27 April 2009

Global policy response – the unprecedented becomes commonplace

- **While the outlook for the global economy in 2009 is the worst in over 60 years, the policy response to the “great recession” has been unprecedented.**
- **The G20 meeting held in London earlier this month produced a result that was much stronger than general expectations and, if implemented, could help the global economy and financial system pull out of the current turmoil.**
- **Policy initiatives in the US have also been very aggressive but they have needed to be, given the extent of dislocation in the financial system.**
- **The policy response in Australia has also been very aggressive and holds out the hope that having entered the global recession in pretty good shape, we will be one of the first countries out of the downturn.**

Introduction

In early April 2009, against the back-drop of the worst global recession in over 60 years, the leaders of the G20[1] met in London. Market expectations from the G20 meeting were, however, relatively low, with concerns that agreeing on a specific set of policy measures would be beyond such a diverse group of nations dealing with the economic and financial crisis in their own way and in their own timeframe.

However, markets were pleasantly surprised by the outcome, with some concrete policy measures announced and a more detailed plan for the future. Since the London summit, global equity markets have rallied strongly over April, with the Dow up around 23%, the London market up 18% and the Australian market also up around 19%.

This paper (the second in our thought pieces) will explore what policies were announced at the G20 meeting[2], as well as looking at the other policies that have been put in place both in the United States and here in Australia.

So while the global economic environment is the worst in over 60 years, what is also clear is the policy response has been unprecedented. While it took authorities in some countries a little longer than others to understand the gravity of the economic outlook that was being driven by the global financial crisis, by the second half of 2008, it was pretty clear that policy initiatives were coming quickly and with surprising resolve.

It certainly seems clear that the authorities of the world’s major economies have heeded the lessons of history and are determined to provide the policy stimulus needed to ensure that this economic downturn, as severe as it is, does not persist for longer than absolutely necessary and that when the global economy recovers, the architecture of the world’s financial system will be redesigned in a way to help ensure that a repeat of this episode is not likely (or is at least dramatically reduced).

It certainly seems premature to declare the worst of the global recession over, with general expectations that there is likely more bad economic news ahead of us, than behind. This view was reinforced by the Minutes of the April Reserve Bank of Australia (RBA) Board meeting, where they stated that “members noted, however, there was now considerable economic policy stimulus in place in most countries, which could be expected to support recovery over time. Tentative signs of improvement could be seen in some indicators for several countries, but it was too early yet to judge how durable they would prove to be.”

In addition, on 23 April 2009, the International Monetary Fund (IMF) released their latest global economic forecast and now expect the world economy to ‘grow’ by -1.3% in 2009, the worst year since the end of WWII, with a modest 1.9%

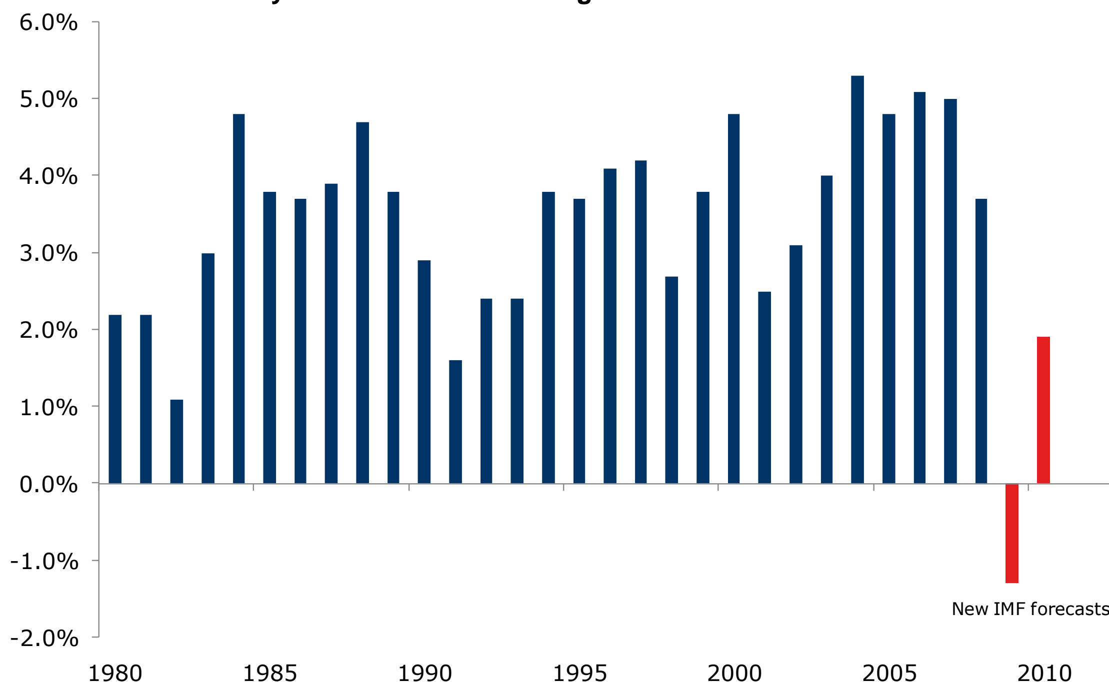
[1] The Group of 20, or G20, comprises 19 countries; Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Sth Korea, Mexico, Russia, Saudi Arabia, Sth Africa, Turkey, United Kingdom and the United States. The 20th member is the European Union, with the position held by the rotating presidency of the European Central Bank. To ensure co-ordination, the leaders of the IMF and World Bank also attend. The G20 accounts for 90% of global GDP, 80% of world trade and 75% of the world’s population.

