

# Flash Comment

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## Total global financial crisis

**Overview:** Markets are in turmoil as the fallout from the financial crisis goes global and hits Euroland hard. Things went from bad to worse yesterday evening, when the House of Representatives rejected the USD 700bn bailout. The compromise bill had been hammered out by high level members of Congress over the weekend. While a bill is likely to be passed in some form, the rejection increases the risk that the final bill will be a watered-down version with a more limited healing effect on the financial system. In our view, developments in recent weeks have already caused damage to the real economy, as access to funding has been cut off.

The spill-over to Europe comes via a number of channels. The direct spill-over from US markets and rising global risk aversion is clear. Global growth prospects decline every day the crisis rages on, and confidence in banks around the globe is crashing. Distrust of the banking sector in Europe was already surging on the back of bailouts of Dexia, Hype Real Estate, Fortis, Glitnir and Bradford & Bingley, and just this morning Ireland rescued a number of banks – see more below.

**The bill:** The vote was 228-205, with 133 Republicans and 95 Democrats voting no. The Senate will now have to work on a new proposal to capture the 12 votes that is needed to pass the bill. This will likely be done via balanced changes to the bill that would turn the needed number of Republicans in the House around without turning more Democrats against the proposal. Today is a Jewish holiday in the US, so a new vote in the Senate will not be held until Wednesday at the earliest. If the Senate votes yes, the bill must be approved by the House of Representatives.

**Central bank actions:** The Fed stepped up its liquidity injections yesterday by massively expanding its dollar facilities. Three measures were taken: firstly, an increase in total TAF auctions from USD 150bn to USD 300bn, all in 84-day funds; secondly, an additional USD 150bn in TAF auctions to be held in November to provide extra liquidity in the weeks surrounding year-end; and thirdly, an increase in currency swap lines with foreign central banks, taking the total from USD 290bn to USD 620bn.

More central bank actions are likely in the coming days and weeks. Further liquidity-providing measures will be taken and the probability of coordinated rate cuts from global central banks has risen. However, delivering a Fed rate cut before the US bill has been passed could be viewed as unwanted interfering in US politics, and so the Fed is likely to prefer to wait until a bill has been passed.

The ECBs monetary policy meeting on Thursday will be very interesting. The outlook for monetary policy in Euroland is clearly shifting towards cuts. The economic implications are clearly negative due to lower global growth and, domestically, from increased tightening of credit with the risk of a regular credit crunch. At the same time, funding costs are surging for both corporates and households, and this is tantamount to a rate hike. Nothing is more deflationary than a credit crunch, and commodity prices have dropped significantly recently. All in all, everything points to a softer tone from the ECB, with an increased focus on risks.

**Government actions:** Following the “bank run” on US money market mutual funds, a guarantee program was set up with the Treasury insuring the holdings of any publicly offered eligible money market mutual fund – both retail and institutional – for the next year. Currently the FDIC provides insurance that guarantees the safety of checking and savings deposits of member banks – currently up to USD 100,000bn per depositor per bank. If the risk of further bank runs increases, the next step could be to expand the current limit to a full guarantee of banks deposits.

In addition, if the rescue package passes but fails to heal the financial system, we are likely to see further bank bailout on an individual basis. Targeting the real economy, a second fiscal stimulus package could be an option, but such a package would not be on the cards before next year when a new president takes office.

Europe’s financial stability arrangements remain anchored at the national level. According to current principles each member country is individually responsible for its financial sector stability, including resolving systemic banking crises. One potential stumbling block for bailouts in Euroland is that a solution has to meet the EU’s competition rules. In order to facilitate acting speedily as soon as an individual bank crisis is in sight, the Commission has prepared an ad hoc procedure, making it possible to respond to sudden and urgent requests from member states.

The European Commission is in charge of applying EU competition rules to large mergers with a cross-border dimension, and enforces rules regulating state aid to industry. Furthermore, while antitrust rules cannot be suspended in economic emergencies, it is possible to apply the regulations flexibly. “We have the possibility to apply the competition rules in a way fit to the circumstances,” Commission competition spokesman Jonathan Todd said following the Fortis case.

If problems emerge in a pan-European bank, there are no agreed rules on early intervention and on actions to take to remedy the situation. The EU has no strategy to handle a pan-European banking crisis, except to pledge that authorities will work together. In the Fortis case it worked well, as explained by Commission spokesman Johannes Laitenberger: “What we saw this weekend is that the system works ... both nationally and also trans-nationally”. However, this model is unlikely to work as well in other parts of Europe, since the Benelux countries already operate as a closely linked team. Different national authorities may have different priorities because of different interests or a different assessment of risks – and the more so if the crisis becomes acute.

Speed might be hampered by coordination difficulties, lack of agreement between countries on the role (if any) public funding should play in crisis resolution, and on the division of tasks between supervisors in ‘home’ (headquarters) and ‘host’ (local) jurisdictions. At every step, agreement may take so long that it might be overtaken by events on the ground, with consequent increases in the cost of any remedy.

#### **Ireland issues very broad guarantee**

Irish authorities have already introduced a broad guarantee of bank deposits, bonds, etc. The guarantee extends to all deposits, including retail, commercial, institutional and interbank and also bonds, senior debt and dated subordinated debt. It also covers all money borrowed by Irish banks from other financial institutions. The guarantee extends to: Allied Irish Bank, Bank of Ireland, Anglo Irish Bank, Irish Life and Permanent, Irish Nationwide Building Society and the Educational Building Society.

This is a very broad and direct rescue operation. It is a much bigger rescue and much more interventionist than e.g. the USD 700bn bailout plan in the US. However, the rescue comes with strings attached. The price for this rescue is: “The guarantee is being provided at a charge to the institutions concerned and will be subject to specific terms and conditions so that the taxpayers’ interest can be protected,” the Irish Department of Finance said in a statement. The agreement runs for 2 years. This is a model that could be invoked in other Euroland countries if the need emerges.

#### **The Fortis model**

More bailouts in line with Fortis are clearly also a possibility. Under the hastily arranged rescue, Belgium will make the biggest contribution, taking a 49% stake in the Belgian arm of the company, Fortis Bank NV/SA, for EUR 4.7bn. The Dutch government will take a 49% stake in the Dutch arm, Fortis Bank Nederland Holding, for EUR 4.0bn, and Luxembourg will buy a 49% stake in Fortis Banque Luxembourg for EUR 2.5bn through a convertible loan.

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