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Beauty and the Beast



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Beauty and the Beast

By **Roman Scott**

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The last twelve months have been a good year for the doomsayers club. Never popular, or much liked, before this crisis, we are at least fashionable now. Papers print our views without turning a hair, and even girls talk to us. Gloom, once a contrarian badge of pride for a very small club, has gone mainstream. Media have been filled with comparisons to the 1930's Great Depression, with visions of tent cities in the prairies and soup kitchens in New York. The chattering classes have returned to home-cooked meals, saving soap ends, and biking to work (assuming they still have a job). The intelligentsia delight in debating the end of capitalism or 'The World As We Know It', which really means the rich world as Westerners have known it. Even the IMF, whose forecasts have consistently underestimated downturns for twenty years, has become a born again doomster. Its latest round of downward revisions to its GDP forecasts are so depressing they would make even Nouriel Roubini jump off a bridge. What's an old pessimist to do?

Well of course, the best line would be for me to turn a bull on the US economy and dollar after banishing it five years ago, jump back into the markets, and, why not, even buy Citibank stock. A sufficient number of brave souls appear to have been doing just that recently, enough to move equity markets to bull like returns of over 20% in a month. Contrarianism has a new label, the 'green-shoots of recovery' school. They advocate that risks may now be to the upside for a V shaped recovery, faster than expected return to trend growth in the US (2.5%-3%), and a 'China rescues the world' idea that the Chinese mountain of savings and consumers will pick up the slack in world demand, pushed along by a mammoth fiscal stimulus package. Some of their arguments have merit, and there may indeed be some light at the end of the tunnel. Or is there?

This Q2 review will try to tackle this issue. There appear to be three key questions. The first is where I traditionally start, on the current state of the global economy. Businesses and investors face huge uncertainty because the range of options goes from complete meltdown-a five years or longer 1930's style depression, to salvation-a V shaped recovery from Q3/4, with a return to trend growth by early 2010. Beauty, or the Beast?

Secondly, the fundamental question that underpins all our hopes is whether the bank crisis that created the problems will be effectively solved by the bank rescue plans that have been announced. Whatever green shoots there may be in the real economy cannot recover without this. Foremost here is the Obama administrations' latest plan for troubled US banks.

Finally, there is the question of what the future will hold for the economy. Many things will never be the same again, and there will be many surprises we cannot anticipate today. But we can set expectations for some big picture changes that are fairly obvious already.

The State of the Global Economy

Depression

Recently I have stopped reading fiction. I hear such fantastical stories every day about where the world is or may be going that I don't have to. One problem with meltdowns is that everyone turns to forecasting, and the madness of the markets seems to infect otherwise perfectly normal people. And it doesn't seem to stop at taxi drivers. At one recent high powered lunch here in Singapore, with her majesty's representative and a top financial guru, conversation turned to a story about a wealthy businessman so utterly convinced all money and property would soon be worthless with the world returning to a medieval barter system of exchange that he had sold everything for a yacht to cruise the eastern seaboard with useful stuff to barter. That we should have even listened to the story gravely, rather than fall off our chairs laughing, I regard as a sign of early senility in all present. So let me be very clear. The world is not returning to the stone-age. It is not even returning to the Great Depression. For the majority of us, your house will remain the best place to live, not a tent; your visa card will still work, the malls will still be crowded at the weekend, and finding parking will remain more of a headache than finding a loaf of bread to eat. Civil disturbances and tear gas will be rare events unless you live in Bangkok, in which case you will feel at home. Tent cities will not sprout up in Hampstead Garden Suburb.

The world has indeed just experienced Great Depression levels of demand contraction and an equally precipitous collapse in trade flows and equity markets. But the economic world in 2009 is nothing like that of the 1930's. The sheer wealth of nations that now exist cannot be compared, coupled with an extraordinary level of information dissemination and the ability for policy makers to understand in real-time the impact of the crisis on markets and economies and do something about it. Asia and other newly industrializing countries did not have a role then, or the fiscal power of their reserves and household savings. Monetary policy today has real power with free floating paper currencies and independent central banks, not the disastrous Depression era commitment to maintain currency ties to gold reserves and severe monetary austerity (Hoover raised interest rates, not lowered them, after the 1929 crash). Social safety nets and public health systems are light years ahead of the thirties, and not just in European welfare states.

It is precisely *because* of the experience of the 1930's that the threat of a repeat of the same policy mistakes was always limited. The Great Depression was the result of seriously flawed central bank

policy-from the Federal Reserve, the Bank of England and the Banque de France-and every central banker since has been haunted by the desire to understand those mistakes and ensure they are never repeated. In times of extreme stress and a total collapse in private demand Keynesian style stimulus has become orthodox, even for fiscal conservatives in Europe and Asia. At least part of the damage from the collapse in private sector demand can be offset by replacing it with state driven demand, be that infrastructure, education and R&D, or simply hiring more civil servants. The world has developed a capacity, and willingness, for coordinated fiscal stimulus impossible to conceive of in the thirties.

