



Somber International Banking Conference Focuses on Downside Risks to Global Economy

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This year, ... most officials focused on downside risks to global economic growth, though none seemed to believe a recession was on the immediate horizon for either the United States or Europe.

Executive Summary

Standish Global Macro Strategist Tom Higgins reports that the mood was somber at this year's Group of Thirty International Banking Seminar, which he was invited to attend in Washington, D.C., at the end of September.¹ The Group brings together top officials in public and private finance to discuss global financial and systemic matters. This year, ... most officials focused on downside risks to global economic growth, though none seemed to believe a recession was on the immediate horizon for either the United States or Europe. By contrast, Tom says, Standish is somewhat more pessimistic about current conditions, particularly when it comes to Europe. Standish sees an elevated risk of a European banking crisis triggered by an event, such as a Greek default, which might result in large write-downs of cross-holdings of peripheral sovereign debt in the financial sector. If that happened, Tom believes a European recession could ensue, threatening global growth. Below he summarizes the remarks of some of the leading banking officials in attendance, such as Federal Reserve Chairman Ben Bernanke, European Central Bank President Jean Claude Trichet, IMF Director Christine Lagarde, Bank of Japan Governor Maasaki Shirakawa, and World Bank President Robert Zoellick.

Dr. Ben S. Bernanke Chairman of the U.S. Federal Reserve System

Dr. Bernanke began by acknowledging that the overall tone of the economic data in the U.S. has been disappointing. He discussed the large downward revisions to the U.S. GDP data for the first half of the year and recalled how he once joked with former Fed Chairman Alan Greenspan about how Bernanke would like to revise his interest rate decisions in light of the new information.



¹ The 26th Annual Group of Thirty International Banking Seminar was held at the Inter-American Development Bank in Washington, D.C., on September 25, 2011. The Group of Thirty, established in 1978, is a private, nonprofit, international body of very senior representatives of the private and public sectors and academia. It aims to deepen understanding of international economic and financial issues, to explore the international repercussions of decisions taken in the public and private sectors, and to examine the choices available to market practitioners and policymakers.

Mr. Trichet said the issues of the euro currency and financial stability are separate, but were being confused by some market participants as one in the same. He felt the markets had also overlooked the ECB's promise to provide liquidity on an "unlimited basis" for term loans up to three months.

He said the Fed was beginning to see evidence that growth was reaccelerating, as some of the temporary drags from the Japanese-related supply disruptions and elevated energy prices began to fade. The Fed expects real GDP growth in the 2%-plus range in the second half of 2011.

However, he described the weakness in consumer spending as "quite worrying." He noted that households are even more pessimistic than would be predicted by the data, using the Fed's econometric models. He cited four factors that seemed to be weighing on confidence: 1) the weakness in the U.S. labor market; 2) the soft housing market; 3) the debt ceiling debate; and 4) the sovereign debt crisis in Europe.

Lastly, he said that concerns about a global slowdown can lead to a self-fulfilling prophecy if financial conditions continue to tighten. He mentioned that Greece has the potential to be a Lehman-type event for Europe and that U.S. officials have urged European leaders to attend to this serious matter. He lamented that even without a crisis, the ongoing uncertainty is detrimental to the global economy.

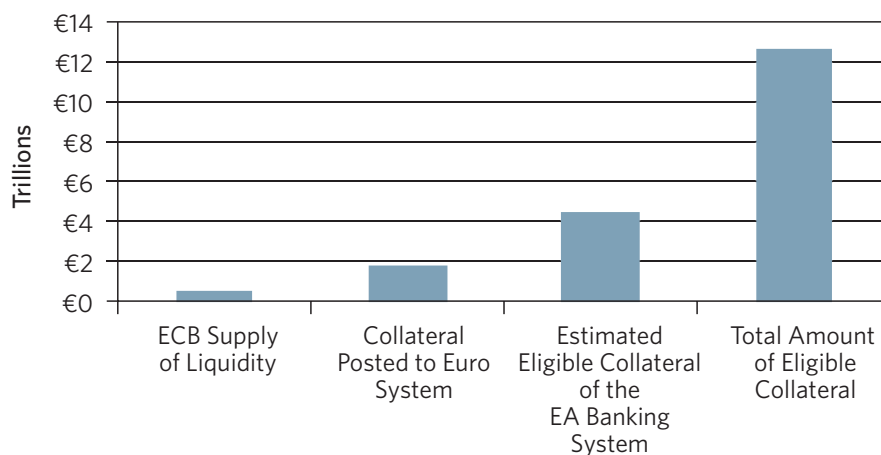
Jean Claude Trichet
President of the European Central Bank

Mr. Trichet began by noting that the European Central Bank (ECB) had revised down its forecast for eurozone GDP growth and that "the balance of risks remains on the downside." He said that the sovereign problem and the banking problem are highly correlated and that structural reform is essential.

He warned European leaders to "do all that you have said you will do and stand ready to do more." He was referring to the changes to the European Financial Stabilization Fund (EFSF) that were agreed to in principle by eurozone member governments back in July, but have yet to be passed by all 17 national parliaments. These changes include giving the EFSF the ability to purchase bonds on the secondary market as well as recapitalize the banking system.

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Exhibit 1 - ECB Promises to Provide Liquidity on an "Unlimited Basis"



Source: ECB as of September 2011.

Mr. Shanmugaratnam said he worried that Western leaders were too focused on short-term political gains without thinking about the long-term economic costs of their actions.

