Philequity Corner (March 17, 2008)
By Valentino Sy

US credit crisis & bailouts - Reminiscent of 1997 Asian Financial Crisis

In our previous article entitled "*The US can learn from the 1997 Asian Financial Crisis*" (see the January 21, 2008 issue of **The Philippine Star**) we discussed the parallels of the 1997 Asian financial crisis and the more recent US housing and credit crisis. Back then, Asia had a massive non-performing loan (NPL) problem where banks could not find buyers for their NPLs which resulted in a liquidity crisis. The same thing is happening now in the US. Suddenly, there are few buyers of mortgages, CDOs and other financial instruments, creating liquidity squeeze on the financial system. In its latest move, the Fed had to put up a US$200 billion facility to provide liquidity.

Fed's Smartest Move Yet

In an attempt to ease liquidity strains in the financial system, the Fed announced a new measure called Term Securities Lending Facility (TSLF). Touted by many as the Fed's "smartest" move yet, this is new facility is based on the existing Term Auction Facility (TAF) but with the following key changes:

1. The lending window was increased to US$200 billion from the US$20 billion.
2. The TSLF is up to a 28-day term while the TAF is overnight lending only.
3. The TSLF accepts (via repo agreements) a broader set of collateral - including agency debt, agency residential mortgage backed securities (MBS) and even non-agency AAA/Aaa rated private residential MBS - in exchange for Treasuries.
4. Lending under the new program will be with primary dealers (which includes non-depositary institutions), thereby extending the window to investment banks and securities dealers previously not given direct access to the Fed for relief from funding strains.

Although this latest Fed move is not a cure-all, we believe that it is an important step in relieving forced-selling of agency debt and high-quality MBS, and in reducing the shortage of bank liquidity evident in wide LIBOR spreads. Allowing dealers to swap these securities for Treasurys will encourage some spread tightening in high-grade securities.

Concerted central bank action

In addition, the Fed announced that it would increase its temporary reciprocal currency swap lines with the European Central Bank and the Swiss National Bank, taking up the provision of up to US$ 30 billion and US$6 billion, respectively. The Bank of Canada, the Bank of England, the European Central Bank and the Swiss National Bank also announced specific measures in conjunction with the Fed action last week.

Is the bottom in sight?

Upon announcement of these new measures last Tuesday, the Dow Jones Industrial Average (DJIA) surged over 400 points while the S&P and Nasdaq saw their biggest one-day gains in more than 5 years. This big rebound has led some investors and analysts to observe that a bottom in the market may be near.

Those hopes were further boosted on Thursday by a positive report from Standard and Poor's which said that the bulk of the write-downs linked to sub-prime loans was probably behind for banks. This was enough to overcome news on Wednesday over the collapse of Carlyle Capital Corp. Ltd, a closed-end fund affiliated with the Carlyle Group.

By Friday, however, the confidence built up over the past few days was shattered when news of a Fed bailout on Bear Sterns hit the market. The Fed had to invoke a Depression-era law to allow a non-bank to borrow through its discount window with JP Morgan as the conduit. Hours after the rescue, Lehman Brothers announced that it has secured a three-year credit line from banks. These developments ignited fears that other major Wall Street firms might fail. Unable to sustain the earlier momentum, the DJIA suffered a 194-point loss on Friday, ending flat for the weak despite Tuesday's big surge.

Eerily similar

In the current environment, the Fed's US$200 billion TSLF and the bailout of Bear Sterns is reenacting what Asian central banks did in 1997. Back then, the IMF issued bailouts to Korea (US$56 billion), Indonesia (US$40 billion) and Thailand (US$17 billion). With funding from the IMF, these countries were then able to close insolvent financial institutions and set up centralized asset management companies (AMCs) to deal with the impaired assets as part of their restructuring program. So what is happening now is that the US government, thru the Fed, is taking over these insolvent firms to prevent further collateral damage to the financial system.

The good news is that we know that the Fed is not going to stand back and let the markets unravel by themselves. This shows that the Fed is willing to undertake innovative initiatives to facilitate the proper functioning of credit markets and reflate the US economy.

Markets may take time to recover

Since August 2007, the Fed has acted aggressively to try to ease credit market woes and bolster the economy, but so far the markets continue to be volatile. Similar to the 1997 Asian financial crisis, more bailouts may be needed. The US$200 billion lending facility may not be enough. The Fed and other central banks, together with the sovereign wealth funds, may need to be more aggressive to put up more liquidity in the system.

While the markets may go down further, we know that in time, just like in 1997, the markets will recover. And with the measures taken by the Fed, just like what Asian governments did in 1997, we know that in due time this current credit crisis will be resolved. When one is wounded, it takes time to recuperate.

For comments and inquiries, you can email us at info@philequity.net. You can also view our archived articles at www.philequity.net or www.yehey.com/finance.