LESSONS FROM THE GLOBAL ECONOMIC CRISIS

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LESSONS FROM HISTORY: THE BEAST IS BACK

One view of economic processes sees outcomes from finely-calculated rational decisions.

- ***Another approach sees economies populated by unruly beasts dominated by greed and fear.***

Truth is probably a mix, but today we take a walk mainly on the wild side.

Agenda

- **The beast is never tamed – the ugly side of animal spirits.**

- **Everything is connected to everything else on the skeleton.**

- **Forget most of your life's experience of cycle behaviour. This is different!**

A: THE RESHAPING OF POLICY

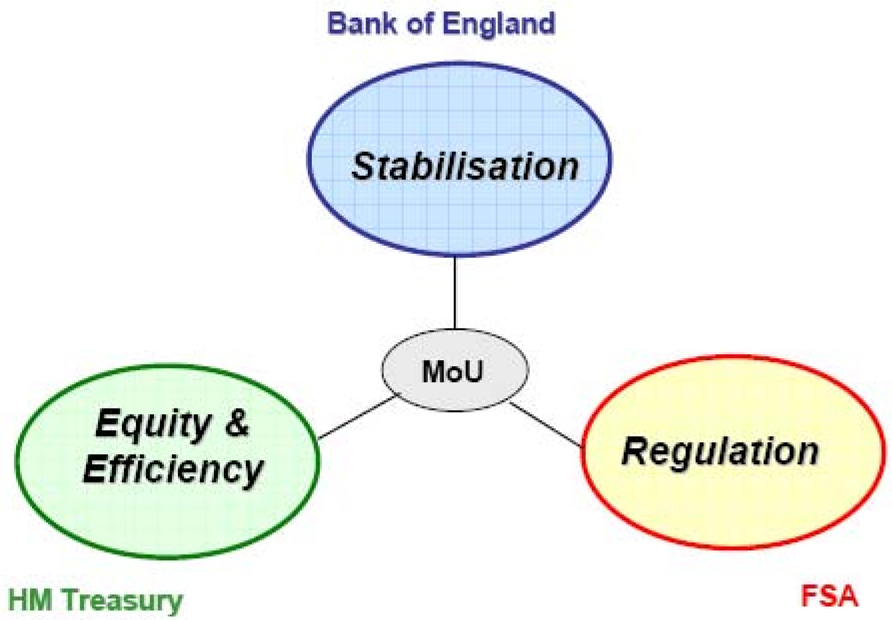
FORTY YEARS BACK

- **40 years ago the “new economists” of the Kennedy-Johnson era proclaimed the death of the business cycle.**

- **Just in time to be overwhelmed by stagflation, safari suits and flares.**

- **It took a quarter century to recover from the experience.**

STRUTS AND SWAGGERS RETURN IN THE NOUGHTIES MODEL



Source: "Seven Lessons from the Last Three Years", Speech by John Gieve, Deputy Governor BoE, 19 February 2009

EVERYTHING NEATLY ORDERED WITH STABILISATION REDUCED TO A TAYLOR RULE.
MUM WOULD BE PLEASED.

LITTLE BOYS GET UP TO MISCHIEF

- **Little boys are hard-wired to get into mischief, monstering Mum's neatly-ordered Great Moderation. Bigger boys do the same, given the chance.**

- **One-Tel paid their sales force on names not deposits, so why be surprised that None-Tel soon had long lists of phantoms?**

- **Securitisers paid their workers on names not creditworthiness, so why be surprised when they turned up long lists of sub-prime NINJAs? What's the difference?**

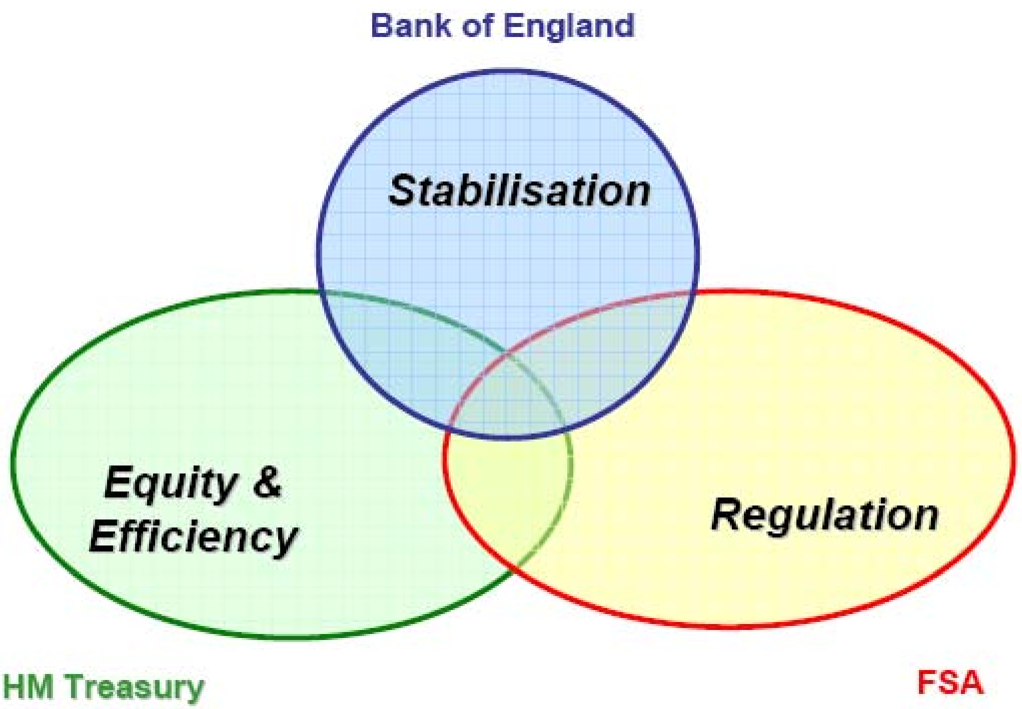
- **Investment bank chiefs get paid mostly in performance bonuses and are rarely there for long before golden parachuting out. Why not punt the performance?**

- **Don't heap all the blame on finance types. How many takeovers benefit shareholders?**

THE WORLD IS FULL OF CRAZY BRAVE PUNTERS.
WHY ELSE BUY LOTTERY TICKETS OR PLAY THE POKIES?

