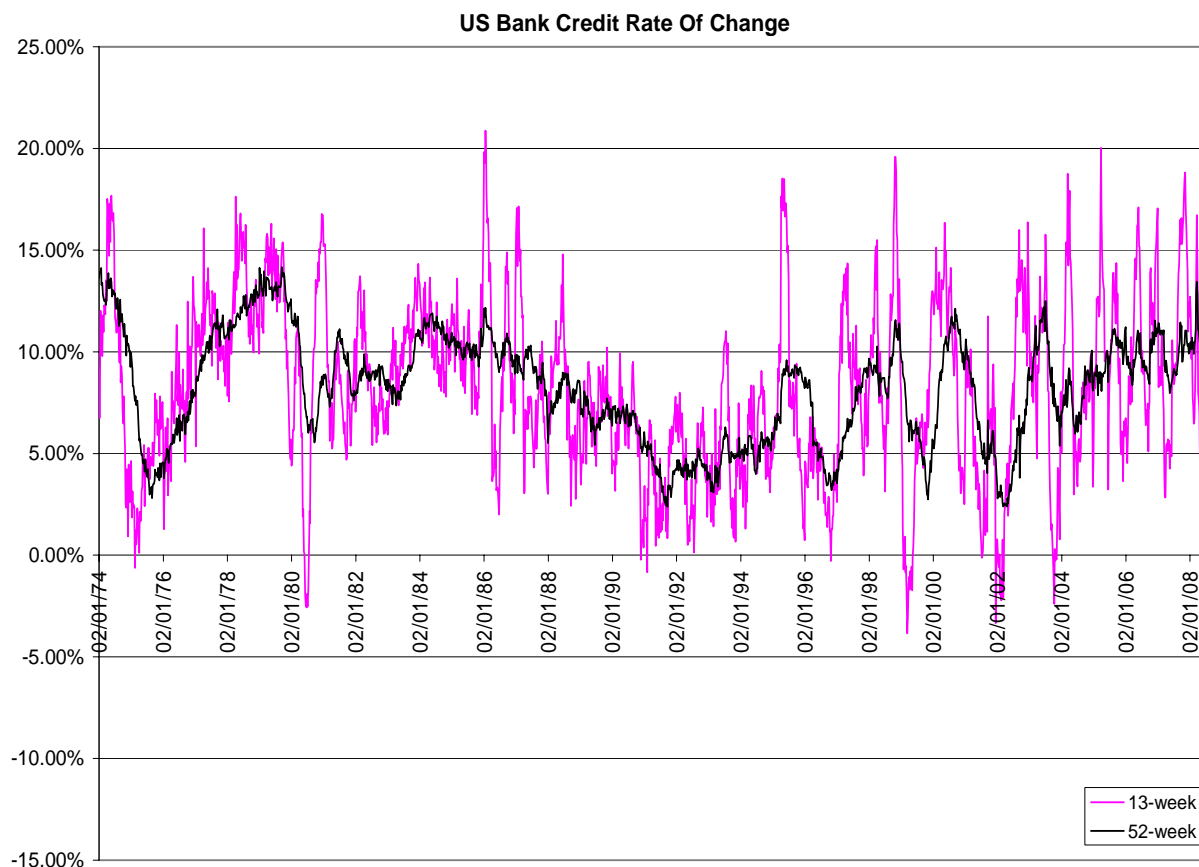


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Credit Contraction

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In the pi Economics May 'monthly' I noted that, for all the anguish about the credit crisis, the actual reduction in credit growth, according to the data, had been quite modest. I suggested that this was one of the signs, along with the continued growth of currency carry trades, and the comparative resilience of economies and equity markets, that the true credit crisis had barely even begun yet.

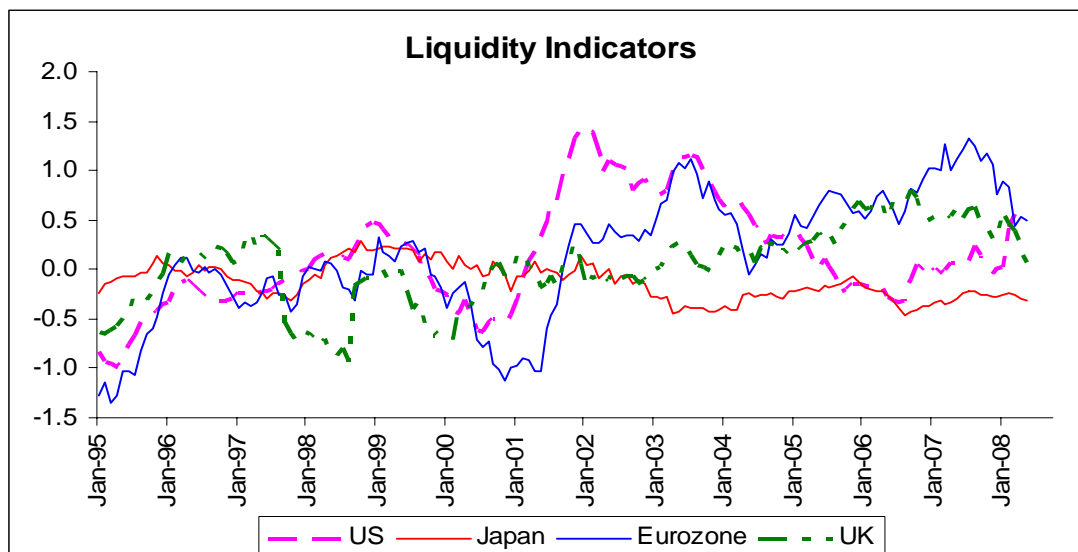
There are now some fairly clear signs that the phase of credit contraction is beginning. The starkest illustration of this is in the chart below, showing the 13 week annualized rate of change (pink line) of total bank credit for the US (in the chart, along with the 52 week rate of change). The decline in bank credit over the past 13 weeks has been the greatest seen in any 13 week period in at least the past 30 years.



