
Reflections on the Crisis & the Post-Crisis World

Bank Negara Malaysia

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A Summary and Sequential Snapshot

- A Crisis OF The System and NOT a Crisis Within the System
- 2008: The Year Where the Unthinkable Became Thinkable
- The Outcome: A Series of Market Accidents and Policy Mistakes Illustrating Inadequate Public and Private Infrastructures
- New Facts on the Ground at Every Level—most Visibly, Changes in Financial Institutions and Capital Structures
- 2009: The Bumpy Journey to a New Destination
- From an Entitlement Culture to a Thrift Culture, with all the Related Paradoxes
- No Reset Button
- Navigating, and Positioning for BOTH the Journey and the Destination

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Outline

- Context – How Did We Get Here and Why?
- Why are Policy Responses More Important than Ever?
- How Will the Short-Term Play Out?
- What are the Likely Longer-Term Consequences?
- What are the Implications for Market Participants?

How Did We Get Here and Why? The Volatile Combination of Structural Weakness and Excessive Cyclical Swings

- Global Imbalances
- Inadequate National and International Policy Infrastructure
- Lax Risk Management at the Level of Individuals, Firms, Rating Agencies, and Self-Regulatory Agencies
- Excessive Production and Consumption of Innovation (with “Disruptive” Characteristics)
- Inevitable Market Accidents
- The Inherent Risk of Policy Mistakes

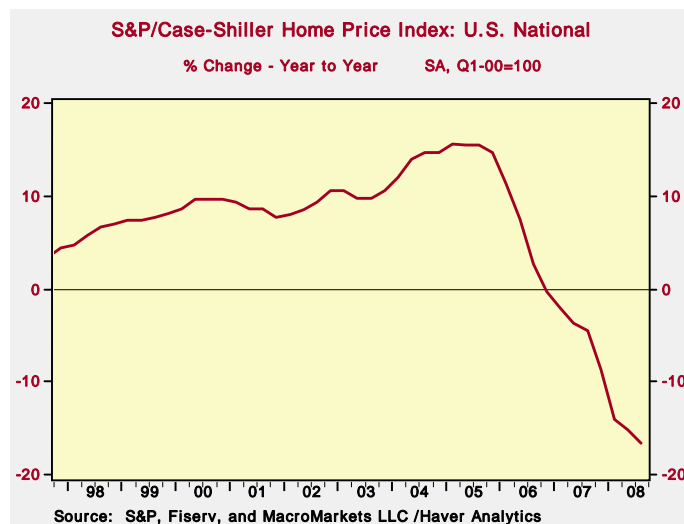
How Did We Get Here and Why? Cascading Problems as Four “Systemic” Balance Sheets Turn Contractionary

- Housing, 2006
- Financial Sector, 2007
- US Consumer, 2008
- Rest of the World, 2008

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Housing – National Home Prices

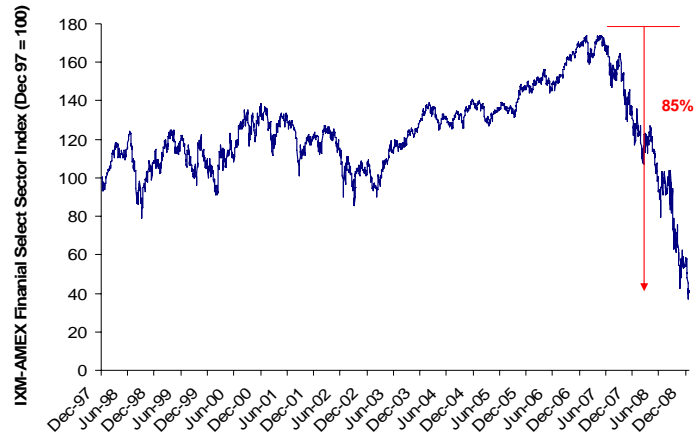


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Financial Sector – Massive Banking Balance Sheet Turn Starting In Mid-2007