THE NOUGHTIES NEUTERED: TODAY'S POLICY MODEL

ALL HANDS TO THE PUMP



Source: John Gieve, BoE, op.cit.

MoU MISSING IN ACTION

MONETARY POLICY MISERIES: BLOWING BUBBLES

- **Excessive policy focus on consumer prices. Why not asset prices as well?**

- **Partly put in the too hard basket. Fed (and RBA) said how do you know when a bubble begins to bubble? PBoC took a different view in mid-2007.**

- **Besides, it might be less costly to mop up after the bubble has splattered. Cue the Hammers song, exit Greenspan, reputation splattered.**

- **Bubble bursting now being taken more seriously, lowering future growth peaks since requisite higher interest rates and tighter regulation slows expansions.**

- **Thought also being given to other instruments, such as designing counter-cyclical capital adequacy regulations (in place of today's pro-cyclical measures) and variable margin loan and loan-to-valuation restrictions (for more see Gieve).**

SERENELY PADDLING CENTRAL BANKERS IN INWARD TURMOIL

MONETARY POLICY MISERIES: REFLOATING THE TITANIC

- **Fears that a zero policy rate bound stops monetary policy operating are overblown. As Ben Bernanke has preached for years, there is a range of other instruments (shortly to be seen) like purchasing government, agency and even corporate bonds.**

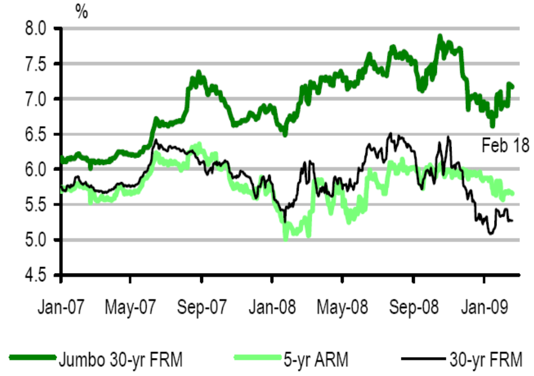
- **In debt deleveraging circumstances the difficulty is not a lack of instruments; it is whether any will be effective. Monetary policy has the job in front of it to persuade people to take on more of the stuff they are trying to rid themselves of.**

- **There is also a question of how prepared banks are to lend, especially when confronted by profitable opportunities to park funds safely in government bonds. Central banks will seek to recapitalise banks through a normal yield curve.**

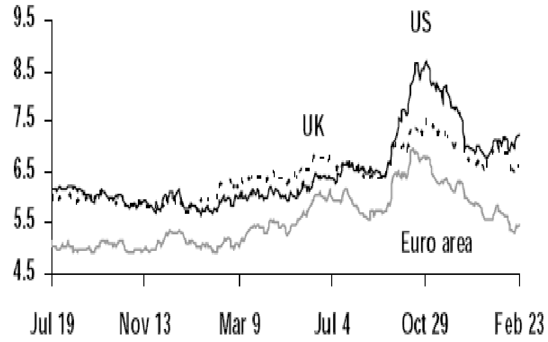
MONETARY STIMULUS: WHAT STIMULUS?