[2] Information from G20 Leaders communiqué, 2 April, 2009

growth recovery now expected in 2010 (see chart below for details). For the world's advanced economies, 'growth' is forecast at -3.8% in 2009 and at zero in 2010, while for emerging market and developing economies growth is expected to be 1.6% in 2009 and 4.0% in 2010. For Australia, the IMF expects 'growth' of -1.4% in 2009, before a recovery to growth of 0.6% in 2010.

Nevertheless, we must also remember that financial markets are forward looking and that a sustained recovery in markets is likely to begin before signs of economic recovery are confirmed. Markets are clearly dealing with just such a scenario at present – but it is worth remembering that all bear markets can have a number of relatively solid rallies before a true bull market returns.

International Monetary Fund world economic growth forecasts



Source: IMF World Economic Outlook, April 22, 2009

The G20 policy announcements

The following highlights the key policy decisions announced at the G20 London meeting:

- **The financial commitment**
  - Increased funding for the IMF of $US500bn, from $US250bn to $US750bn
  - An additional $US250bn in allocations of special drawing rights (SDRs) to the IMF to support their global activity
  - An additional $US100bn of funding for multilateral development banks (MDBs)
  - An agreement to make available $US250bn as support for trade finance
  - An agreement for the IMF to use additional resources from gold sales for concessional financing for the poorest of countries ,and
  - All up this financial commitment totalled $A1.1tr to "help restore credit, growth and jobs in the world economy."

- **Focus on growth and jobs**
  - The G20 stated that to date the easing of fiscal policy among members accounted for $US5tr and would raise output by 4% (over a number of years) and that this "will save or create millions of jobs which would otherwise have been destroyed."
  - In addition, the G20 stated that "we are committed to deliver the scale of sustained fiscal efforts necessary to restore growth.", and
  - The following table illustrates the size of the fiscal response to date from most of the countries in the G20. We note how large Australia's contribution is, especially relative to the size of Australia's economic downturn.