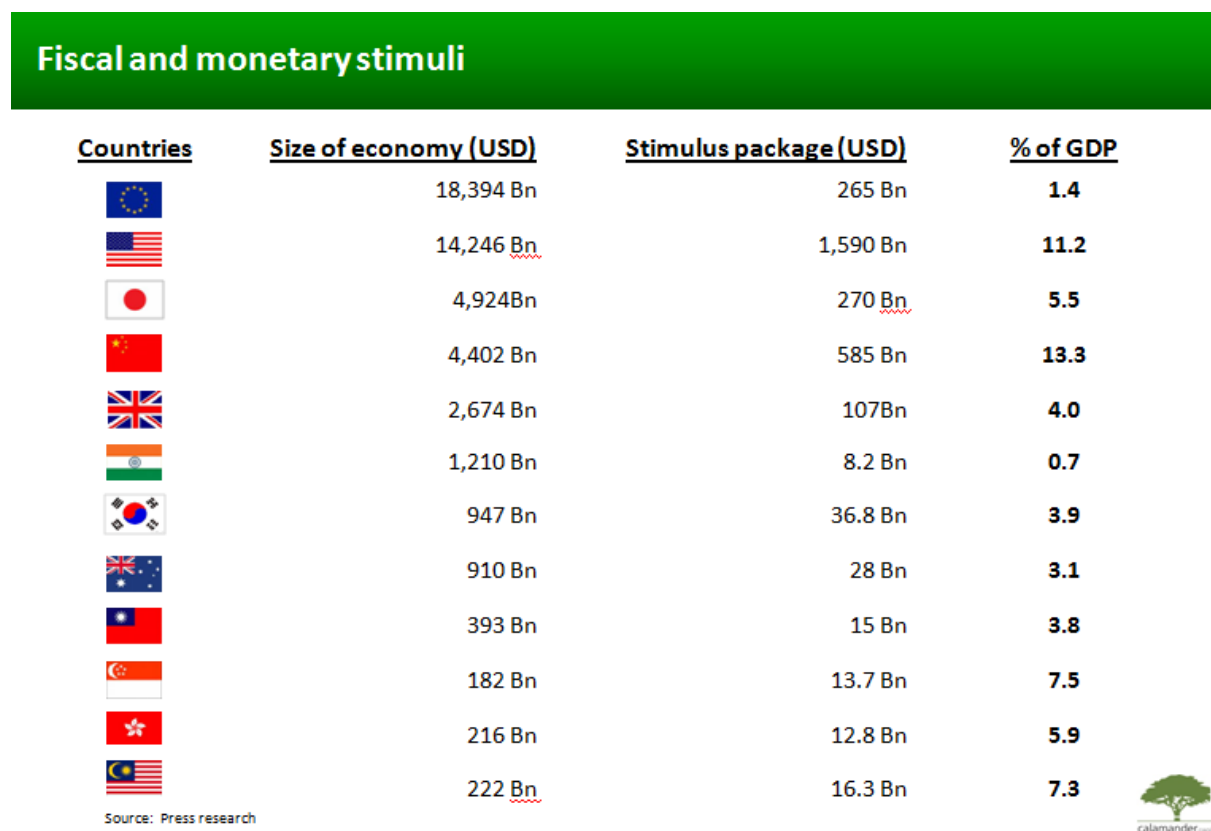


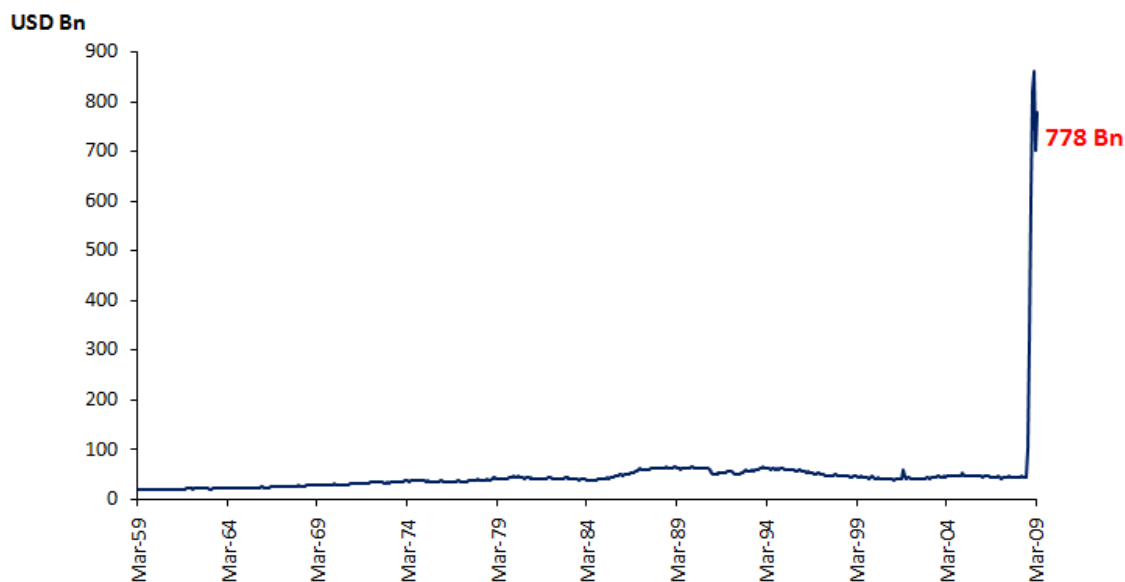
Fig. 1: World fiscal stimulus packages

Governments have used it, and the threat of Depression has been averted. The extent of policy action and its coordination around the world is unprecedented. The stimulus package of the US alone, at 1.6 trillion, equals the GDP of Spain, the world's eighth largest economy, and China's package larger than Indonesia, Asean's largest economy. The balance sheet of the Federal Reserve has ballooned from less than USD 50 bn to 778 bn. You cannot drop that amount of money into the system and not get a positive response at some point. Real rates are effectively zero to negative in the major economies. Although monetary easing hits the limits of its effectiveness quickly, direct fiscal stimulus is a more powerful, and longer lasting, tool. Quantitative easing, injecting cash by other means, has rounded out the medicine in the US, the UK and Japan, with the Fed having bought USD 2.2 tn of assets including

mortgage backed securities, and the UK and Japan buying their sovereign debt to the tune of USD 110-120 bn apiece.

Even the London G20 meeting has proven to be more than just a nice photo opportunity for world leaders and done its part. Progress was made in avoiding the risk of progressive currency devaluation wars between nations, and the resources of the IMF strengthened just in time to deal with the looming threat I mentioned in the November review-East Europe. Investors are right to feel more confident. The Beast is back in the cave, for now. The probabilities are that he will stay there, and the Depression scenario will go down in history books as a near miss.

US Federal Reserve balance



Source: US Federal Reserve



Fig.2: US Fed Reserve balance

The 'Green Shoots' school

Then there is the Beauty. Those that have thought capitalism was dead have only had to watch the markets recently to witness the return of the primal forces of greed and fear. Since March the fifth, the US (DJIA) is up 22%, UK (FTSE 100) 18%, China (SSEA) 10%, Euro area (DJ EURO STOXX 50) 47%, and Singapore (STI) 22%. Brokers are happy, at least those old enough to recall the simple joys of

transaction commissions rather than prop desk gambling. Supportive ‘green shoot’ commentators are popping up like mushrooms. One recent weekend edition of Singapore’s Business Times had everyone penning pieces on the risks to the upside, and why it is not too late to jump back into the water. Even the cautious FT can see some light at the end of the tunnel.

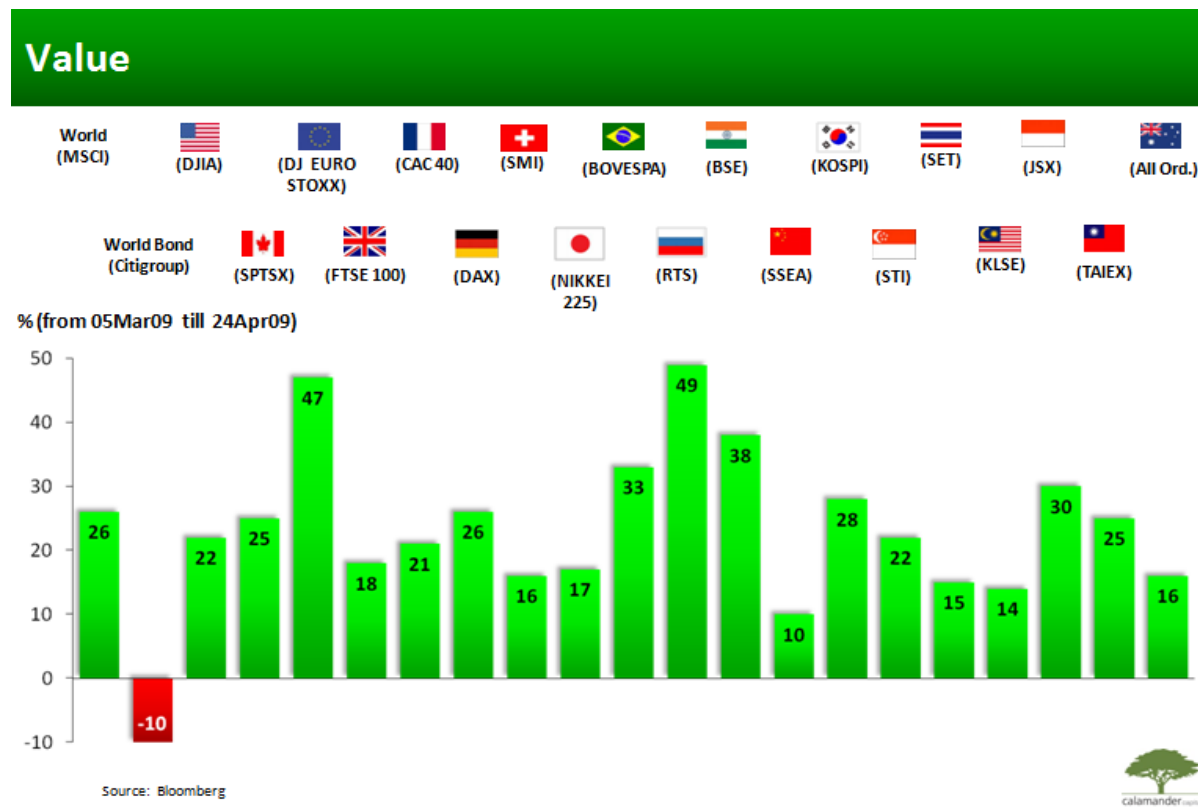


Fig. 3: Equity markets

The ‘Green Shoot-ists’ appear to have six arguments, both for markets and the economy. These are: 1. *Confidence* is returning after the G-20 meeting; 2. *Value*-stocks, and everything else, are cheap; 3. *Liquidity*- huge amounts of cash are sitting on the sidelines and will turn the markets; 4. *Timing*-the US has been in recession for long enough now for a turning point; 5. *Fiscal and monetary stimuli* will work soon; and 6. *G3 economies* are bottoming out.

There is a seventh ‘Green Shoots’ argument: that economists’ forecasts always miss the bus. The consensus for economists was badly wrong on the way down, they argue, so what’s there to say they haven’t got it equally wrong now when bearishness has become the new consensus. Business Week’s latest cover simply reads ‘What Good Are Economists Anyway? Fair point (although Business Week’s sensationalist covers have an equally long track record of being widely off the mark). I will not attempt any defense for this one, other than to remind you, many economists and strategists since the tech

bubble era have been consistently warning about the US and global economic imbalances: the credit-based consumption, debt levels and poor savings of the US; and the matching problem of under consumption, too high savings and export driven economies in Asia. These were not a few lone voices in the wilderness, but a large, respected, and very vocal minority who worried about the sustainability of the model, and the consequences were it to unravel. Governments did not listen, allowing the stresses to build up to an extreme level that did not allow for the orderly winding down of the excesses. Instead the dam burst. Not all the messengers deserve to be shot as a result.



Fig. 4: Business Week, 27 April 2009

Confidence: Of course market economies depend on confidence and even relatively minor improvements can create a self generating source of recovery, investment, and demand (just as the opposite applies when confidence is lost). Governments are thus justified in attempting to 'talk the economy or markets up'.



Fig. 5: Confidence – talking the economy up













That said, rationality and data still set the sails of confidence. No amount of confidence boosting measures will change a consumer's feelings when they've lost or feel they may lose their job. Confidence drowns quickly in a sea of debt, and a huge number of businesses and consumers now hold more debt than they can pay for many years, or have cashflow crises. Broadly however, confidence has risen since the G-20 meeting. The key business confidence indexes, other than Japan, continue to decline but at a slower rate - the US conference board is at -0.3%, and Europe at -6.0%. Japan's Tankan survey, which has always been the confidence index equivalent of a mortuary, turned in a gruesome -58% q-o-q drop for Q1. Consumer confidence also appears to be stabilising, as in the US (0.03%) and Europe (-2.8%).

Value: It is true that stocks are cheap in all markets, as are most other asset classes. All sinking ships eventually hit the bottom, and this does appear to be the case. Yes broker analysts remain biased in favour of 'buy' calls and over ambitious earnings forecasts. But the carnage in the markets has priced most of that in, even after the recent rally. Emerging market Asia (non-Japan) in particular offers the best combination of long term strategic value and bargain prices, as does Brazil. Other than banks, which the market continues to misjudge, opportunities abound. The institutional selling pressures which had stifled market recovery remain, as wealthy investors continue to abandon hedge funds, forcing liquidation. But the worst of the redemptions and deleveraging are behind us. Emerging markets in particular will gain, having been the most punished in the Q3 2008 flight from risk.

The 'wealth effect' works both ways. This is the detrimental impact on economic activity experienced when the value of investments (such as equities) and real assets (such as homes) decline. People feel poorer on their household balance sheet, so they spend less. This has been a major force suppressing demand during this recession because the extent of losses across all asset markets has been so high. Conversely, strong rises in asset values drives confidence, and will push consumption up.

Liquidity: It is also true that the volume of cash in savings and other liquid assets sitting on the sidelines are substantial. For the US and most other major economies this sum exceeds both the underlying economy and the size of stock markets. History shows that liquidity eventually turns all depressed markets when deployed. But liquidity in itself is a necessary, but not sufficient condition for a recovery. Economic activity and confidence have to show signs of recovery first.