USD LIBOR SPREADS

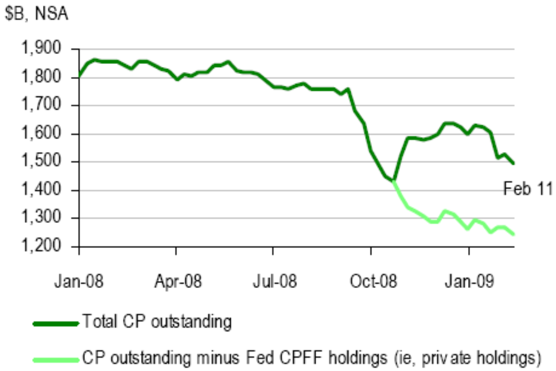
US MORTGAGE RATES



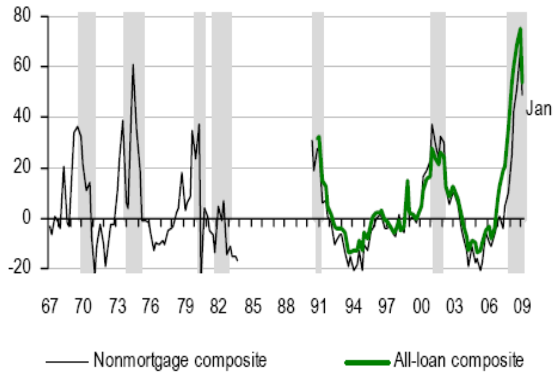
CORPORATE RATES



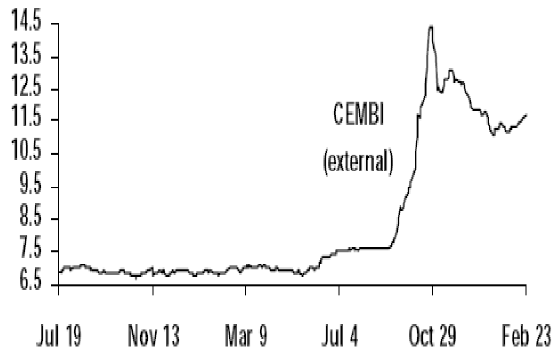
US CP OUTSTANDING



TIGHTENING STANDARDS



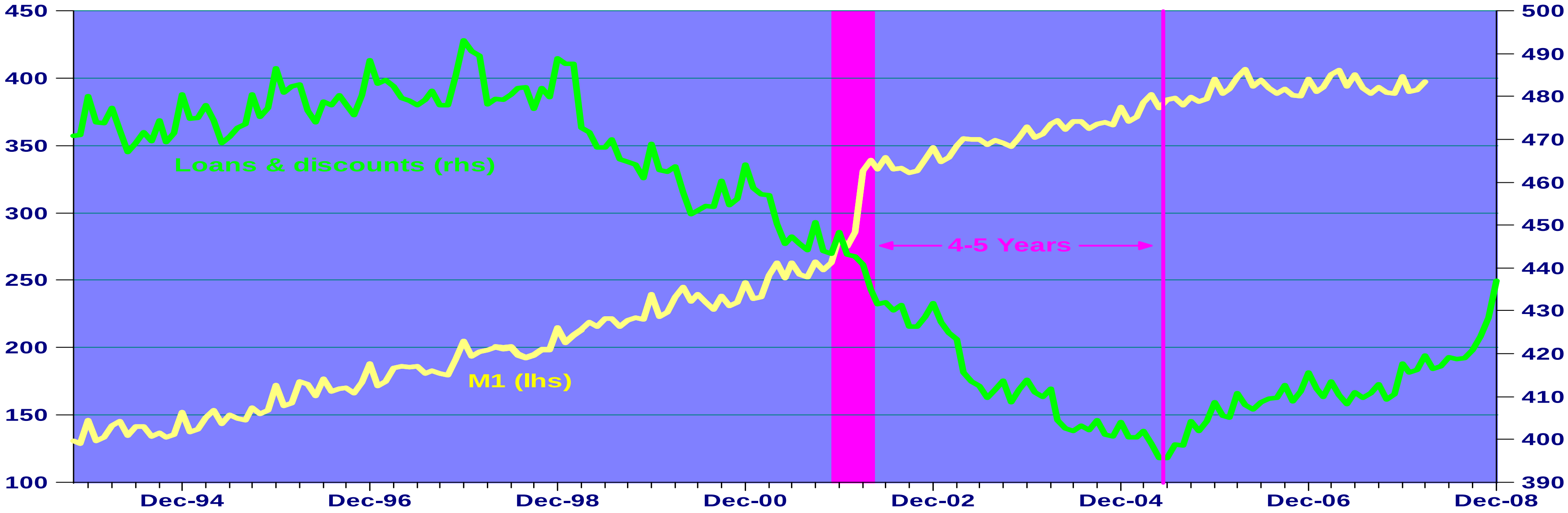
EM CORPORATE BONDS



Sources: UBS US Economic Perspectives, JP Morgan Daily Financial Markets Monitor.

FIXING THE BANKS

JAPANESE-STYLE QUANTITATIVE EASING



Source: BoJ (CEIC). Data are in ¥ trillions.

- **Despite monetary flooding, nothing happened to Japanese lending until the "dirty thirty" zombies were fixed. Likewise, nothing will happen elsewhere until banks are fixed. Do you go good bank - bad bank, nationalisation or both? TARP in trouble. Korean example from 1998.**

- **When does the global financial centre of gravity follow goods production eastward?**

FLEXING THE FISCALS

- **Fiscal policy, out of favour for decades, is now back with a bang for stabilisation purposes in most countries.**

- **Some (e.g., "Austrians", "Ricardian equivalence" devotees and Mundell-Flemingistas) reckon fiscals don't fire; most economists do, but at non-multiplied rates.**

- **US fiscals have to be immersed in a festering pork barrel called Congress. Politicians like pork everywhere, but decision processes fairly prompt in most non-US places.**

- **Chief problem is that while it is easy to get politicians into the pork barrel, it is damnably difficult to get them out again.**

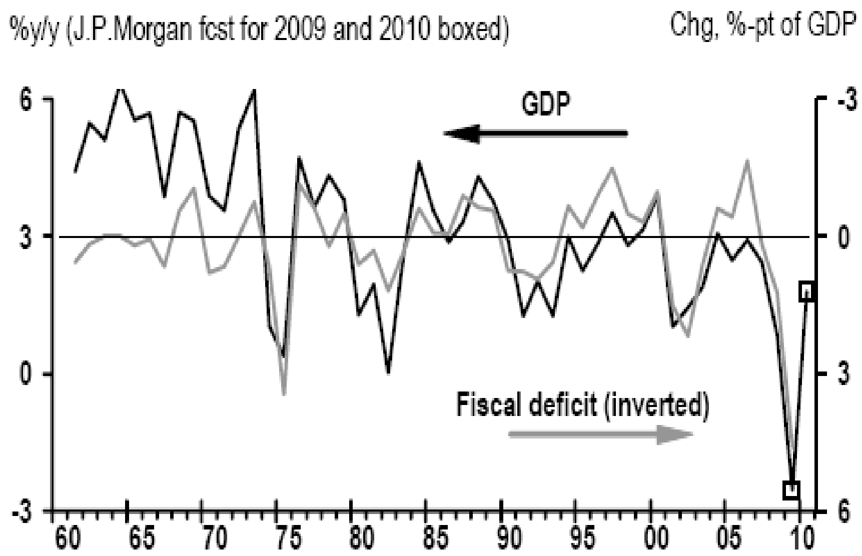
- **Advisers have learnt to propose self-terminating stimuli like temporary tax cuts and bonuses and infrastructure spends rather than permanent tax and welfare breaks.**

WHAT'S HAPPENING TO THE FISCALS

GENERAL GOVERNMENT BALANCE

	Fiscal Position		Change 2008 to 2009	
	2008	*2009*	*Cyclical*	*Discretionary*
Global	**-2.6**	**-6.8**	**-2.5**	**-1.7**
Developed	**-3.1**	**-7.7**	**-2.9**	**-1.7**
US	-3.2	-10.2	-5.0	-2.0
Euroland	-2.0	-4.0	-1.0	-1.0
Japan	-6.0	-9.7	-1.7	-2.0
UK	-5.9	-9.1	-1.6	-1.6
LatAm	**-0.6**	**-3.3**	**-1.7**	**-1.0**
EM Asia	**-1.4**	**-3.6**	**-0.1**	**-2.1**
China	-0.5	-3.0	-0.4	-2.1
India	-6.5	-6.3	5.2	-5.0
Korea	1.5	-2.0	-2.4	-1.1
CEEMEA	**0.8**	**-3.6**	**-3.8**	**-0.5**

DEVELOPED ECONOMIES



Source: JP Morgan, Priming the Pump, 13 February 2009. Negative signs in the table mean deficits or movements toward deficit. Data in table are % of GDP.

