

CSFI

CENTRE FOR THE STUDY OF FINANCIAL INNOVATION

5 DERBY STREET
LONDON W1J 7AB

TEL: 020 7493 0173
FAX: 020 7493 0190

'End of the world? Armageddon? Or just a mini-diversion on the motorway of eternal progress?' A round-table discussion with Martin Wolf (*Financial Times*), John Plender (*Financial Times*), Anthony Hilton (*Evening Standard*), and Edward Hadas (*Breakingviews*) held on Thursday, January 31, 2008, at Pewterers' Hall, London.

The first speaker explained that the interaction between the housing market and the financial system, particularly in a modern transaction-oriented securitised financial system, was what caused the predicament. What the economy faced was a standard credit bubble, but this time, bankers had made it more complex to work out who owns what "rubbishy" paper, and therefore with whom you can safely deal. He felt a US recession to be overwhelmingly probable. The Fed is "panicked out of its wits". He was sceptical about the fiscal and monetary boost, because it was difficult to sustain American demand at anything like recent levels, since US households had been spending such an incredibly high proportion of their income, and borrowing so much. If they really crash the dollar seriously, then inflation is going to become a big problem.

He said that the direct effect from the US on the UK and Europe would be significant, but not that vast. The UK looks to be a prime candidate for having problems similar to those in the US, although not so severe. On the issue of decoupling, he went on, if you look at the big emerging countries, particularly China and India, their direct dependence on US markets is not that large. In China's case, 8% of GDP is its gross exports to the US, and in India, only 2%, and they could boost domestic demand to meet a shortfall in export demand.

The second speaker said the situation reminded him of 1973, particularly the problem with opacity. He thinks there is more to come, and made a reference to monolines, the vulnerable bond insurers. Setting this credit crunch apart is that whereas normally companies run out of money - this time it is people. And while companies can rebuild their balance sheets quickly, people can't. He does not think the US can decouple from emerging markets such as China. Personal spending in China is 1/7 of that in the US, so if there is a 10% drop in consumer spending, that would require a 70% rise in Chinese spending. He thinks the financial system hijacked the world economy.

The third speaker said the key question was the US. The Central Bank's risk may turn out to be severe inflationary consequences: people who have been pushing the gold price up don't feel their expectations are remotely well anchored. The generalised liquidity problem has been sorted out, he added: problem has moved onto monolines. The speaker said he would not want to be in bonds on a long view, in the context of worries on inflation. Equities in the US are expensive; in UK they are fair value. Commercial property had a setback but now its yield has a positive carry if you are able to borrow. May be easier to make money out of currencies this year than usually.

If you think about excess savings in Asia which would have had a phenomenally deflationary impact had the US not been prepared to absorb excess savings, we're now in a position where US household balance sheets are being rebuilt. The US is no longer going to be offsetting excess savings in Asia. Who is going to be doing that job now? The chair asked the third speaker how one can account for the fact that, on the whole, equity markets have been resilient. The speaker said that the forecasts of corporate earnings in the US were overblown for too long and, to a lesser extent, those in the UK too.

The fourth speaker put forward some pessimistic thoughts. The eternal problem, he said, is to try and get cash, or money, or credit - or a combination of the three - in line with economic activity, and the idea of trusting banks to measure how risky their business is, is akin to putting faith in a three year old, alone in a room, not to eat cake. We have had an unprecedented imbalance in the global financial system.

The third speaker said that if there are setbacks to China's growth process, the potential political consequences, and how they then rebound into the international arena, is worrying. The first speaker remarked that, on the upside, credit prices push up the asset prices, making everyone look more solvent, but on the downside, institutions look undervalued at best and bust at worst: make them transparent and force them to get capital.

The third said that it was evident that shareholders were applying pressure to individual commercial banks and investment banks. But if sovereign wealth funds become substantial owners of capital in Western banking systems, their ability to apply pressure is probably less than that of other shareholders for political reasons.