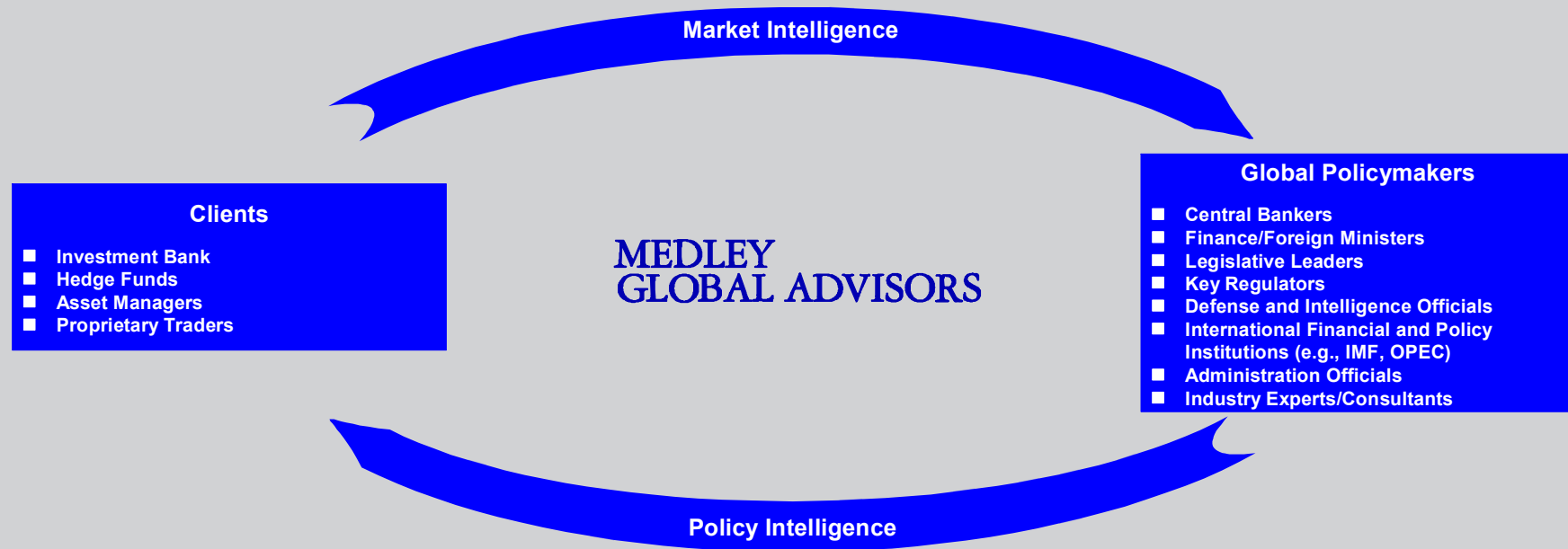


Coping with a Modern Credit Crisis



Who are Medley Global Advisors (MGA)?

- Founded in 1997, MGA is the premier policy intelligence firm for many of the world's leading investors and traders
- MGA provides proprietary content, derived from primary sources, on a consultancy / retainer basis



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The Background

- There is no do doubt that the Great Economic Moderation has delivered significant benefits over the past 20 years
- At the same time , however , this period also created significant tail risks
- Something that attracted increased attention in recent years
- A focus the markets largely ignored , at least until strains became evident in the US Subprime market
- That catalyst for the repricing of risk found amplification through financial innovation and the use of leverage
- A combination that ultimately led policymakers having to stare down the unanticipated threat of systemic risk

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Forewarned was not Forearmed