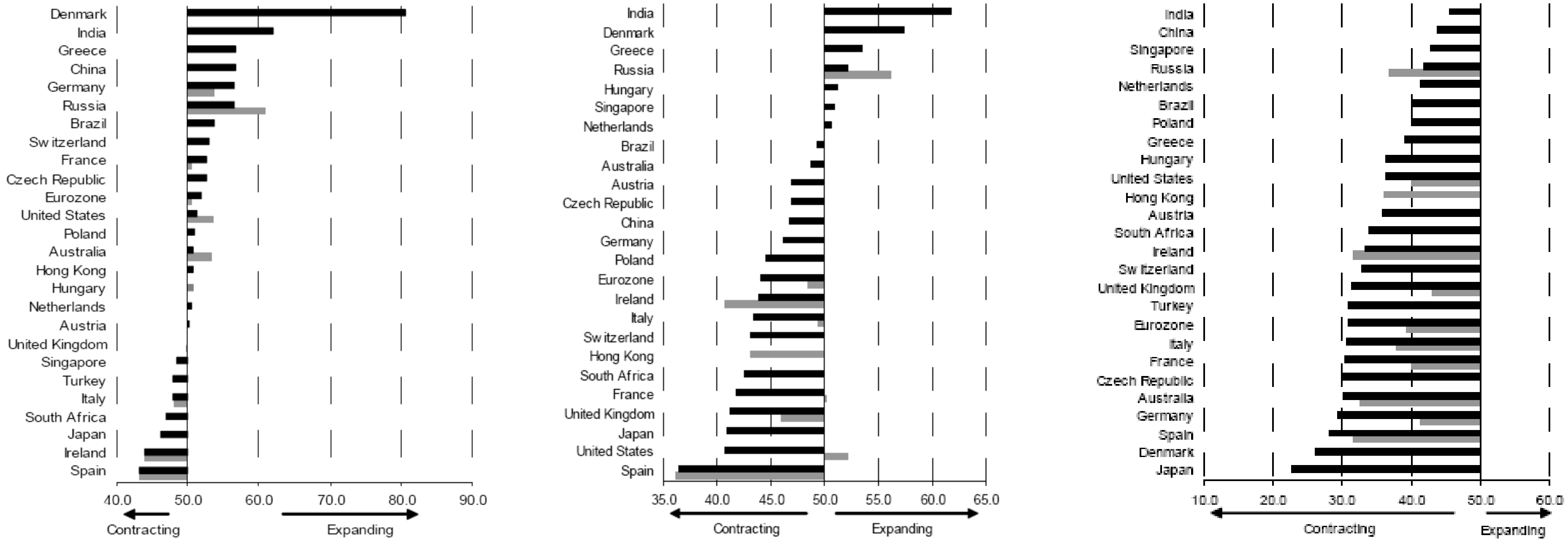
- **JP Morgan economists estimate bigger part of fiscal deterioration due to induced consequences of recession (lower revenues, bigger welfare spends).**
- **Blocs differ in discretionary stimulus (ideology, IMF and other constraints), but 1.7% hit has a big global GDP hole to fill.**

B EVERYTHING’S CONNECTED

DOMINO ROLL FALLS

GLOBAL PMI COUNTRY SPLITS

MAY 2008 SEPTEMBER 2008 FEBRUARY 2009

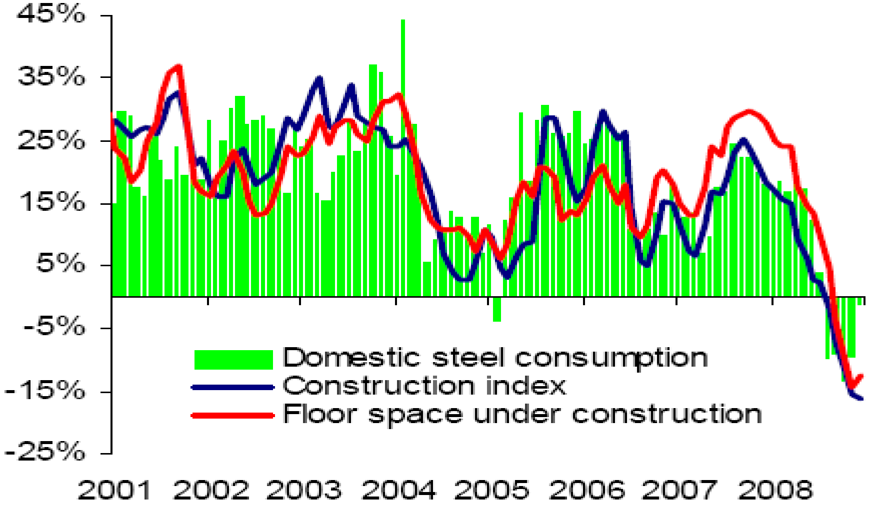


Source: JP Morgan, Global All-Industry PMI, various. Dark bars are manufacturing, light-grey bars are non-manufacturing.

