# Two speeds - a world perspective

## ■ Emerging markets lead world growth, but are not without risk

- US Economics


- Ellen Zentner; Executive Director
- Senior US Economist
- ellen.zentner@nomura.com


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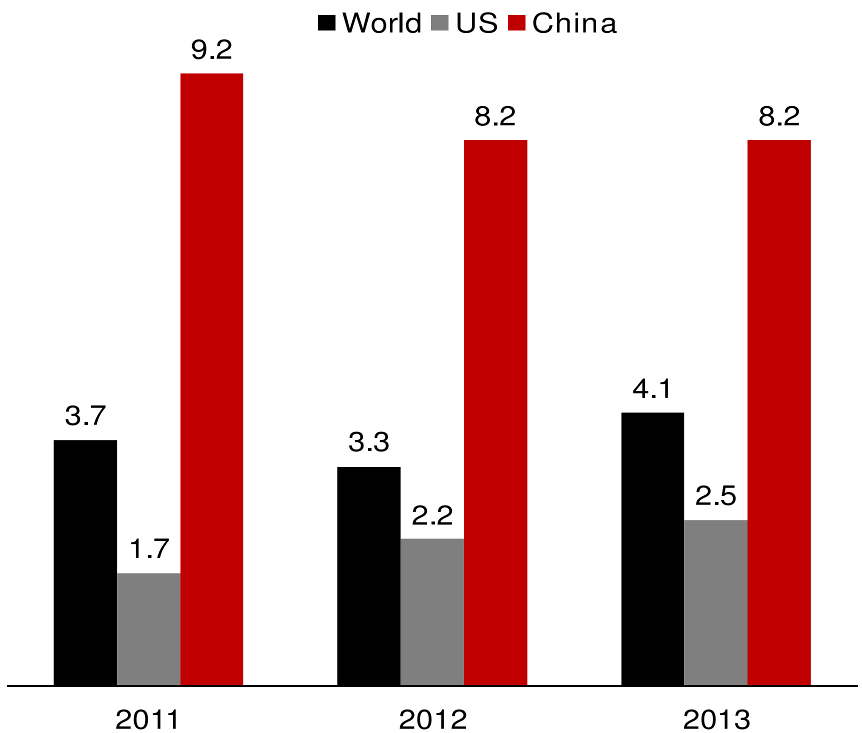
# World growth
## developed nations lagging

### GDP growth rates



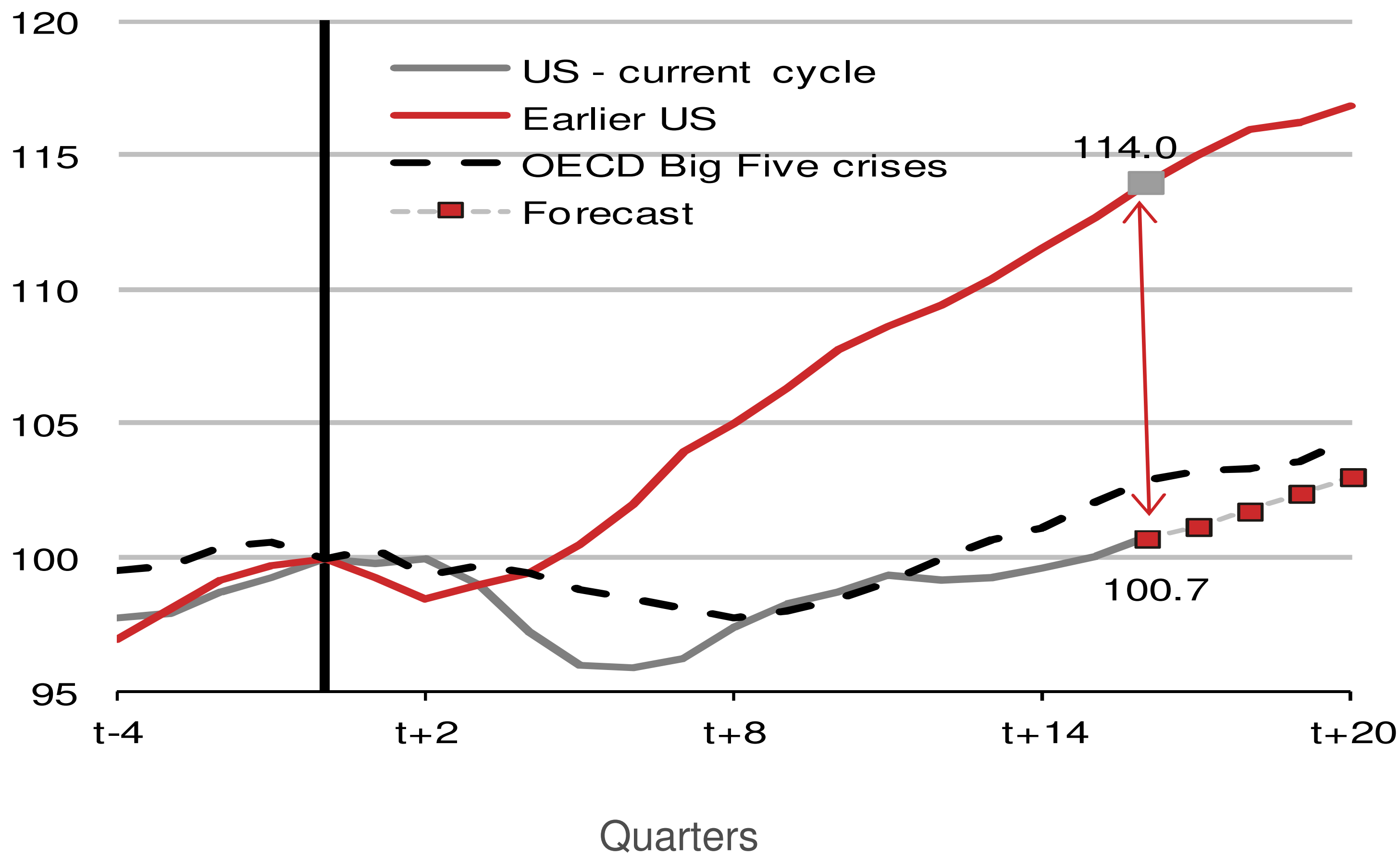

### Contributions to growth

| | 2011 | 2012 | 2013 |
|---|---|---|---|
| Global growth (% y-o-y) | 3.7 | 3.3 | 4.1 |
| Contributions to growth (pp): | | | |
| Developed | 0.8 | 0.7 | 1.1 |
| *United States* | *0.4* | *0.5* | *0.6* |
| *Euro area* | *0.3* | *-0.1* | *0.2* |
| *United Kingdom* | *0.0* | *0.0* | *0.1* |
| *Japan* | *0.0* | *0.1* | *0.1* |
| Emerging Markets | 3.0 | 2.6 | 3.0 |
| *China* | *1.6* | *1.5* | *1.5* |
| *India* | *0.5* | *0.5* | *0.6* |

