A Tale of Two Liquidities

Remarks by

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Good morning. I want to talk about the outlook for the world economy, but set in the context of the developing liquidity crisis.

Start first with the overall outlook. Because of gloomy forecasts for the United States, world growth is expected to slow, from around 5 percent this year (weighted by GDP at PPP exchange rates) to about 4.5 percent next year. The US will slow sharply in the 4th quarter – whether it moves into recession is really only an academic issue for the next two quarters will be painfully slow, between 0 and 1 percent. But barring a low probability default by a major financial institution, trend growth should resume by the second or third quarter of next year. I don't expect much additional support to growth from the Euro area or Japan. The key upside growth possibilities to this baseline lie in the emerging markets, where extremely strong productivity growth and demand for commodities is continuing to propel income growth. Indeed, China growing at 11 ½ percent, India at 9 percent, and Russia at 8 percent account for more than half of world growth. The emerging markets will, however face interesting challenges in coping with slowing industrial country growth – this may well herald a sea change in some of their strategies, including that of China. The risks to the overall forecast are, however, predominantly to the downside.

An important difference between this period of sustained growth and previous periods is the low level of both short and long term real interest rates over the last 5 years, certainly relative to the last two decades. These very low rates have created the most important risk now facing the world economy, the overpriced housing markets, the attendant risks of financial sector turmoil, and the possible consequences on household consumption.

Let me explain. The low short rates resulted from extremely accommodative monetary policy as G-3 central banks cut rates sharply to stave off deflation after the recession of 2001, and were not equally quick to raise rates as economies improved. By contrast, the long rates fell following the collapse in investment in both emerging markets and developed countries after the crises in 1998 and the ICT bubble in 2001**.** Emerging market governments became more circumspect and increased budgetary surpluses, even while cutting back on public investment. For instance, in Philippines, investment fell from 24% of GDP in 1996 to 17% in 2006, while its savings rose from 14% to 20%. From borrowing 10% of its GDP, it now pumps out 2.5 percent as a current account surplus.

Moreover, as industrial economies recovered, corporate investment did not pick up, at least not to the extent warranted by the growth. As a result, the worldwide excess of desired savings over actual investment – the so-called savings glut -- pushed its way into the main markets that were open to investment, housing in industrial countries, lifting house prices and raising residential construction.

The US was not alone in this. Housing prices have reached higher values relative to rent or incomes in Ireland, Spain, the Netherlands, the United Kingdom, and New Zealand for example, though not in Germany or Japan. But the U.S. went further in financial innovation. With steadily rising housing prices, easy financing brought more low-income households into the market.

There was some logic to the lending, and it went something like this: “With such a strong housing market, all I need is to get this buyer into the house. If the loan has low "teaser" rates she has to pay very little over the first few months. By the time she has to pay anything significant, the house will have appreciated 10 percent, and she will have the equity to refinance or make future payments."

Indeed, credit quality mattered little. If the buyer could not make even the low initial payments, the lender could repossess the house, sell it quickly in the hot market, recouping any losses through the price appreciation. Indeed, loans to the bottom of the pyramid were called NINJA loans, loans to those with NO Income, No Jobs, and No Assets. In short, the continuously rising house prices and housing market liquidity fed on each other.

And so it went till the Federal Reserve started raising rates. With fewer buyers able to afford normal mortgages, the first reaction of lenders was to increase the volume of exotic loans so as to keep the buyers coming. But eventually houses stayed on the market longer and prices started falling. More buyers, with negative equity in the house, started defaulting. Adjustable-rate mortgages to subprime borrowers accounted for only 7.3 percent of all home loans but 44 percent of all new foreclosures in the third quarter. U.S. builders were quick to cut building, but sales fell even faster than construction. And so they are now sitting on about 10 months of inventory, perhaps significantly more because sale cancellations tend to be undercounted. Estimates suggest it will take a year to two years to clear the back log, with a further fall of about 7 to 10 percent in house prices to bring about balance.

Given that repossessed houses now could not be sold easily, the underlying credit quality of buyers – whether they had a job, whether they had income, whether they had assets, started mattering, for that would indicate whether they were liable to default.

Meanwhile, in financial markets, the original mortgage had been bundled into a pool, and then securities of different seniority sold against it. Financial engineers further bundled the securities sold by the mortgage pools into securities pools, and sold claims against them, and so on. Thus were born the CDO, the CDO squared… Rating agencies went along certifying senior tranches as of the highest credit rating, even though they had little sense of their default properties. And because nearly everyone was paying, it did not matter.

Why were these complex assets created? Go back to the savings glut. Financial institutions in countries with excess savings like Germany and Japan were looking to invest their foreign exchange earnings, while pension funds and insurance funds in the U.S. were looking for higher yielding long term paper to match their long term liabilities. Many of these institutions were constrained to invest in high quality debt instruments. The highly rated tranches of mortgage backed securities of CDOs were exactly what they wanted, especially if the AAA tranche of the CDO paid 200 basis points above corporate AAAs. Of course, there is an old adage in finance – there is no return without risk – but this was forgotten in the frenzied search for yield.