- **Growth was fading ahead of September's Lehman demise, but credit seizures brought on universal collapse. Export-dependent economies like Germany and Japan crunched especially. But note prior fade as housing boom burst including China.**

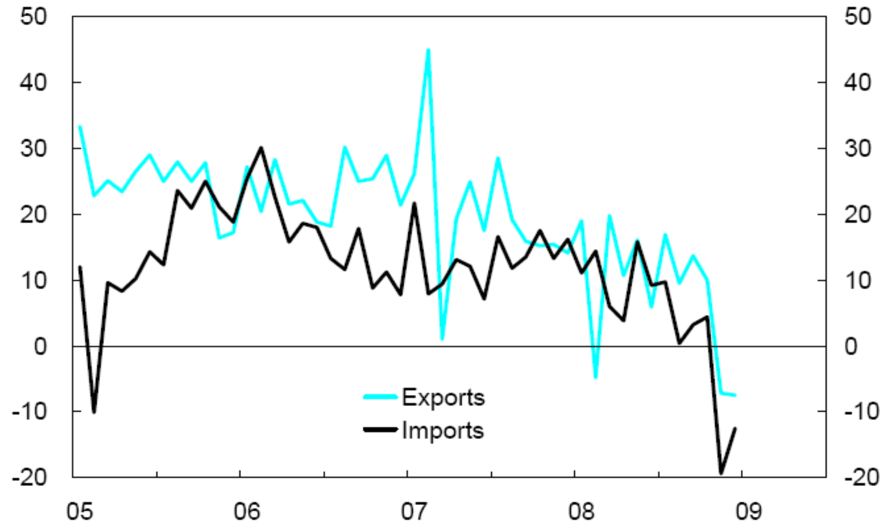
UNLUCKY CHINA

PROPERTY-RELATED GROWTH



Source: Tao Wang, UBS, 6 February 2009. Data are annual % changes.

REAL MERCHANDISE TRADE GROWTH

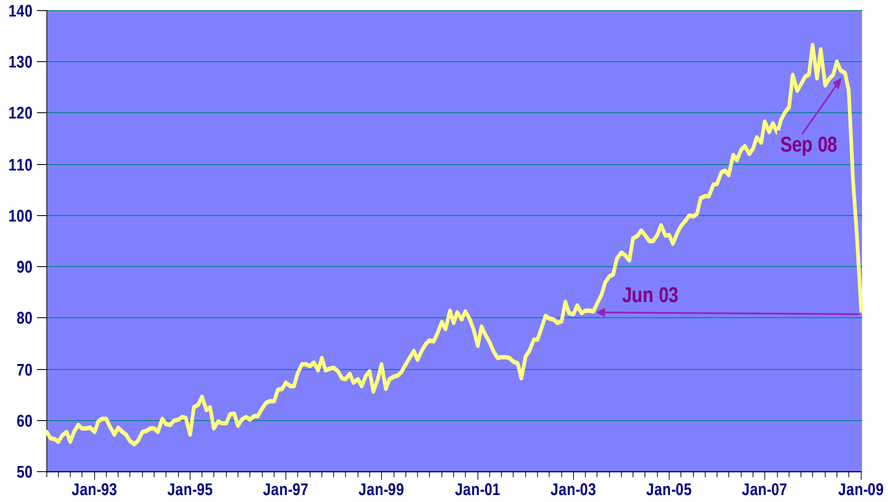


Source: Ken Peng, Citi, 9 February 2009. Data are annual % changes of real variables.

- **Prior to the global trade collapse in last quarter 2008 China was engaged in two major shifts — a secular move up market from low-value-added TCF and related (from South China especially) and a cyclical shakeout of property and shares as the PBoC pricked a bubble. Global credit sclerosis caught it before either transition was complete.**

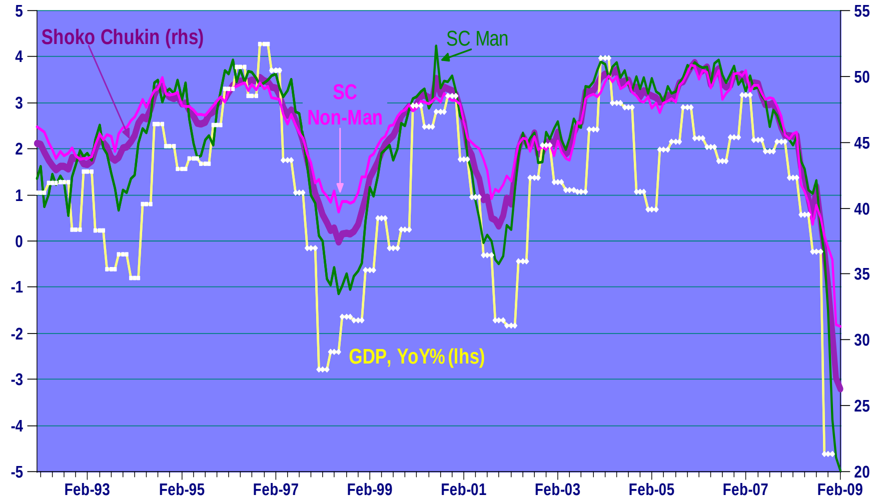
EXPORT-DEPENDENT JAPAN COPS THE EXHAUST

REAL EXPORTS



Source: Bank of Japan (CEIC). Index base of 100 = 2005 (seasonally adjusted).

SHOKO CHUKIN SHOCKER

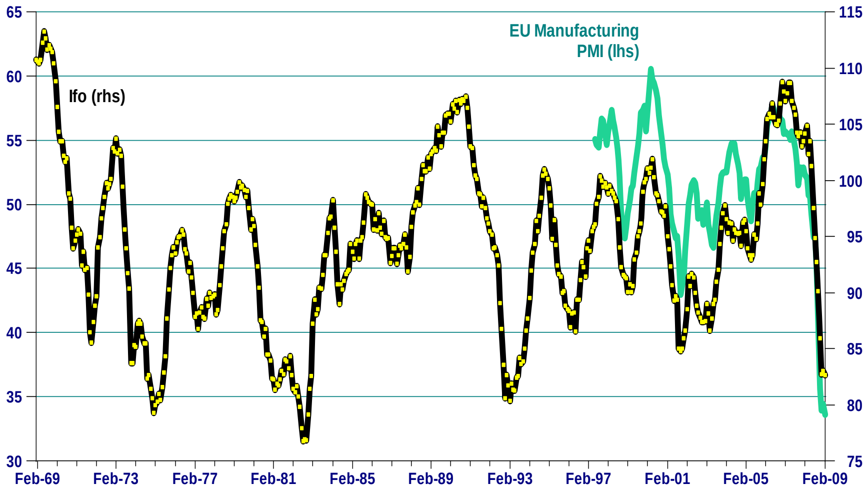


Source: CEIC. Shoko Chukin seasonally adjusted in house.