Source: Nomura Global Economics

# Tracking earlier post-crisis recoveries

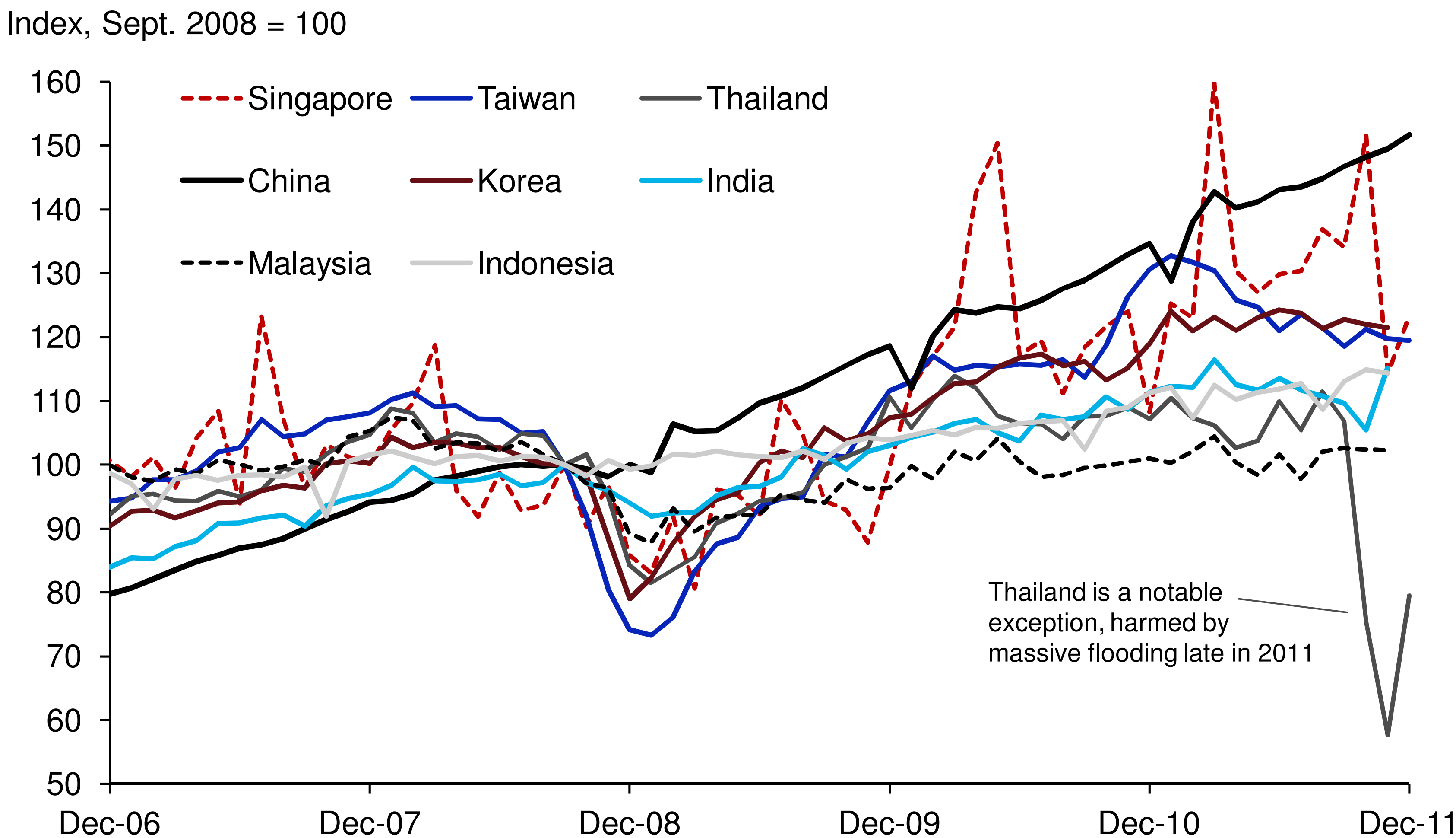
## Real GDP around recessions and financial crises (index, time t =100)




Source: OECD, Nomura Global Economics; Note: "Earlier US" is average of last 10 recessions; OECD Big Five financial crises first identified by Kaminsky and Reinhart (1999); Countries are Spain (1977), Norway (1987), Finland (1991), Sweden (1991) and Japan (1997); We use 1997 for Japan (instead of 1992) is this was the start of the most intense phase of the financial crisis there.

# Asian economies have shot well past pre-crisis levels

## Seasonally adjusted industrial output in levels




Source: CEIC and Nomura Global Economics

# Stresses in China are a concern


Source: Bloomberg; NY Fed; Nomura Global Economics

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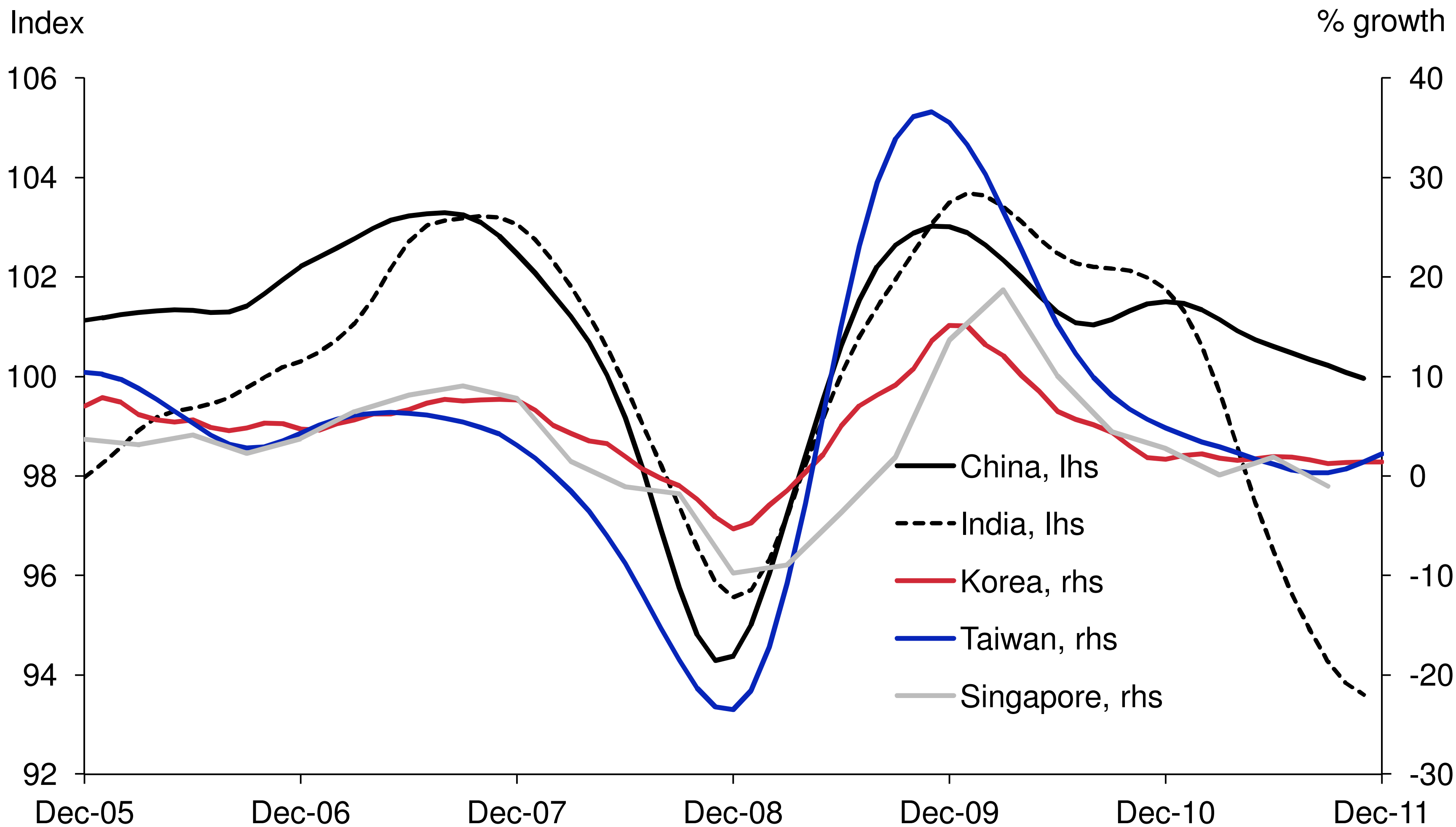
# Leading indexes – cooling, not collapsing bar India