85% Decrease in Financial Sector Equity

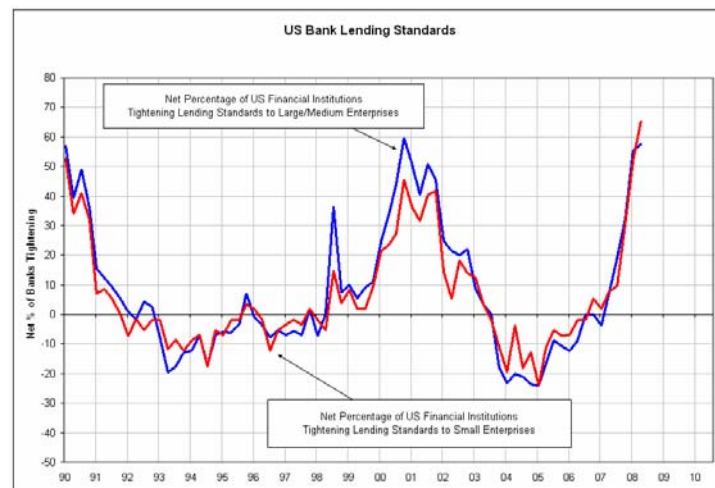


SOURCE: Bloomberg

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Financial – Transmission to Rest of Economy Via Tighter Lending Standards



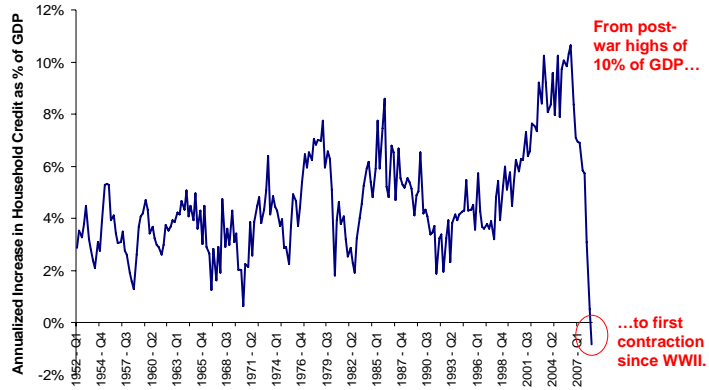
SOURCE: Federal Reserve, Haver, PIMCO

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Growth – Credit Collapse Puts Dramatic Squeeze on Final Demand

Increment to Household Credit as % of GDP



SOURCE: Federal Reserve, Haver, PIMCO

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US Consumer – Household Wealth Buffeted by Housing & Equities

Households & Nonprofit Organizations: Net Worth

% Change - Year to Year NSA, Bil.\$

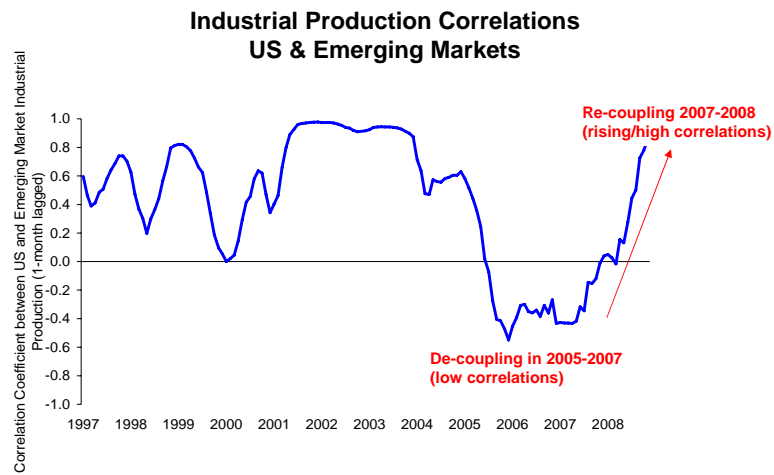


Source: Federal Reserve Board /Haver Analytics

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Rest of the World – Hopes of Re-Coupling Have Yielded to Reality of Re-Coupling



SOURCE: Haver, IMF, PIMCO.