- **Japan got its recent momentum from exports, especially capital goods and intermediate components through China.**
- **Exports collapse, and so does the economy, despite no credit crisis. Can tell same story about Germany, except latter also has banking problems.**

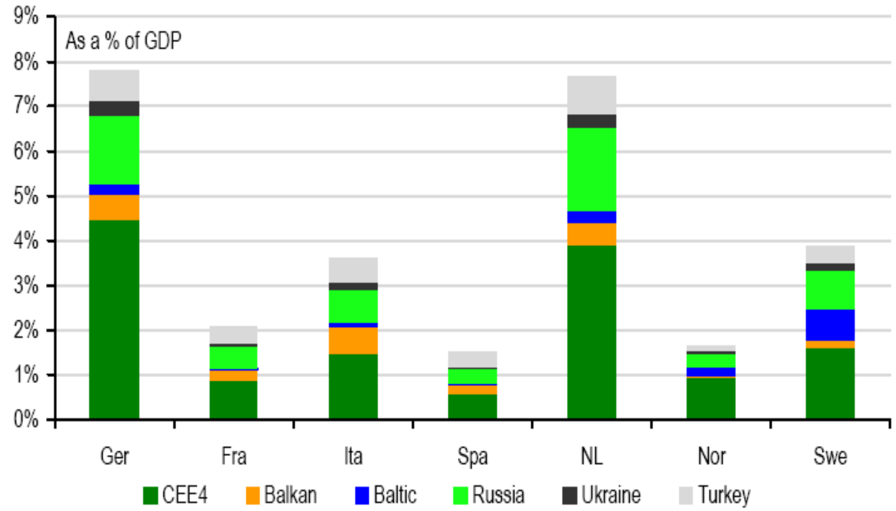
EUROPE IN TROUBLE

EUROPEAN BUSINESS WILTS



Source: Bloomberg, Credit Suisse.

OLD EURO EASTERN EUROPE EXPORTS



Source: IMF, UBS. CEE4 is Poland, Hungary, Czech Republic and Slovakia.

- **Europe has its own credit problems, but it is also a victim of reduced risk appetite through its export and financial exposure to a capital-starved Eastern Europe. Eastern Europe takes over 30% of the old Euro area's exports, more than double that for either the US or Asia. Its next biggest market is the UK (17.4%)! Exposures also vary by country. Austrian, Swedish and (possibly) Belgian banks are the most exposed.**

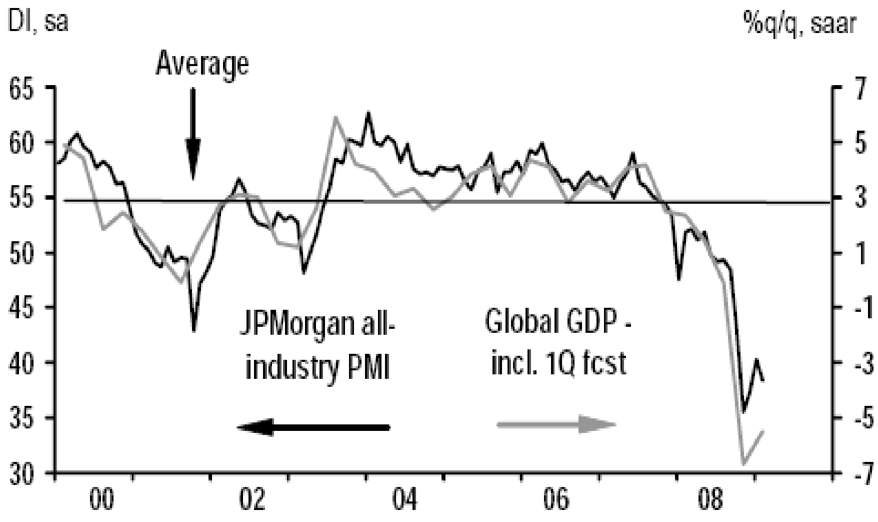
C: WHAT WILL THIS CYCLE BRING?

THIS IS YOUR GREAT GREAT GRANDFATHER'S CYCLE

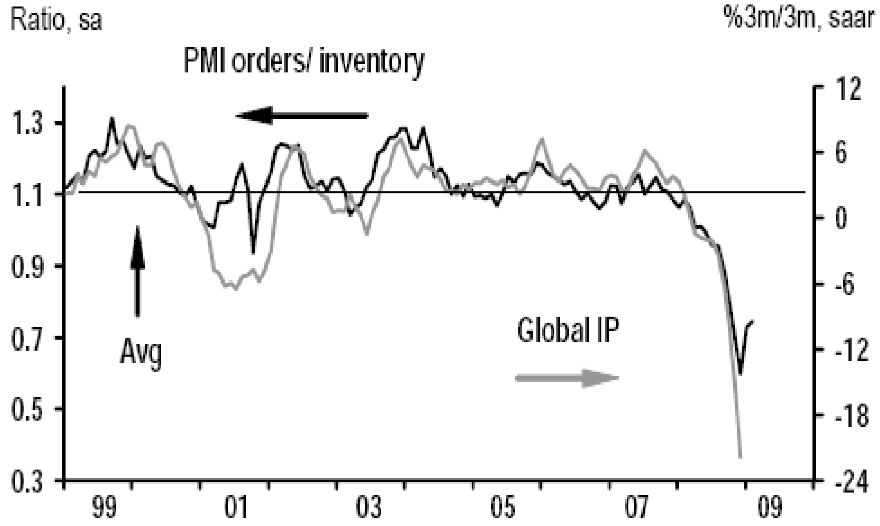
- **Cycles in past half century have been shaped by central bank euthanasia, or "taking the punch away from the party" (William McChesney Martin — 50's,60's Fedhead).**
- **Result was a truncated downturn averaging 9½ months (peak to trough, NBER method) over last 30 years (four episodes) of US business cycle history.**
- **This one is already 15 months old (from December 2007), and counting. Next month will equal longest on post-WW2 record.**
- **Average length of downturn from 1854 to 1919 (16 cycles) was 22 months, and 18 months between 1919 and 1945 (6 cycles).**
- **Hence popularity of the guess that recovery will start in 2010 — but it's just a guess. Longest US downturns were 65 months (1870s) and 43 months (1930s).**