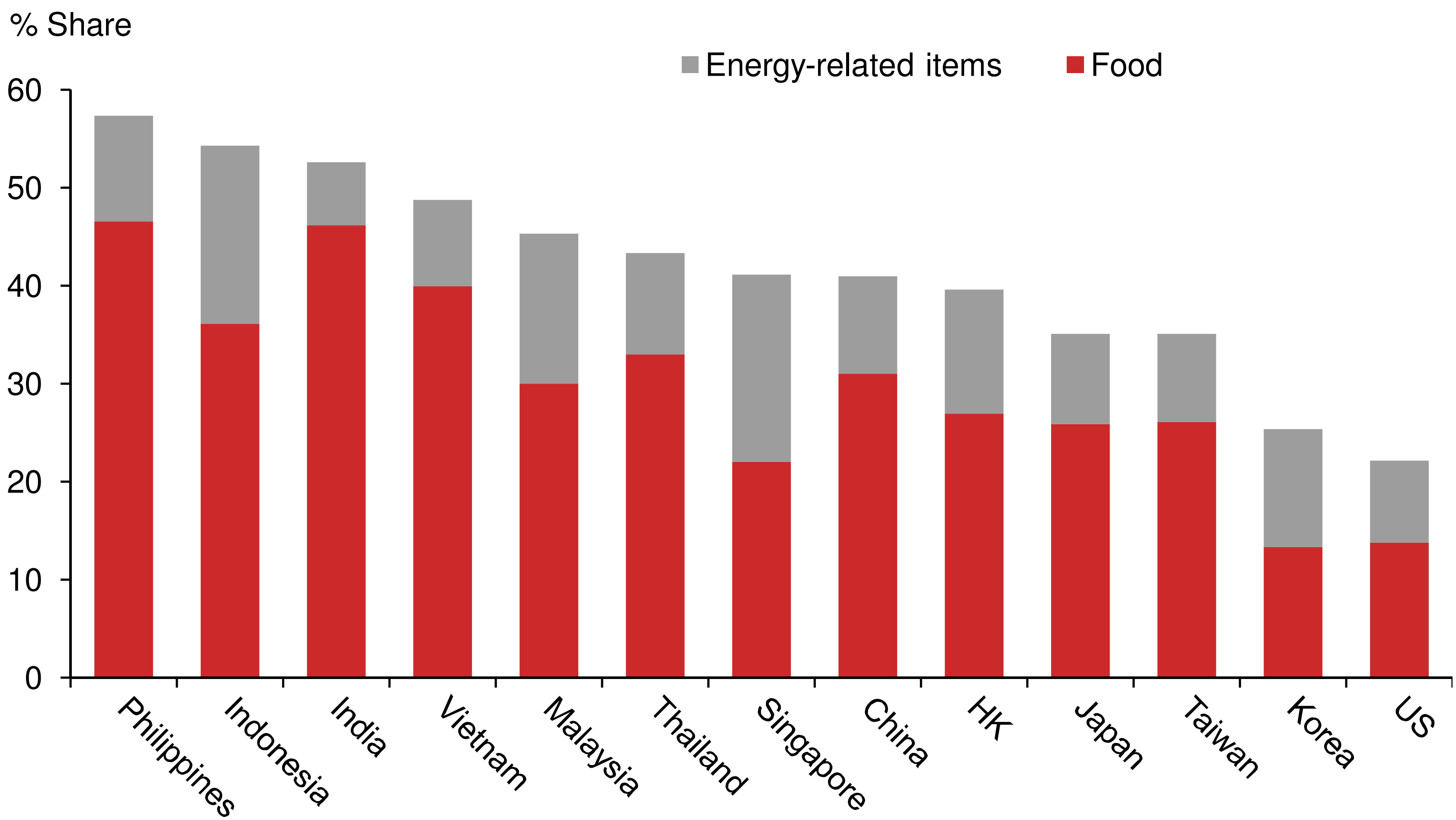
## Official leading economic indexes




Source: Korea: National Statistics Office; Taiwan: Council for Economic Planning; China and India: OECD; Singapore: Economic Development Board; Nomura Global Economics

# Asia's high exposure to commodity prices

## Weightings of food and energy items in Asian CPI




Source: China Statistics Yearbook; CEIC; Nomura Global Economics

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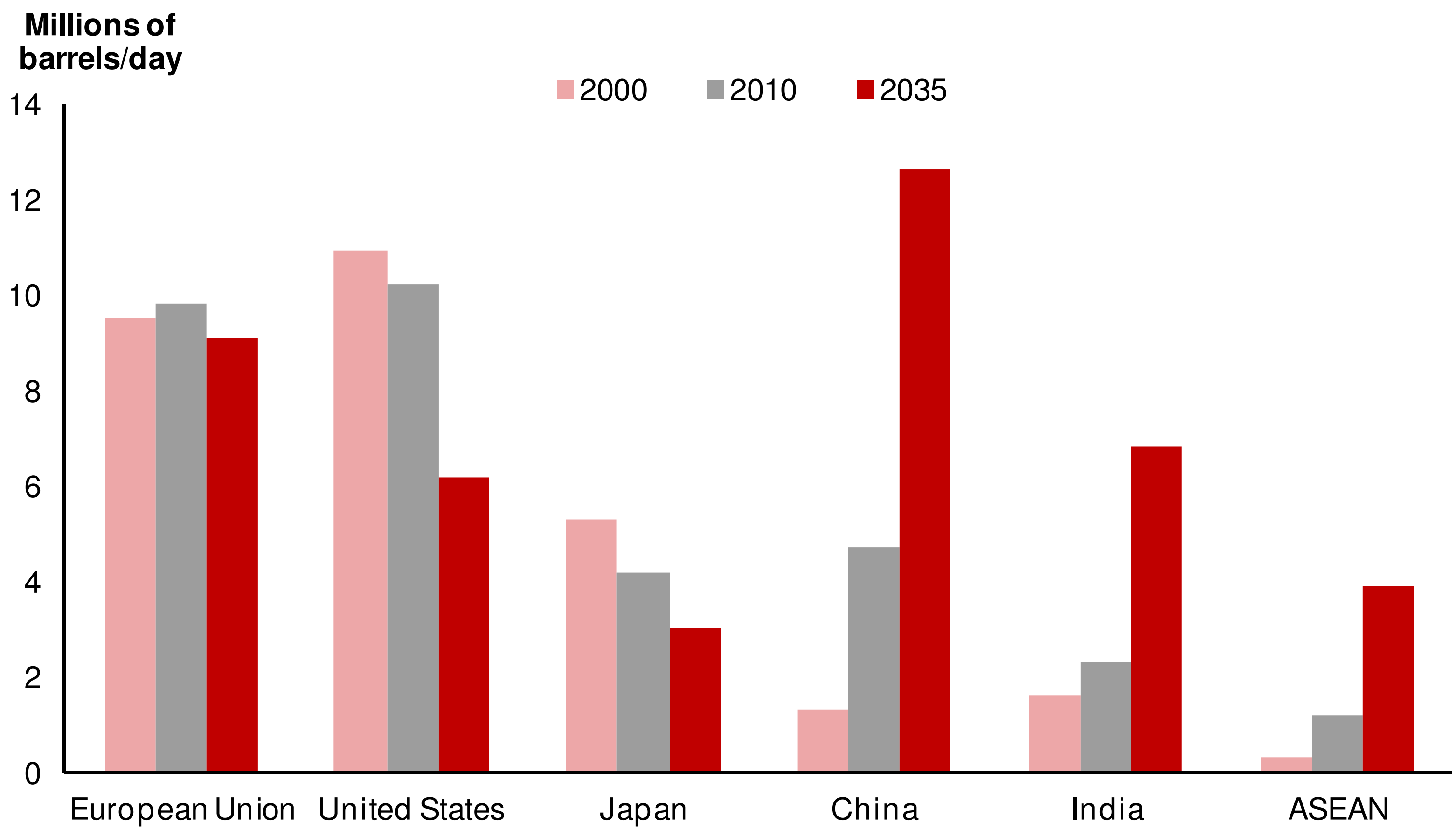
# Net imports of oil

