Citywire

How the central banks should tackle the credit crisis

By Nicholas Paler | 15:56:20 | 18 September 2008

The rescue of AIG by the Federal Reserve gave markets in the States a brief boost earlier this week, as investors breathed a sigh of relief that the nation's largest insurer would not be allowed to go to the wall.

The implications of the collapse of a firm so ingrained in the global financial system were simply too far reaching for it to happen - understandable given it has operations in over 130 countries worldwide and assets of over $1 trillion.

However, the last 48 hours have shown that the decisive action has failed to bolster confidence, with shares once again going into free-fall yesterday in the UK, the States, and elsewhere around the world, amid ongoing concerns about the stability of the financial system.

So what needs to be done to head off this crisis? Investors have put forward a number of ideas, including a co-ordinated central bank stance, which eventually emerged this morning in the form of a $180 billion injection of cash to alleviate pressures in US short-term funding, as well as further steps.

David Oakes, the chief investment officer at Mercater Capital Management, said the creation of a super-fund which buys up the toxic assets would help.

Such a move was taken in 1989 when the Resolution Trust Corporation was launched by the US government to buy up assets of savings and loans associations which had been crippled by the savings and loans crisis.

'An obvious solution would be the creation of such a fund,' Oakes said.

He noted some positive steps had already been taken, such as the takeover deal of HBOS by Lloyds TSB, which was done at a higher price than expected, as well as the move to impose restrictions on naked short selling, a form of futures trading based on making money via a share price fall.

Oakes added: 'The commodity price drop will also help as it will give strength to central banks and allow them to cut interest rates.'

Jeremy Batstone-Carr, head of research at Charles Stanley Stockbrokers, said the ongoing problem which is yet to be addressed is that central bank policies so far have been reactive, not proactive.

He said: 'Although the Fed has bailed AIG out, it is still reacting to pressure from the market and not actually taking steps to end it (the crisis).

'It's all reactive and we want to see central banks move, and the market blink, not the other way around.'

He added that to defeat the credit crisis, central banks around the globe needed to take co-ordinated action, something which was emerging today.

Aegon Asset Management's head of equities, Innes McKeand, agreed that much of the actions taken had been reactive, and he said there was yet to be a 'magic-bullet' solution, such as the creation of an institution designed to buy up all the toxic debt from the banks.

'The pieces are falling into place (in terms of reaching the end of the credit crisis) but right now we still have good quality and bad quality banks, and things have been done out of sheer necessity,' he said.

'One thing we might expect to see going forward is the creation of a big institution in the US to buy all the bad assets, as that is a classic solution, but there has been no magic bullet so far.'