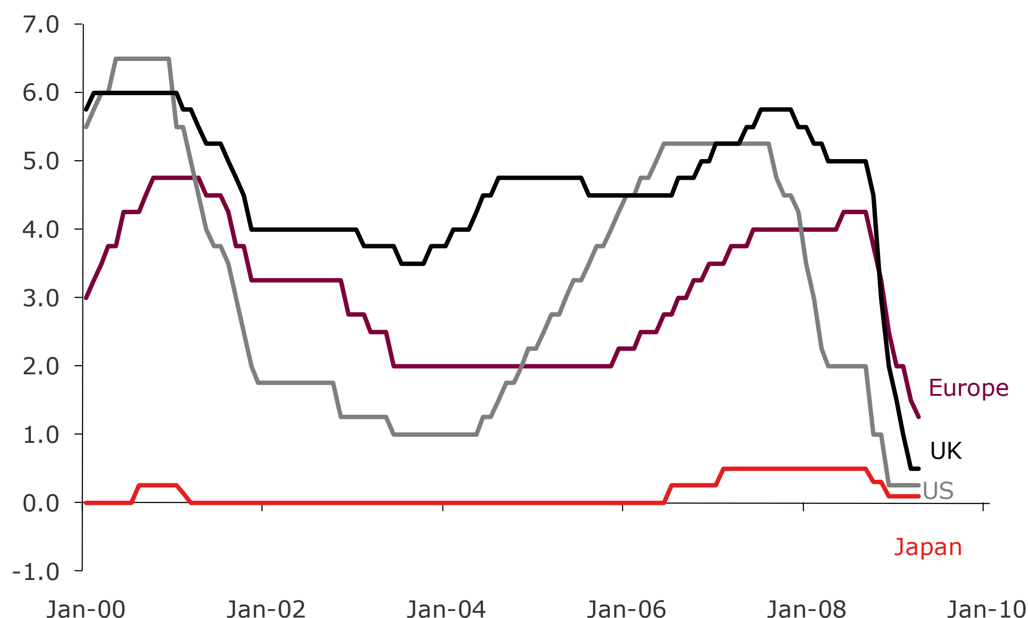
Fiscal policy easing, % of GDP relative to 2007 baseline

Country	2009	2010
Argentina	1.3	-
Australia	2.1	1.7
Brazil	0.4	0.2
Canada	1.5	1.3
China	3.2	2.7
France	0.7	0.7
Germany	1.5	2.0
India	0.6	-
Indonesia	1.3	0.6
Italy	0.2	0.1
Japan	1.4	0.4
Korea	2.3	1.3
Mexico	1.5	-
Russia	2.3	1.6
Saudi Arabia	3.3	3.5
Sth Africa	1.8	-0.6
UK	1.4	-0.1
US	2.0	1.8

Source: IMF

- The G20 supported the recent aggressive monetary policy easing by central banks, stating that "our central banks have pledged to maintain expansionary policies for as long as needed and to use the full range of monetary policy instruments, including unconventional instruments, consistent with price stability." The following chart shows the dramatic reduction in interest rates around the world, with those countries that have reached the zero-limit (ie. the US, UK and Japan) now undertaking either Quantitative Easing or Credit Easing, or a combination of both.

Official interest rates in selected countries



Source: RBA, data to 27 April 2009

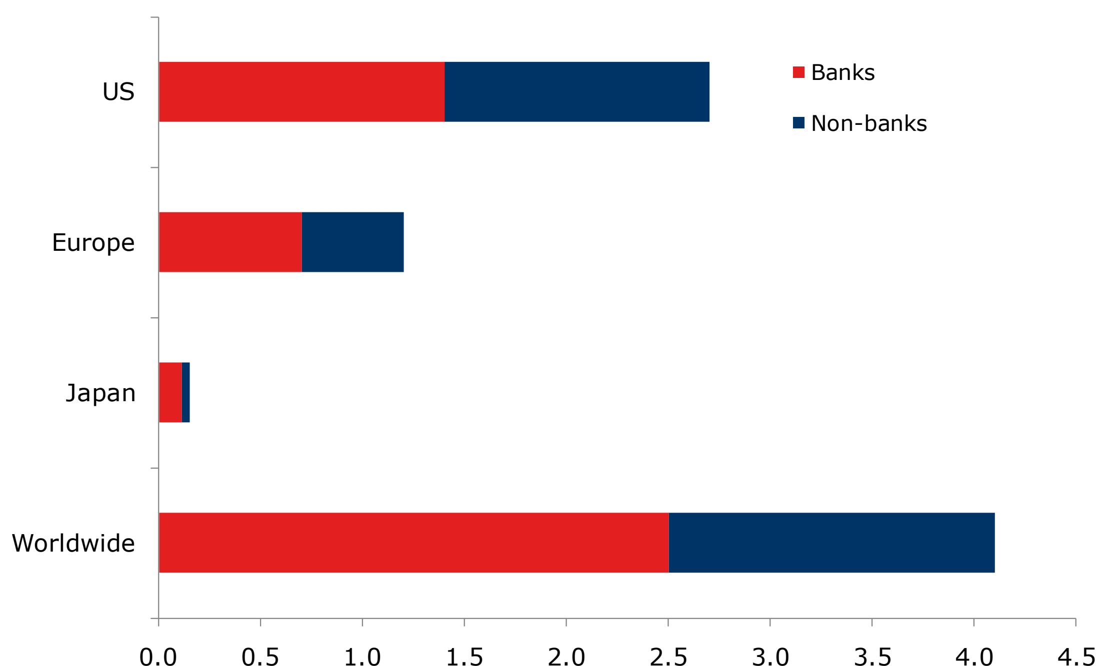
- The G20 also noted that "our actions to restore growth cannot be effective until we restore domestic lending and international capital flows". As a result the G20 stated that "we are committed to take all necessary actions to restore the normal flow of credit through the financial system and ensure the soundness of systemically important institutions."
- In what was likely a response to those worried about the longer-term implications of the size of the policy response, especially with regard to inflation, the G20 also stated that "we are resolved to ensure long-term fiscal sustainability and price stability and will put in place credible exit strategies from the measures that need to be taken now to support the financial sector and restore global growth."

