The Credit Crisis: A Monetary Explanation

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33rd Annual IOSCO Conference
Paris, 28 May 2008
I. The Golden Age:
- strong economy, easy money
- all asset classes do well

II. Tougher Times Ahead:
- growth peaks, tighter money
- bonds sell off
- credit spreads widen
- housing markets deteriorate
- equities still ok

III. Bear Market:
- (growth) recession, money still tight
- credit and equity bear markets
- bonds rally
- safe havens sought

IV. Recovery:
- growth picks up, rates low
- bond yields rise
- credit spreads tighten
- equities recover
Serial Bubble Blowers

Super-low real interest rates earlier this decade in the advanced economies.. pumped up excess liquidity and asset markets around the globe

Source: IMF

Source: IMF, Haver, Morgan Stanley Research
Excess liquidity growth turned negative in 2006-07. As in previous episodes, this led to a meltdown in the most overvalued asset class. Bonds in 1994, equities in 2000, credit and real estate in 2007/8.
A Pro-Active Fed: Real Short Rate Already Below Zero

Following 325 bp of rate cuts, the Fed funds rate has dropped way below its neutral (natural) level

Real rates negative now

Latest reading:
-0.1%
(FFR 2.0% minus 2.1% core PCE)
The liquidity crisis pushed 3-month Euribor into restrictive territory last year. But easing money market tensions and higher inflation have eased the monetary policy stance recently.

Source: J. Fels & M. Pradhan, Where is Neutrality for the Fed and the ECB? 19 September 2007
Interest Rates are far below their neutral level in Emerging Market countries such as China and India.
Strong Domestic Demand Growth in EM

The gap between domestic demand growth in emerging and advanced economies is widening

Domestic Demand Growth (YoY in percent)

- World
- Advanced
- Emerging
Morgan Stanley

**Slower Growth, Higher Inflation**

- **Global GDP Growth Drops Below Trend**
- **CPI Inflation is Rising Everywhere**

Source: IMF, Morgan Stanley Research

Source: IMF, Morgan Stanley

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Some Scary Parallels with the 1970s

- Soaring energy and food prices..
- Meet overly lax monetary and fiscal policies..
- .. while productivity growth is slowing.
- A weak dollar is stoking inflation in the US and the dollar peggers.
- Competitive pressures from China, India (then: Japan, Korea) fuel protectist tendencies
- The likely result: slower growth and higher inflation for longer
Heading North-West

- Stagflation
- Depression
- Slump
- Inflation
- Deflation
- Inflationary Boom
- Deflationary Boom
- USA (1930s)
- USA (1970s)
- Europe (1970s)
- USA (1995-05)
- Japan (1990s)
- USA (1880-96)
- Europe (1930s)
- China

Countries and Times:
- USA (1880-96)
- USA (1920s)
- USA (1930s)
- USA (1950s)
- USA (1990s)
- Japan (1990s)
- USA (1995-05)
- UK (1930s)
- Europe (1970s)
- Europe (1930s)
Conclusions

- **Globalization, a productivity boom and deregulation conspired to keep inflation very low in the last 15 years. Inflation-targeting central banks thus cut interest rates to record lows.**

- **Low interest rates pumped up excess liquidity and encouraged excessive risk-taking in financial markets. Excess savings from EM economies amplified this effect.**

- **Worry #1: The Fed’s aggressive response to the credit crisis and easy monetary policy in EM countries risks pumping up the next bubble – commodities, EM equities?**

- **Worry #2: The return of a 1970s type stagflationary environment.**
Morgan Stanley

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