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# Assessing the Global Financial Crisis

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## **ASSESSING THE GLOBAL FINANCIAL CRISIS**

This document summarizes a discussion among APCO Worldwide's International Advisory Council (IAC) members about the ongoing deleveraging of the world's credit markets and the implications for business during the coming months. The members of APCO's IAC, who have held senior positions in government and business, view the crisis as creating an exceptionally fluid and dynamic business environment that is likely to result in significant changes in capital flows, investment patterns and political dynamics during the remainder of this year and throughout 2009. They anticipate profound changes to the regulatory regimes governing the financial services sectors in the G-7 countries and the European Union (EU), as well as ongoing improvisation by governments around the world to deal with the unique challenges created by the current situation. These are likely to include further capital infusions by governments into major financial institutions, the development of new coordination mechanisms to strengthen financial stability and to move beyond the informal Bretton Woods II system that evolved since 2001.

### **Overview of the current economic turmoil**

#### ***United States***

The U.S. economy remains in the midst of a massive deleveraging on a scale that has not been seen since the 1920s. Borrowing by U.S. consumers and businesses, largely financed by savings provided by China and foreign energy producers, is undergoing rapid constriction, even as federal borrowing has rapidly increased. U.S. Treasury bonds, paying negligible rates of interest, remain the final safe haven for foreign funds seeking safety. The bubbles that have burst now include not only real estate and the stock market, but even a widening range of commodities, starting with oil.

In the immediate aftermath of the disappearance of the entire investment banking industry in the United States into failure, absorption or conversion to commercial banking, the market for commercial paper is essentially frozen. For example, Coca-Cola is reportedly one of only three major U.S. companies able to obtain substantial 30-day loans to cover ongoing operating expenses. Companies (and SMEs in particular) are expected to face a much tighter credit line. American Express has reduced the line of credit to twice as many card holders than it usually does this year. The standard index for commercial lending, the LIBOR rate, has also risen dramatically, leaving about a 4 percentage point gap between LIBOR and government Treasury bill rates with corresponding maturities; under normal circumstances, the difference is generally negligible. Economic activity has weakened across all 12 Federal Reserve Districts, as consumer spending, manufacturing and the labor market all weakened in response to consumer uncertainty and the credit crunch.

Further pressures remain. Hedge funds face a day of reckoning at the end of this year, as open redemption periods will require them to liquidate vast components of their holdings with massive losses. Moreover, private equity firm activities remain constrained by the limited availability of credit. As a consequence, there are now likely to be fewer leveraged deals, fewer deals of any kind and fewer exit opportunities for companies that are privately held. In the meantime, regulators are looking to assess the degree to which regulated financial institutions have accumulated losses associated with off-balance sheet vehicles

and how to integrate recognition of such debt in a fashion that will not lead to further financial institution failures.

The bottom line: this is not an esoteric exercise. Businesses large and small, as well as individuals are simply unable to borrow. The dramatic capital injections into major banks by the United States in October are unlikely to remain the final word on government interventions to rebuild U.S. credit markets. These remain uncharted waters. Nobody knows exactly where this will lead.

Due to the fluid nature of the situation, there is a heavy improvisational element to everything that the U.S. Treasury Department is doing. The Treasury is rapidly moving to reach agreements with vendors to help it respond to the fallout. Yet, all of these activities are taking place in the final days of a lame-duck Administration whose appointees will be leaving government in a small number of weeks.

The financial situation has dramatically impacted the election, both the actual situation and how it is being covered by the press. Whoever is elected will need to make the economy the number one priority and have a stimulus package ready to launch during his first week in office. The Obama campaign has already begun to work on a version of this plan and is engaged in informal consultations on what elements could be introduced to provide new lending and new employment in the U.S. during the first six months of 2009. To date, the McCain campaign has focused primarily on the prospect of further cuts in individual and business taxes to provide stimulus in that period. In practice, a combination of short-term federal job-training and subsidy programs with tax cuts are likely to become part of a stimulus package regardless of who wins the election.