Liquidity

<u>Countries</u>	<u>Gross national savings (% of GDP)</u>	<u>Gross national savings (USD Bn)</u>	<u>Equity market cap (USD Bn)</u>
	11.9%	1,700	13,116
	20.6%	3,791	3,185
	26.7%	1,314	2,913
	15.1%	403	1,721
	49%	2,157	5,000
	38%	460	1,247
	25%	393	642
	30%	503	324
	30.5%	66	1,329
	47.6%	87	441
	50.3%	112	189
	44.3%	803	526

Source: Press research



Fig. 6: Liquidity

Timing: The crux of this argument is that nothing lasts forever in economics, and recessions in general don't last that long. The first is true, but the second depends how you define recessions. For the US official data puts the average length of its post war recessions at less than one year. However the suppression of demand as balance sheets are repaired and the wealth effect can linger long after recessions are officially over, as can poor equity market declines. It is never healthy to compare relative destruction, but the data on previous recessions makes a point. The current recession, at 17 months (starting December 2007 according to the NBER), is already the longest in post war US history, which would argue that the end must be in sight soon. However if we compare to the 34 months of the Great Depression the US is not even half way through. The probability is somewhere in between. Depression has been averted, and the 34 months of the Great Depression included at least half of that time wasted pursuing the wrong policies. But the severity of the present recession earns the silver medal in comparative declines. That would put a timeline of between 24 and 27 months this time round, not exactly a strong argument for recovery today, but supportive of my expectation for a real economy recovery in Q4 2009 to Q1 2010. As for the markets, the current bear market at 20 months has matched the run time of the 1973 oil shock, but not reached the 30 month tech bubble bear or the 34 month Great Depression. But markets typically anticipate recovery by 6 months or so, which would imply equities bottoming from this quarter to next.

Timing

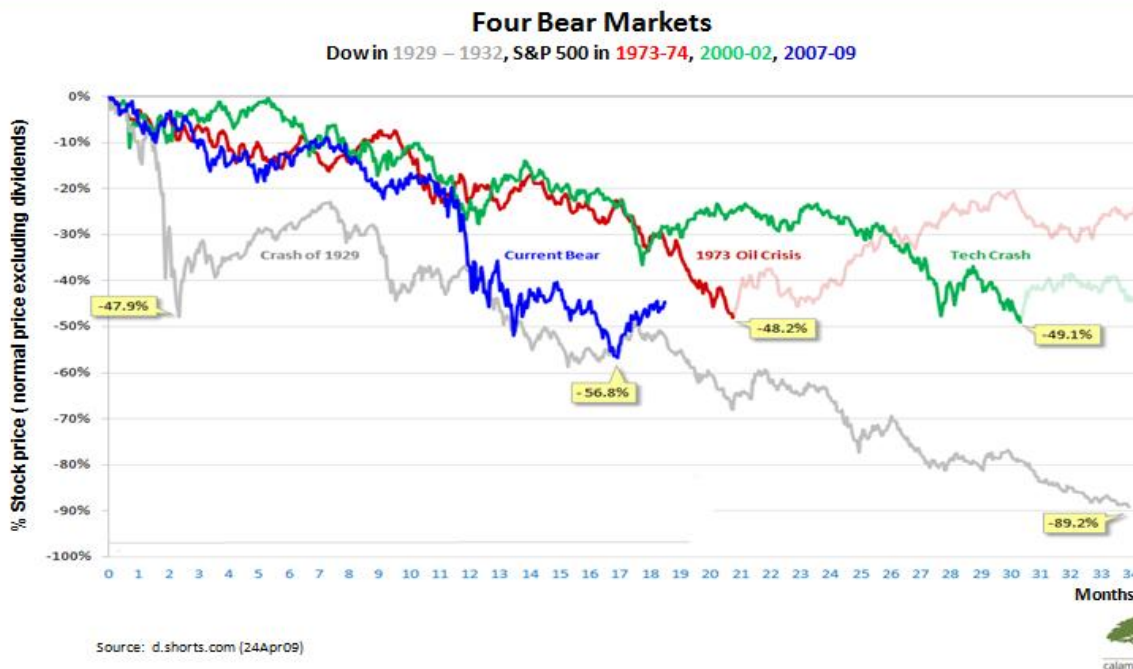


Fig. 7: Bear markets compared, length of time vs depth of decline

So far, its *quatre point* for the Green Shoots theorists, and *nil point* for the bears. Confidence, value, liquidity and timing are all sound arguments. So why am I not buying the market? Because this is not a mere recession, it is both a financial crisis (which as we have argued repeatedly is fundamentally different), and it also represents a secular change for the current global economic system that depends on US consumption and credit, supported by Asian exports and savings. This is Bernanke's 'savings imbalance' argument. A tipping point has been reached, so that old standards and models for recovery do not necessarily apply. G3 data indicate that these fundamental changes, which will slow down the recovery significantly, have started. You cannot expect a rapid pit-stop and return to the race if you change the engine not just the tyres.

The G3 economies and fiscal stimulus packages

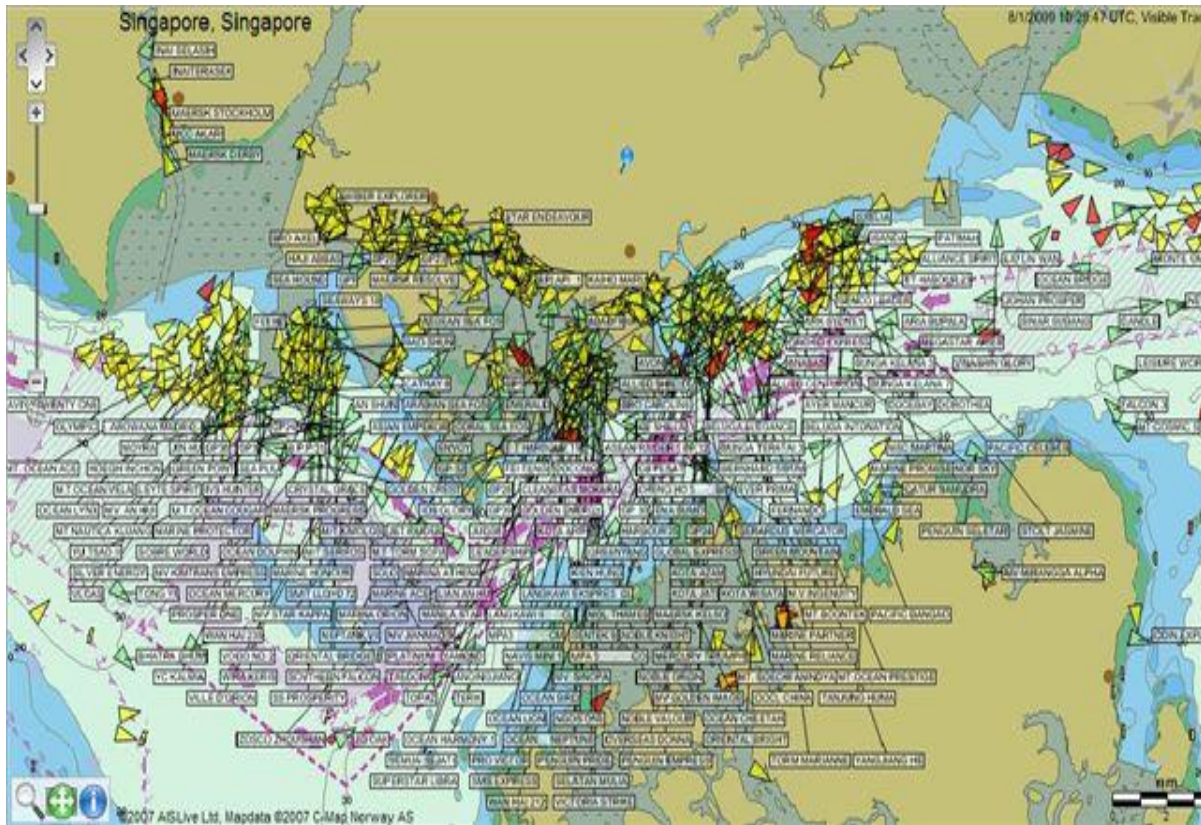


Fig. 8: Singapore container ships at anchor

This last quarter in all major economies has been a disaster. The US has posted negative 6.3%, the UK negative 1.9%, and Singapore, my favourite barometer of world trade, negative 11.5% (yes that's not a typo). The EU and Japan haven't released figures yet, but given the dismal Q3 2008 numbers (negative 1.4% and 3.2% respectively), expect the worst. Japan in particular, given it is the second largest country economy, is a disaster. Global trade has fallen off a cliff, with major exporting nations (Japan, Germany, China, Asian tigers etc.) experiencing 20-40% falls in exports. Each week I run past hundreds of empty container ships parked along Singapore's east coast. Trade sensitive industries have been decimated: global shipping, Asian consumer electronics, German machine tools, Japanese and German cars, Asian components, Chinese toys and household goods, steel...the list goes on. Aviation, a dog industry at the best of times and bell-weather of the cycle, has followed suit. As for US autos, enough has been said already, but I'm British so we know what it's like to lose a national car industry.