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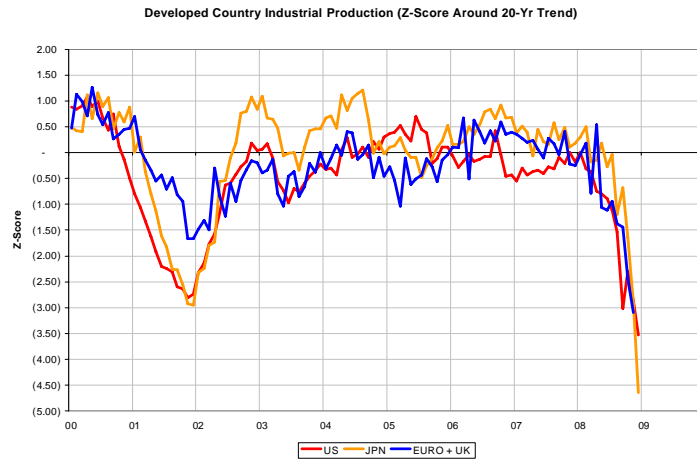
Short-Term Implications

- Collapse in Economic Growth
- Price Dis-Inflation
- Asset Price Collapses

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Collapse in Global IP

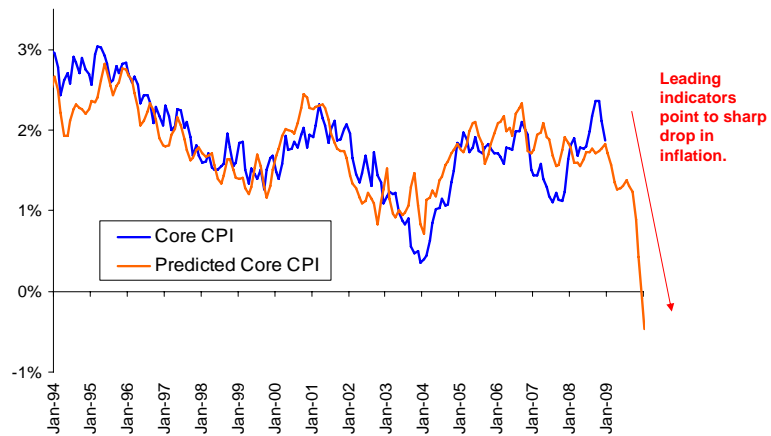


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Inflation – Plunge in Activity Raises Real Risks of Deflation

Actual Core CPI vs. Predicted Core CPI
(based on core retail sales)



SOURCE: Haver, PIMCO

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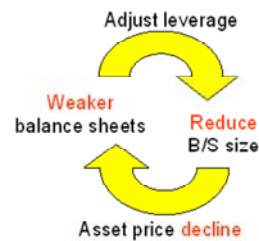
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Asset Prices – Deleveraging Weighs Down Asset Prices of All Types

Liquidity Accelerator during **Boom**...



...becomes Liquidity Spiral during **Bust**



SOURCE: Tobias Adrian & Hyun Song Shin (2007), "Liquidity and Leverage," working paper, September

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Policy Response—From Orthodox to Unorthodox: “Whatever It Takes;” And Making Sure “It Does Not Happen Again”

- Monetary—Race to Zero
- Fiscal—Stunning Change in Approach
- Unorthodox—Supplementing and By-Passing Fatigued Transmission Mechanisms
- Unorthodox—Dealing with Overhangs
- Regulatory Catch Up
- “Never Again”

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Multi-Pronged Policy Response: US And Beyond

Fiscal

- \$900B+ Stimulus (Public Investment, Tax Cuts, Assistance to States)

Monetary

- Fed Rate Cuts (zero to 0.25% overnight rate)