SHORT-TERM PORTENTS GRUESOME

PMI AND GLOBAL GDP PULSE



PMI RATIO AND GLOBAL IP PULSE

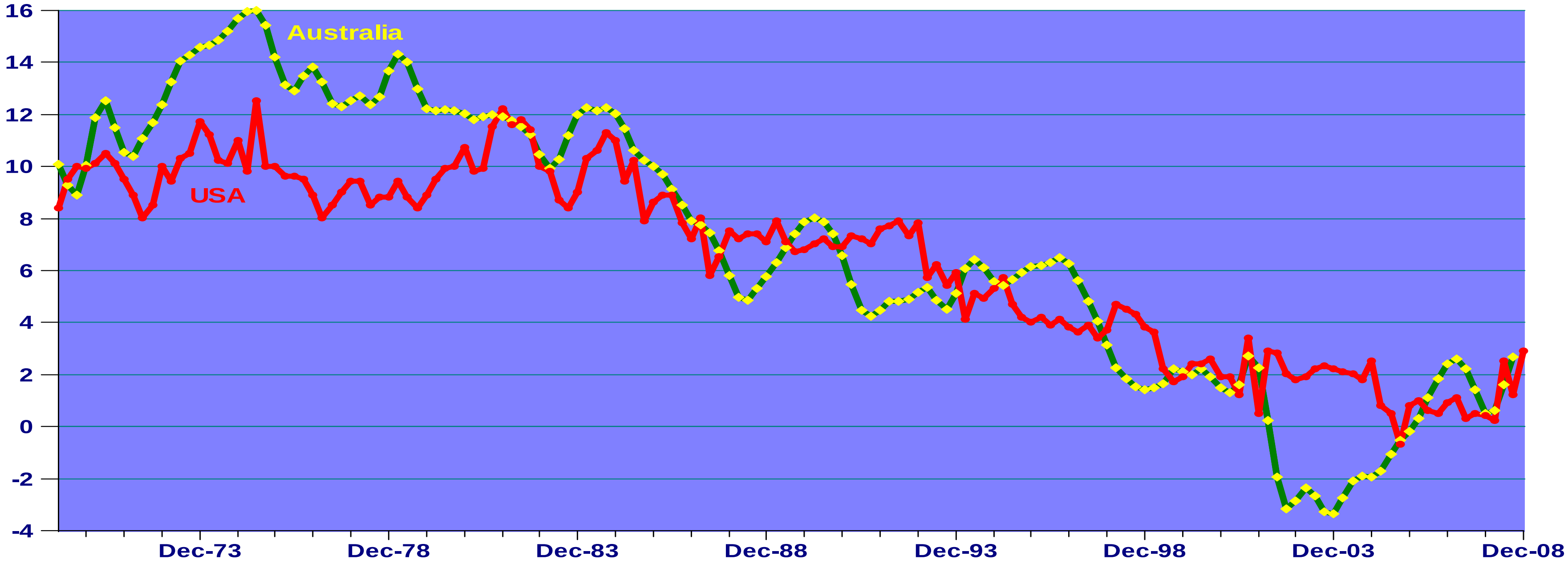


Sources: JP Morgan, February 2009 Global PMI surveys.

- **Having hit the sales wall in second half 2008, global business is now slashing inventories and ripping up orders. This is a finite process, but liquidations still in effect. Estimated finish of general stock cycle around mid-2009.**

ANGLO-SAXON CONSUMER HIBERNATION

HOUSEHOLD SAVING RATIO



Source: BEA (sa); ABS (trend).

- **Waiting in the Anglo Saxon wings are more rebounds of household saving ratios in consequence of wealth reductions. Much less so for Europeans, not at all for Asians.**

- **Saving ratio rebound carries adverse implications for corporate earnings.**

ASIA TO THE RESCUE?

Two dimensions:

- **Demand for Australian bulks.**

- **Can Asian domestic demands save world growth?**

CHINESE STOCKS SHOCKS

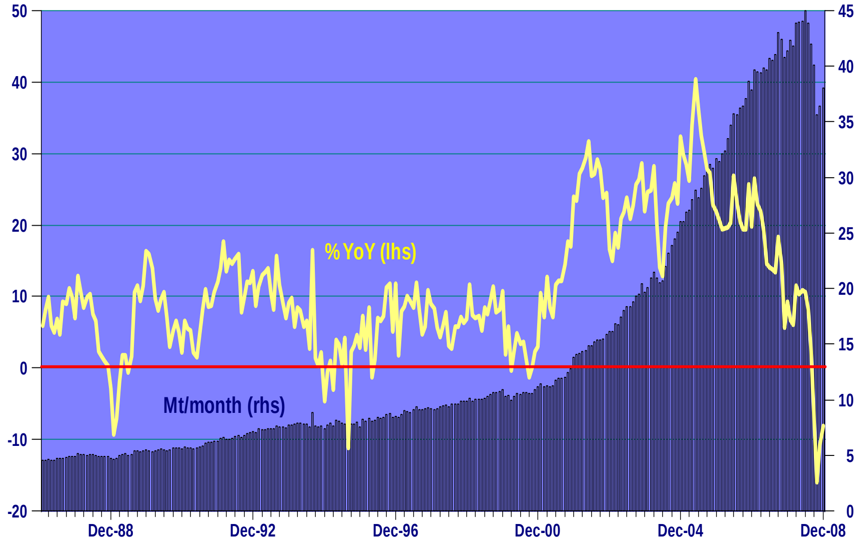
China is going through two separate inventory cycles.