- In another welcome sign of cooperation, the G20 also stated that "we will conduct our policies cooperatively and responsibly with regard to the impact on other countries and will refrain from competitive devaluation of our currencies and promote a stable and well-functioning international monetary system.", and
- The G20 also agreed that they would support "candid, even handed and independent IMF surveillance of our economies and financial sectors, of the impact of our policies on others, and of risks facing the global economy."

➢ **Strengthening financial systems**

- A big part of the G20 agreement was the decision to support an ongoing strengthening of financial supervision, stating that "we each agree to ensure our domestic regulatory systems are strong (and) we also agree to establish the much greater consistency and systematic cooperation between economies, and the framework of internationally agreed high standards, that a global financial system requires."
- The G20 Leaders also stated that "regulators and supervisors must protect consumers and investors, support market discipline, avoid adverse impacts on other countries, reduce the scope of regulatory arbitrage, support competition and dynamism, and keep pace with innovation in the marketplace."
- Significantly, to put into practice this commitment, the G20 agreed to establish the Financial Stability Board (FSB). The FSB will be the successor to the Financial Stability Forum (FSF) and will include each country in the G20, plus Spain and the European Commission.
- The G20 stated that "the FSB should collaborate with the IMF to provide early warning of macroeconomic and financial risks and the actions needed to address them; to reshape our regulatory systems so that our authorities are able to identify and take account of macro-prudential risks; to extend and oversight to all systematically important financial institutions, instruments and markets. This will include, for the first time, systematically important hedge funds."
- The FSB will also "endorse and implement … tough new principles on pay and compensation … to support sustainable compensation schemes and the corporate social responsibility of all firms."
- In a nod to the future capital needs of the banking system, the G20 also stated that "once recovery is assured" the FSB will "take action … to improve the quality, quantity, and international consistency of capital in the banking system. In future, regulation must prevent excessive leverage and require buffers of resources to be built up in good times."
- The FSB will also "take action against non-cooperative jurisdictions, including tax havens" and will also "extend regulatory oversight and registration to Credit Rating Agencies to ensure they meet the international code of good practice, particularly to prevent unacceptable conflicts of interest.", and
- The G20 Finance Ministers (including Treasurer Swan) are due to meet again in November to discuss progress with the FSB.

