Global Crisis, Phase IV: Saving the Eurozone, And More

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One Page Summary

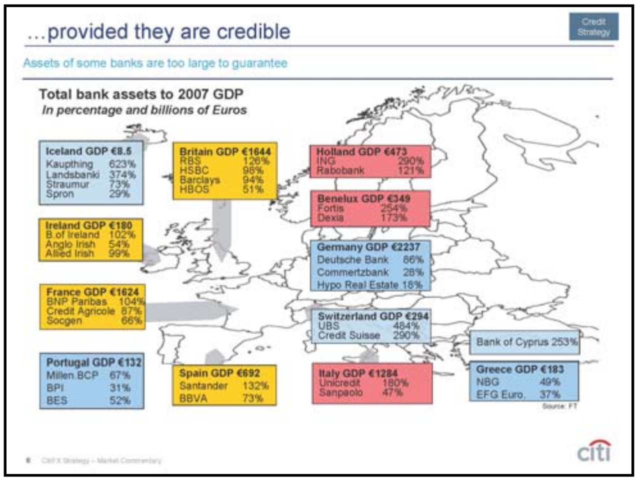
- Phase I: Global crisis of confidence, from handling Lehman and AIG
- Phase II: By Sept 29th, the only chance was:
  - bank recapitalization, (temporary) guarantees, dramatic mortgage restructuring, fiscal stimulus
  - Original Paulson Plan/TARP flawed (then and now)
- Phase III: G-7, U-turn from Oct 10th to 12th
  - Stabilized core banking system
- Created next set of issues: including eurozone (Phase IV)
  - As well as insurance, other financial institutions; US and elsewhere
- Phase V: Emerging Markets
  - Russia, Korea, Argentina,……China
- Phase VI: rising inflation at heart of global economic and financial system

Who Dunnit?

- The Usual Suspects:
  - Was it housing?
  - Or overexpansion of credit?
  - Or excessive risk taking by financial institutions?
- Caution: while major vulnerability always have deep roots, the depth and duration of crises can result from relatively small missteps
  - Lehman allowed to fail; AIG "rescued" but creditors took a big hit
  - Immediate policy response from US was too little, and Europe showed up way too late
- See the original Baseline Scenario, September 29th
  - Officials moved from denial to disorganization to mere disarray, in the following 2 weeks

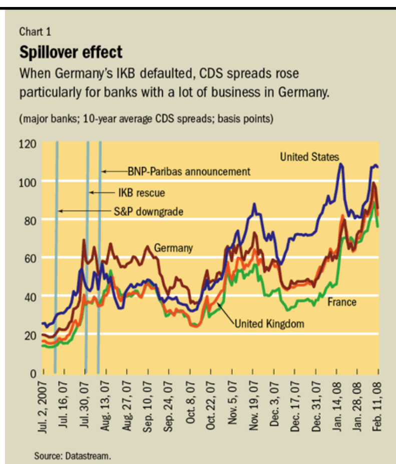
The Situation Today

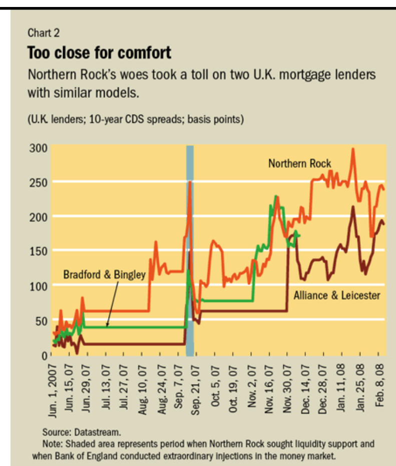
- Jump from (financial) companies to countries
  - The Iceland affair (Tom Clancy?); week of October 5th
  - Danger of global financial war
    - Averted, October 12th?
    - Or just postponed, a bit?
- Bank recapitalizations in G10 did serve as a stop-gap measure
  - Combined with large (partial) guarantees
  - This might destabilize other parts of the global financial system
  - But it stabilizes the European core, right?

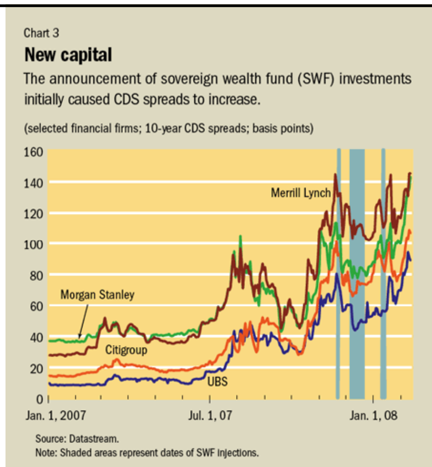


How Would You Know Where There is Pressure?