Unorthodox

- Encourage banking system to lend more.
 - Special Fed Liquidity Facilities (TAF, PDCF)
 - Capital Injections into Banks (TARP I)
 - Ring Fencing Toxic Assets and Bad Bank Proposal
- “Go around” banking sector to extend credit.
 - Outright Asset Purchases (Mortgage-Backed Securities, CPFF)
 - Government-sponsored “Shadow Banking System” (TALF)

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Unorthodox Measures Clearly Visible On The Fed’s Balance Sheet

Balance Sheet of the Federal Reserve

US\$ Millions	Oct 3, 2007	Jan 15, 2009	
Assets	906,708	2,092,607	
US Treasury Debt	779,624	475,515	
Repos	35,250	40,000	
Term Auction Facility (TAF)	-	371,297	Facilities to provide liquidity to the financial sector.
Discount Window	26	66,481	
Primary Dealer Credit Facility (PDCF)	-	33,406	Facilities to provide targeted credit to end-users.
ABCP Facility	-	16,093	
AIG Loan	-	85,868	
Bear Stearns	-	27,122	
Commercial Paper Funding Facility (CPFF)	-	334,705	Explosive increase in reserve money.
Fannie/Freddie Debentures	-	24,158	
Mortgage-Backed Securities	-	5,634	
Other (including Foreign CB Swaps)	91,808	612,328	
Liabilities	906,708	2,092,607	
Treasury Supplementary Account	0	199,686	
Reverse Repos	34,542	78,836	
Currency in Circulation	814,600	880,819	
Banking Sector Reserves	4,172	823,125	
Other Liabilities & Capital	53,394	110,141	

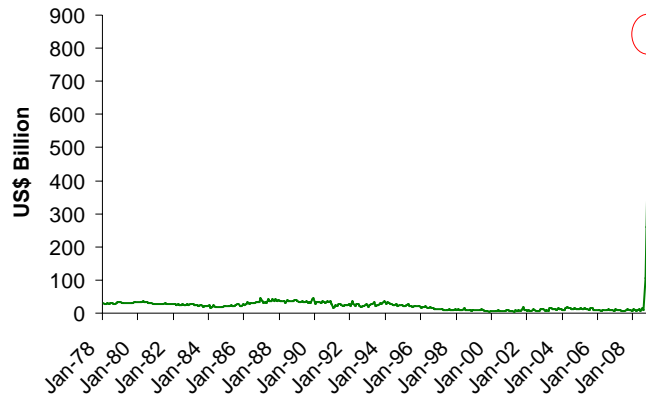
Term Asset-Backed Securities Loan Facility (TALF) will be launched in February, will explicit aim of restarting securitized lending using Federal Reserve financing.

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Resulting Expansion of Reserve Money is Extraordinary

Banking System Reserves



SOURCE: Federal Reserve

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Longer-Term Implications

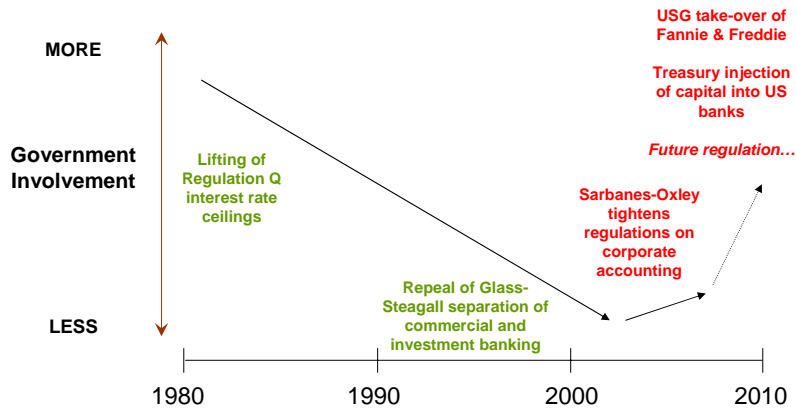
The Global System Will NOT Reset Quickly Or Fully: We Are on a BUMPY Journey to a NEW Destination