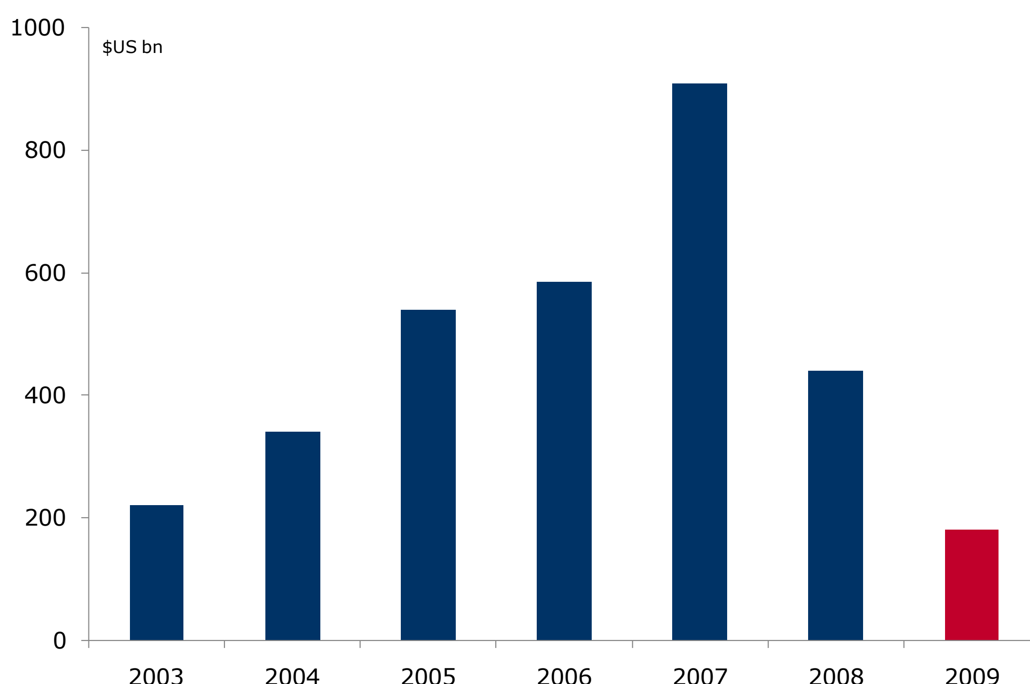
IMF estimates of write-downs on toxic assets by 2010



Source: IMF

- **Strengthening our global financial institutions**
  - One of the major areas of concern for the G20 was the sudden loss of capital flows into emerging markets and developing economies, ie. the G20 wanted to make sure that the financial crisis in the developed world doesn't lead to further significant problems for developing economies, given their ongoing need for global capital inflows. See chart below for details on global capital flows to the emerging world.
  - This is, partly, why the G20 decided to increase the financial resources available to the IMF and other 'Multilateral Development Banks' (MDB) by $US850bn.
  - This includes immediate financing for the IMF of $US250bn and the ability for the IMF to increase borrowings by up to $US500bn. MDBs will be able to increase their lending to developing nations by "at least $US100bn".
  - Perhaps more significantly than the increased financial resources for the IMF and other multi-lateral bodies, is the commitment from the G20 to reform these bodies as well.
  - To this end the G20 stated "we are determined to reform and modernise the international financial institutions to ensure they can assist members and shareholders effectively in the new challenges they face. We will reform their mandates, scope and governance to reflect changes in the world economy and the new challenges of globalisation, and that emerging and developing economies, including the poorest, must have greater voice and representation."

Net private flows to emerging markets (2009 is estimate only)



Source: Institute for International Finance, AFR

- **Resisting protectionism and promoting global trade and investment;**
  - The G20 note that after underpinning rising prosperity for half a century, world trade growth "is now falling for the first time in 25 years."
  - The leaders agreed, therefore, that "reinvigorating world trade and investment is essential for restoring global growth. We will not repeat the historic mistakes of protectionism of previous eras."
  - Essentially this was a commitment by the G20 members not to introduce any measures that could limit global trade or be perceived as protectionism, with an accompanying commitment to act through the World Trade Organisation (WTO) if any such polices or disputes arose.
  - Importantly, the G20 also stated that "we remain committed to reaching an ambitious and balanced conclusion to the Doha Development Round, which is urgently needed."

- **Ensuring a fair and sustainable recovery for all;**
  - Under this topic the G20 agreed to ensure that the poorest of nations were not left behind in the recovery process (ie. by ensuring capital flow to those nations).
  - In addition, the G20 stated "we recognise the human dimension to the crisis. We commit to support those affected by the crisis by creating employment opportunities and through income support measures."
  - Finally, the G20 also stated that "we agree to make the best possible use of investment funded by fiscal stimulus programmes towards the goal of building a resilient, sustainable, and green recovery. We will make the transition towards clean, innovative, resources efficient, low carbon technologies and infrastructure."

