

## Doing the right thing

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### Weekly Comment



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In real life, disastrous events cannot be prevented by going back in time, and do things differently, thereby preventing the disastrous outcome from coming about.

We cannot go back to the morning of 9/11 and prevent people from boarding planes that would then be used as flying bombs on the World Trade Centre in New York.

But lawmakers are a different breed. For them you need a special dispensation so that they can eventually change their minds, and still do the right thing.

This week will probably see the most important event in the lifetime of many of us, considering the downside if this event were not to take place.

Last Monday the US House of Representatives got the opportunity to gloriously sink the \$700bn proposed bailout plan to get the US banking going again, and did so with glee, voting 205 for and 228 against the motion.

Lest we forget, many of these US lawmakers voted nay because of apparent voter fury about the intended bank bailout, and everything surrounding it.

This nay vote by the House instantaneously reaped the whirlwind of even greater financial panic and massive equity market sell-offs worldwide, on a scale even intimidating to US lawmakers, many apparently afterwards regretting they had voted against the motion and bringing about a deepening of the growing global calamity.

It apparently helped that in many cases constituents now let it be known they weren't amused about their sinking investments. Thus the stock market sell-off may have concentrated enough minds to decide what is needed.

It is now for the US Senate later today to show leadership. With a few bells and whistles added to the proposals (such as \$100bn of tax breaks for many favoured causes, also intended to keep the US economy afloat), it is considered likely that the Senate will pass the \$700bn bailout. The House will then get another opportunity on Thursday to think over its sins, and following Senate leadership vote once more on the matter.

By Friday, Mr Bush may sign the bailout into law, after which Congress can recess and the final electioneering season is upon us.

It would now seem highly likely US Treasury Secretary Paulson is going to get his trillion after all.

According to US President Teddy Roosevelt's dictum over a century ago "in any moment of decision, the best thing you can do is the right thing, the next best thing is the wrong thing, and the worst thing you can do is nothing".

Well, by a process of elimination, US policymakers and lawmakers have worked these Roosevelt options in reverse.

Firstly, they didn't do enough these past 14 months by keeping policy responses piecemeal rather than going comprehensive early (and consequently seeing things going from bad to worse).

Then secondly this week they invited financial Armageddon by shooting down the bailout.

Finally, presumably today and on Thursday, follows redemption as fine calculation has shown whose votes can be reversed to get the necessary majorities.

As Churchill put it, with some experience in WW1 and especially WW2, Americans can be expected to do the right thing after exhausting all other opportunities.

This week's events was another fine example of such US brinkmanship in which the world held its breath, a few more financial institutions went bankrupt, and central banks ceased to be lenders of last resort, instead becoming lenders of first resort as banks no longer wanted to deal with each other, yet they had to keep funding their balance sheets or fail.

So assuming victory is at hand (paraphrasing history once more), what's next?

The biggest headaches probably still lie ahead.

The simple truth is that US financial institutions own a lot of paper assets that are difficult to value. But in auctions of \$50bn apiece for specific asset classes, the US Treasury hopes to start making prices well above prevailing market values, though also well short of intrinsic value.

This should assist banks in stabilising their balance sheets and capital positions. By selling off distressed toxic paper in return for gold-plated, triple-A rated, US Treasury bonds, banks should regain trust in trading with each other, as the likelihood of more catastrophic bank failures recede.

Still, even this bailout will leave the US banking system undercapitalized while banks will continue to deleverage (shrink) their balance sheets, getting rid of assets they can't support and writing off still mounting losses, impairing their credit lending ability for some while.

If this week's events are therefore the turning point in the 14-month financial crisis, it will still take quite a while getting back to what will pass as normal.

It is unlikely that the rich industrial countries can sidestep the growth weakening currently underway, with

some countries already recognizable in recession and others to follow shortly.

Growth has been fatally weakened by high commodity prices, falling house prices, impaired access to credit and in some instances higher interest rates, with even corporate businesses now increasingly husbanding cash flow, implying fixed investment, inventory and labour cutbacks in some countries.

