

The Double-Shock Economy

Nariman Behravesh
Chief Economist

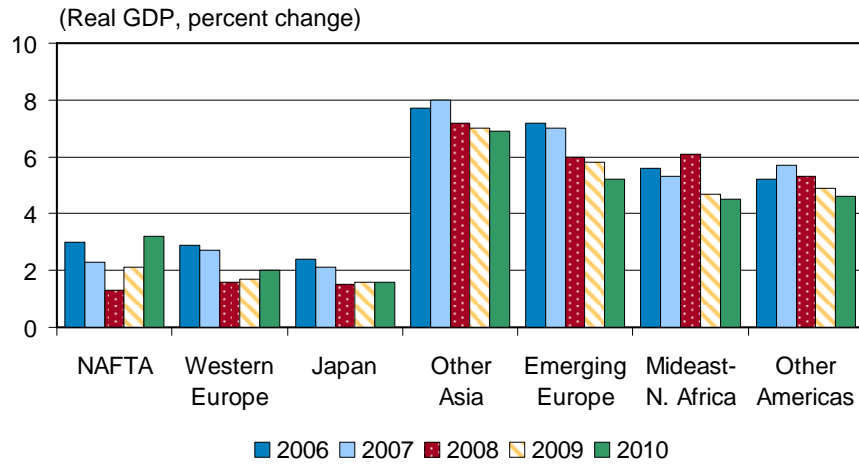
NAHB
April 24, 2008

Copyright © 2008 Global Insight, Inc.

Global Shock Waves

- The “double-shock” economy – subprime crisis plus record-high oil prices
- Crisis status – we are not out of the woods yet
- Global transmission of crisis – no de-coupling
- Crisis management – shifting into high gear
- Inflation – how big of a threat?
- U.S. recession with a sizeable risk of a double-dip
- The risks are predominantly on the downside

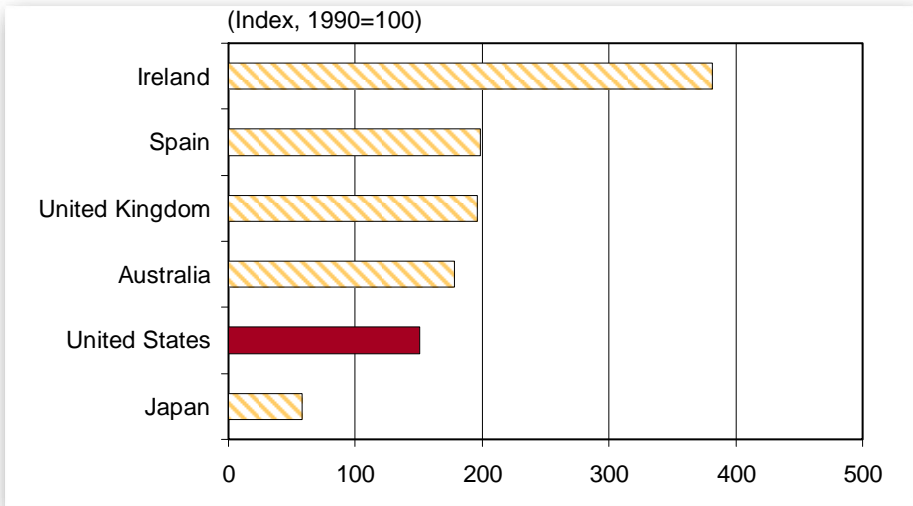
Wide Variations in Regional Economic Growth



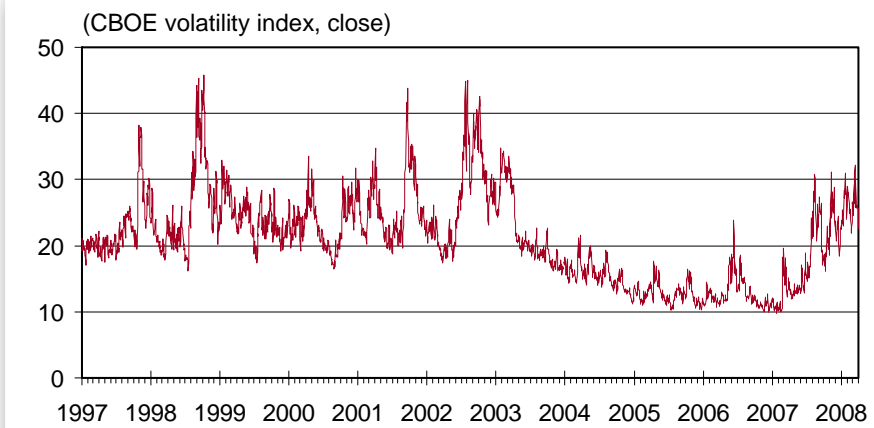
Roots and Status of the Crisis

- Financial deregulation and innovation
- Global housing boom – exacerbated by local land-use regulations in the United States
- Low (global) interest rates – exacerbated by (lack of) Fed actions in 2003 and 2004
- Poor regulatory oversight – despite plethora of regulatory institutions
- Toxic combination of high leverage, lack of transparency, and abuse of off-balance-sheet accounting
- Ratings agencies “asleep at the switch”
- Credit markets “locked up”
- Wasn't Basel II suppose to prevent this?
- Estimated total global losses = \$400 billion
- Declared losses so far = \$250 billion