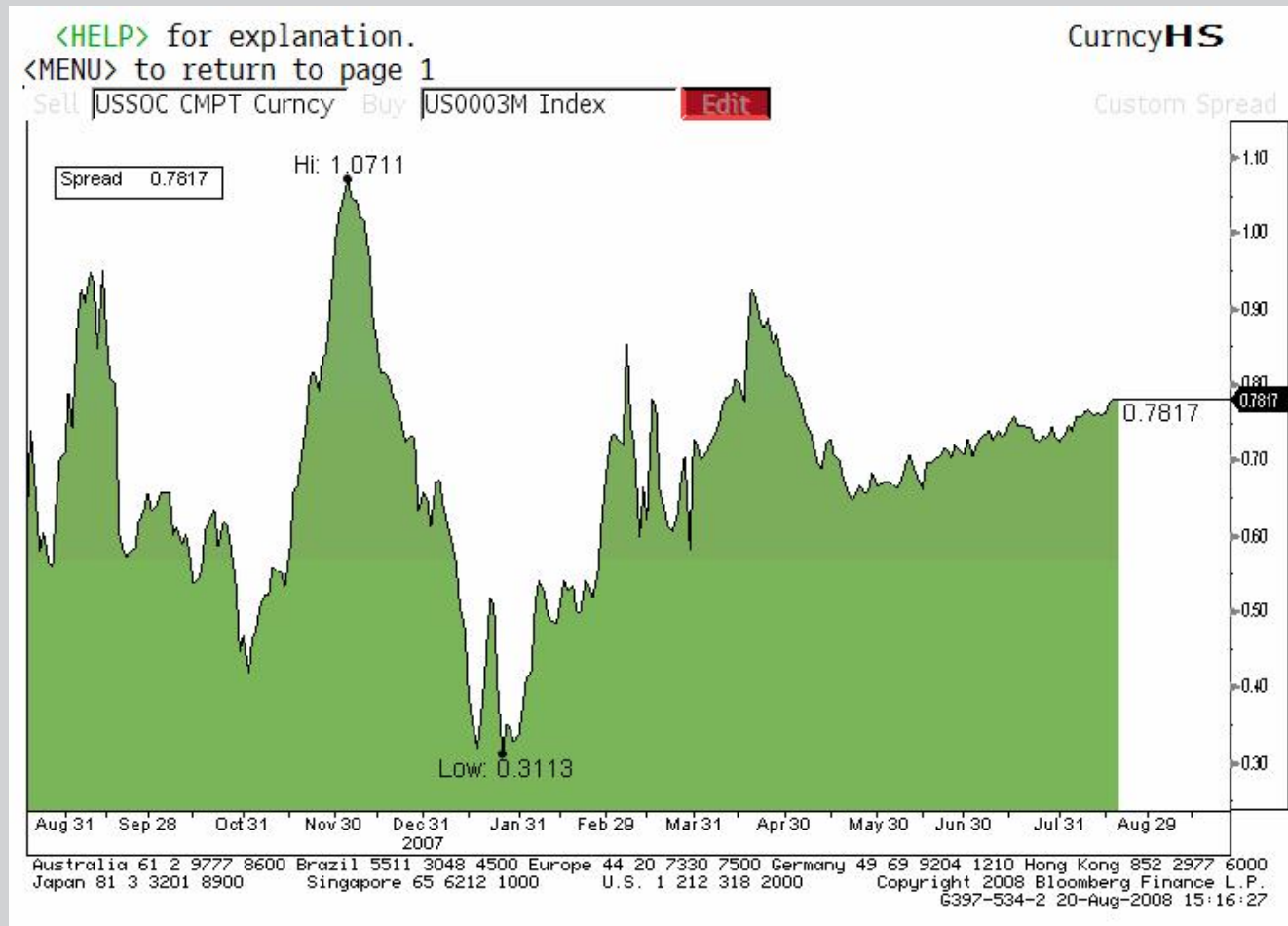
- In its early days policymakers broadly welcomed the corrective impulse in credit markets
- Which drove an incremental approach to administering medicine to the markets ills
- The surprise was the speed and intensity with which this crisis hit the systemically most important financial institutions
- An escalation which ultimately drove an unprecedented policy response
- Effectively rewriting the playbook on how to clean up a financial mess

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The rough road to normalisation

- As they gathered last weekend Policymakers were hopeful they have now built an effective stability bridge
- Major challenges do , however , remain and the extension of financial stress through 08 and into 09 is a reality
- Time is needed to overcome three significant issues
 - ongoing pockets of significant illiquidity
 - a profitable , but undercapitalised global banking system
 - the persistence of balance sheet 'fears'
- A combination which is layered with rotation risk from a deteriorating real economy
- And points to a rough road ahead