Given the plentiful financing, the demand for highly rated bonds paying above market rates was expanded by other strategies. For example, the oldest investment strategy in the book is borrowing short term and investing in longer term assets – the strategy followed by banks in setting up special investment vehicles or by Northern Rock, the UK bank that nearly failed. Again, this worked so long as commercial paper finance continued to be available, and itself created more demand for exotic securities.

As liquidity drained from the housing market, everything changed. Securitized mortgage pools were easy to understand and undifferentiated when the housing market was liquid – they all had low risk. But as liquidity started drying up and defaults increased, pools became differentiated based on how careful the originator had been, how well documented the loans were, who they were to, etc. Information started mattering more and it was hard to get at. Ratings became suspect. This immediately created a problem for those who owned claims on the mortgage pools, and wanted to borrow against, or sell them. In the same way as a used car salesman has to sell a car at a significant discount because the buyer suspects the car may be a lemon, once the mortgage pool has become differentiated, arm's length buyers like foreigners or pension funds are reluctant to buy, and lenders are unwilling to lend, without knowing much more.

The securities issued by CDOs became doubly hard to value, because not only were they subject to the same underlying information problems besetting mortgages, but also because they were leveraged claims on these assets, with much more complicated default properties. Thus illiquidity in the housing market created information risk, which coupled with complexity risk, destroyed liquidity for asset backed securities in the financial market.

Many of the investors in the market did not have the capability of going beyond the now unreliable ratings to ascertain quality. Unfortunately, the obvious investors who could, the large money center banks, were preparing their balance sheets to take on other commitments that might devolve on them. And thus credit markets became paralyzed.

So financing in the asset backed paper market will take time to reappear, which means there will be less financing for housing. The housing market will thus take a longer time to stabilize, and will stabilize at lower prices. In the meantime, defaults will continue to rise as more loans reset to higher rates – about 350 billion subprime over the next year -- and as more loans made in the later, more lax, periods come to the fore.

Let me return to the macroeconomic consequences though. We have seen one effect of the housing collapse, the fall in residential investment, which has subtracted a percentage point off US growth over the last few quarters. But there are two other consequences that are yet to appear. One is the possible consequence on US consumption growth thus far. In part, still reasonable job growth and payroll growth seems to have supported the amazing US household’s consumption, even though savings are negative. But I see substantial downside risk here. Rising housing defaults, deteriorating confidence, and increasingly visible declines in housing wealth must eventually convince the US shopper to save more, as will tighter consumption credit. Moreover, rising energy prices will reduce disposable income, and constrain households. Perhaps most important, though, the slowing in productivity growth and the decline in non-financial corporate profitability will slow job growth as well as wages.

The knock on effect on investment will be important, especially if the credit squeeze also limits the plans of small and medium corporations. Note that in the last two quarters in the US, inventories have been building. Moreover government expenditure has also been higher than normal. These will reverse. While the falling dollar and rising exports will support income growth, the baseline forecast for the US is extremely slow growth – between 0 and 1 percent over the next quarter, and between 1 and 2 over the next 5 or 6 quarters.

Can the Euro area and Japan pick up the slack? The Euro area started growing strongly in 2006, but is likely to face a number of spillovers from the US credit crisis. A number of its financial institutions are exposed to US assets, and this will have an effect on credit growth and confidence. Moreover, even though housing markets in the Euro area have not seen the lending excesses that were seen in the US, some are more highly priced according to most traditional measures than the US. Coupled with the strengthening Euro and the slowing of its major export market, growth next year will slow. The ECB does not have much room with inflation already at 3 percent, substantially above its area of comfort, even with a slowing economy. It is unlikely that the Euro area will step up to fill the loss in world demand, despite reforms over the last few years that have improved its potential growth somewhat.

That leaves Japan among big industrial countries. While Japanese investment has been strong till the last two quarters, consumption growth continues to be weak, as reflected in the extremely weak confidence numbers. In part, this reflects low wage growth, as older higher paid workers retire and are replaced by younger lower paid workers. It also reflects the change in the nature of employment from lifetime to contractual employment. Finally, it reflects the fact that small firms in Japan, which contribute the bulk of employment, are not doing as well as large firms. As carry trades are unwound, and the yen appreciates against the dollar, Japan will have additional concerns from slowing exports and investment losses by speculating housewives. Bottom line: While there could be positive surprises from Japan, don’t hold your breath.

Let us turn to the emerging markets. Of course, as I said when I started, the really good news continues to be from the continued growth of emerging markets in Asia, Middle East, Latin America, and the CIS. Growth in many of these countries has been based on strong exports of manufactured goods and of commodities, in many cases based on very competitive exchange rates.