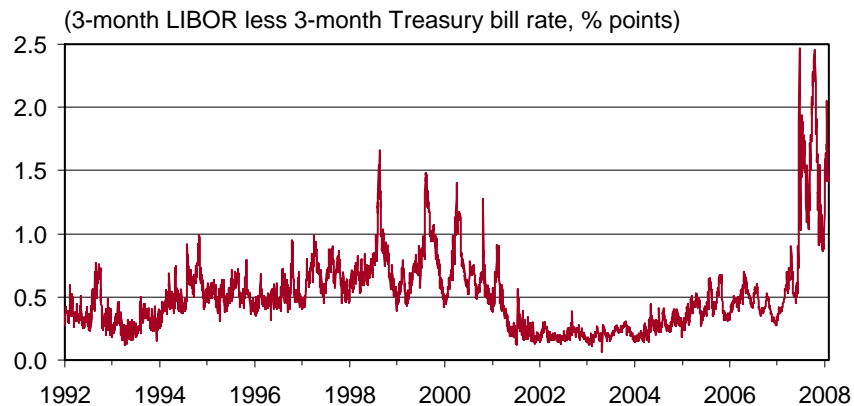
Real House Prices, 2006



Stock Market Volatility – Not So High



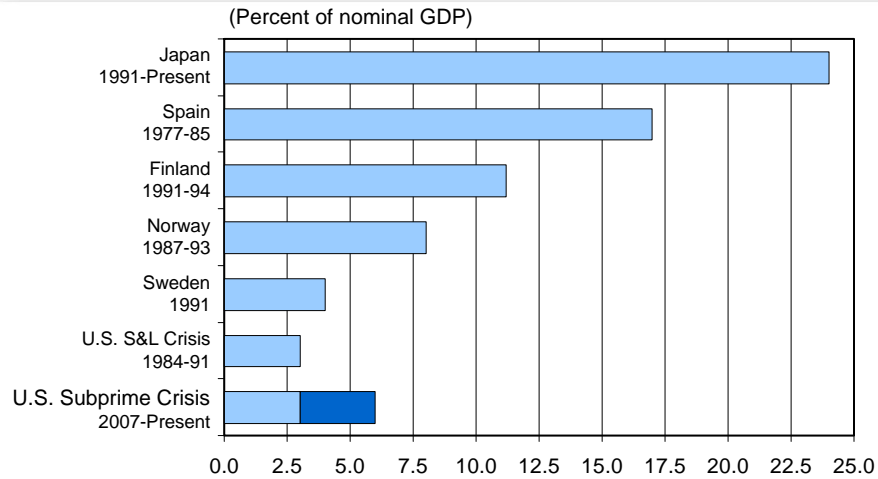
Treasury Eurodollar (TED) Spreads



Comparison with Other Crises

- **Great Depression:** Fed slow to act; fiscal policy restrictive; protectionism – 7,000 banks failed
- **Japan's Banking Crisis:** BOJ slow to react, housing/commercial/stock market bubble; slow recognition and resolution of problem
- **U.S. Savings and Loan Crisis:** Followed financial de-regulation; commercial real-estate speculation; substantial government involvement – 2,700 financial institutions failed
- **Subprime crisis:** Not as bad as other crises – yet; very few institutions have failed—so far; less speculative?

Credit Losses from Recent Banking Crises

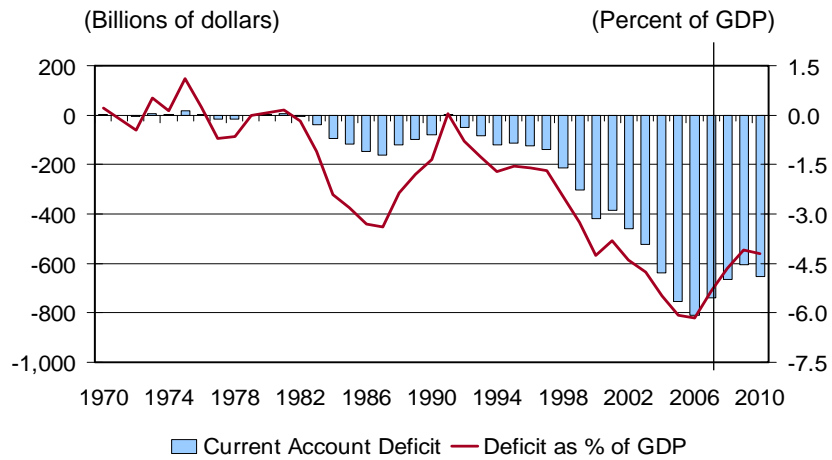


Source: OEDC

Global Transmission of Crisis – No De-Coupling

- **Trade:** How do you avoid being hurt when 18% of the global economy (U.S. consumer spending) decelerates from 3% growth to 0%?
- **Direct trade measures** understate true exposure—increasing trade in tasks rather than finished products
- **Exchange Rates:** The addiction to export-led growth leaves Germany, Japan, and China vulnerable
- **Stock Markets:** The contagion has already begun
- **Credit Crunch:** Europe has already suffered; what about Asia?
- **Profits and FDI:** A repeat of 2001?