Statistics and charts: Jamie Lee

It has to be admitted that it is possible that this exaggerates the true situation a little. Short term rates of change are inevitably volatile, as is obvious from the chart, and there was a jump in bank credit at around the time of the Bear Stearns problem, with which we are comparing when we look at the 13 week rate of change now. It will be very important to see how the bank credit and money numbers develop over the next few weeks.

It is not only in the US, however. In the UK most recent money and credit indicators have also shown a dramatic slowing from previous rapid growth rates. This is already showing up clearly in the pi Economics liquidity indicators, which show a marked downturn for the UK (dashed green line in the chart below).



I have been largely ignoring these liquidity indicators because they are most influenced by money supply growth which, as I have explained in past ‘monthlies’, is not necessarily a good guide in the early phase of this crisis. The likelihood is that liquidity indicators that depend heavily on measures of money will ultimately reflect the crisis, but more as lagging indicators than leading indicators.

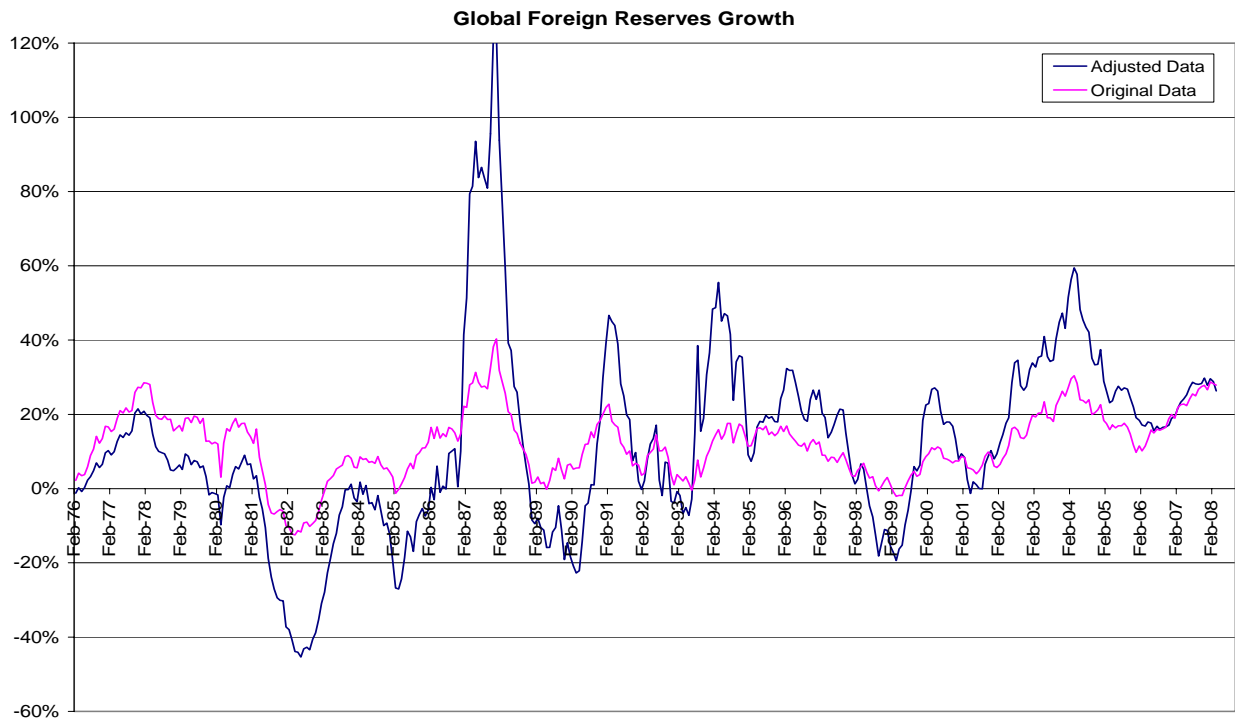
Nevertheless, a couple of points from the above chart are worth noting. The most important point is that, as well as the UK, there has been a marked downturn in the liquidity indicator for the Eurozone, where monetary conditions had long been the loosest. This has occurred partly because of the further rise in interbank interest rates (a component of the indicator) and also because of the rise in inflation (which detracts from liquidity). At the same time the liquidity indicator for the US has risen quite sharply, reflecting Fed rate cuts. At face value, the result is that the US, which had the tightest liquidity of any of the regions/countries in 2005, now has the loosest, if these indicators are to be believed.