Policies moves in the United States

Of course, in addition to agreeing (and driving) the reforms agreed on at the G20 Leaders meeting, the United States has also introduced a seemingly bewildering array of policy initiatives to deal with the effects of the financial crisis and the recession. Below is a brief time-line of the US policy initiatives and their expected impact.[3]

2007

August 10	FOMC announces that it "will provide reserves as necessary" to keep the actual Federal Funds rate as close as it can to the target rate and that "as always, the discount window is available as a source of funding."
September 18	FOMC reduces the Federal Funds target rate by 50bp to 4.75%.
October 31	FOMC reduces the Federal Funds target rate by 25bp to 4.50%.
December 11	FOMC reduces the Federal Funds target rate by 25bp to 4.25%.
December 12	FOMC announces the creation of the Term Auction Facility (TAF) in which fixed amounts of term funds will be auctioned to depository institutions against a wide variety of collateral.
	Fed also authorises temporary reciprocal swap lines with the ECB ($US20bn) and Swiss National Bank ($US4bn), for six months.

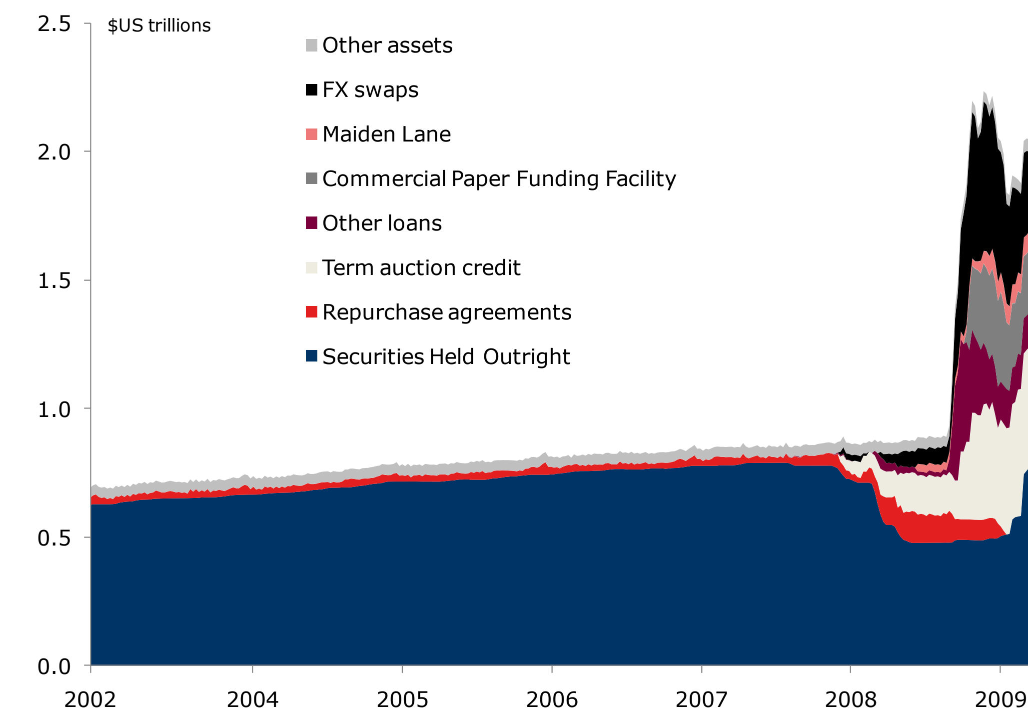
2008

January 22	At an inter-meeting conference call FOMC announces a 75bp cut in the Fed Funds target rate to 3.5%.
January 30	FOMC reduces the Fed Funds target rate by 50bp to 3.0%.
March 11	Fed announces the creation of the Term Securities Lending Facility (TSLF), which "will lend up to $US200bn of Treasury securities for 28-day terms against federal agency debt, federal agency residential mortgage-backed securities (MBS), non-agency AAA/Aaa private label residential MBS, and other securities."
	The Fed also increased its swap lines with the ECB and SNB by $US10bn and $US2bn, respectively, and extended those lines to September 30, 2008.
March 14	The Fed approves the financing arrangement between JPMorgan Chase and Bear Sterns.
March 16	The Fed establishes the Primary Dealer Credit Facility (PDCF), extending credit to primary dealers at the primary credit rate against a broad range of investment grade securities."
March 18	FOMC reduces the Fed Funds target rate by 75bp to 2.25%.
April 30	FOMC reduces the Fed Funds target rate by 25bp to 2.00%.
May 2	FOMC expands the list of eligible securities in TSLF auctions to include AAA/Aaa rates asset-backed securities.
	FOMC also expands swap lines to ECB and SNB by $US20bn and $US6bn, respectively and expands TAF auctions from $US50bn to $US75bn.
June 25	FOMC votes to leave Fed Funds target rate at 2.0%.
July 13	Treasury announces a temporary increase in the credit lines of Fannie Mae and Freddie Mac and a temporary authorisation for the Treasury to purchase equity in either GSE if needed.
July 15	The Securities Exchange Commission (SEC) issues an emergency order temporarily prohibiting naked short selling in the securities of Fannie Mae, Freddie Mac, and primary dealers at commercial and investment banks.
July 30	The Fed extends the TSLF and PDCF to January 30, 2009, introduces auctions of options on $US50bn of draws on the TSLF and introduces 84-day TAF loans. The Fed also increases its swap line with the ECB to $US55bn.
August 5	FOMC votes to leave Fed Funds target rate at 2.0%.