Current Account Deficit: Peaking at Last

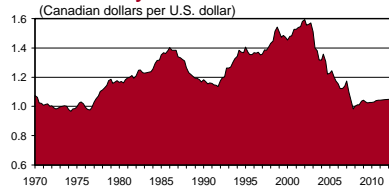


The U.S. Dollar – Further Weakness This Year

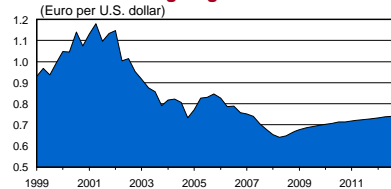
- A combination of a still-large current account deficit and financial jitters have pushed the dollar down in recent months
- Since the Fed is likely to keep cutting rates—more than other central banks—the dollar will continue to depreciate against the key currencies through the summer
- By mid-year the dollar will likely hit bottom relative to the euro and sterling...
- ...However the yen, renminbi, and other Asian currencies are likely to keep appreciating
- The dollar is not that weak and the euro is not that strong
- Worries about oil exporters and/or Asian central banks dumping dollars have been overblown
- European hopes for coordinated intervention are unlikely to be realized
- Talk about the U.S. dollar losing its status as the primary reserve currency confuses cyclical and structural trends

U.S. Dollar Exchange Rates

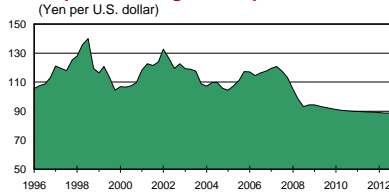
Near Parity with the Canadian Dollar



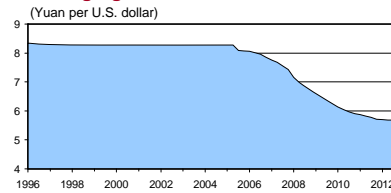
Mid-2008 Trough Against the Euro



Depreciation Against Japanese Yen



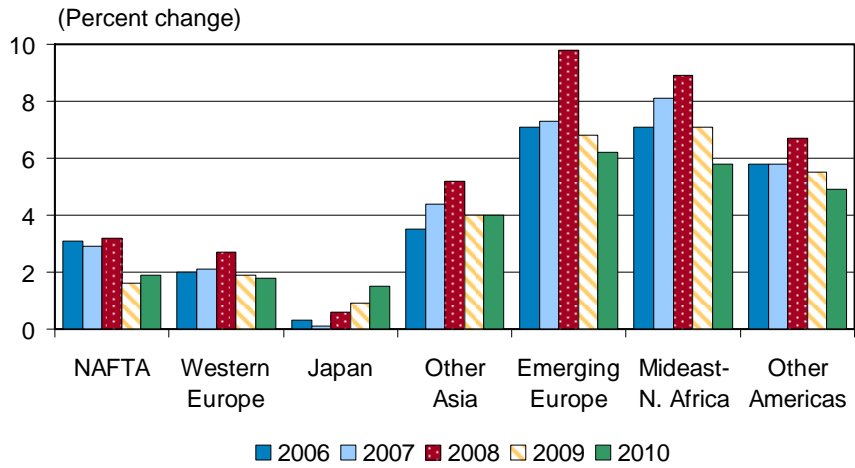
Falling Against China's Renminbi



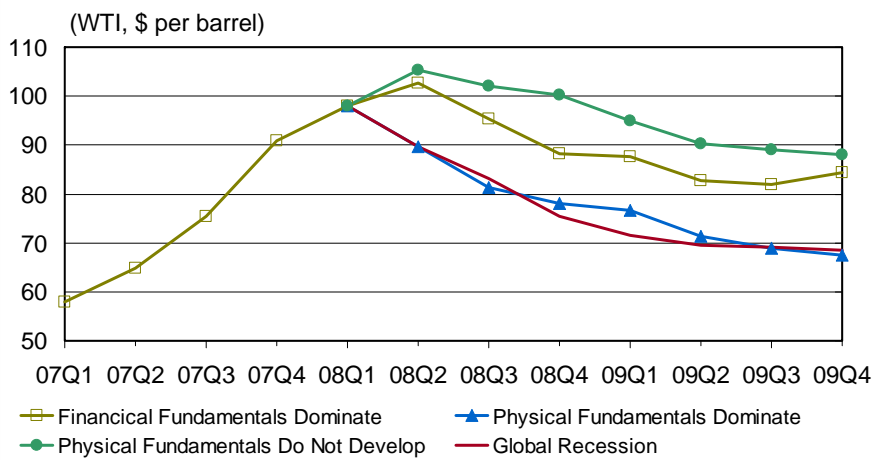
Global Inflation – How Big of a Threat?