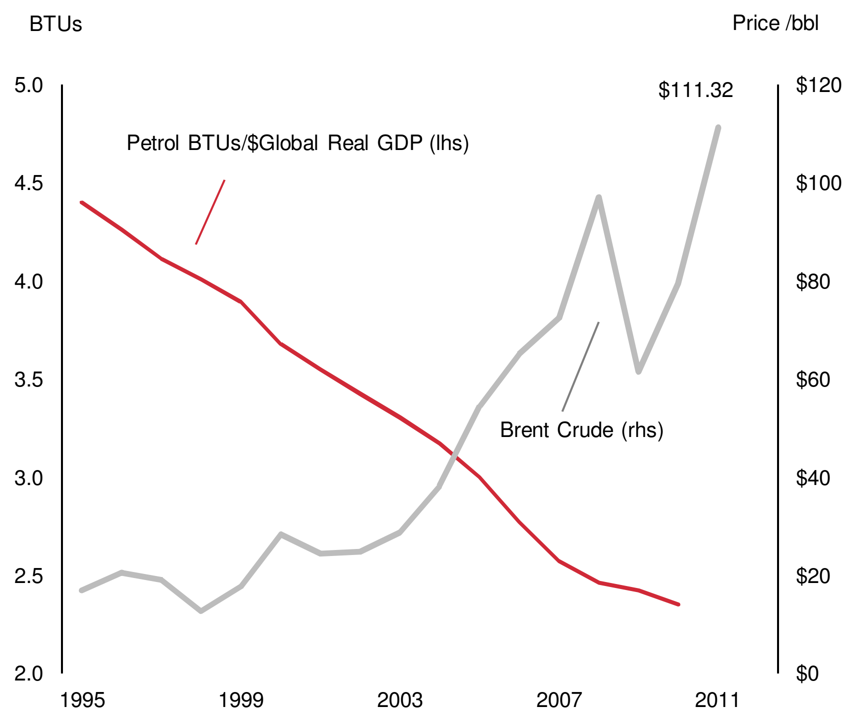
## Asia ex-Japan becoming more dependent