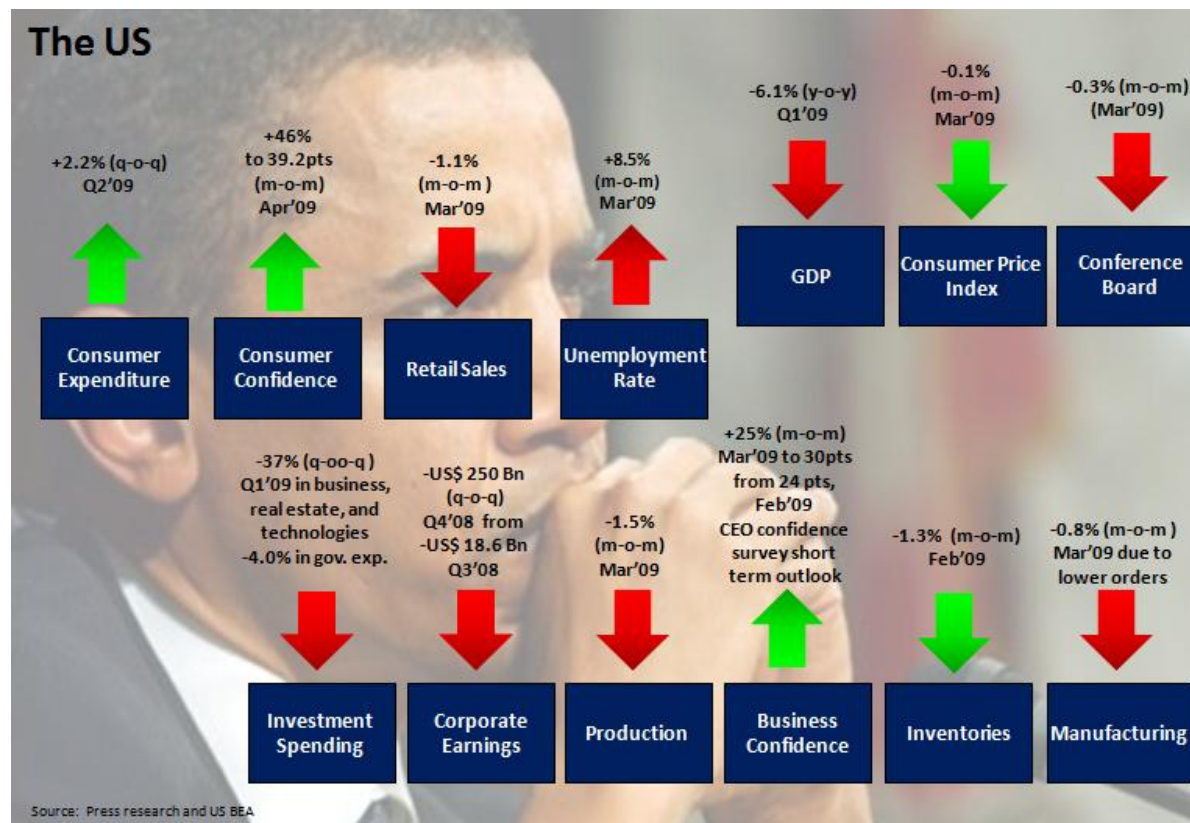


Fig. 9: US economic data

Meanwhile in the financial sector, non-performing loans, insufficient capital, and very tight credit conditions continue. US interbank spreads remain well above 100 basis points, a huge improvement from the Armageddon levels in October, but over double normal rates. Banks still do not trust each other. Unemployment invariably leads to consumer credit defaults, so credit cards and other unsecured personal lines will be the next shoe to drop. Businesses, especially small ones, find the 'credit crunch' very real despite the rhetoric of the major banks that they are open for business and lending again. Talk to any trader and their biggest complaint is the unavailability of LC's. To be fair, the banks are not entirely at fault. The risk of lending has gone up dramatically just as credit risk standards have tightened and capital is limited. They could ask for more collateral, but asset values are falling and markets less liquid if you have to sell.

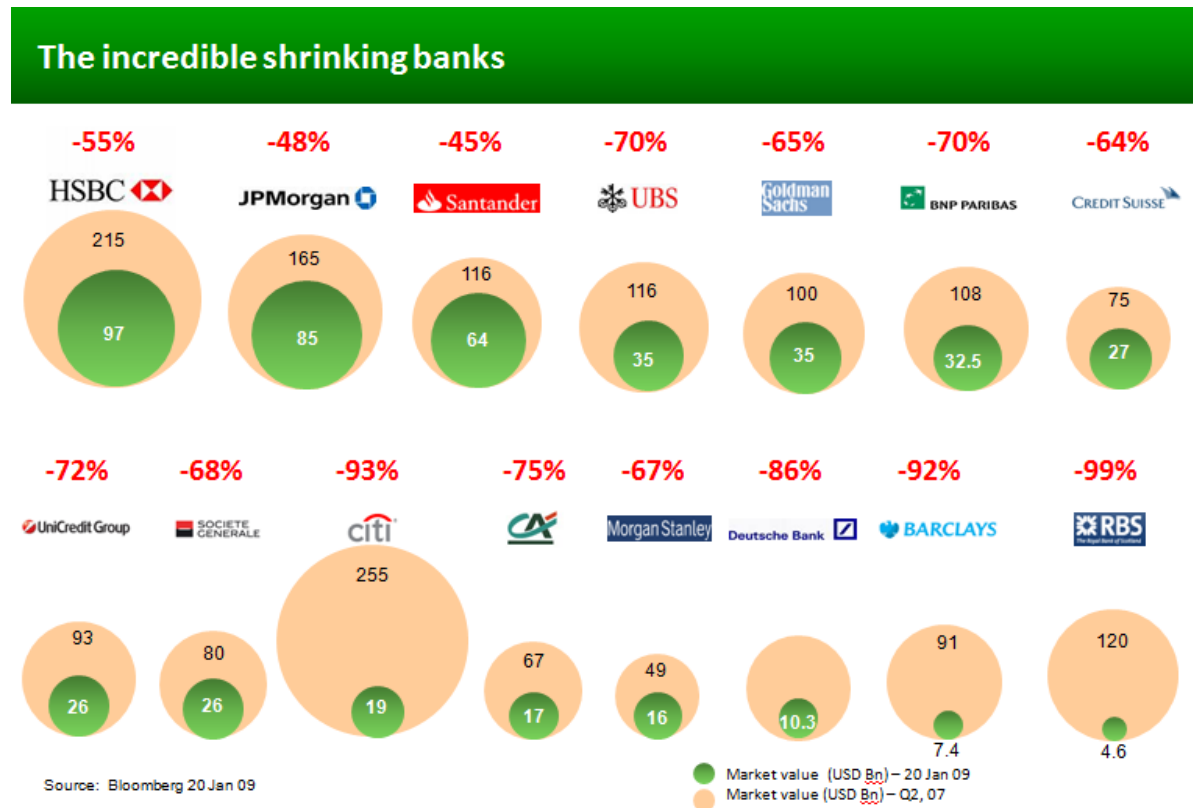


Fig. 10: Bank's market caps shrinking

In the EU my main worries are Spain, the UK and Ireland, stranded with problems with house price deflation and indebted consumers, and in the UK the troubles in banking. The other worry is Germany, with its European version of the Japanese export model (although with the virtues of better fiscal prudence). The EU, and particularly Germany, have yet to accept the full consequences of the recession, and stimulate enough.