- Inflationary pressure are higher in most regions—especially in the emerging world
- Monetary and fiscal policies are largely stimulative and output gaps have mostly closed
- Among the G7, inflation is the most problematic in the Eurozone
- Calling the current U.S. predicament stagflation is an exaggeration
- While supply/demand fundamentals suggest oil prices in the \$80 to \$85 range, speculative investment could push prices well above current levels in the near term
- No sustained weakening in commodities prices until U.S. interest rates bottom out and the dollar stops falling

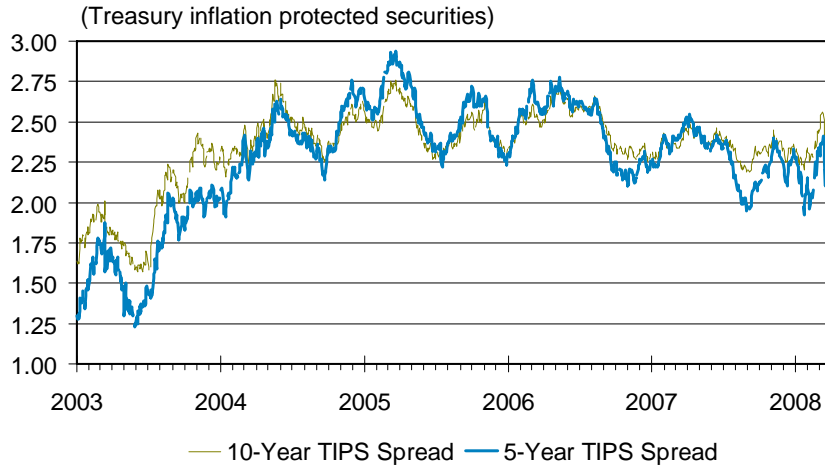
Consumer Price Inflation Has Picked Up In All Regions



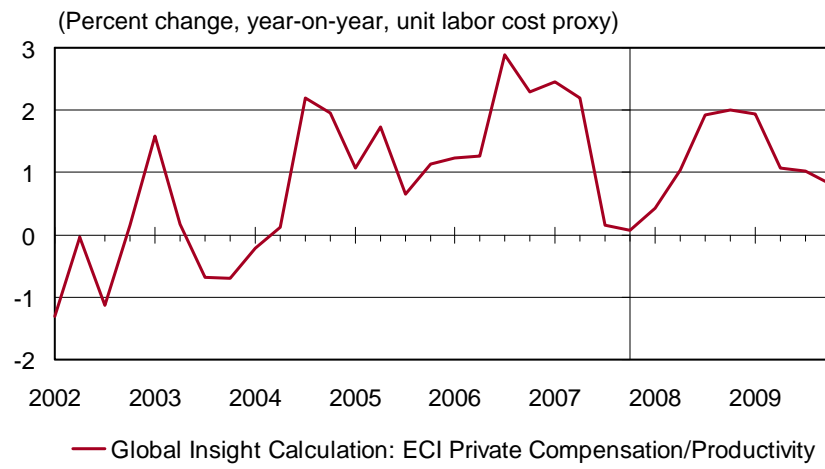
Crude Oil Scenarios



U.S. Inflation Compensation



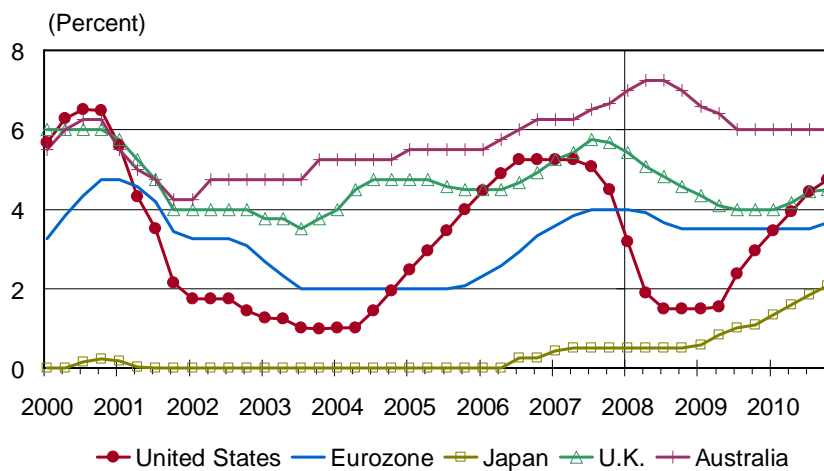
Labor Cost Pressures Easing



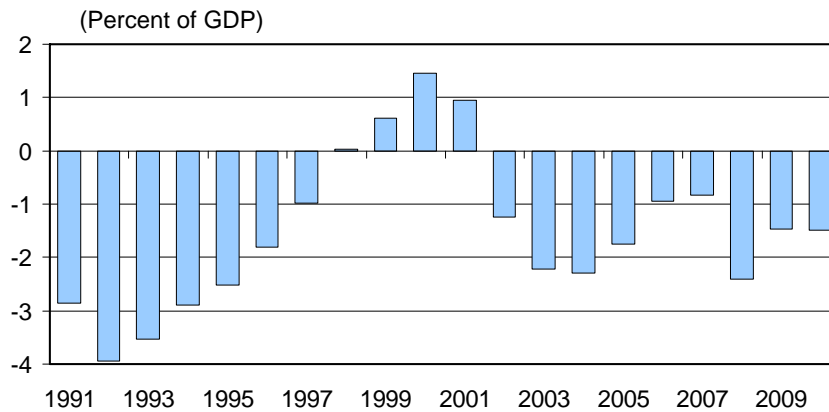
Crisis Management – Shifting into High Gear