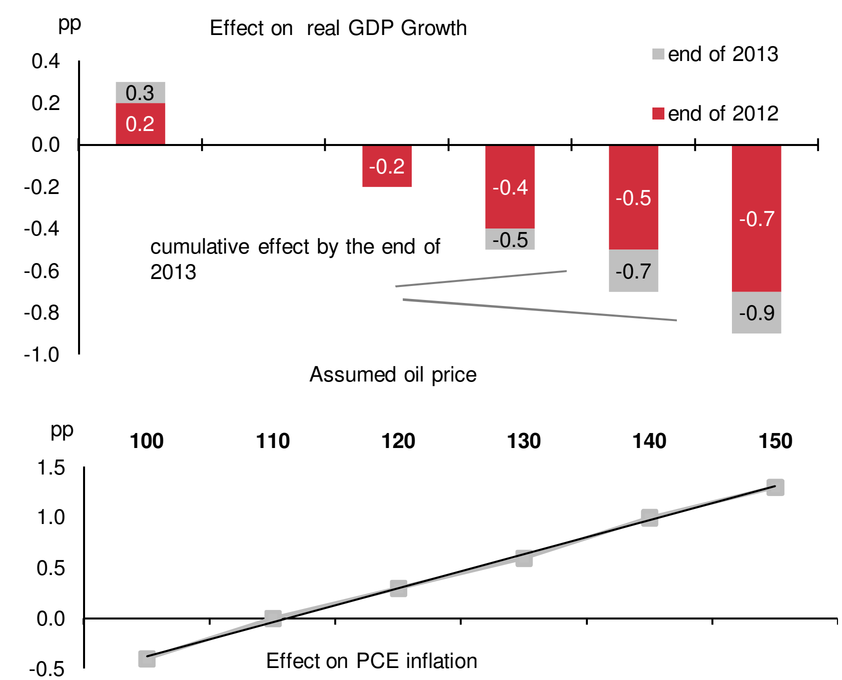

Source: Energy Information Administration; Nomura Global Economics

# World and US not as vulnerable to oil price increases

## World is less dependent on oil today



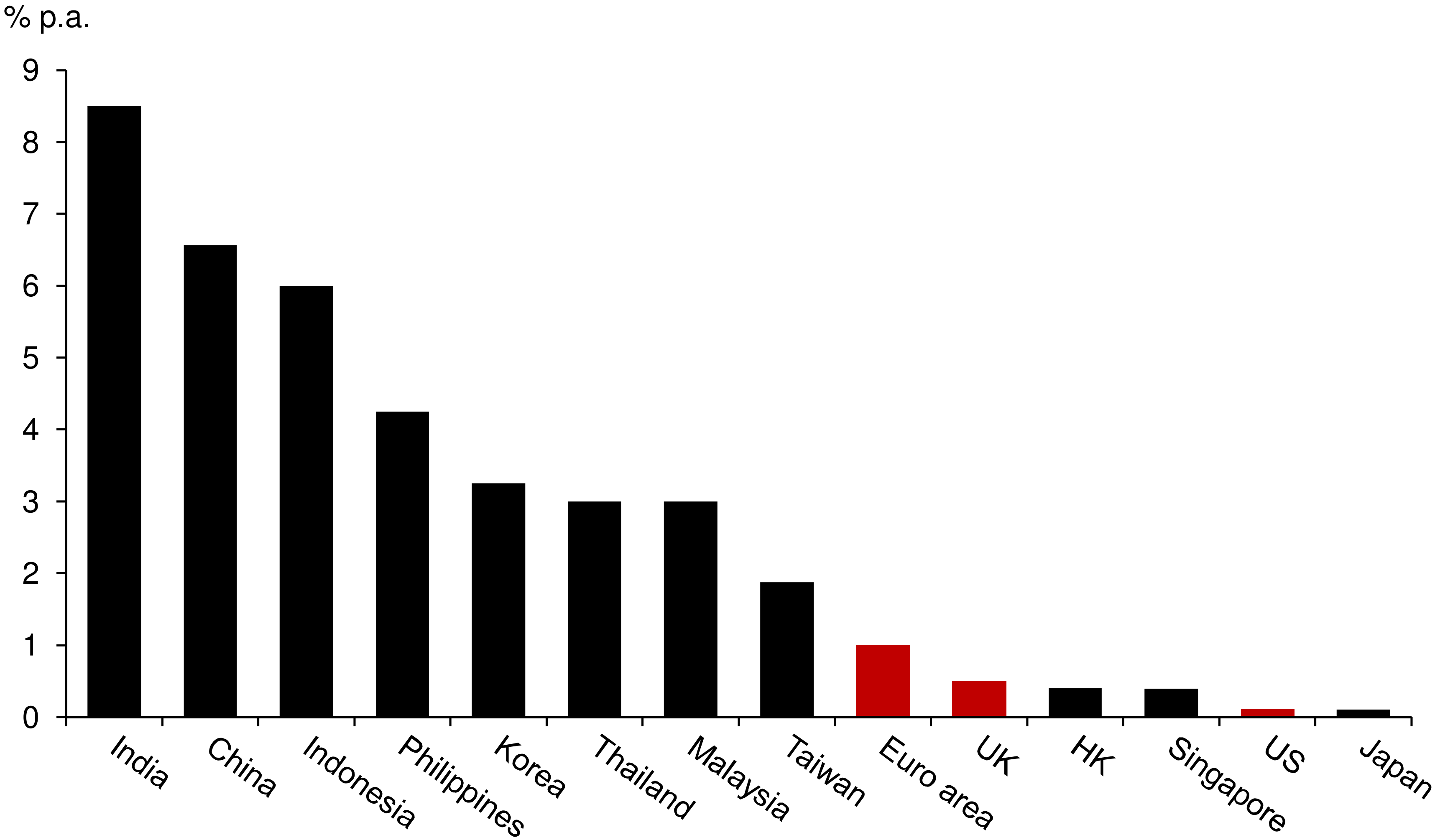

## $10/bbl increase = 0.2pp hit to US GDP




Source: Energy Information Administration; IMF; Nomura Global Economics

# Asia has lots of room to cut interest rates…

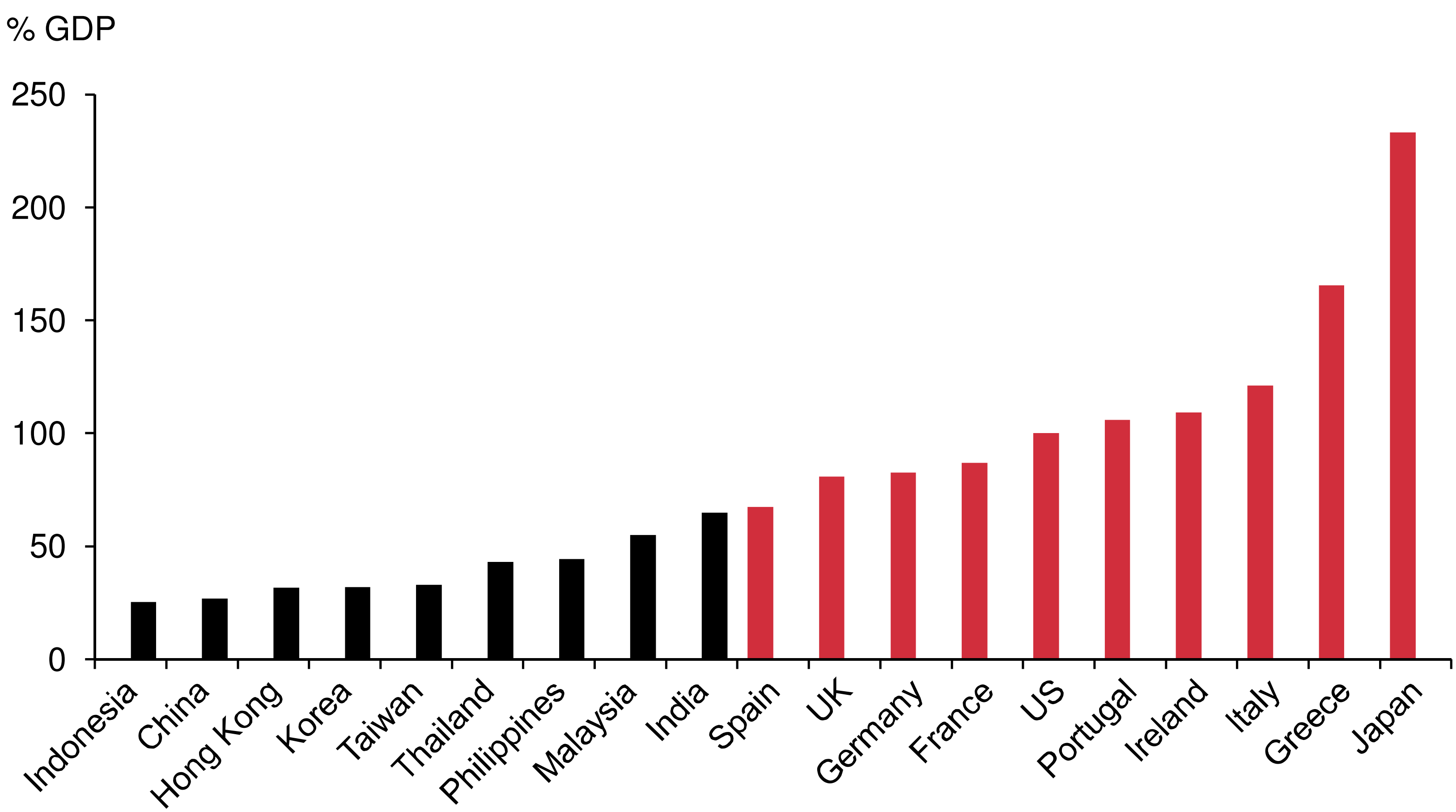
## Latest policy interest rates in Asia and the G3




Source: Bloomberg; CEIC; Nomura Global Economics. Note: For China, we use the 1-yr bank lending rate; for HK and Singapore we use the 3m inter-bank rates.

