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Credit crisis far from over: expert

Geoffrey Newman | *May 02, 2008*

A DERIVATIVES expert who two years ago warned of a potential meltdown in global credit markets has cautioned that the crisis is far from over, and has endorsed recent calls to relax controls on inflation and allow higher prices to help markets trade their way out of their problems.

Longtime critic of derivatives markets, Satyajit Das, says those who believe the US sub-prime loans crisis, and the drought in credit markets it triggered, are nearly over are wrong.

"I think the cycle has some way to run yet," he told a Financial Services Institute of Australasia function in Sydney yesterday. "It's a matter of years, not a matter of months."

In particular, investors in the US stock market, which has climbed off its lows amid a growing mood that the worst of the crunch was over, were being too optimistic, he said.

The author of *Traders, Guns & Money* warned that many of the problem financial instruments were still hidden and the total amount of debt attached to them largely unknown.

Losses incurred by US banks were certain to rise as \$US1 trillion (\$1.06 trillion) in sub-prime housing loans was due to reset to higher interest rates in the next two years.

The use of credit card debt -- now totalling \$US915 billion -- was cushioning US home owners. But, in an ominous sign, card issuers were rapidly increasing their provisions for bad debts, by as much as 500 per cent in the case of one bank.

The use of sub-prime debt structures was also a feature of other markets, such as private equity, where \$US300 billion in loans were due to be refinanced in the next two years.

Mr Das said another \$US1-\$US5 trillion of assets would have to come back on to US bank balance sheets as a result of defaults on housing and other debts, and it was unclear how the banks could fund them -- issuance of preference shares by US banks was already at a record high. He said losses at financial institutions from the credit crunch were likely to almost double to \$US400 billion.

There were also second-round effects to come as the damage done to the real economy from financial sector losses fed back into further bank losses.

Mr Das said there needed to be a massive reduction in debt levels globally or a "nuclear deleveraging" before the crisis could be said to be over. That could be achieved through an economic crash "on the scale of 1929" but allowing inflation to rise would help to avoid that scenario. Higher inflation was a legitimate policy option since it reduced the real value of debt and gave companies and individuals breathing space to reduce their leverage by helping to put a floor under asset prices.

His comments come as some economists urge Australia's Reserve Bank to relax its inflation targeting policy to help avoid a severe economic downturn.

He acknowledged that as inflation rose higher it was more difficult to control it, but noted the global economy was moving into a period of higher inflation anyway. "It could be the lesser of two evils," he said.

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