- Early in the crisis central banks were quick to inject large amounts of liquidity into the banking systems
- Only some central banks have lowered rates—though money supply growth remains strong in many regions
- Crisis management British- and German-style: nationalization or near-nationalization
- Crisis management American-style: guarantees and loans to investment banks
- Next step for the United States is likely to be more government purchases of mortgages
- More rate cuts on the way for the G7
- Fiscal policy remains broadly stimulative in key economies and will be temporarily even more stimulative in the United States
- Who is crisis manager in the Eurozone?
- Re-regulation: A high risk of throwing out the baby with the bath water

Policy Interest Rates on Different Paths



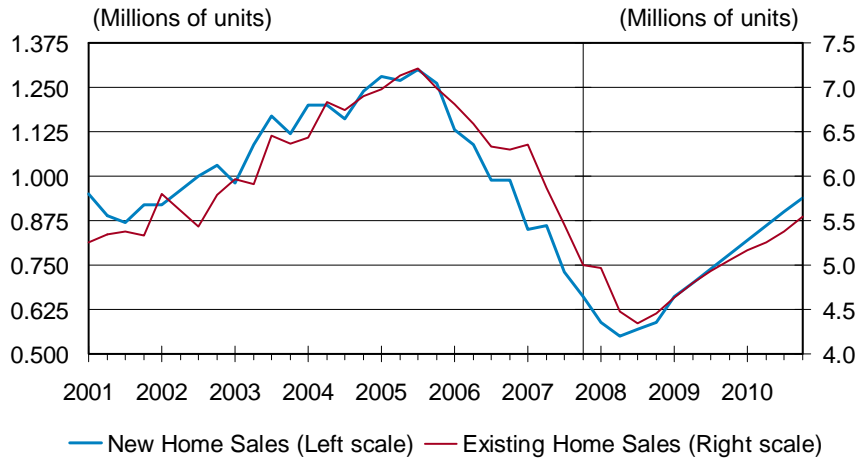
U.S. Full-Employment Budget Balance



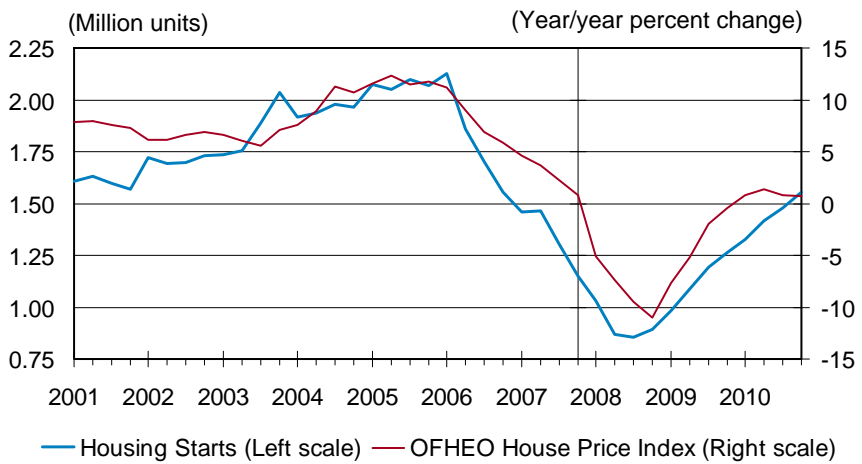
U.S. – Stagnation May Be a Bigger Threat than Recession

- **Causes for concern**
 - Almost all the lights are flashing red
 - Housing trough still a long way off
 - Consumer spending has come to a halt
 - The “recovery” will be tepid
 - Risk: Vicious cycle of credit crunch and recession
- **Causes for comfort**
 - Strong export growth—so far
 - Corporate balance sheets are still healthy
 - Inventories are lean
 - Substantial monetary and fiscal stimulus
 - After a slow start, crisis management by the Fed has been good
 - The capital now available to fix the subprime mess is substantial
- **Bottom Line: Mild to moderate recession, with continuing, large downside risks, especially with regard to stagnation**

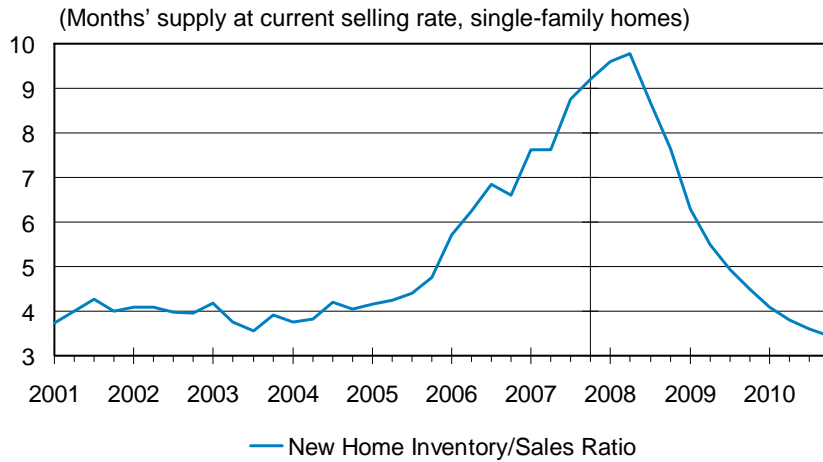
Home Sales Probably Not Quite At Bottom Yet



