

Staying alive as global markets went up in flames



PETER
COSTELLO

In hindsight, Lehman Brothers was too big to fail.

At the height of summer, the Australian bush is tinder dry. Any spark can ignite it, and fire will leap from tree to tree, destroying all in its path. To manage the risk, firebreaks need to be built and undergrowth cleared well in advance.

Over a long time, combustible undergrowth built up in the US financial system – poor credit practices, complex derivatives, off-balance sheet liabilities and lax prudential standards allowed by gaping holes in the regulatory system. The housing bubble collapse ignited the mix.

The housing downturn and the subprime crisis started in August 2007, and by December the US had moved into recession. Through last year, mortgage lenders and small banks began collapsing. Bear Stearns had to be rescued, and mortgage underwriters Fannie Mae and Freddie Mac needed government guarantees. When Lehman Brothers filed for bankruptcy a year ago yesterday, the subprime crisis gave way to the global financial crisis.

In hindsight, Lehman was too big to fail. It should have been rescued. But the US Treasury and the banking supervisor, the Federal Reserve, did not have the tools or will to do so. Lehman shook confidence in the financial system. Venerable institutions began to look vulnerable. Credit markets seized up and short-term interest rates rocketed. The US was already in recession. The financial crisis deepened it.

Over the course of the decade, both the US and Britain had run large budget deficits. Their national governments carried huge debt. In an attempt to recover from recession, each has undertaken large stimulus spending. Their debt starting point was bad enough; their finish will be even worse.

A country cannot just spend its way out of recession. If it were just a question of spending, the US and Britain would have avoided the downturn. Neither Barack Obama nor Gordon Brown's government is a slouch in the spending department. The fundamental causes were the combustible mix – the unstable financial system and the housing correction which set it off.

In Australia, we prepared much better. Our regulatory arrangements were strong, while stress-testing of financial institutions had identified and resolved weaknesses. We had firebreaks in place.

No major financial institution in Australia will fail. None looked like failing. None of our banks will report a loss, not for one year. The only deposit-taking institutions to get into trouble were the mortgage and debenture trusts, disadvantaged when the Government guaranteed their competitors.

There has been useful discussion of this crisis internationally, particularly in the G20. But there has been no international rescue. No international lender of last resort rescued the US or Britain. Developed economies are expected to look after themselves.

It is a lesson Australia learnt in the Asian financial crisis. The International Monetary Fund and World Bank assisted Thailand, Korea and Indonesia. But that aid came with some nasty (and ill-judged) conditions. Australia was expected to look after itself, and it did.

The Asian crisis sent exchange rates plummeting through the region; the Australian dollar suffered a huge drop. Hedge funds began shorting it, and we spent substantial reserves trying to stabilise it. In 1999 I raised the issue with Asia-Pacific Economic Co-operation group finance ministers, hoping we could get co-operation on stabilising currencies. Was it acceptable

for large pools of private capital to destabilise a currency? Why should a country disclose its level of official reserves when other players – subject to no regulation – were not obliged to report their positions or reserves?

The US team in the Asian financial crisis was Larry Summers and Tim Geithner – the same team working for the Obama Administration on this crisis. They did not see any need for disclosure by hedge funds in 1999. Back then, their economy was not affected.

Now it is. I was interested to note in Barack Obama's plan for regulatory reform, hedge funds will be subject to disclosure and reporting requirements.

Countries invariably see problems from their own perspective. When something affects another country, it is an economic adjustment; if it affects your own, it becomes a crisis. If it is your crisis, you will have to fix it.

In the Asian crisis, we didn't have the luxury of outside assistance. It was a wake-up call. We realised we had better take prevention measures ourselves. It meant setting-up better supervision of our financial system. And it meant paying off federal debt to get our sovereign credit rating back up to AAA. When the Government guarantees Australian institutions in wholesale markets, it can do so with an impeccable credit rating.

Our financial system has outperformed the world. Our institutions were well-managed. We didn't allow a housing bubble to build up and take the economy down. The lessons of the past were remarkably useful in preparing for the challenges of this crisis. But if you don't put prevention measures in place, don't be surprised if the fire creates havoc.

Peter Costello is a former federal treasurer and the member for Higgins.