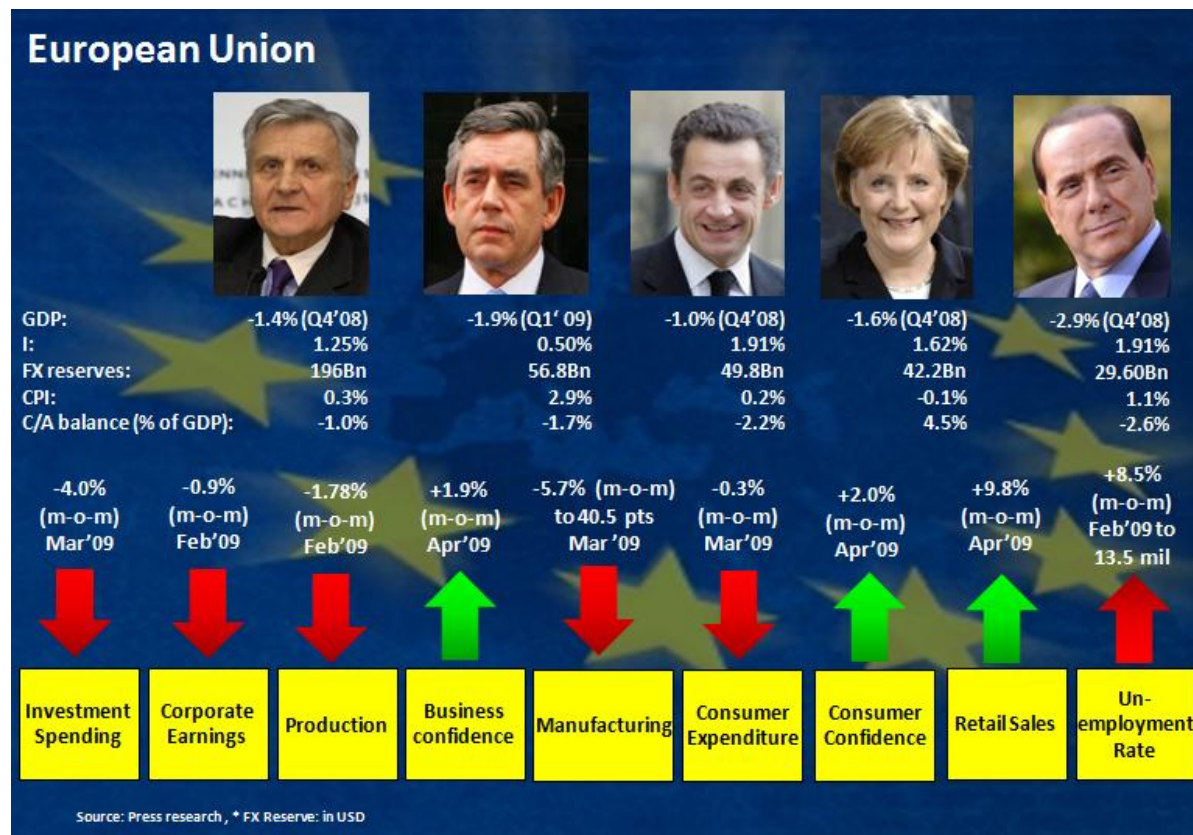


Fig. 11: EU economic data

Of the EU top 5 it is the UK that will suffer the most for now. Whilst policy response has been much faster and much better quality than in the US, both on bank rescue plans (no idealist opposition to nationalization), aggressive easing, and a strong fiscal stimulus package, the government has consistently underestimated the economic fallout. Alistair Darling appears only now to be accepting in public that the last two quarters (-1.6%, and -1.9%) are likely to be repeated for a few quarters yet, whilst he clings to strong recovery from next year. Election considerations are trumping prudence. The reality is that Britain will do well to stay above negative three percent for 2009, and will be trading water for some time in 2010 before real recovery sets in. Britain cannot escape having the worst legacy position in the EU with household debt levels above even US levels, and household savings not much better. Home prices, having risen the most, are now the most at risk for a prolonged correction. Whilst Britain has both more manufacturing and a more diversified economy than generally recognised, it does have the most exposure to a financial services sector that is being severely downsized.

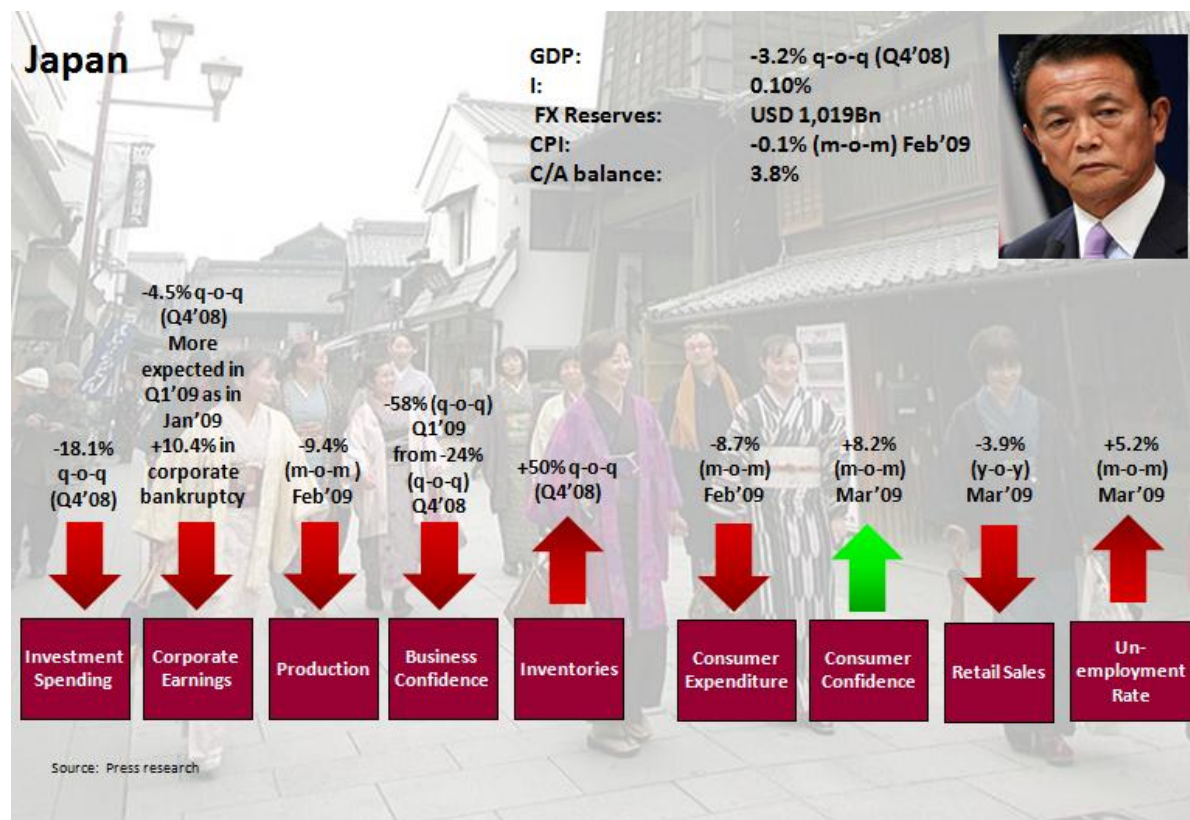


Fig. 12: Japan economic data

Meanwhile Japan remains in the doghouse. It was the Japanese, after all, that invented the export orientated, corporate sector driven, economic model that placed consumers second to export industries, and directed high consumer savings to provide cheap loans to big business and for infrastructure. Fifty years on, and the Japanese still haven't learnt to consume. The limited recovery the Japanese economy had shown since 2003 was export driven as usual, not consumption. So when global trade collapsed at the end of last year, Japan was hung out to dry.

So the contraction in demand in G3 economies looks set to continue for some time. Unemployment is where the damage is being done. The US continues to shed jobs at well over half a million a month. US jobless numbers, at 8.5%, are at a 25 year high, and now exceed the stubbornly high levels of continental Europe. The UK is looking at over 10%, and the highly understated Japan figure 4.4%. This is dismal; given official unemployment data are consistently underestimated. Add in the 'under-employed' and those who choose not to bother working because prospects are so poor, and the US and UK will end up in the high teens, with the EU and Japan not too far behind. This is close to the 20% plus levels experienced in Asia's financial crisis but not at the 25% jobless during the Great Depression. The good news? Remarkably retail sales in the US, having declined every month since last summer, have held up much better than I expected, as have China's. The pivotal US home sales market has shown

signs of life, although this is led by secondary market foreclosed houses not new builds, where prices continue to fall. Picking up cheap foreclosed properties at half price is a good start, but that will not drive recovery in the mainstream housing, construction and home fittings industry.

So where do we stand? If there are green shoots in this lot, they are very well hidden. Clearly this level of demand contraction cannot go on, and as argued above policy has ensured that it won't.

The problem is that the demand gap is simply too large to cover, however much largesse has been provided by governments. The demand gap is the difference between long run trend growth, and the expectations for current growth for this year-an indication of 'lost' GDP demand that has to be recovered. This is important, because of these long run trend growth rates, businesses have built a level of capacity, jobs, retail sales, and economic activity to serve the level of demand they have experienced over the last five years and assume they will have over the next five. A business that has built an operation and budgets based on a 10% growth rate a year, having experienced that for several years, faces a major problem if growth is suddenly zero. If growth actually declines, it's a disaster. My estimates for the 2009 demand gap are:

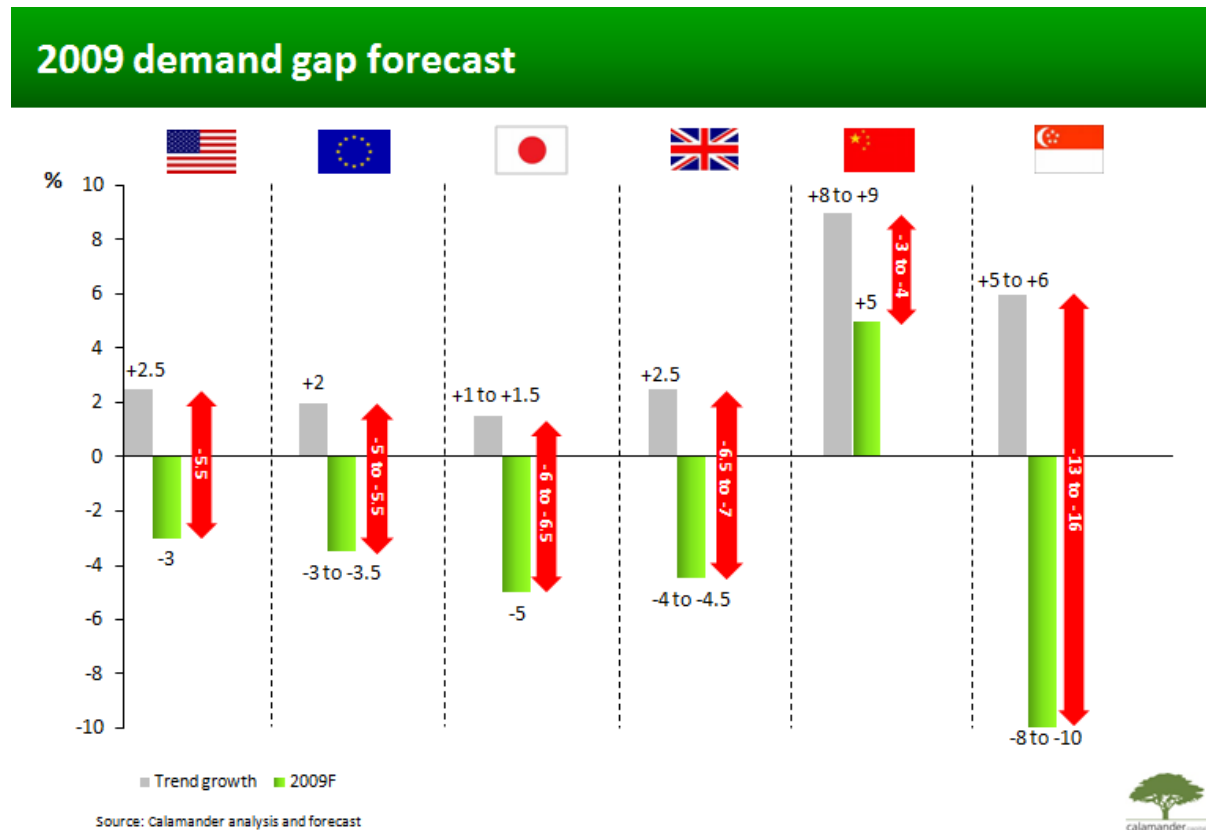


Fig. 13: Calamander's 2009 demand gap forecast



This is a huge gap, remembering that the stimulus packages announced are 2-3 year deals, not just for this year. Globally, the government stimuli will amount to about 2%-3% of global GDP for this year, nowhere near enough to make up for a demand gap. The Fed's fiscal gurus make much of the so called 'multiplier effect', i.e. the idea that one dollar of state stimulus results in more than one dollar of end demand, by triggering a private sector response and investment that turbo boosts the stimulus. This concept may have some legs, but the multiplier is never going to be 2, but more like 1.2 to 1.3. So I believe that *the current level of stimulus is simply too small to offset the drop in consumption, especially by US consumers, the worlds mainstay, but also in the rest of the G3. Governments will have no choice but to ask for more, and will face a stony response from tax payers' representatives sitting in Congress or in parliaments. The current stimulus is part one of a three act play.*