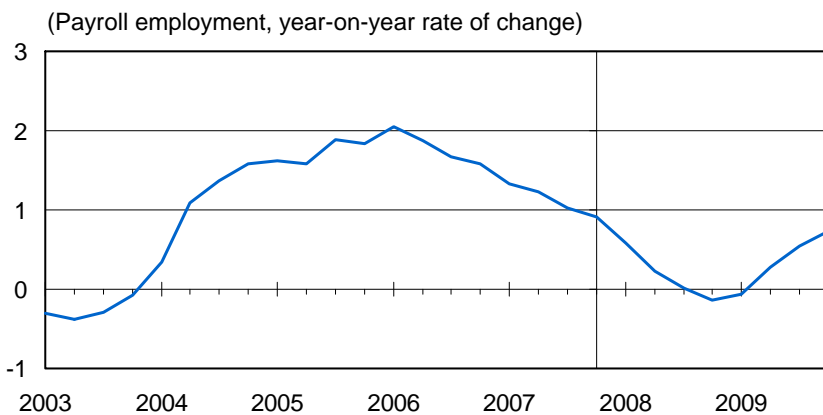
Housing Starts Dip Further, Prices to Fall Sharply in 2008



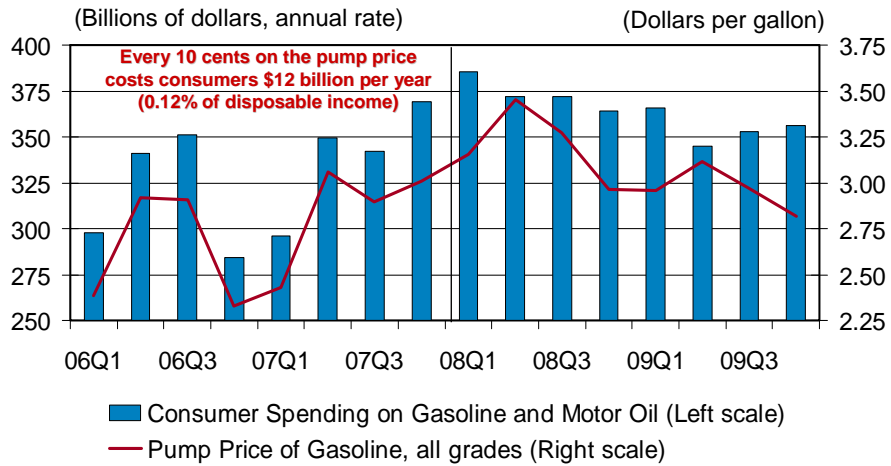
Inventory Overhang Will Get Worse Before It Gets Better