### **Asian Markets**

The Asian economies have learned from the 1997 crisis, so the regional banks are not as leveraged. In fact, a recent Merrill Lynch analysis on leverage of 500 listed Thai corporations indicated that their average leverage has declined from 3x in 1997 to 0.39x in the second quarter of this year. However, there will still be dire consequences and repercussions from the crisis across the Asian markets, particularly harming the export sectors.

Primarily due to lessons learned in the 1997 crisis, most Asian countries also have much better financial regulatory regimes in place than they did a decade ago. Their commercial banks have better corporate governance and better internal risk management and their corporate sectors have much lower leverage. Direct exposure to both sub-prime and derivatives overseas is limited.

Several Asian securities markets were in "bubble mode" a year ago, but the decline in market indices of the Chinese, Indian and Southeast Asian share markets started a year ago and has proceeded downwards rapidly. By the time of the Lehman Brothers collapse, much of the bubble had already been squeezed out of these markets. Thus far, these sharp declines in Asian stock market valuations have not had major economic consequences in Asia. Similar to the October 1987 New York market crash, they have been confined to stock market events.

Most Asian countries are either in strong surplus, or at least comfortable in their trade balance and international reserve position. Overall macro-economic management in most

Asian countries has been reasonably sound in recent years. Compared with the United States, savings rates are healthy and the level of household debt is not excessive. Over the past two years, the Chinese government has taken a number of steps to rein in excesses in the securities, property and credit markets with a certain degree of success, particularly in the past 12 months. Nonetheless, if contraction of economic growth in China over the next year or two is severe, it will be interesting to see how robust the real estate mortgage and credit card portfolios of Chinese banks are, what the rate of default will be and how Chinese banks will cope with the first serious consumer credit problems that they have ever faced. When Chinese banks last faced massive non-performing loans 10 years ago, consumer credit was not a significant part of their portfolios. It could transpire that some of the Chinese domestic real estate credit turns out to be sub-prime in quality as well, but not packaged or sold as such.

Asia, with the exception of Japan, does not have significant indigenous investment banks operating internationally.

Asian economies will be impacted next year as a result of declining exports to the rest of the world, leading to declining investment, declining consumption and lower accumulation of foreign currency reserves. There will be impact on the health of Asian bank balance sheets, but Asia should be able to avoid the complete freezing up of credit that has hit the United States, or that hit countries like Thailand in 1997 and 1998. As Chinese economic growth declines, this will lead to reduced demand for a number of different commodities and resultant sharp commodity price declines.

### ***Russia***

Russia is suffering from direct implications of the crisis at the moment, which highlighted its strong dependence on the West and vulnerability vis-à-vis the rest of the world. To date, its stock market has lost more than two-thirds of its value and trading has been repeatedly suspended.

The Russian authorities have already assigned US\$230 billion for the support of its banking sector and large private companies; it is equivalent to two-thirds of the 2008 state budget and 13.6 percent of Russia's GDP. Russia's companies will also have to compensate in the coming months for their taxes and some foreign debt in the estimated amount of US\$180 billion, which will create a new need for capital. The tax administration decision to lower the tax level for some sectors of the economy will only slightly improve the situation. The developing situation can create further potential for mergers and acquisitions. The plunge in the Russian Stock Exchange capitalization has on the other hand created new opportunities for foreign investments in selected companies. And, a number of the country's wealthiest individuals have turned to the Russian government for possible assistance to avoid default, creating the potential for further renationalizations.

Falling prices for natural resources can put the state budget under pressure. In order to keep the level of social expenditures, the government would have to re-allocate funds for 2009 from a financial perspective, in particular limit the foreseen high rise of expenditures in the defense and military sector. Despite the market failures, Russia's economy is relatively less leveraged than the West and there may still be significant opportunities for business growth.

## **Europe**

The situation in Germany is relatively calm, thanks to a government umbrella protection of investments.

