Risk Managing the Elephant in the Room

In this issue we will again look at the credit crisis from the perspective of risk professionals.

As Risk Reward has been consistently reviewing the causes of the crisis (this is well documented in previous updates) in this update we look at the lessons from the past and their impact on the solutions for today.

It remains our belief that the actions being taken are dealing with symptoms and are actually ignoring what we see as the elephant in the room.

Globally we are seeing governments and central banks seeking to reduce interest rates and increase public spending to stimulate their economies. The question that everyone is now considering is whether this will actually have the desired results. Our views are clear. Since the actions do not deal in any way with the causes of the crisis, but with the symptoms, they will inevitably make matters significantly worse.

Risk Reward has previously explained the crisis dates from 2003/4, not 2007, so any analysis that commences with the latter date will be fundamentally flawed. Further the crisis commenced with concerns over asset securitisation and whether these assets, which have no other significant acquirers, actually can be suitable for the banking book of financial institutions. This is a real problem since the assets were designed to develop AAA rated assets for the banking book to replace sovereign assets and thereby enhance the yield.

The Impact of Reducing Interest Rates

Both the UK and the USA have now reduced interest rates below rates of inflation. The consequences of this are many:

- Anyone with deposits will feel worse off. In real terms their deposits will decline in value and they will consequently wish to reduce their consumption to compensate. Since for every borrower there are typically eight depositors, this has a significant impact on market consumption.
- Companies with significant cash will move their deposits to higher interest rate countries, thereby removing liquidity from the banking sector at exactly the time when it is most required. Such countries include the GCC, for example.

The reduction in interest rates has had a significant impact on the currencies concerned. In the case of sterling we are seeing a reduction of typically 30% against a basket of currencies. This had to be expected. The problem for a country like the UK which imports a significant proportion of (Continue d on page 2)
the goods available for sale due to the limited manufacturing base is that it starts to import inflation. With commodities priced in dollars (a 25% depreciation) and the remainder experiencing 30% depreciation, cost inflation is certain to take off at exactly the same time when people are feeling times are tough.

Basically the governments have taken a historic economic model that is effective for an exporting country and applied it to a country that is a net importer. With regret this will have exacerbated the problem as we will see later.

Funding Large Scale Projects

The other issue has been whether countries should commence large infrastructure projects in an effort to stimulate the economy. The problem with such projects is that the type of work uses labour that tends to come from overseas and therefore there is a leakage of cash from the economy. Further these assets are often not income generative and are therefore unable to increase the value of the economy.

There is no evidence that a failure to build was actually the cause of the crisis. Indeed there is a lot of concern at the level of borrowing within the economy. That bank borrowing is in effect being replaced with government borrowing is one of the most surprising outcomes of this entire process. We cannot see any way in which such spending can in any way result in a shortening of the crisis – indeed we are concerned that it may in effect extend the process significantly.

The Actions that Were Actually Required

Perversely perhaps we are of the view that increasing rather than reducing interest rates would have assisted with solving the issues that are of concern. Higher interest rates provide support to the currency and reduce the price of imports. At the same time there is a real rate of return if such rates are higher than inflation, resulting in both individuals and firms placing greater funds on deposit at the banks. This in turn provides additional liquidity within the banking sector and enables the banks to extend credit to other firms – effectively unlocking the credit impasse which we are currently suffering.

One of the concerns that we have had throughout the crisis was the limited experience in their roles of many of the international global players during this crisis. This lack of experience combined with a similarity of outlook and an intention of dealing with symptoms rather than problems has compounded the situation.

It is our belief that eventually sensible people will recognise the actions that must be taken that drives our expectations for next year. It is our view that the actions taken on the UK economy will have extended recession in the UK by at least six months and that such a recession will be far deeper than was in effect necessary.