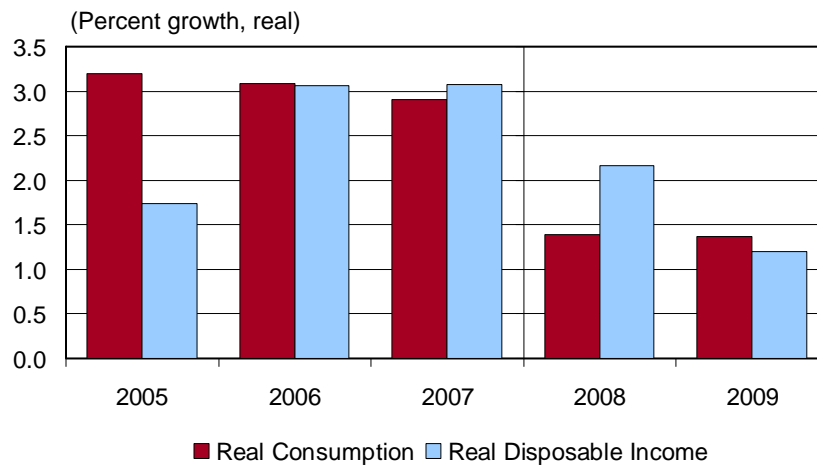
Employment Growth Decelerating



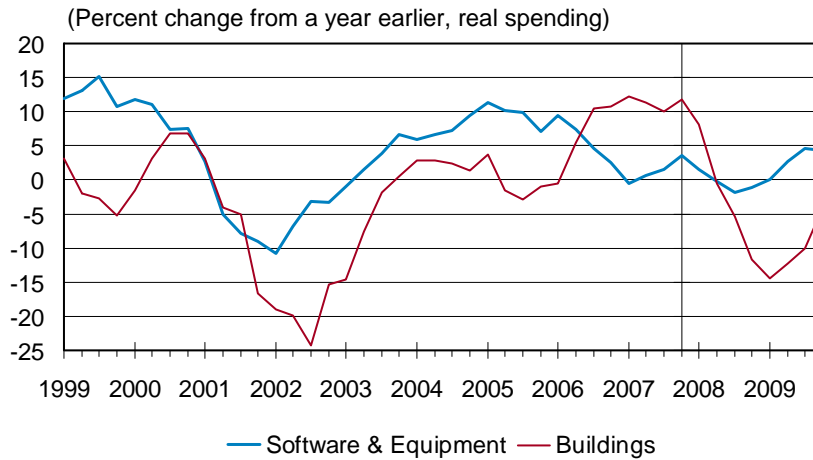
Gasoline Burden Rising



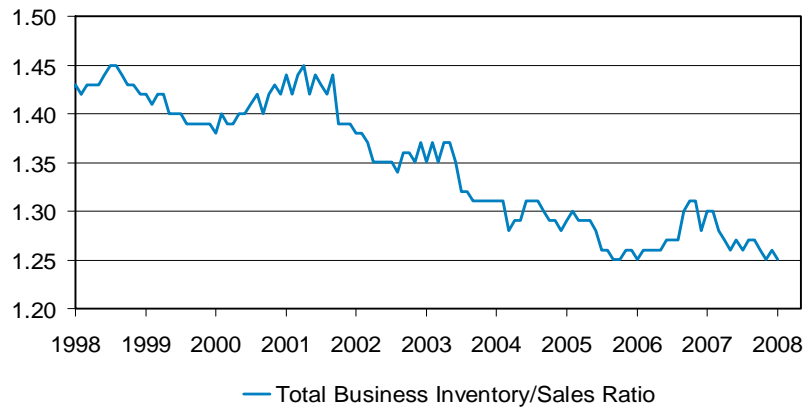
Consumption Growth Will Fall Short of Tax-Rebate Enhanced Income Growth in 2008



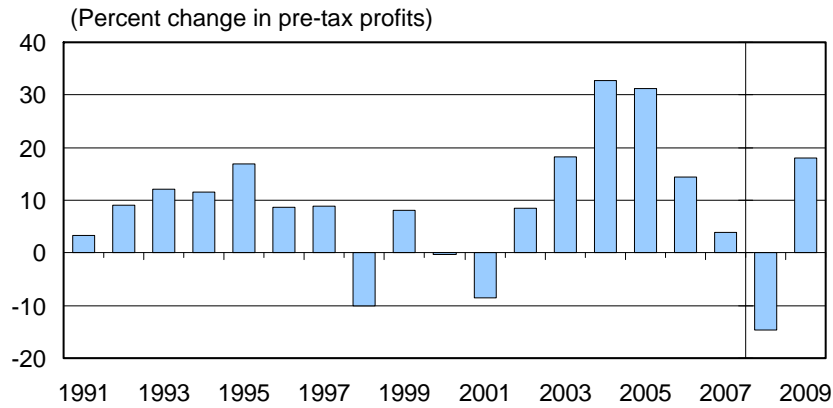
The Business Capital Spending Cycle: Construction Is Peaking