Many commentators are looking for an increase in domestic demand in emerging markets, to compensate for the slowdown in the United States, and the eventual shrinkage of its current account deficit. Indeed, emerging markets now account for more than half US exports. Domestic consumption is picking up in a number of countries including China, while governments, such as those in the Philippines and in the Middle East, are once again turning to much neglected public investment. Yet years of strong growth and cutbacks in public investment, which have restored fiscal and external health to emerging markets, have also eaten up excess capacity. Any increase in domestic demand, if it is to not result in increases in bottle necks and already high inflation, will have to be accompanied by a shift in production from an external focus to an internal focus.

China is a clear example. Years of breakneck growth have led to some serious imbalances in the economy, with household consumption alarmingly low for a country of its size, while investment growth, though no doubt incorrectly measured, is too high. A slowdown in the US and the Euro area will slow China somewhat (the US now accounts for only 24% of exports from China and Hong Kong), but only from extraordinary, and probably excessive, growth to very high growth. The greater concerns are probably domestic. Chinese inflation is high. Negative real interest rates on deposits are causing depositors to move into an overheated stock market with potential consequences when it returns to earth.

Chinese authorities also want to shift investment away from the overheating coastal areas to the internal western provinces, while boosting household consumption and thus reducing the politically inconvenient trade surpluses. The key to all this is to allow the real exchange rate to appreciate. With grain prices high around the world, this may be the ideal time to do it for the pain for Chinese farmers, a stated concern of the Chinese authorities, is likely to be small.

More generally, to increase the weight of domestic demand to compensate for the fall in demand provided by industrial countries, emerging market currencies will have to appreciate, and the weight of output will shift from traded goods like T shirts and electronics to non-traded goods like real estate and health services over the next few years.

This will be a dramatic turnaround in strategy that few emerging markets are prepared for. International competition disciplines the production of traded goods. Firms have little leeway in pricing, while unions cannot push too hard for wages. Productivity growth and innovation is a byproduct of that competition, even in countries with relatively poor institutional environments. So are low inflation and responsible fiscal policy, for corporations cannot be taxed too much without rendering them uncompetitive.

A shift from an outward focus to an inward focus will thus have to be accompanied by much more institutional discipline. With fewer constraints on underlying inflation, central banks will have to be much more focused on targeting low inflation, especially as exchange pegs become less viable. Labor markets will have to be more flexible, while product markets will have to be deregulated far more if profitable productive growth is sought in the non-traded goods sector. With more expenditure flowing to assets like housing, the financial sector will have to be careful not to precipitate booms and busts, and this will mean more financial sector reforms. And finally, governments will have to meet the greater demand for public investment without eroding fiscal discipline, maintaining greater caution as the cushion of large foreign exchange reserves diminishes and increases their vulnerability.

The enormous inflow of capital into emerging markets in recent weeks could simply be a temporary search for safe havens from the credit crisis enveloping the industrial world. Equally, it could be a recognition that emerging market currencies will have to appreciate as the U.S. slows, and there will be opportunities in the non-traded goods sector. One can sympathize with emerging market central bankers and finance ministers who are desperately trying to slow the appreciation and trying to keep out “hot money”. Certainly they have to avoid having an overvalued currency for that will make the transition from an export led strategy abrupt and painful.

But they should also devote some of their energies to planning for an environment where exports are more difficult and greater internal discipline is necessary. And rather than attempting individually to hold down their nominal rate because competing countries in the region are doing so, they would be better advised to reach regional agreements to appreciate collectively.

Not all non-industrial countries will shrink their exports as demand shifts to emerging markets. Commodity producers are likely to face increased demand because the commodity-intensity of demand in emerging markets is higher. This bodes well for Africa, the Middle East, and Latin America, provided they can sustain good macroeconomic environments, and avoid the curse of natural resources.

Industrial countries will also face adjustment problems. Globalization has made it easier for them to contain inflation. Effective inflation targeting and the associated great moderation will become more difficult to sustain as the tailwind from emerging market competition diminishes. Fiscal discipline will become more necessary.

Put differently, the world is approaching a turning point after nearly a decade of growth without serious emerging market crises and declining volatility of growth. It has benefited enormously from the relative specialization of significant parts of the developed world, primarily the United States, in the output of non-traded goods and the specialization of emerging markets in traded goods. The United States, with its strong institutions and impeccable credit, was in a good position to handle this specialization, though the housing crisis shows that even it has its limits. As the US reduces its current account deficit, a transition in specialization will have to take place. In the medium term, this will, in my view, increase risks in emerging markets, while also creating opportunities. Some countries in Emerging Europe, in my view, already have some of the historic diseases of emerging market – large current account and fiscal deficits, overpriced housing, mismatched currency borrowing, and overvalued exchange rates [Latvia – CA deficit of 24%, inflation 13%, property prices rising at 60%]. Whether further transitions can be handled without new problems is a key medium term question the world now faces.

To summarize and conclude: Dramatic slowing in the US into the new year. Moderate Euro and Japanese growth. Emerging markets will slow, but not hugely, barring a real recession in the industrial world. Some will, however, need to significantly change their growth strategy. If credit issues can be sorted out – and I believe they will with a little more pain than currently anticipated -- the world will resume growing strongly by 2009. With this introduction, I would now be happy to answer questions.

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