However, we are just beginning to see the impact in the European financial sector – it will probably get worse before it gets better. In an effort to discourage bank failures, the EU has agreed to relax ‘mark to market’ requirements, which will allow banks to keep assets on their books at purchase price rather than require them to mark them down to current valuations. Short-term, this will assist banks; longer-term, it creates the risk that toxic debt and other problem assets will remain as hidden liabilities within financial institution portfolios.

The mid-October decision by the EU to commit to injecting a total of 1 trillion Euros into the European banking sector by the EU member states reflects a recognition that coordinated action to recapitalize the banks was required. Notably, the EU also committed to creating an informal warning, information-exchange and evaluation mechanism which it termed a “financial crisis cell.” The cell will be made up of representatives of the EU presidency, the president of the European Commission, the president of the European Central Bank and the president of the Euro group, and is likely to be married up with representatives from the Federal Reserve, the U.S. Treasury and others in the near future. The EU leaders have committed to undertaking a comprehensive review of existing regulation and supervision of the EU’s financial sector, focusing on cross-border activities and have agreed to develop an EU-wide system for consolidated, coordinated financial services supervision.

Separately, the EU Commission and Council are looking at the possibility of EU-wide action by Directive to address perceived deficiencies in the accounting principles and other standards relied on by financial rating agencies. They are also considering whether to take action to address executive compensation in order to combat risks associated with short-term risk taking by executives seeking to maximize share price and bonuses.

Also of significance are the ongoing efforts by French President Nicholas Sarkozy to expand the involvement of non-G-7 and EU nations into participation in international efforts to combat the crisis, including Brazil, China, Egypt, India and South Africa. President Sarkozy, meeting with Canadian President Stephen Harper, also suggested separate Francophone efforts by the 55-French speaking nations, to develop a coordinated response to the crisis that would take place in a complementary fashion to activities undertaken in other contexts.

## **The Gulf States**

The local markets, in particular those in the United Arab Emirates, have seen losses mirroring those in Asia.

The financial crisis may lead to lower energy prices. Oil has dropped to as low as US\$70 a barrel and futures are trending to the US\$70-US\$80 a barrel range. This could have real implications for the Gulf States as their spending has been based on the anticipation of higher energy revenues than may now be realistic. OPEC is now considering curtailing production in order to stabilize the price of oil to at least the US\$80-US\$90 per barrel range.

## Implications

There is no question that government involvement in markets will be dramatically increased in the coming months amid efforts to create a new system for global governance and regulation of capital market activities. The crisis may lead to several global outcomes.

The rise of protectionism, especially in light of Doha failure, may inspire more oversight and regulation as well as tighter controls over cross-border investments, capital flows and M&A activities. The major tasks for the next phase of regulation include the development of a system that provides for the universal application of harmonized standards and norms for financial institutions, regardless of location. The elimination of regulatory arbitrage to counter those who would exploit lower standards of regulation to achieve greater market returns will be a major goal of such regulation. The new system will likely also strive for increased transparency to regulators of all activities of financial institutions, ensuring that consolidated supervision provides a full view of all of their activities and risks.

In the United States, we are likely to see efforts at regulatory consolidation closer to the lines previously undertaken by the United Kingdom with the creation of a Financial Services Authority, as opposed to the multi-regulator approach undertaken to date by the United States. The US\$750 billion financial bailout package enacted by Congress includes the requirement that the U.S. Treasury provide a new comprehensive plan for financial services regulation by April 2009. We anticipate that this will include efforts to extend oversight to hedge funds and at least indirect supervision of private equity firms to the extent they intersect with regulated financial institutions. We expect the incoming Administration and Congress to revisit in particular the authorities and staffing of the Securities and Exchange Commission and the Commodities Futures Trading Commission, both of whose limitations have been seen as implicated in the current crisis.

In turn, we anticipate that the United States will reach out to major financial services partners, starting with the G-8 and the EU, but also Latin America, East Asia and new major players such as Dubai. The purpose of this outreach would be to seek the extension of coverage of regulation to historically lesser-regulated entities, such as hedge funds on a global basis, in the goal of addressing the risks created by lack of transparency and regulatory arbitrage.

