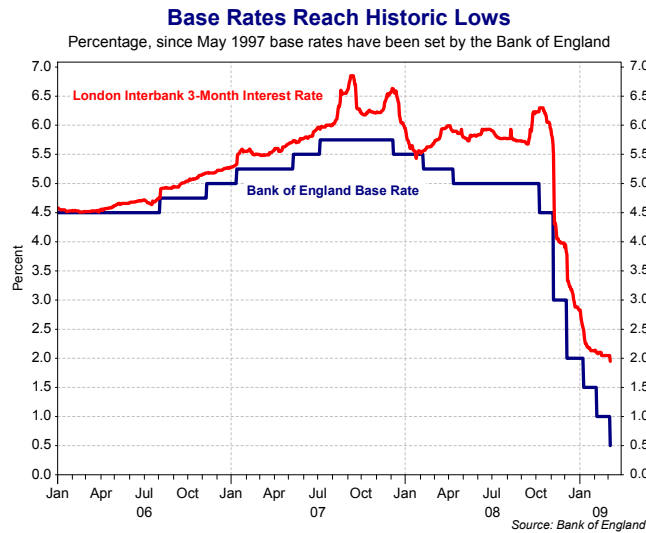


Stephen King on the Global Economy



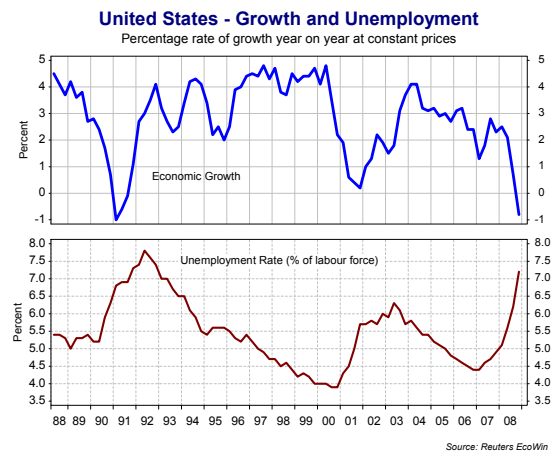
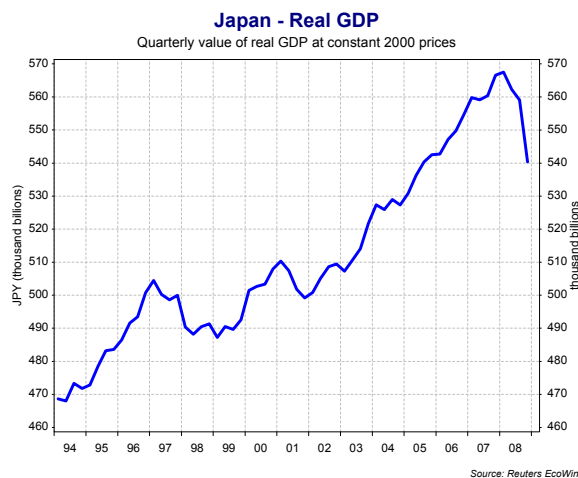
There are so many moving parts at the moment that no one country can fix the problems - this demands a coordinated response.

There is a real sense that macro-economic policy has lost control and with it the risk of a descent into economic nationalism - protectionism through different doors - can become acute.

Growth forecasts have collapsed

There has been a dramatic deterioration in consensus forecasts about economic growth in the last twelve months. A year ago there was confidence that policy makers could sort out the crisis, this confidence no longer exists.

1. Incredibly weak orders for supply chain businesses especially in the USA.
2. Industrial production in Japan has collapsed – down 8% in November, 9% in December 10% in January – together a 30% fall in output in just 3 months - a huge fall in demand in a tiny space of time
3. Export-heavy economies are feeling the brunt of the first year on year decline in global GDP for over 45 years.



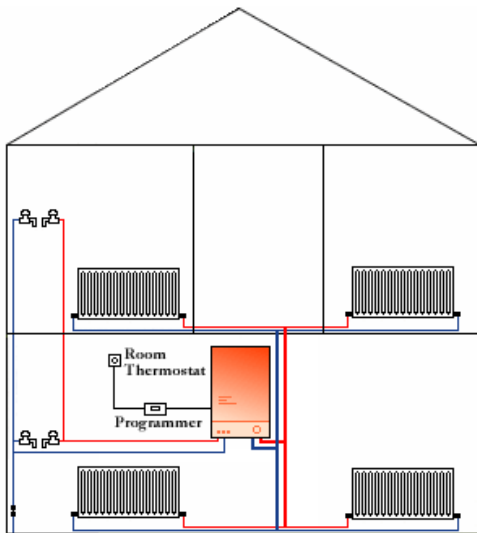
Deflation threats

There are significant deflationary forces in the world economy

- Falling wages / wage freezes
- Falling prices for raw materials
- A collapse in pricing power for manufacturers and retailers across many markets

The fall in government bond yields is in part a result of a flight to quality but also a reflection of the expectation of low inflation - and financial markets have lost confidence in the ability of central banks to achieve what they are mandated to achieve i.e. their inflation target.