# … and expand fiscal policy

## Estimates of general government debt in 2011




Source: IMF; Nomura Global Economics

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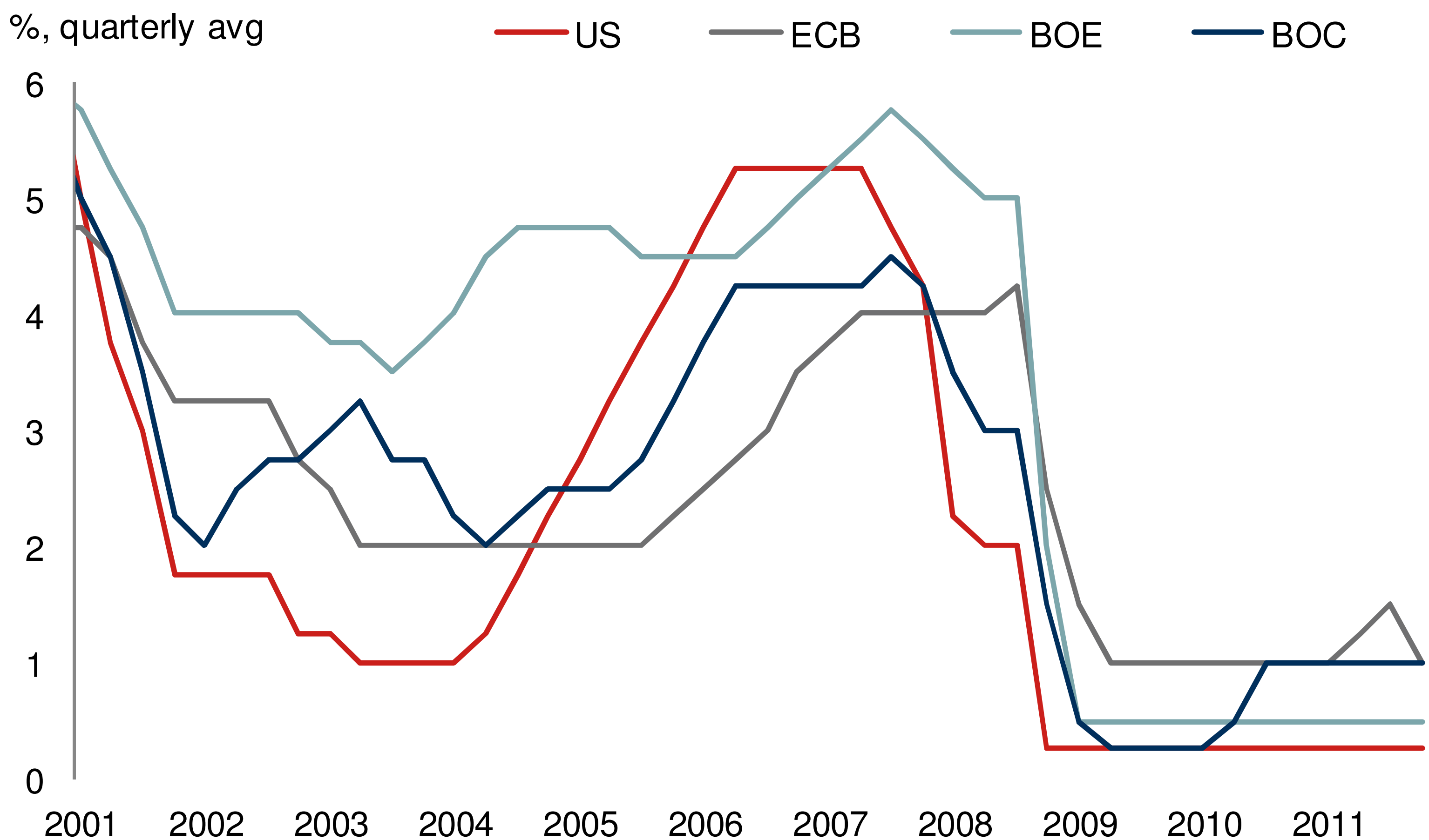
# Global policy rates

