Some Quick Thoughts on the Global Crisis

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The residential real estate and real estate finance crisis in the United States and in other countries, particularly the United Kingdom, Ireland, Iceland, Denmark, Spain, Australia, and New Zealand has evolved into an international banking crisis of 19th century proportions. Excessive leverage, the excessive use of wholesale short-term funds, and extreme mismatches between asset and liability maturities that characterized the so-called "shadow banking system" have been compounded by momentum trading in the commodity markets. We are now reverting to mean in all global markets, including the BRIC markets and economies and the OPEC markets and economies. "Economic decoupling," which was never a particularly sound thesis, has failed.

China has remained softer after the Olympics than was generally expected. They are burdened with excess capacity in their real estate markets after several years of speculation, and appear to be experiencing the "Olympic Curse." They have not returned to world commodity markets with new orders, and have refused a request for an iron ore price increase from Vale do Rio Doce, causing shock waves in Australia and Brazil. The Baltic Dry shipping index has collapsed reflecting overcapacity in bulk dry shipping and the lack of new Chinese orders. China has the advantage of very large reserves and a backlog infrastructure needs, but they have risk of social instability because of the extent of the real estate and securities speculation and the losses that have been experienced. Real estate companies in Australia are experiencing a crisis, as are the infrastructure finance companies.

Russia has duplicated the financial abuses of 1997-1998 and is experiencing a similar banking crisis. The Russian people felt secure in the recent economic environment and felt great national pride in the recovery of their country. But, while the oligarchs played in the financial markets, and the government abused foreign investors, the government also overreached with respect to its geopolitical ambitions. The aggressive government posture with respect to Georgia, Ukraine, Central Asia, Iran, the Baltics, energy supplies to Europe, and its activities in Africa and South America frightened more foreign investors. A mild capital flight was already underway when oil prices began to decline. A Russian broker then failed. The Russian banks refused to lend to each other. The stock market fell sharply, and both Russian and foreign investors attempted to get capital out of the country quickly. The government has attempted to stabilize the banking system without success so far. The fear is that many small banks will be discovered to have been self dealing for the benefit of their managers as in 1998.

Brazil and India are more diversified economically and financially than Russia, and their financial markets and institutions have been better regulated and managed. But both countries have benefited from the world consumer boom, the globalization of lending and portfolio investing, and the excess liquidity that existed in the dollar world in 2004-2006. During the liquidity bubble, there was a lack of risk discrimination in both Brazil and India. As a result, there are excesses in real estate in both countries. Both countries are under stress now as global speculation unwinds, but with a different mix of problems in each. Brazil is more vulnerable to a global commodity crash. India is probably more vulnerable to internal financial, political, and social stresses.

The U.S. financial crisis is probably nearing its climax, which I have expected to come around October 15, which is just the middle of the week when we normally have our worst seasonal money market stresses. But, because of the sensitive political timing of the crisis, there are more than the usual unknowns. The U.S. economy is benefiting from lower oil prices, mortgage refinance at lower rates, housing production that is now well below normal sales rates, meaning the beginning of some healthy inventory liquidation, and a dollar that has stabilized at a level that makes U.S. industry fully competitive with European industry. I do believe that we are in recession in the U.S., but one which is moderated by a trade recovery (exports up and imports down), and which could be ended with incentives for appropriate business investment, infrastructure modernization, and energy development. I believe that the world is falling into recession, with the Europeans in the worst situation among the developed regions. And, I believe that the global commodity markets are vulnerable to a very sharp correction as they revert to mean everywhere. I am particularly concerned about the oil markets, because of the risk that Persian Gulf economies and institutions could be the "Black Swan."

It is appropriate to build reserves and to lengthen liabilities so that there will be capacity to take advantage of the opportunities that will emerge during the next six to nine months.