- Credit default swap spreads tell a tale
  - Measure perceived risk of default
  - Of course, worries about the market itself (net vs. gross); counterparty risk, etc
    - Look at relative pricing
- Three episodes:
  - Spillovers from initial European failures
  - Why did they have to save Northern Rock?
  - The effect of sovereign wealth fund investments in US-European banks





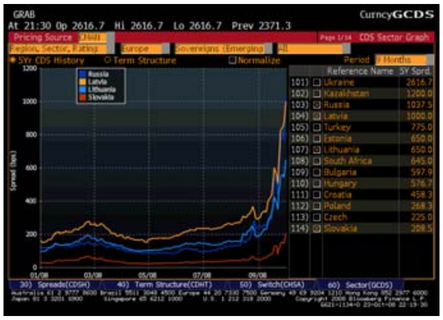


CDS Spreads October 22: European Sovereigns

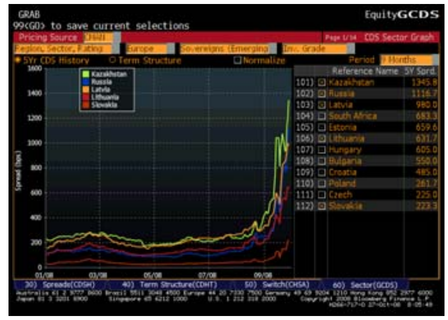
CDS Spreads October 23: European Sovereigns

European Sovereigns, CDS spreads, October 27, 8am London

East European Sovereigns, CDS, October 23



East European Sovereigns, CDS, October 27, 8am London (after Ukraine announcement)



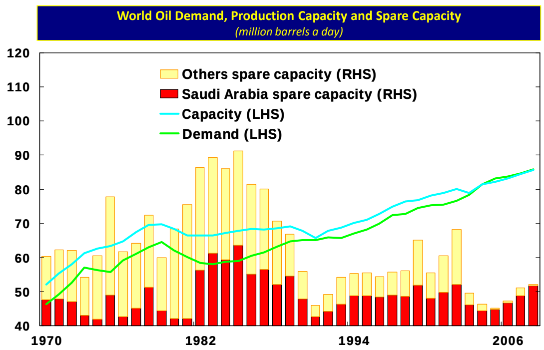
Saving the Eurozone?

- The crisis mechanism
  - Divergence in economic performance (e.g., Spain vs. Germany)
  - Monetary policy remains relatively tight
  - Cost of funding for some governments goes up
    - Real constraints on fiscal policy response
- What they need: 4 points
  1. Cut interest rates aggressively
  2. European Stability Fund (15% of GDP, access based on 100bp difference in government bond rates)
  3. Fiscal expansion (1% of GDP)
  4. Integrated financial regulatory framework, include the UK and Swiss
- They will cut interest rates, to some extent
  - But what are the odds on even one of the remaining three items happening over the next 12 months?

What(ever) Next for the Global Economy?

- Oil and other commodity prices falling
  - Major problem for developing countries and key emerging markets
- Small shocks in some places continue to become major disruptions elsewhere (often far away)
- Policy begins to go bad in emerging markets
- And policymakers continue to have “communication moments” (or worse) inside G7

Oil Supply Growth Will Continue into 2009, While Demand Falls (But Supply Shocks Possible and Portfolio Shifts Will Come)



So Wither Oil Prices?

Spot the G7 Dramatic Recapitalizations (in Australian commodity stocks)

Out of Economics and Into Chaos Theory

- CDOs based on corporate debt are going bad
- German growth forecast for 2009
  - Down to 0.2% from 1.2% in April
- Alexei Kudrin (Oct 21): average oil price for 2009 will not drop below $70
  - Some countries now using $45 for 2009 budgeting
- Emerging Market corporates report losses on exchange rates, failed hedges
  - Contrast Canada, Australia vs. Brazil et al; the danger of previously "obvious" one way bets

How much is that Subprime in the Window?

Policy Moves, Emerging Market Contributions

- Leading analysts' measures of vulnerability, macroeconomic and financial
  – East Central Europe tops any list; Hungary at medium-high level
  – Relatively safe countries: Russia, Korea, Argentina and of course China
- But vulnerability, again, does not predict sequencing or severity
  – Russia: ban the words "crisis" and "collapse"; information is on the web, of course
  – So China: not allow access to websites, such as http://BaselineScenario.com
  – Argentina: take the money and run (to de facto default on government debt)
    - Pension assets
  – Korea: where is the money exactly?

Policy Messages, From the G7

- Europe (Bini Smaghi, October 20th): the people (and society) who let Lehman fail are to blame
  – ECB internal debate on inflation "window" is obvious; most likely they will begin to cut interest rates more seriously
  – Look at Italian pension liabilities, for example
- US: still planning to spend $450bn in auctions to buy MBS, CDOs, etc. What will this achieve?
- Good time for a G20 meeting
  – Could we all, please, step back from (another) brink?
  – Can we combine the best from all strategies, or will it all become a bad joke?

Think the Unthinkable: Two Examples

- Things we know "for sure"

1. China will continue to grow at 8-9%
    - Even the pessimists think that real growth will be at least 5%
    - One view: Chinese exports will be flat next year
      – Who will buy more Chinese goods than in 2008?
    - And, of course, the renminbi will continue to appreciate
2. There will be global recession and risk of deflation
    – No imminent prospect of inflation
      - Because global "output gap" drives inflation…

China Overshooting?

China's Exchange Rate, Forward
Current Spot: 6.84

Is that in New Dollars or Old Dollars?

- No deflation (falling prices) in United States, some others
  - Bernanke: we will not repeat the mistakes of the 1930s
  - Competitive devaluation beginning: UK, Canada, Australia
- What's your model of inflation?
  - Output gap view: no inflation
    - But Fed is credit provider of first resort; how can they cut this off when the economy recovers?
  - And how do you now control liquidity? Expect volatility, at least
  - And there is the budget deficit (Bernanke November 21, 2002)
    - Global inflation, move into commodities as store of value
    - Interest rates rise
    - Monetize the deficit (remember Sargent and Wallace?)
- It couldn't happen here
  - Recession and inflation: more emerging market characteristics in the heart of the global economy
    - Remember spring 2008: rising commodity prices with declining growth prospects?