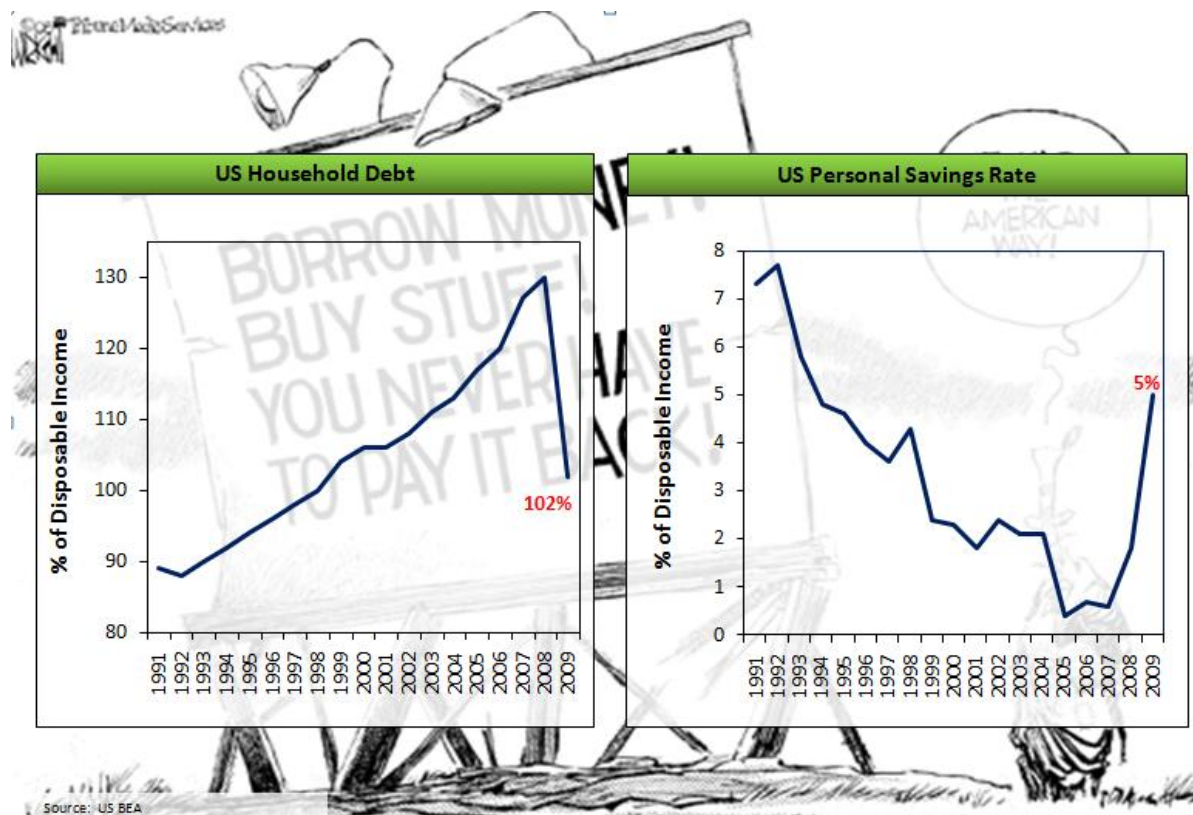


Fig. 14: US personal savings rate and household debt

The second problem with the stimulus is that there is a huge difference between directly stimulating private sector demand through low interest rate financing (which is what interest rate policy has set out to accomplish), and replacing the lost demand from the private sector with public sector demand, which is what much of the fiscal stimulus will achieve. The benefit to the consumer of fiscal stimulus is indirect and comes from supporting employment, and the model seems to assume that job support will in turn assure a return to consumption and spending as before. Give them a job, and they will return to Wal-Mart is the idea.

Suppose instead US consumers, after a decade of credit fueled hyper-consumption, have been shocked enough into mending their ways. Personal balance sheets are massively damaged- by debt, by the collapse in the value of their main asset the home, and by huge losses in directly held equities and retirement plans. Evidence is strong that Americans are not going back to the malls in a hurry, but are saving, paying down debt, and cutting unnecessary consumption. They may thank Uncle Sam for keeping them employed, but they will not return the favour by consuming. A decade ago the core measure that triggered my bearishness on the US was the decline in US savings rates to only 2% of household income from around 4% for much of the nineties, whilst household debt levels crossed the 100% line. By 2005 these tiny savings were almost gone (0.6% income) and household debt was approaching 120% of income. Time to exit, as I did.

In a stunning turnaround, the US savings rate has doubled in the last year to nearly *5% of income for the first time since 1995*. Debt levels are already following in reverse. The future of US consumption is being written before our eyes, and it is not what will benefit immediate recovery for a world still dependent on US consumption. It is, in short, the correct act of rebalancing by US consumers long necessary, i.e. save more and spend less. *The problem is, who is going to replace the US consumer? The Europeans will not, the Japanese cannot, and the Chinese don't know how (yet).* And that is the problem.

Bank Rescue Plans

Financial crises are completely different animals from normal cyclical or inflation shock recessions, and global growth cannot resume until the banking system is fixed. Why? *'Bank crises invariably lead to a severe and prolonged withdrawal of credit, which in turn leads to a dramatic restriction in business investment, consumer spending, and widespread de-leveraging (by both borrowers). Risk is avoided and capital is preserved and used to pay back debt and rebuild balance sheets. This is devastating for an economy, as Asians recall from their experience of the Asian financial crisis.'*

Though I hate to repeat myself, I quote from my own piece from one year ago because it needs to be said again, and I am not going to rewrite the piece. The market and many economists/strategists don't seem to accept either this fact or the dismal state of the balance sheets of the major G2 banks. The cold hard facts are that several key banks in the US and Europe are insolvent. They cannot lend like they used to, and won't be able to rebuild their capital to do so for a long time. Economic growth cannot return to trend (i.e. normal growth rates) without it. Banks really are 'systemic to the economy', and the consequences of failure lead to economic catastrophe, as Lehman Brothers demonstrated. They have to be rescued, in whole not in part, and only governments can rescue them. Recently several of these banks have released good profit figures, to strong approval from many otherwise intelligent commentators. This is a joke, and buying the stock even more so. A profit and loss is something a bank makes up at the end of each year depending on circumstance and how much dividend and tax it wants to pay. If you think those are real numbers, think again-for a bank only the balance sheet counts. Through a sleight of hand with the accounting regulator US banks have managed to bury the true extent of losses in their balance sheets, or what is left of them, and voila- a profit appears. It really is that simple.

So far so good (or bad). Don't believe the insolvent part? Even the IMF is accepting reality (the US government is still in denial), and has revised estimates of bank bad loans to USD 4.05 trillion, of which 2.71 are in the US system, and another 1.34 trillion in the EU and Japan. The 2.71 trillion of US toxic debt is held by a banking system capitalized at only USD 1.4 trillion today, so bad loans exceed the entire worth of all US banks. The book value of their capital is even lower. Worse, these damaged banks can call on the support of a government rescue fund (the TARP) that is merely USD 0.59 trillion, of which only 0.11 trillion remains available for use. There just isn't enough cash to cover these toxic assets, the banks are insolvent.