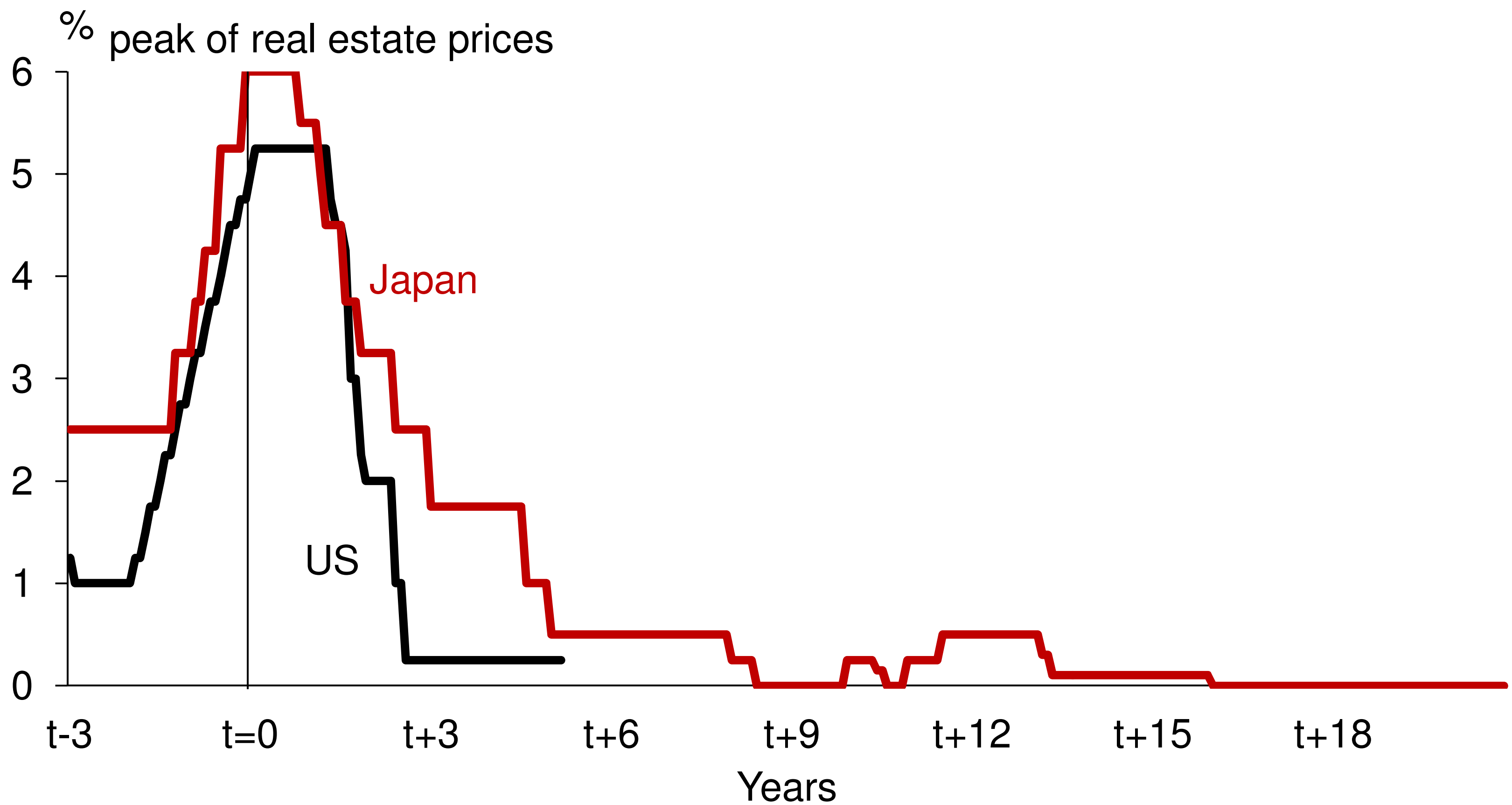



Source: Bloomberg; Nomura Global Economics

# The Fed was much quicker to get to the zero bound

## It took three years for the Fed to cut rates to close to zero; it took the BOJ nine years

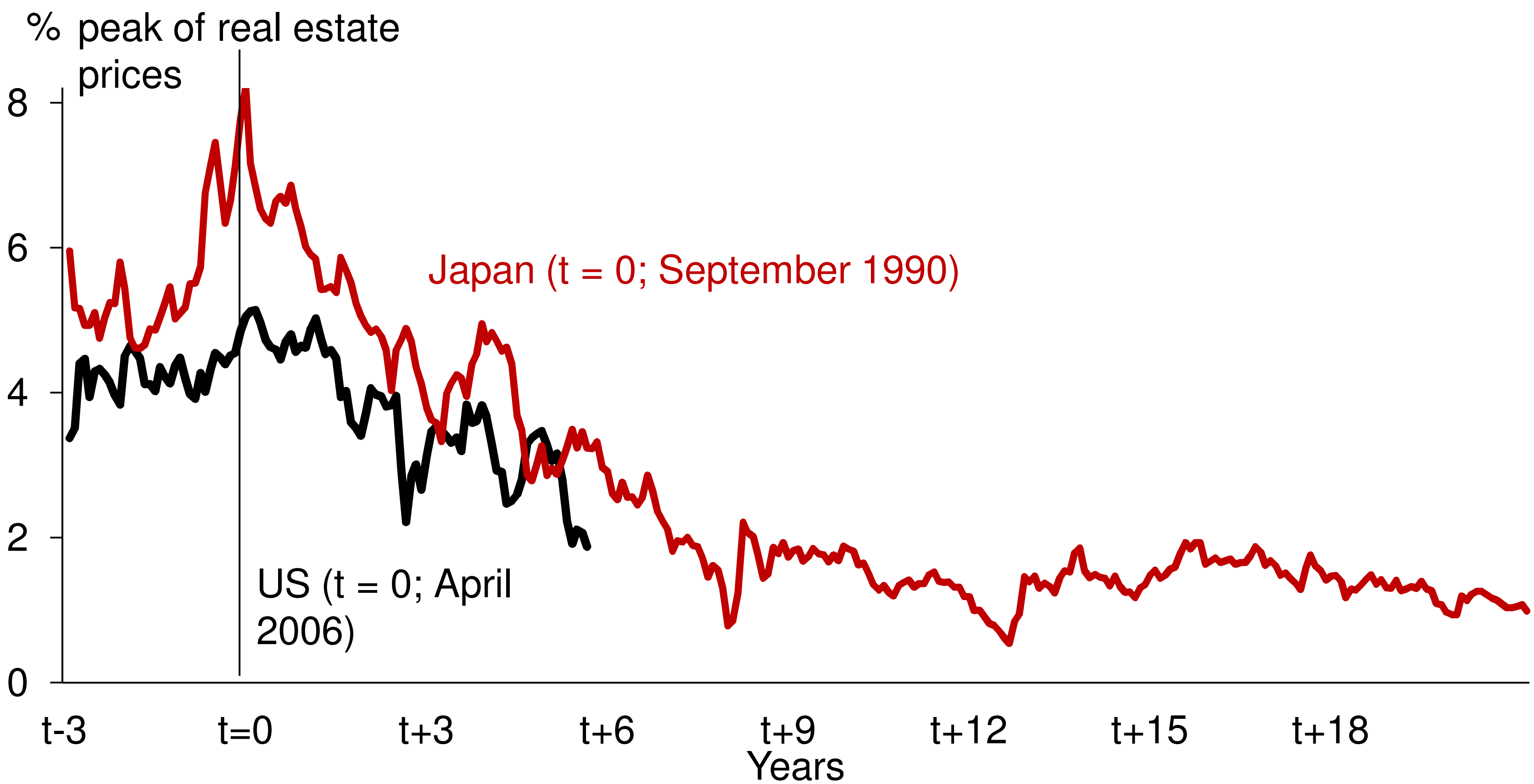
### Central bank policy rates (Japan t = 0, September 1990 | US t = 0, April 2006)




Source: Bank of Japan; Federal Reserve; Nomura Global Economics

# Long-term yields: US following in Japan's footsteps?

## JGB and UST 10-year yields




Source: Bloomberg; Nomura Global Economics

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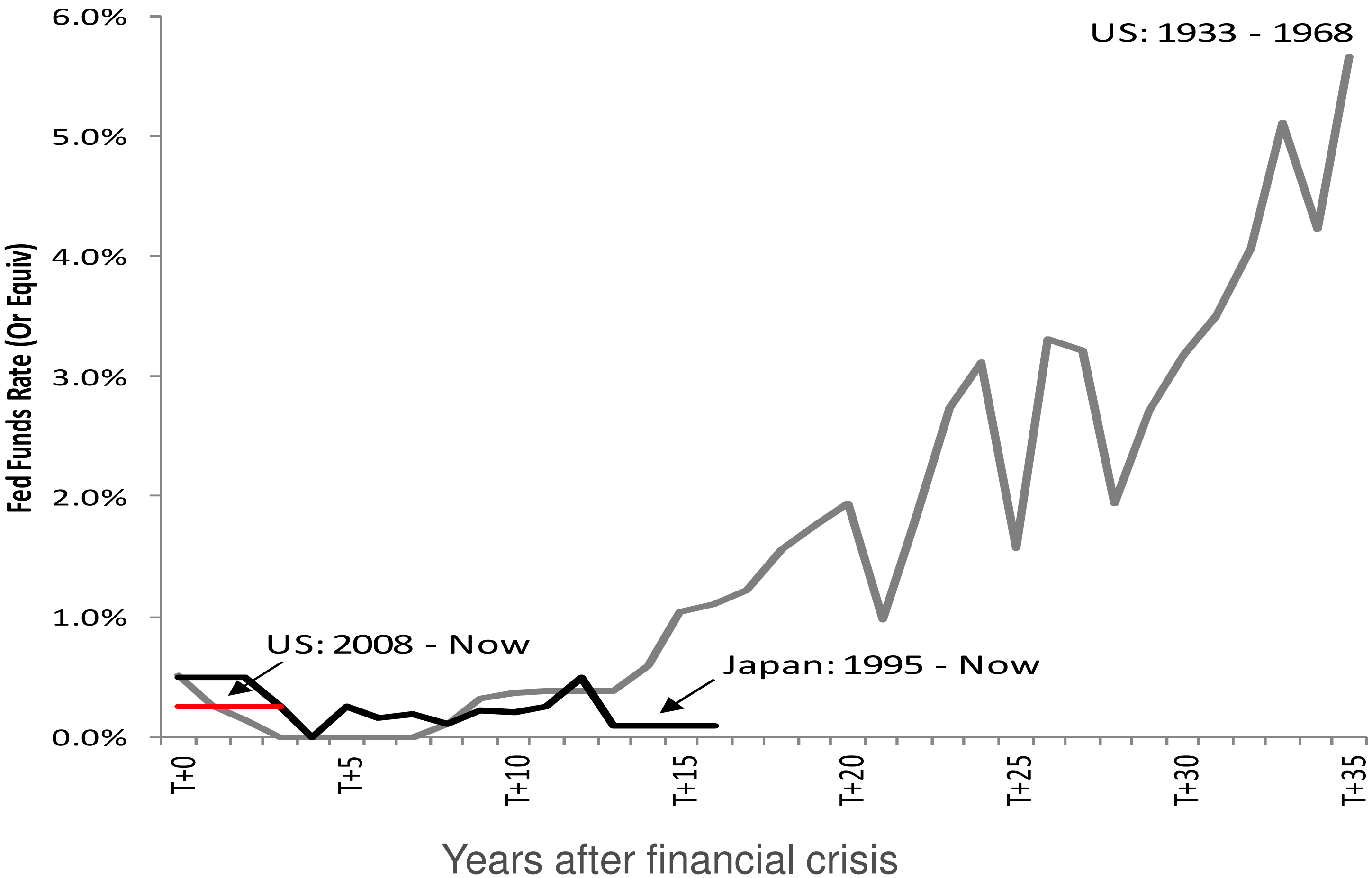
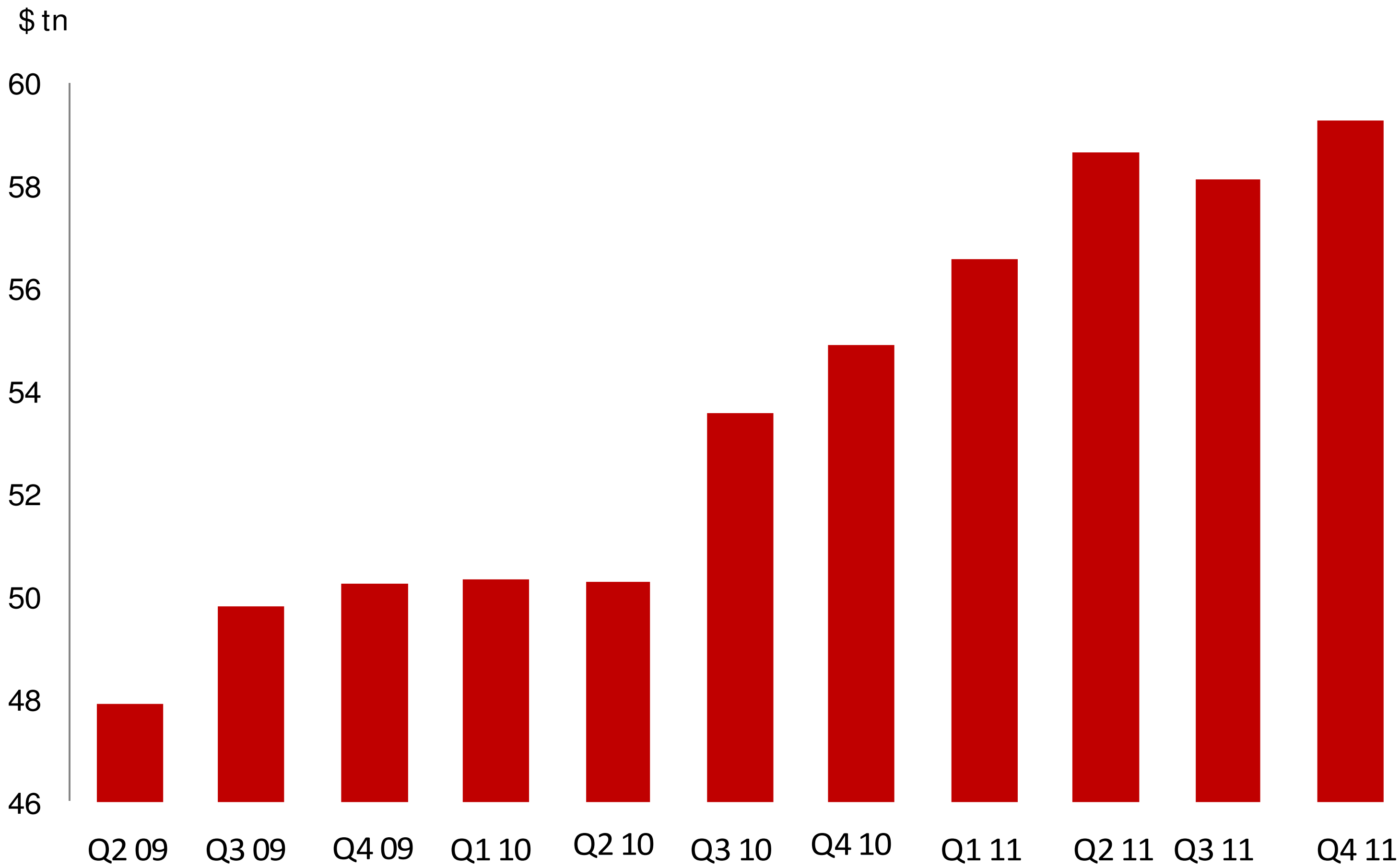
# A post-crisis perspective on rates




