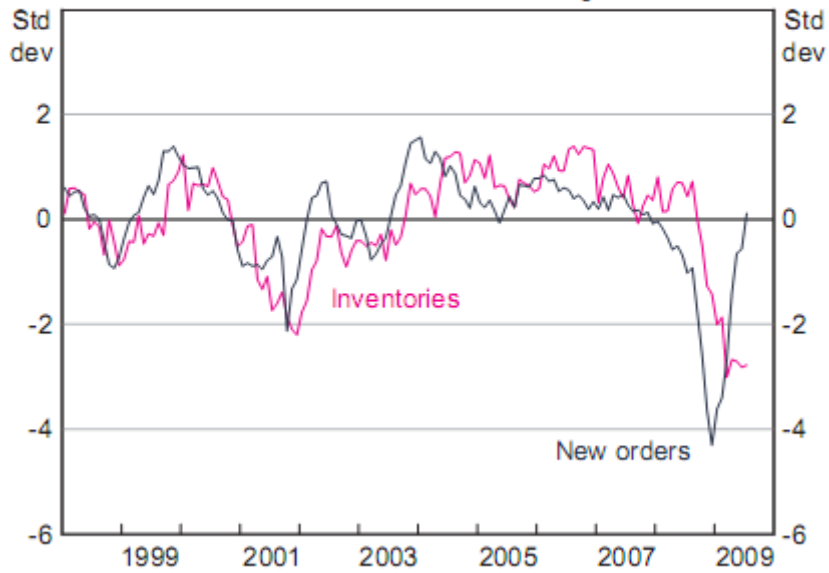


Appendix 1.4

Graph A3

Global Manufacturing PMI

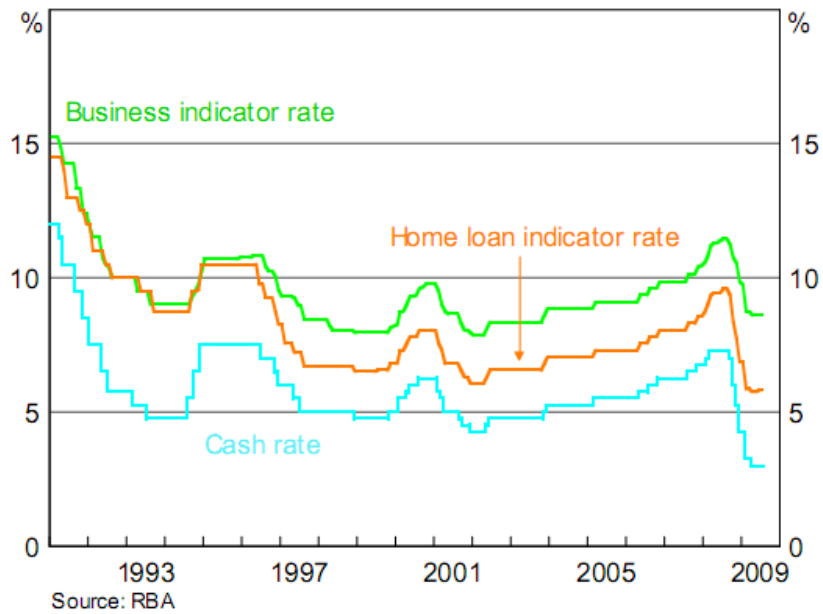
Standard deviation from average



Sources: JPMorgan Chase & Co. and Markit; RBA

Appendix 1.5

Nominal Interest Rates



Source: RBA

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