Masaaki Shirakawa
Governor of the Bank of Japan

Mr. Shirakawa addressed the issue of whether the West is "turning Japanese" by highlighting differences between the US/European experience today and that of Japan in the 1990s: 1) Demographic patterns put a strain on the rebalancing process in Japan. The same may be true for Europe today, he said, given its aging population; whereas the problem is not as serious in the U.S.; 2) The Japanese did not allow bad firms to fail, and he cautioned the United States and Europe against repeating this mistake; and 3) Japan benefited from a strong global economy in the 1990s, unlike the economic conditions the U.S. and Europe face today.

Mr. Shirakawa said that a full recovery from the 2008 global financial crisis will take time. He commented that aggressive monetary easing cannot offset the need for deleveraging. In fact, he said, easing can only aggravate imbalances by artificially supporting demand.

Tharman Shanmugaratnam
Deputy Prime Minister and Finance Minister of Singapore

From an emerging markets perspective, Mr. Shanmugaratnam discussed solutions to the debt and deleveraging problems that plague the advanced economies. He said any solution must address legacy debts and rekindling growth. He argued that legislators need to attack long-term entitlement and tax reform and use the proceeds for short-term Keynesian-type stimulus.

Mr. Shanmugaratnam said he worried that Western leaders were too focused on short-term political gains without thinking about the long-term economic costs of their actions. He said advanced economies need to be clear about their narrative for the future and right now they are not.

Ms. Lagarde said that European leaders need to set out a roadmap. She felt the sense of urgency was shared and expected a solution with “real vision.”

Christine Lagarde

Managing Director of the International Monetary Fund

Ms. Lagarde was more optimistic than the other conference participants. She noted that the sovereign debt issues in Europe, combined with the weakened state of the banking system, caused the recent fall in investor confidence. However, she believes the actions taken to date should prevent a repeat of the 2008 global financial crisis. Ms. Lagarde said that European leaders need to set out a roadmap. She felt the sense of urgency was shared and expected a solution with “real vision.”

Robert Zoellick

President of the World Bank

Mr. Zoellick was a bit more pessimistic about Europe than Ms. Lagarde. He said that although all of the advanced economies have problems, the eurozone is in the “bull’s eye.” He felt that the ECB’s liquidity measures would only buy time for European leaders to address structural flaws in the currency union.

Mr. Zoellick said the eurozone has two issues: 1) sovereign debt and its impact on the banking system; and 2) a lack of competitiveness in the peripheral economies. He argued that Europe has monetary union, but needs to move in the direction of fiscal union. He also said that neither the U.S. nor Europe should expect to be bailed out by China.

Mr. Zoellick said the Chinese recognize that the structure of their growth model is unsustainable, and they have asked the World Bank for advice on how they should change this as part of their five-year plan. The question, he said, is whether they adopt the necessary measures for restructuring.

Question & Answer Session

Question 1: Do you believe the liquidity measures that have been put into place thus far are sufficient to avoid a repeat of 2008?

Bernanke: There were two reasons for 2008: 1) non-banks lacked access to liquidity; and 2) some institutions, such as Lehman, had no collateral to post for loans. Today, there are very few non-banks, and the Fed has increased flexibility under Dodd-Frank to lend on an industry basis, but not on an individual firm basis. U.S. financial institutions are better capitalized, and Basel III is raising capital requirements to provide a better buffer. Before 2008, he said, we had forgotten the lessons of the past. Retail bank runs are not a great risk, but wholesale bank runs are.

Shirakawa: The existence of a liquidity backstop is viewed as critical if we are to avoid a repeat of 2008.

Trichet: The liquidity measures do not mean that we do not have to work hard to avoid a repeat of 2008.

Question 2: Is the problem today an absence of demand, and if so, do central banks have any ammunition left to attack that problem?

Trichet: It is confidence more than demand. Demand will follow once confidence is restored.

Bernanke: Confidence is part of the problem, but demand is weak for other reasons including deleveraging in the household sector. As for monetary policy, we can do more, but we must consider whether we should do more.

Shirakawa: The difference between demand and supply becomes blurred when growth is stagnant for a decade or more as it has been in Japan.

Bernanke: Confidence is part of the problem, but demand is weak for other reasons including deleveraging in the household sector. As for monetary policy, we can do more, but we must consider whether we should do more.

The Standish View

Though we think a repeat of the 2008 global financial crisis has a low probability, we are already witnessing worrying signs of increased correlations amongst different asset classes, which suggests that some investors may be selling the liquid assets that they *can* sell rather than assets they *want* to sell. Consequently, we expect financial market volatility to remain high and risk assets to underperform until we get some resolution on the European front. In this environment, we continue to maintain the defensive posture in our portfolios that we began implementing earlier this year.

Thomas D. Higgins, PhD, Global Macro Strategist

Tom is the Global Macro Strategist for Standish. He is responsible for developing views on the global economy and making relative value recommendations among global bond markets, currencies, and sectors. Before joining Standish in 2010, Tom was employed as the Chief Economist for Payden & Rygel Investment Management in Los Angeles and served as International Economist at The Conference Board. Tom received his Ph.D. and M.A. degrees in Economics from Fordham University and holds a B.A. in Economics from Drew University. Tom has eighteen years of experience analyzing financial markets. He is a member of both the American Economics Association and the National Association of Business Economics (NABE). Tom was President of the Los Angeles Chapter of the NABE from 2006-2007. He is a past board member of the Los Angeles Economic Development Corporation and the California Council on Economic Education. Tom was the 2010 Recipient of the Robert T. Parry Award for Exemplary Contributions in the Field of Economics.

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