Rotten fish and the red herring compared

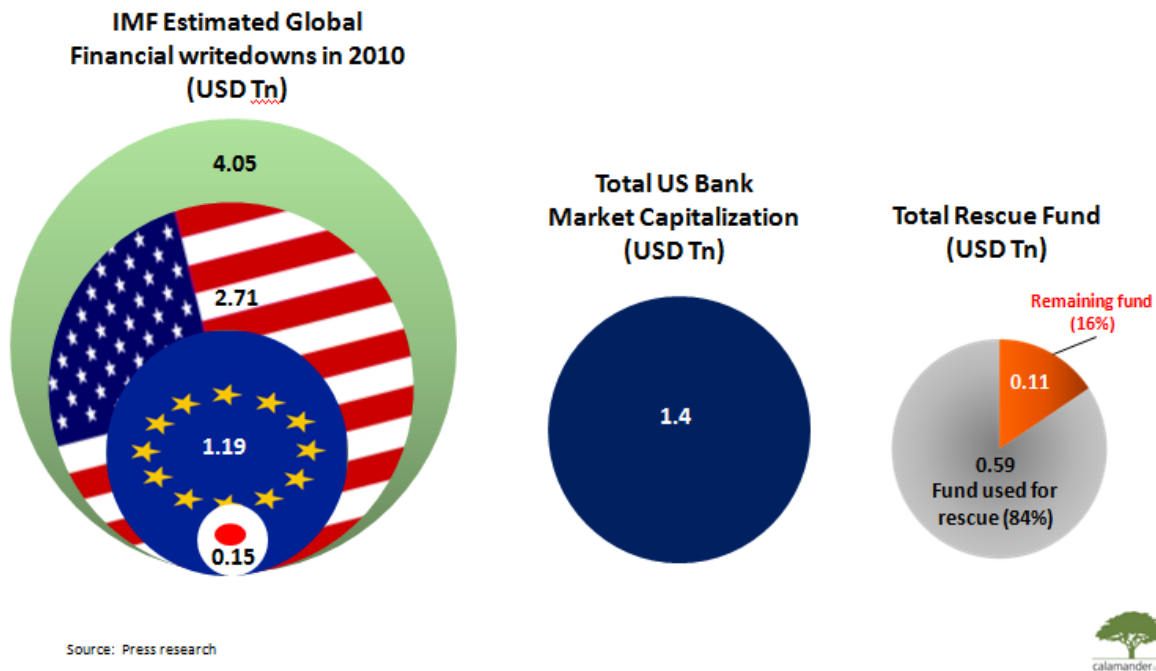


Fig. 15: Toxic debt levels

With such figures one would have expected the US administration to have turned all their resources to fixing this. Instead, we have witnessed 18 months of denial and foot dragging, followed by policy missteps. Political dogma (anti-nationalisation and government rescue) has trumped common sense. The UK had just as big a banking problem, but by the close of last year had already fixed it and moved on. The US continues to struggle with a policy akin to the Japanese approach of keeping 'zombie' banks alive, whilst not really fixing the problem.

That leaves what to make of the latest incarnation, the Geithner 'Public/Private partnership' bank rescue plan. Sadly the plan is as fatally flawed as its predecessors, and will not fix the problems either. Clearly the Geithner plan is a political compromise, designed merely to keep the dogs at bay, again. Firstly it is way too small. The Obama administration must have known that it needed to be three times the size given the toxic debt figures above, but if they asked for that Congress would have rioted.

Secondly the plan pretends, or even worse believes, that this is a liquidity problem, not a default problem. Remove the blockages, i.e. provide a market mechanism, and price discovery, and the market will start flowing again, so that the banks can freely sell these things. To be sure liquidity has disappeared and the lack of a market meant the debt cannot be sold and restructured. But the market collapsed a year ago because nobody trusted the assets, and they still don't for the good reason that these assets really are worth a lot less than their book value. This is not just a liquidity problem. The assets are bad.

Thirdly, the Public private partnership is a red herring. Trying to initiate a market for the toxic loans with public sector participation is laudable, but markets for severely distressed debt offer very low prices because the risks are high and returns uncertain. The banks have no choice but to ask for the book value of these assets after provisions, else in selling they go bankrupt. Private buyers are not dumb (not that dumb), so to compensate them for the risk and extreme opaqueness of the assets, they will offer low prices. How low is low? A similar exercise during my time in Indonesia with IBRA (their government bank restructuring agency during the Asian Crisis) yielded private sector offers of about 25 cents to the dollar. The same exercise at China's bank asset management yielded 22 cents to the dollar, as did Korea's toxic assets.

I am not suggesting that the current US toxic bank assets are as poor as those we had to deal with in Jakarta, but they may well be, and if better not that much better to justify the 55-75 cents to the dollar that many banks will require to stay solvent. It is not as if there is no competition-the world is awash with assets at bargain of the century level prices, most of which can offer just as good prospects for supernormal returns with much greater pricing clarity. So therein lies the problem. The banks just will not sell their toxic assets low enough, else they will be insolvent. The investors asked to make an offer will not bid high enough, as the risks are poor quality credits. The only way forward will be for the government to underwrite the risk, which is as good as handing over the money to buy the assets to the private 'investors'.

The capitulation of FASB (Financial Accounting Standards Board - the US accounting standard bearer) on mark to market accounting, to the huge sigh of relief from the banks, has only added to the woes of anyone interested in real price discovery. The auction process was meant to encourage greater confidence in banks valuations of dodgy assets. Now, private bidders will be even less confident, and thus will bid even lower.

So the Geithner plan is fatally flawed and will fail, and this fact alone is enough to stifle any hope for the 'green shoots'. The only hope is for the US to call a spade a spade, follow the example of the UK and our approach in Asia a decade ago, and accept that full nationalisation, full recapitalisation, and complete separation of good from bad assets, under government care is the only way to go when banks collapse. Nationalisation allows for an unimpeded restructuring effort using all the best resources for the job, and provides an eventual return for taxpayers when the banks -under care can be returned to the private sector via an IPO or trade sale. This approach works-I know, because I have experienced it firsthand. The sooner US policy reaches this point the sooner US economic activity and trade can be rebuilt.

The New World Order

A decade ago Asia went through much the same crisis. Those overburdened by debt were corporations not consumers, and a currency collapse was added into the mix, but the results were equally brutal. In the space of six months the region went through a dramatic collapse of economic activity, trade, and equity markets. Banks were filled to the brim with toxic assets and required government rescues, leaving them unable, and too nervous, to lend. The experience was brutal, but the changes that resulted were highly positive and permanent. The imbalances that caused the problem had been building for some time, but it took a crisis to force change. The excesses of Asia's weaknesses were not eradicated completely, but they were tamed: a corporate not consumer economy, crony capitalism, corruption, weak banks with poor credit standards, and foreign currency debt still exist but less meaningful to their respective economies. The cleansing allowed Asia to capitalize on its strengths and flourish in the decade after.

America, and the free market capitalism it has championed successfully for a century, is facing down as great a crisis. It is not out of the woods yet. Many see a dark future, and question even the survival of capitalism. They are wrong. This is not the end of capitalism, nor of America, nor of the banking industry. This is the start of a painful change process, a rebalancing that will serve to trim the speculative, leveraged excesses of 'casino capitalism' whilst preserving the fundamental strengths of the most successful economic model yet devised. That may be no bad thing, as America's excesses have proven to be as damaging as Asia's. The absolute belief in markets, the abdication of responsibility by the state, 'light touch'/self regulation, excessive political lobbying to protect corporate interests, the cult of salesmanship over value, the cult of capital markets over real assets and savings, and fiscal imprudence are but some of these. After recent events more regulation is needed.

The banking industry is where the new regulatory battle lines will be drawn first. Bankers will resist, but politicians are aware that the electorate is in no mood to let the industry go back to its old ways easily. The likelihood is a lightweight version of the Glass Steagall controls put in place after the Great depression for much the same reason. These could enforce a stricter separation between 'main street'

and 'wall street' banking, and the balance sheets of ordinary people from the proprietary trading books of investment banks.

For banking that means 'Back to the Future'. Once upon a time banking was a simple, dare I say boring business. It did not attract the best and the brightest, but they got to see their kids grow up, didn't do a hundred flights a year, went to bed at 10, and lived a lot longer. The joke was the 3-6-3 model: take deposits at 3%, lend at 6%, and hit the golf course at 3pm. Banks will have to return to the old fashioned model: knowing their customers, holding their assets, lending against income, and making a credit decision for themselves not outsourcing it to a ratings agency or a broker. For employees, an industry that is more highly regulated and less profitable will make for a less exciting, but less risky career. Bankers will return to looking like accountants. Again, this is no bad thing. Far too many of the best and the brightest have been lost to arcane pursuits on arbitrage trading desks, rather than creating the next technological breakthrough.

Tougher regulation is just one aspect of the new power of the state. In the process of the crisis restructuring ahead, governments will end up owning much larger sections of the economy like it or not. A key pillar of the new world order will be the return of state power, as part of a more balanced and regulated capitalist growth model. This may be 'European style' capitalism, where the state plays a more prominent role than the US. That does not mean a return to state corporatism, with state industrial policy guiding growth rather than markets. Lest we forget, the hundreds of millions of Asians that have been dragged out of poverty in the last decade have to thank the adoption of free market capitalism by their governments and a shift away from state control of assets and production. The only continuously successful state corporatism model has been Singapore, which has different circumstances and scale, and faces its own challenges in adapting its model to the new world. So as global capitalism welcomes back the state, it has to be careful to ensure tougher policing of the markets and better regulation (required) does not evolve into inefficient state interference and permanent state control of businesses.

Greater government involvement also raises the threat of more trade protectionism- an easy political ploy to ensure higher levels of domestic employment when the ranks of the jobless are rising. This is a natural response in crises, and left unchecked could unravel decades of progress in trade and global demand. Trade has successfully delivered on its promise that it makes the pie bigger for everyone. The G20 meeting made progress in halting this slide, but the threat remains.

The final paradox of this crisis is that the tumultuous change the global economy continues to face has not changed the big picture for the long term-that of the rise of Asia, and the shift from West to East. Many ask me what has happened to my long held Asian bullishness, given the crash in Asian economies and the discrediting of the 'Asian decoupling' theory given so much prominence a couple of years ago. The answer is nothing. I remain a big fan of the long term secular shift to Asia today as five years ago.

This crisis has moved at warp speed, every week is a new beginning and news becomes dated very fast, but the long term future is absolutely clear.

My thesis has been that the current demand slump cannot be filled by others, and requires the US to stabilise itself and grow again. At 23% of the world economy, the US is larger than Japan, China and Germany combined (respectively number 2, 3, and 4 in the rankings); the US is also larger than the combined GDP's of the entire emerging and newly industrialising world.