Problems with the central heating system



Monetary policy acts as a central heating system for the Macroeconomy - the thermostat controls the boiler and if the boiler is working, it is a straightforward job to manage the overall temperature in a house or room

Conventional view

Central bank adjusts the policy rate
Assumes a relationship between policy rate and AD/prices (transmission mechanism)
This works as long as the financial system is working properly, but the latter has now

broken down

Feel the pain - tighter credit

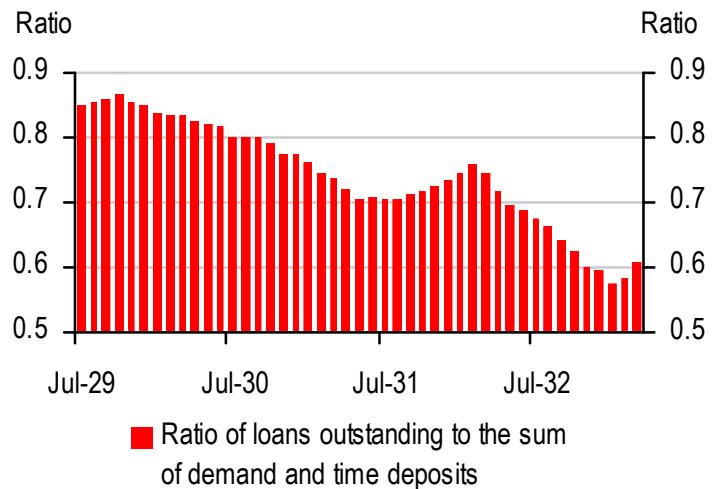
Although policy rates have come down, actual borrowing rates for people and business have not. Then factor in the constrained quantity of lending at any given price - the right definition of a credit crunch. 75% of US banks have tightened credit conditions

Sub-prime lending to emerging economies?

Western Banks increased lending into emerging markets - it grew rapidly from 2002 to 2007 - this access to western finance has dried up as banks develop a home bias result the credit crunch has widened to countries that had nothing to do with the financial euphoria in the first place. Exports have collapse because of the drying up of export credit.

Back to the 1930s

Consider the experience of the 1930s and in particular the ratio of loans to the amount of deposits (see the accompanying chart) The ratio was 85% in late 1920s ... falling to 58% in 1932 ... a huge monetary contraction 10,000 banks went bust - most local and tiny institutions and specialized banks lending to farmers and car makers - the result was a dramatic fall in lending and a recession that became a depression



2008/09

Banks do not depend solely on deposits but also on wholesale funding - the result has been a large rise in leverage - for example, the loan to deposit ratio in the UK at the moment is around 145%

Securitization has speeded up this process - now collapsing because of toxic assets and has borrowing in the inter-bank market - leading to complex layers of banks lending to each other.

The problem is of course that few people know where the toxic debts are and the risk premiums on lending to each other have grown. Effectively what we are seeing now is a wholesale bank run rather than the collapse of a large number of retail banks (aka Northern Rock).

Deflation – Two Perspectives

Keynesian deflation

Economic recession puts downward pressure on prices and wages – but wages tend to be sticky, there are plenty of people keen to avoid wage cuts and wage freezes. If prices are falling but wages not, business profits will suffer and this could lead to a huge rise in unemployment.

Irving Fisher on deflation

Central banks can only cut nominal interest rates to the floor (zero per cent) but if prices and wages are falling, real interest rates will rise and the real value of existing business and household debt will increase – there is a strong incentive for people to use any rise in

real incomes to save and pay down some of their debts rather than spend on new goods and services.

The quantity theory of money comes back into focus.

$$M \times V = P \times T$$

Money supply (M) multiplied by the velocity of circulation = the value of national output (price level x volume of transactions)

We are seeing a contraction in the money supply because of the credit crunch / fall in lending. If velocity of circulation is stable then this will lead to a fall in the value of GDP.

But matters are made worse if velocity is also declining – households are starting to hoard cash as are companies worried about insolvency and the lack of credit and hedge funds holding onto cash because of fears over investors wanting to redeem their money.

A fall in the velocity of circulation of money significantly increases the risks of a deflationary recession.

How to prop up the banking system

Strategies include:

1. Injecting capital into banks – shoving taxpayers money into the banks to provide them with sufficient capital to avoid failure – the danger is (a) it doesn't really solve their funding problems and (b) it promotes economic nationalism because national governments will insist on the banks they have supported maintaining lending at home but choking off lending to overseas businesses and markets.
2. Lending guarantees
3. Purchase of private assets e.g. through quantitative easing by central banks

Ultimately we seem to be moving either to nationalisation of the banking system or a complete monetization of the system with the government becoming borrower of last resort – issuing gilts to finance its own spending with the Bank of England prepared to expand its own balance sheet to buy them up – in effect the Bank of England by-passes the entire banking system.

Monetary and fiscal policy is becoming one and the same thing. Will the Central Bank be strong enough to place a constraint on government borrowing? Does the BoE have an exit strategy for its new policy of injecting cash direct into the economic system?

Geoff Riley
Friday, March 06, 2009