- **The first, involving repercussions from the property slowdown underway since late 2007, is largely over. Half of all steel consumed in China is for construction. Some partial recovery already evident in steel production and prices, iron ore and coking coal spot prices and the Baltic Dry. These are signs of the stock cycle turning not indicators of a return to medium-term vitality.**

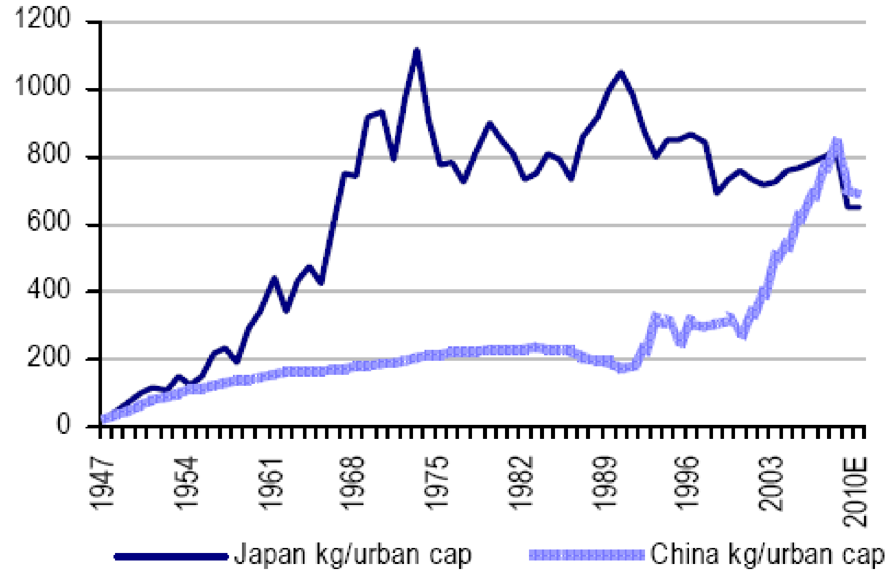
- **The second, involving reactions to late 2008 global consumer goods constraints, is still underway. The inventory cycle timetable for these consumer goods should be similar to elsewhere in the world, i.e. completion by mid-2009.**

HOW MUCH OF THE STEEL SURGE WILL BE REGAINED?

MONTHLY STEEL PRODUCTION: CHINA



STEEL CONSUMPTION/URBANISED HEAD

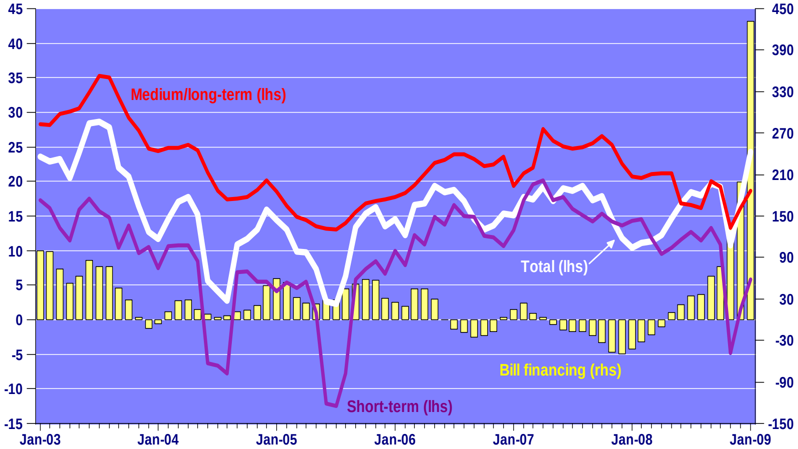


Sources: NBS (CEIC), JISF, UBS (Peter Hickson, 9 February 2009).

- **China's steel surge a magnified version of earlier Japanese rise (60's and early 70's). Latter stalled: will China's? Markets bet on slower growth (4 to 8% pa) as urbanisation continues. Similar theme to smaller India (50mt+pa), but elsewhere steel production still in headlong retreat. China is 40%+ of world steel output.**

WILL CHINA RECOVER THIS YEAR?

BILL FINANCING EXPLODES



Source: PBoC (CEIC). Data are 3mth % changes, saar (in house).

- **Undisclosed December quarterly GDP growth placed between 0 and 3% at annual rates, and may have been negative.**
- **State Council had already reacted with apparently massive fiscal stimulus and a major U-turn by the PBoC. All is not what it seems.**

- **Massive fiscal headlines include re-announcements and private contributions. JPM's 2% of GDP 2009 discretionary stimulus estimate is shared by China watchers.**
- **Strong credit rebound is mainly bill financing for stretched working capital and initial funding of infrastructure stimulus. Premier Wen overstates data as recovery sign.**
- **China will pick up speed this year, but will find recovery tough with sluggishness all around. GDP will print near 8%, but also watch industry data (electricity, steel).**

CAN ASIA SAVE THE WORLD?

- **In real dollars Non-Japan Asia is 12% of global GDP (not the 25% share in non-traded PPP synthetic dollars).**
- **If NJA grew 10% this year the bloc would contribute 1.2 percentage points to a global growth total that needs 3% growth to keep resource utilisation steady.**
- **NJA is not going to grow 10% this year, with its leading member (China) very happy if it got near to 8. India and Korea are the only two other places of size — India will do well to get 6% and Korea is in almost as dire straits as Japan.**
- **Since saving rates are high, consumer demand replacement is even more unlikely.**
- **The world is not going to be a very friendly place for Australians this year.**

WATCH THIS SPACE. COME BACK IN 12 MONTHS.