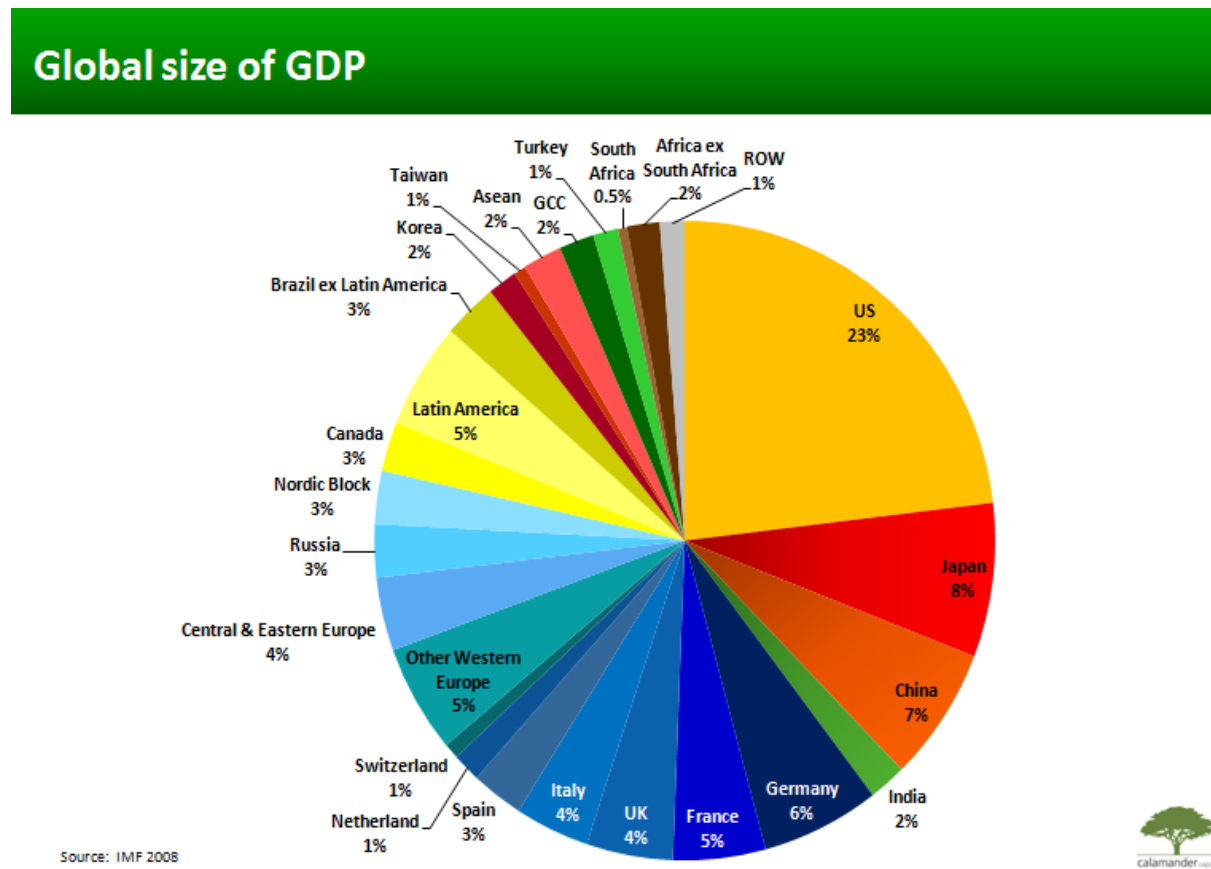
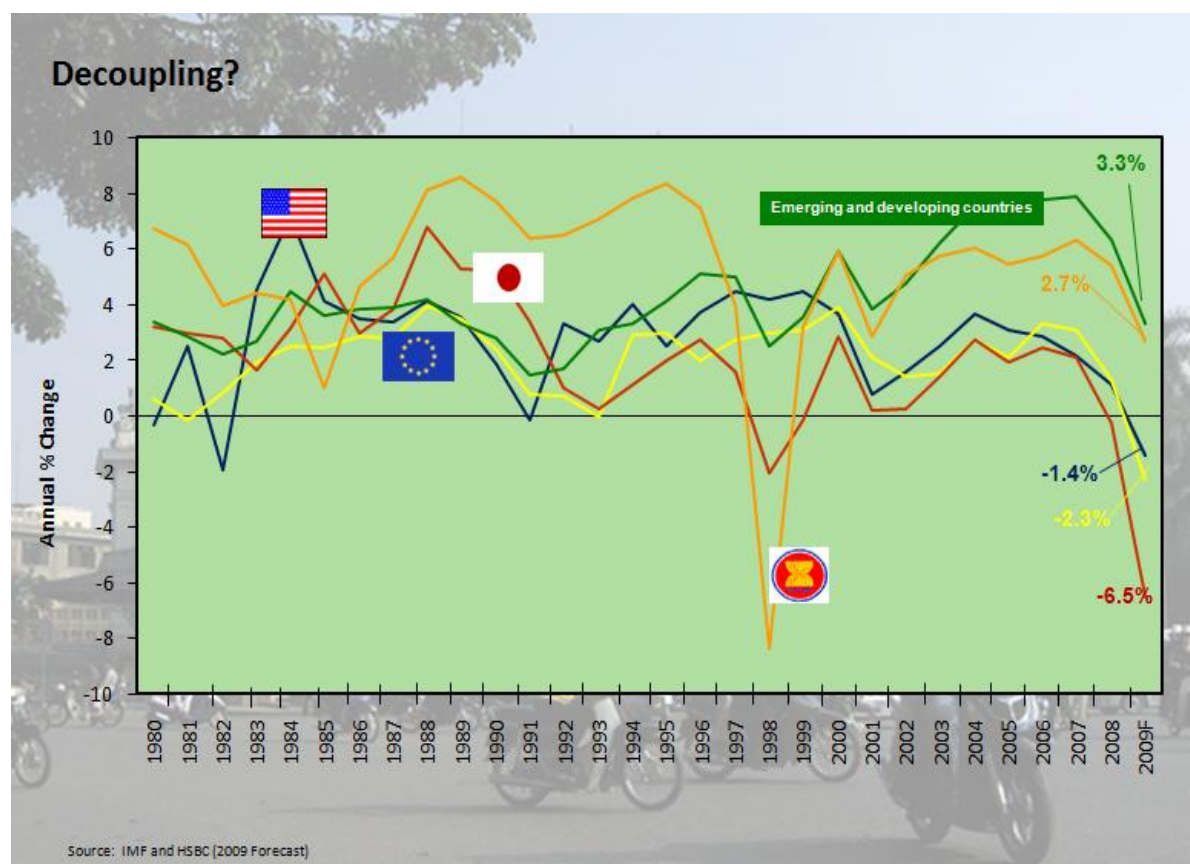


Fig. 16: Global GDP breakdown

Those are big shoes to fill, and the US remains the single major engine of current demand. But current demand is not future demand, and world growth at the margin is already dependent on the emerging markets, principally Asia. The US may be a quarter of the global economy, but half of the growth over the last three years has come from emerging markets, according to IMF data. Those big shoes are shrinking, and will continue to do so. The US banking crisis has simply accelerated the pace of change on both sides. That the political forum chosen for London's recent crisis policy meeting was the little known G20 group and not the standard G8 club was a sea change that spoke volumes about the new

world order. The G20 gave voice for the first time to the biggest emerging markets, not just China and India but Indonesia, Mexico, and Brazil. Only two years ago this would have been unthinkable.

That is not to say Asia can easily rise to take its rightful place. For all the talk of the Pacific 21st Century, and Asian decoupling, the crisis has exposed the continued dependence of Asian export economies on the American consumer. Five years of supercharged Asian growth that seemed to be independent of the G3 abruptly turned last year when the crisis set in, and as G3 demand sank Asia 'recoupled'. I have written before that decoupling was always a flawed idea- decoupling was always meant to be a 2028 achievement, not that of 2008. Asian exports as a percentage of GDP have been climbing not shrinking, and remain over 37% for China and Korea, and over 60% for Taiwan.



F Fig.

17: Regional GDP growth trends

Critical to the rise of 'Chindia' (a common but dreadful label) therefore is the requirement for Asians to develop household consumption and reduce savings, just as much as the need to reduce consumption and increase savings in the US. This will not be easy, and is one reason why I favour strongly India and Indonesia over the long run, both of which have demonstrated that the high growth of an emerging economy can be balanced, and built around a domestic consumer economy with an export component.

Conclusion

The long term trends may be intact, but the short term challenges remain the biggest concern and risk to the resumption of normal trend growth. Global Depression II may have been avoided, but there seems little cause for celebration yet. The limited green shoots that have been spotted are real enough, but they do not change the big issues faced by the real economy. The return of some confidence, plenty of liquidity, good values, and sufficient time wallowing in misery are simply not enough to turn the corner. They are the triumph of hope and cash over fundamentals, as is the recent rally in the markets. Fundamentals, particularly when banks are down, always win in crises. The light at the end of the tunnel will only be turned on when the banking sector is fixed and cleaned of its toxic waste, ready to play its critical intermediary role again between borrower and saver. This depends on the Obama administration and the US treasury getting its act together to fix their badly flawed bank rescue plan. More fiscal stimulus ammunition will then be needed, but the banks are the trickiest part. Ever the optimist, I do believe there is a good chance that the US will eventually get there. As Churchill once opined: *'Americans will always do the right thing, after they have exhausted all the alternatives'*. I sincerely hope he is right.

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