A Modern Credit Crisis Stabilisation but not Normalisation



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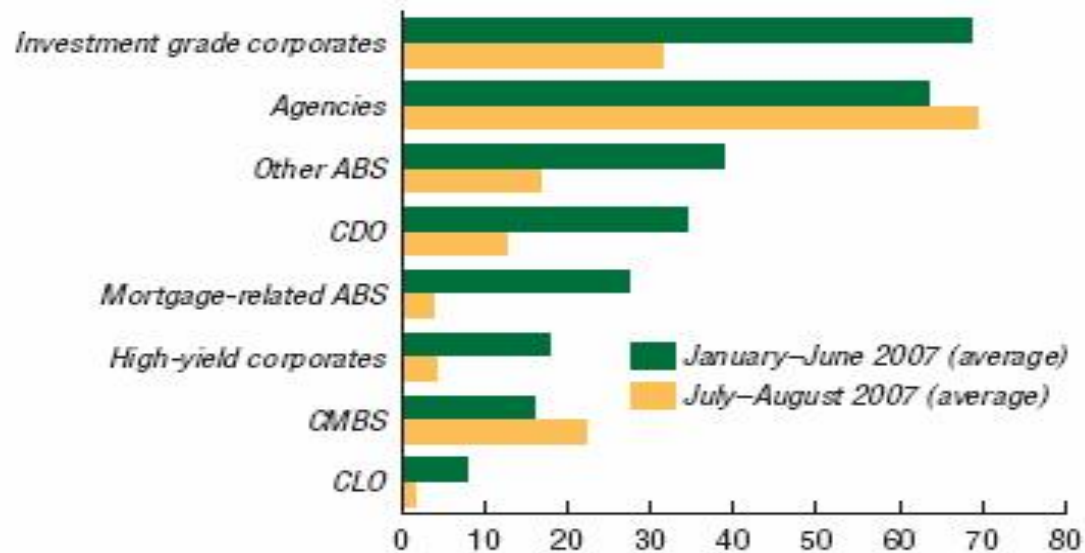
The repair process

- The structure of markets and pricing of credit is set for a medium term transformation ,
- It will be less complex , more transparent and certainly less leveraged
- Feeding off the permanent extension and expansion of central bank liquidity facilities
- A bridge that will eventually allow the concepts of risk and return to re-marry ,
- And set against an environment in which equity is singled and term , liquidity , credit risk premia are all higher
- Overseen by policymakers seeking to extract a regulatory price for the overtime they have put in

2007 Issuance Levels

- 2007 Gross Issuance by sector

Figure 1.5. Gross Debt Issuance by Sector
(In billions of U.S. dollars)



Sources: Bloomberg L.P.; Citigroup; and JPMorgan Chase & Co.
Note: ABS = asset-backed security; CDO = collateralized debt obligation;
CMBS = commercial mortgage-backed security; CLO = collateralized loan obligation.

A Modern Credit Crunch GSE Equity – the graveyard spiral



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GSE Debt – world's away from crisis



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The Macro Policy Response

- The first take from policymakers that this was primarily a failure of markets has been set to one side
- The dominant thought now is to establish a framework that counters the procyclical nature of the current financial system
- In effect imposing a speed limit on the financial economy
- This means strengthening risk management , supervisory and regulatory structures as well as promoting greater transparency
- And addressing compensation structures that have contributed more to the problem than the solution

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What role for Monetary Policy ?

- The near term focus remains on reconciling the challenging risks attached to stagflation-lite
- Which obscures a medium term debate on the role that asset prices / credit aggregates should have
- The emerging thought is that monetary policy should display more symmetry in the way it responds not just to significant financial events
- Building a broader risk management based approach to Monetary Policy
- In which Price Stability remains the dominant medium term target , but balanced against greater consideration of longer term risks , and their associated costs .

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The New Zealand Experience

- Integration within the Global Financial System means you don't just accrue the benefits , but also become exposed to periods of dislocation
- The good news is that , to date , NZ's Financial System has withstood a severe test of the broader Financial Economy
- It is , however , exposed to changes in liquidity dynamics and the price of credit
- An impact that shows up in a general tightening of the credit channel ,
- With the consequence that the RBNZ is not just reviewing its Monetary Policy framework , but also it's Liquidity Management Policies