- Shift in the Public/Private Balance—Ownership AND Control
- Banks as Utilities—De-Risking, Yet Potentially Undermining Credit
- Precautionary Behavior: From An “Entitlement” to a “Thrift” Culture

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Shift In Public/Private Balance – Early Stages Of New Era Of Re-Regulation & Government Involvement

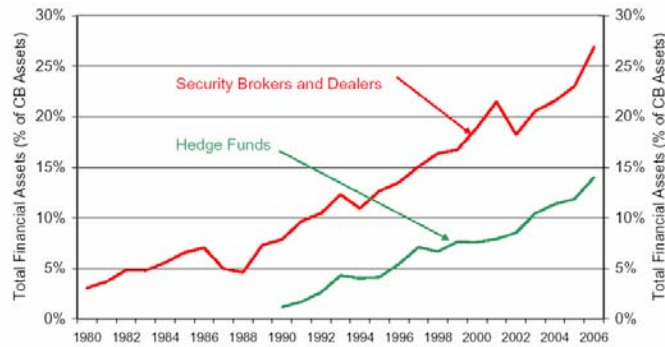


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Banks as Utilities – Era Of Super-Leverage Driven by Broker-Dealers Is Over

Role of Highly Leveraged Players in Financial System



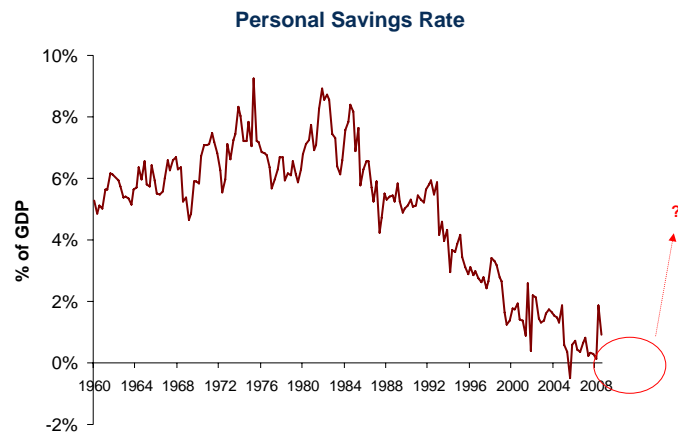
Source:
Total Financial Assets of Security Brokers and Dealers are from table L.129 of the Flow of Funds, Board of Governors of the Federal Reserve.
Total financial assets of Bank Holding Companies are from table L.112 of the Flow of Funds, Board of Governors of the Federal Reserve.
Total Assets Under Management of Hedge Funds are from HFR.

SOURCE: Tobias Adrian & Hyun Song Shin (2007), "Liquidity and Leverage," working paper, September

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Precautionary Behavior – Beginning of a Sustained Rise in US Personal Savings Rates?



SOURCE: Federal Reserve

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Implication For Market Participants: Navigating A Cyclical Dislocation Together With A Secular Re-Alignment: Flow And Stock Reactions

- Journey Strategies: High-hurdle For “Value;” Concentric Circle Mindset; and Dealing with Legacy Issues
- Destination Strategies: Beta Matters; Capital Structure Mindset; Government Exiting is not as Easy as Entering; Step Decline in Endogenous Liquidity
- Risk Management: Diversification Remains Necessary but may no Longer be Sufficient
- Asking the Retooling Question -- at Every Level, and Repeatedly

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Concluding Remarks

- We Are In The Midst Of BOTH A Massive Cyclical Dis-location And A Consequential Secular Re-alignment
- No Reset Button: We Are Witnessing Crisis-driven Changes That Are Fundamentally Changing Many Facts On The Ground
- Everyone Has To Test, And Periodically Retest, The Robustness Of Their Journey AND Destination Strategies
- Critical To Have An Open Mind When It Comes To Re-tooling, Especially As This Is Likely To Take Us Out Of Our Comfort Zones—as Individuals And As Institutions
- Re-tooling Is Neither Easy Not Risk-free; Yet The Cost Of Not Re-tooling Is Greater