As efforts at harmonization move forward, it has become clear that the supposed decoupling of the emerging economies is dead. Markets in Latin America and Asia have found renewed evidence that the old adage “when America sneezes the world catches a cold” remains true. Russia also thought they were “immune.” These notions have been proven to have been greatly exaggerated: The United States is perhaps no longer the single dominant economy, but the global market is more connected than ever before.

There are some opportunities in this situation. Assets in the United States are undergoing substantial downward valuations, marking them as likely targets for a wave of direct foreign investment in 2009. We anticipate such investments to take place in a complex political environment, in which such investment will be simultaneously welcomed by some constituencies given their potential positive impact on jobs and economic growth, while condemned by others concerned about the potential loss of U.S. independence to “foreign influence” or “foreign control.” The Committee on Foreign Investment in the United States

process by which foreign investments are reviewed for their national security implications is likely to see heavy use in the coming year, with Congress taking an especially active interest in transactions relating to sectors of potential political sensitivity, such as energy, telecommunications, transportation, financial services and information technology. Firms considering such transactions will need to augment business decisions with political risk assessments and public and government affairs strategies designed to address such risks.

For now, government policies regarding both regulation and intervention are in an unusually fluid state. The situation provides the opportunity for private sector entities to engage in the policy-making process not only by bringing new information to policy makers but also fresh ideas.

### **APCO's Key Experts and IAC Members**

APCO's team of experts have decades of experience working in government and business on significant financial matters. Their expertise and counsel is available to clients on all aspects of the financial crisis, new regulatory matters and business strategy to help minimize the impact of this financial situation.

#### **Aleksander Kwasniewski, IAC member**

Aleksander Kwasniewski is the former president of Poland. During his 10 years in office he navigated Poland through the delicate transition from communism. He successfully led the adoption of a new national constitution and the campaign committed to Poland's admission to NATO and the European Union.

#### **Don Riegle, chairman, government relations & IAC member**

Don Riegle, former United States senator, served six years as chairman of the Senate Banking Committee and led several major financial restructuring bills to enactment.

#### **Don Bonker, executive vice president & IAC member**

Don Bonker, former United States congressman, was a senior member of the House Foreign Affairs Committee and chairman of the Subcommittee on International Economic Policy and Trade.

#### **Michael G. Oxley, IAC member**

Michael Oxley is former chairman of the House Financial Services Committee. One of the key authors of the landmark Sarbanes-Oxley Act, he provides high-level strategic counsel regarding corporate governance, financial transactions, export and trade promotion, and government oversight and investigations.

#### **Stuart Eizenstat, IAC Member**

Stuart Eizenstat is the former under secretary of state for economic, business and agricultural affairs (the senior economic official at the U.S. Department of State), former United States ambassador to the European Union and former co-chairman of the European-American Business Council.

**Marc Ginsberg, senior vice president & IAC member**

Marc Ginsberg is the former United States ambassador to Morocco, former special U.S. coordinator for Mediterranean trade, investment and security affairs; and former chief financial officer at Galland, Kharasch, Morse & Garfinkle.

**Eugene Lawson, IAC member**

Eugene Lawson is the former president and founder of the U.S.-Russia Business Council and the founder of the U.S.-China Joint Commission on Commerce and Trade. He also served as the vice chairman of the Export-Import Bank of the United States.

**James Stent, IAC member**

James Stent, currently a director of the China Everbright Bank, began his banking career with Citibank and then joined Crocker National Bank, working in New York, Manila, Bangkok and Hong Kong. He is the former deputy president of the Bank of Asia in Thailand and previously served as a director of the China Minsheng Bank.

**Jonathan Winer, senior vice president**

Jonathan Winer is the former United States deputy assistant secretary of state for international law enforcement. At the State Department, he was one of the architects of United States international policies and strategies in financial services regulation and enforcement.

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