Many would agree with this perspective – those who have been arguing that the Fed cut rates too aggressively, undermining the dollar – but I think it is misleading. These indicators do not take into account, for instance, home prices, the decline of which in this cycle has meant that any given level for the Fed funds rate is more restrictive than would have been the case in previous cycles. What I take away from the liquidity indicator chart is that liquidity in Europe is now

finally beginning to tighten up, taking away what had been a prop for global liquidity conditions for a long time.

What about the emerging economies, though? One view I have seen – from a very good analyst – is that monetary conditions in the US and other western economies are becoming deflationary but in the emerging world, thanks to central banks’ currency policies, they are still highly inflationary, creating a volatile combination. I think there has been an element of this, but I think that the situation facing the emerging economies is also changing now, and when the carry trade finally unravels deterioration will occur much more dramatically than anyone expects.

One measure that is used to represent global monetary inflation is the rate of change of central bank holdings of foreign reserves. To the extent that these foreign asset holdings are acquired via currency intervention, as sterilization becomes more difficult they are reflected in excessive domestic monetary growth and liquidity. China is the most well-known case of this. However, we should be a little cautious about interpreting the data for foreign reserve holdings. Data is generally released in dollars but to the extent that a significant proportion of reserves are now held in euro (27% of reserves for which the currency allocation is known, according to the IMF), dollar reserves will have increased simply because of euro appreciation. Also, reserves increase over time because of investment gains and interest earned on the reserves, neither of which results in any increase in the monetary base.



In the chart the pink line shows the year-on-year change in the raw data for total global foreign reserve holdings (last data point is March). The blue line represents an attempt at adjusting the series for the effect of the appreciation of the euro (Deutschmark before 1999) and for interest earnings on the reserves. To do this, we have made some heroic assumptions about the way that reserves are allocated between the currencies and the interest rates that are earned on the

reserves. But we believe that the end result is likely to be a closer approximation to the rate of acquisition of reserves occurring purely through currency intervention than simply looking at the raw data for the reserves.

The adjusted data still show a high rate of acquisition of foreign reserves globally. However, unlike the raw data, it is significantly lower than the peak rate in 2004. The raw data superficially suggest a rate of reserve acquisition pretty much at the peak since the days of the 1987 Louvre Accord to stabilize the dollar. The adjusted data show a rate that is high but has been surpassed a number of times in last two decades.

Potentially most importantly, the adjusted data show the beginnings of a downturn in the most recent months. At the moment this is only a blip on the chart but developments over recent weeks would suggest that this downturn is becoming more pronounced. Most of the Asian emerging currencies have weakened notably against the dollar since April, meaning that the pace of reserve accumulation has clearly dropped – presumably to zero for these countries. In the case of Korea, the authorities have intervened heavily, on a number of occasions selling dollars to support the won, meaning that reserves are now actually declining. This must make it highly likely that when the months between April and July can be added to the chart for the adjusted reserve data above, a clear downturn in adjusted reserves growth will be visible.

In my work on emerging markets I have stressed that emerging currencies as a whole are not particularly undervalued. Most European emerging currencies are heavily overvalued and the Brazilian Real, once very undervalued, is now overvalued also. Because of inflation these overvaluations are increasing further. In Asia, key currencies remain undervalued, but the degree of undervaluation is now much reduced and the Korean Won, in particular, remains a little overvalued against the dollar (and very overvalued against the yen), despite recent declines. With money and credit conditions in the developed economies tightening, it is reasonable to expect that this will now be impacting the emerging world, which is what the foreign reserve data is increasingly likely to be telling us.

The period of incipient deflation in the developed world combining with monetary inflation in the emerging world is therefore coming to an end, with the emerging world joining the west in money and credit contraction also. I view the current period as being, in key ways, the exact opposite of 2003. In 2003 there was still huge angst in the markets and in the financial media about the threat of global deflation, a risk which bond yields at times reflected. Superficial data seemed to lend support to that notion but the important money and credit data clearly indicated a major monetary inflation had been underway, and this was also evidenced by the behaviour of real estate prices and a then nascent rise in gold and commodity prices. Of course, that was the beginning of a long bull move in equity markets. The combination of deflationary sentiment but loose money was, with the benefit of hindsight, ideal for equity markets. Now we increasingly have the opposite.

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