September 7	The Federal Housing Finance Agency places Fannie Mae and Freddie Mac in government "conservatorship". The Treasury also announces that will implement additional measures to support the two GSEs.
September 14	The Fed announces further changes to PDCF and TSLF to increase funds available and broaden the range of eligible securities.
September 15	Lehman Brothers Holdings files for Chapter 11 bankruptcy protection.
	Bank of America announces its intent to purchase Merrill Lynch & Co.
September 16	The Fed Board authorises the Federal Reserve of NY to lend $US85bn to the American Insurance Group (AIG).
	FOMC votes to leave Fed Funds target rate at 2.0%.
September 17	SEC announces a temporary emergency ban on short selling in the stocks of all companies in the financial sector.
September 18	FOMC expands existing swap lines by $US180bn and authorises new swap lines with the Bank of Japan (BoJ), Bank of England (BoE) and Bank of Canada (BoC).

[3] Federal Reserve of St. Louis, last updated 7 April 2009

September 19	The Fed announces the creation of the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) to extend non-recourse loans to US banks to finance their purchase of high-quality asset-backed commercial paper from money market mutual funds. Treasury announces a temporary guarantee program of up to $US50bn for participating money market mutual funds.
September 24	FOMC establishes new swap lines with the RBA ($US10bn), Riksbank ($US10bn), Danmark Nationalbank ($US5bn) and Norges Bank ($US5bn).
September 29	FOMC authorises an $US330bn expansion of swap lines with the BoC, BoE, BoJ, Danmarks Nationalbank, ECB, Norges Bank, RBA, Riksbank and SNB, taking outstanding swap lines to $US620bn. Fed announces an expansion of TAF, increasing the size of the 84-day maturity auction to $US75bn and two forward TAF auctions totalling $US150bn.
October 3	After an initial rejection, Congress passes and President Bush signs into law the Emergency Economic Stabilisation Act 2008, which establishes the $US700bn Troubled Assets Relief Program (TARP).
October 7	Fed announces Commercial Paper Funding Facility (CPFF) to provide a liquidity backstop to US issuers of commercial paper.
October 8	FOMC reduces the Fed Funds target rate by 50bp to 1.50%.
October 28	Treasury purchases a total of $US125bn in preferred stock in nine US banks under the Capital Purchase Program.
October 29	FOMC reduces the Fed Funds target rate by 50bp to 1.00%.
November 18	Executives of Ford, General Motors and Chrysler testify before Congress, requesting access to the TARP for federal loans.
November 23	The Treasury, Fed and FDIC jointly announce an agreement with Citigroup to provide a package of guarantees, liquidity access and capital.
November 25	Fed announces the creation of the Term Asset-Backed Securities Lending Facility (TALF), with the NY Fed to lend up to $US200bn to holders of AAA-rated asset-backed securities and recently originated consumer and small business loans.
December 11	The National Bureau of Economic Research announces that US economic activity peaked in December 2007 and that the economy has since been in recession.
December 16	FOMC establishes a target range for the Fed Funds rate of 0%-0.25%.
December 19	Treasury authorises loans of up to $US13.4bn for GM and $US4bn for Chrysler from the TARP.