Recession is a given this year and early next year in Europe and most of the English-speaking world, even as many parts of the emerging universe slow down.

Besides the bank bailouts now underway nearly everywhere, central banks continue to provide unprecedented volumes of liquidity, effectively becoming the funding middlemen for banks.

Many banks will as yet not deal with each other and will take time recovering their composure. Meanwhile, central banks are interposing themselves between banks, providing necessary liquidity virtually without limit.

Although the US bailout plan this week carries renewed fiscal stimulus (\$100bn of tax breaks), it may not be enough to overcome the loss of growth momentum currently weakening the US economy.

Similar realities are playing out in Europe, with the ECB confronted with a progressively weaker growth performance and the promise of waning inflation next year.

Receding commodity prices also help, with oil again near \$90 and possibly going lower. But it is really the weaker growth to the point of dipping into recession that is promising much slower inflation nearly everywhere from next year.

With asset markets seriously weakened, especially housing but also equities, inflation to recede while growth is going to be weak, the case for monetary easing will grow in intensity.

Not all central banks will act similarly.

Over in Europe, the ECB will probably remain very strict, though markets are betting on a 0.25% cut to 4% before Christmas once the economic data becomes overwhelming, with a possible descent in European rates towards 2.75% next year.

But even in the US, with the Fed already for six months at 2% and criticized for again going so low with its short-term interest rates, market conditions (very wide spreads implying high interest rates for the economy) and weakening growth (consumers spending, business spending and potentially exports fading) are convincing increasing numbers of market participants that another rate cut is in the offing.

There could possibly be another 0.5% rate cut in the US later this month (six days before the Presidential and Congressional elections on 4 November).

Besides, low long-term US bond yields (3.8%) require ultra low short-term rates if banks are to earn their way back to better capitalization, considering the huge write-offs still to come.

Every bit of assistance will now help, so the Fed may still cut rates, as much with US economy as the recovery of banks in mind.

Throughout the emerging universe, policymakers have gone on hold or are now progressively easing policy either by accepting a weaker currency, cutting interest rates or through fiscal action.

South Africa is very much part of that huge herd. It has so far incurred a 10% Rand weakening on trade-weighted this year, and since midyear has seen its small fiscal surplus disappear.

What remains to happen is limited interest rate relief, probably reversing only half the 5% rate increases of the past two years as inflation falls away, especially rapidly next year after having reached a 13.6% high water mark this past month.

A new cycle-of-life is upon us (for those of you watching too much Lion King).

It starts with the financial bailouts in the US and Europe, allowing the world to step away from a 1929-like abyss. It will increasingly be followed up with a new cycle of policy support for growth, now that the inflation risk is receding once again, following the remarkable crisis events of the past year (commodity price shocks superimposed on housing collapses and banking crises).

Though the Rand has reached 8.20-8.30:\$ territory, it is less weak against the Euro at 11.60 and Sterling at 14.50, indicative that much of the currency fury is playing out among the large currencies rather than being directed directly at us.

Provided the world is now undertaking sufficient support action for its financial sector, and underwriting policies aimed in getting growth restarted next year, risk aversion globally should ease and equity markets (and eventually commodities) should be recovering.

It is the kind of development where the world, and South Africa, is saved by the bell. In our specific case our access to foreign capital should hopefully remain unimpaired, and the Rand reasonably supported.

This would clear the way for inflation collapse, although the composition of our domestic inflation will experience a few wrinkles on the way down back towards the SARB's 3%-6% target.

As to interest rates, prime 15.5% today should give way to prime 13% in the course of next year. Timing will be the prerogative of the SARB, though markets are signaling it will happen sooner rather than later.

And with good reason, seeing our growth sacrifice to date, the inflation collapse that is looming and the receding of global financial risks as we move into 2009.

Out there somewhere is the low point in our growth cycle, and renewed recovery. But lags do apply, and one would expect the leading indicators to lead. So far these are still persistently declining.

It will take time to get back on track.

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