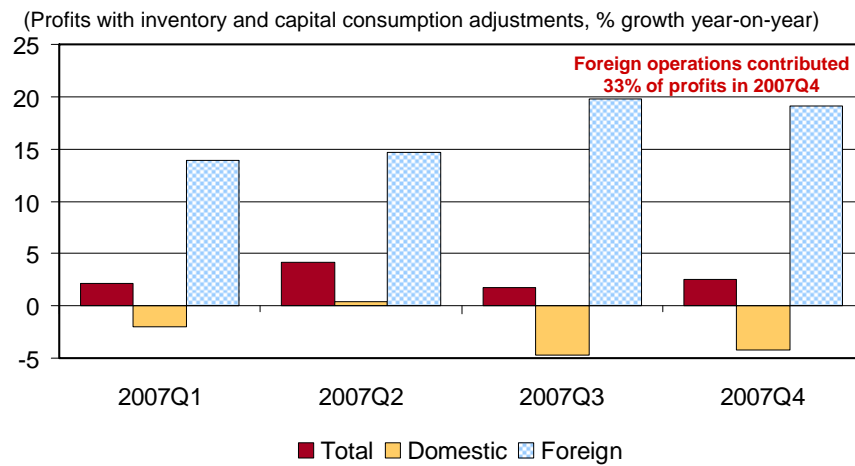
Inventories Are Not A Major Problem



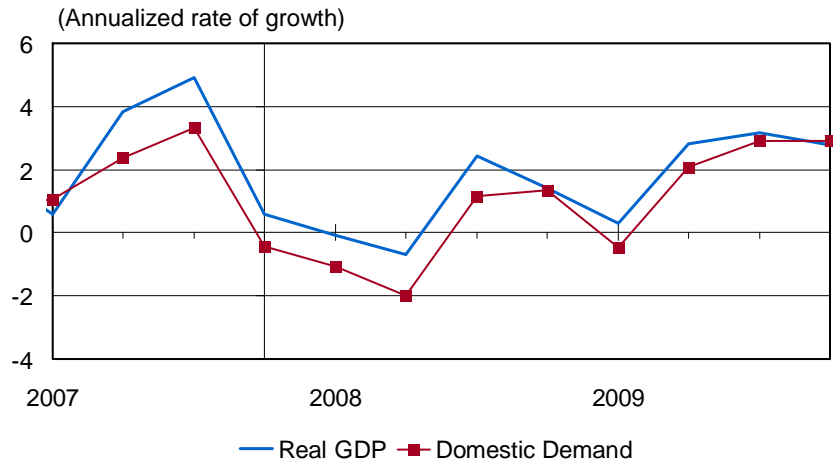
The Profits Boom Is Out of Steam



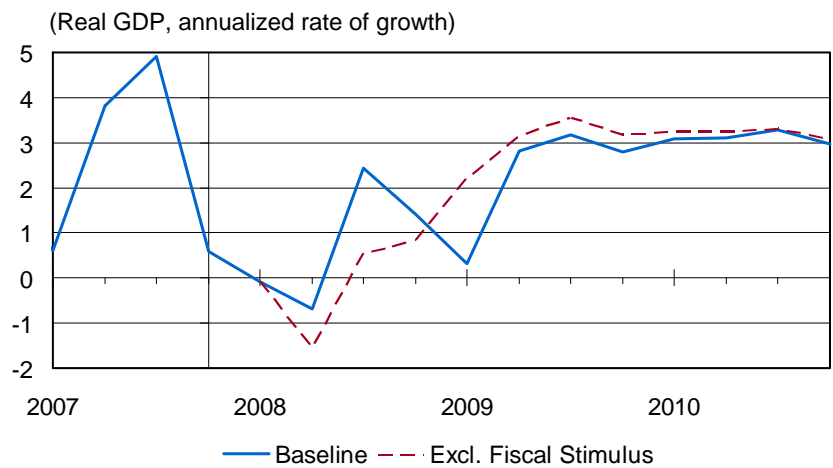
Foreign Operations Are Cushioning the Slowdown in Profits



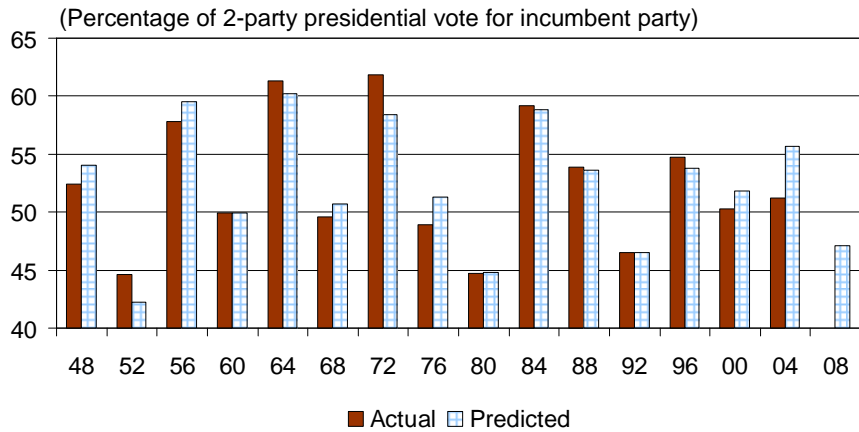
Recession Under Way – Dampened by Foreign Trade



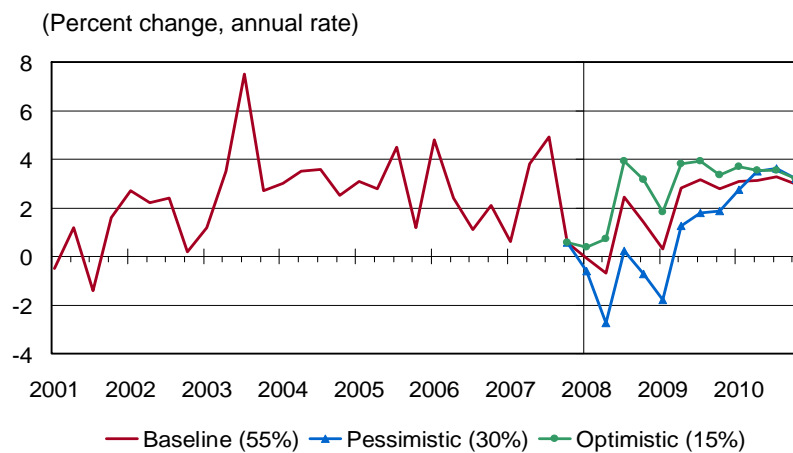
Fiscal Stimulus Pulls Growth Into 2008: GDP



Who Will Win in '08?



Real GDP Growth in Alternative Scenarios



Bottom Line

- Economy is in recession now
- Baseline sees W-shaped recovery
- Tax rebates help bring back growth in the second half of the year but their impact fades by 2009
- Fed has more work to do
- Downside Risk: Prolonged recession – weak improvement in Q3, then relapse
- The rest of the world will “re-couple” with the U.S.
- Presidential victor may be inheriting a poisoned chalice