Increase in the Federal Reserve's balance sheet



Source: US Federal Reserve

2009

January 16	Treasury, Fed and FDIC announces a package of guarantees, liquidity access and capital for Bank of America, which had also purchased Merrill Lynch.
February 10	Treasury Secretary announces a Financial Stability Plan, involving Treasury purchases of convertible preferred stock in eligible banks, the creation of a Public-Private Investment Fund to acquire troubled loans and other assets from financial institutions, expansion of the Fed's TALF and new initiatives to stem residential mortgage foreclosures and to support small business lending.
February 10	Fed announces that it is prepared to expand the TALF to as much as $US1tr and broaden the eligible collateral.
February 17	President Obama signs into law the American Recovery and Reinvestment Act of 2009, which includes spending measures and tax cuts intended to promote economic recovery and valued at $US787bn.
February 18	President Obama announces the Homeowners Affordability and Stability Plan, which will permit the refinancing of mortgages to stem the flow of foreclosures.
February 25	The Fed and FDIC announce that they conduct "stress tests" of eligible US banks. Supervisors will work with firms to estimate the range of possible future losses and the resources to absorb such losses over a two-year period. The assessment process is expected to be completed by the end of April 2009. Banks are expected to be advised how much capital they will need to raise and then be given 6 months to raise this capital from private sector. If they cannot do so, the public sector will provide the capital – along with conditions.
March 18	FOMC maintains target Fed Funds rate at 0%-0.25% and decides to increase the size of the Fed's balance sheet by purchasing up to an additional $US750bn of agency mortgage-backed securities (to a total of $US1.25tr) and to increase it purchases of agency debt by up to $US100bn (to $US200bn). FOMC also decides to purchase up to $US300bn of longer-term Treasury securities over the coming 6 months – ie. this is the start of Quantitative Easing in the US. See chart above for an indication on the substantial increase in the size of the Federal Reserve's balance sheet as a result of its financial market activity.
March 23	The Fed and Treasury issue a joint statement on the appropriate roles of each during the current financial crisis and into the future, and on the steps necessary to ensure financial and monetary stability.
	The Treasury announces details on the Public-Private Investment Program (PPIP) for Legacy Assets.
April 6	The Fed announces new reciprocal swap lines with the BoE, ECB, BoJ and SNB.

Policies in Australia

Australia, too, has played its part in the G20 process and implemented a number of policies at home to help support the economy through recession and to ensure stability in the financial markets and banking system. Below is a brief time-line of the Australian policy initiatives.

2008

2 September	RBA eases policy by 25bp, taking cash to 7.0%.
26 September	Commonwealth government announces support for Residential Mortgage-Backed Securities (RMBS) market, by directing Australian Office of Financial Management (AOFM) to purchase RMBS to ensure a viable source of funds to institutions that can compete with the major banks in the mortgage market.
7 October	RBA eases policy by 100bp, taking cash to 6.0%.
12 October	Government announces deposit and wholesale funding guarantees for the Australian banking system with details flowing in subsequent days/weeks.
14 October	Government announces $A10.4bn "Economic Security Strategy", including lump sum payments to families and pensioners, an increase in the first home buyers grant and extra money for training.
4 November	RBA eases policy by 75bp, taking cash to 5.25%.
29 November	Government announces $A6.2bn car industry support plan.
2 December	RBA eases policy by 100bp, taking cash to 4.25%.
12 December	Government announces $A4.7bn infrastructure plan, with money flowing to States and Local Councils.

2009

3 February	RBA eases policy by 100bp, taking cash to 3.25%.
27 February	Government releases "Updated Economic and Fiscal Outlook" which includes another round of significant fiscal policy easing, totalling $A42bn over 4 years as the "National Building and Jobs Plan". The stimulus includes direct payments to all those earning an income under $A100k pa, significant investment in schools, housing, energy efficiency, community infrastructure and roads, as well as support to small businesses.
27 February	Government announces Australian Business Investment Partnership (ABIP) to provide funds to commercial property sector if foreign banks pull out of refinancing this sector.
25 March	Commonwealth government offers, for a fee, a "time-limited, voluntary guarantee over State government borrowing." The guarantee can be for new debt issued by the States and existing lines of bonds. The measure has an immediate positive impact on State/Commonwealth bond spreads, but full details not yet finalised.
7 April	RBA eases policy by 25bp, taking cash to 3.0%.
	Commonwealth government announces $A43bn National Broadband Network investment plan.
26 April	Commonwealth & State government agree to a $A31.7bn in road and rail infrastructure investment.

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