Source: Bloomberg; Nomura Global Economics

# Global money supply, M2

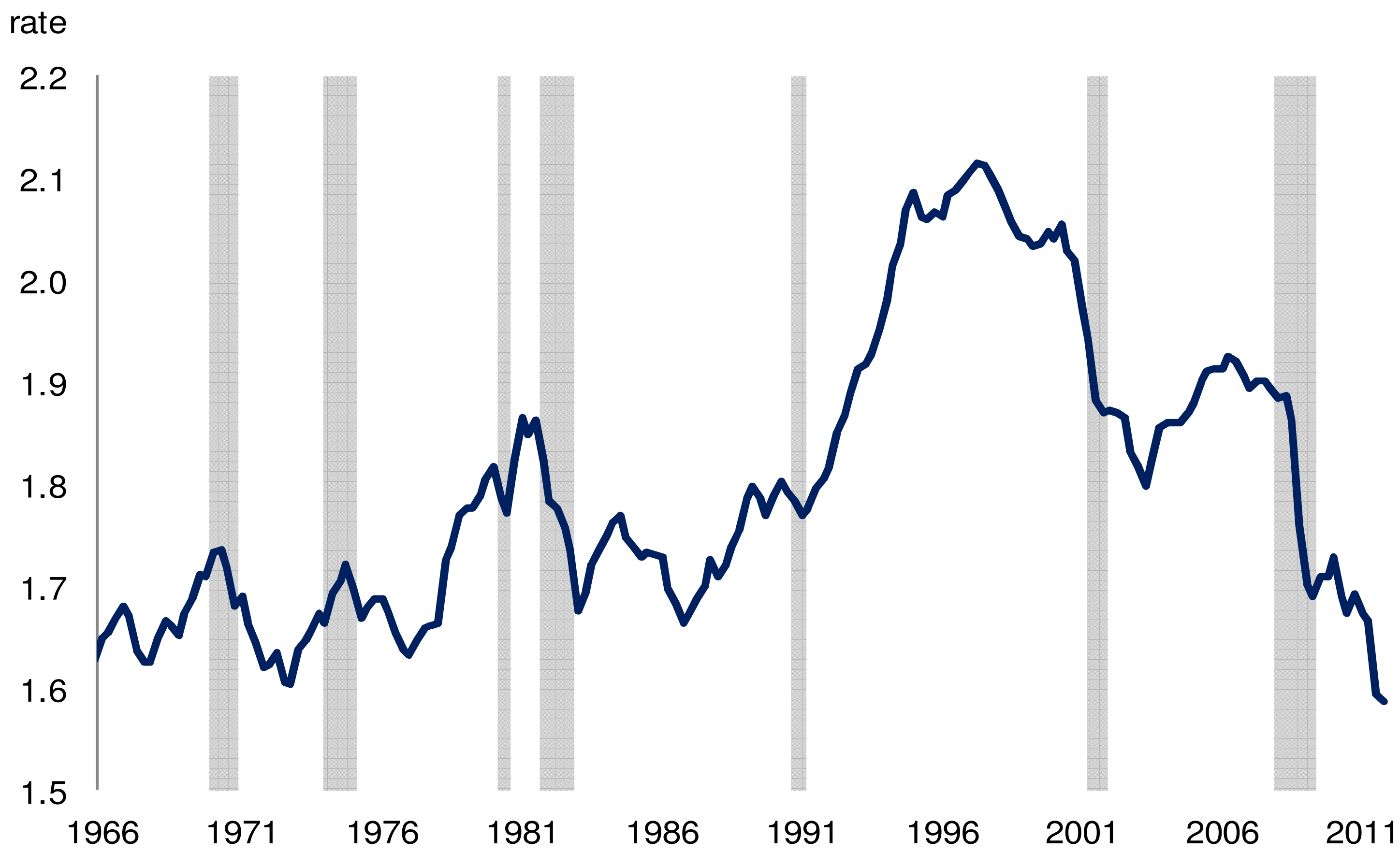
## abundant liquidity




Source: Bloomberg; Nomura Global Economics

# US money velocity

## the rate at which money changes hands (GDP/M2)



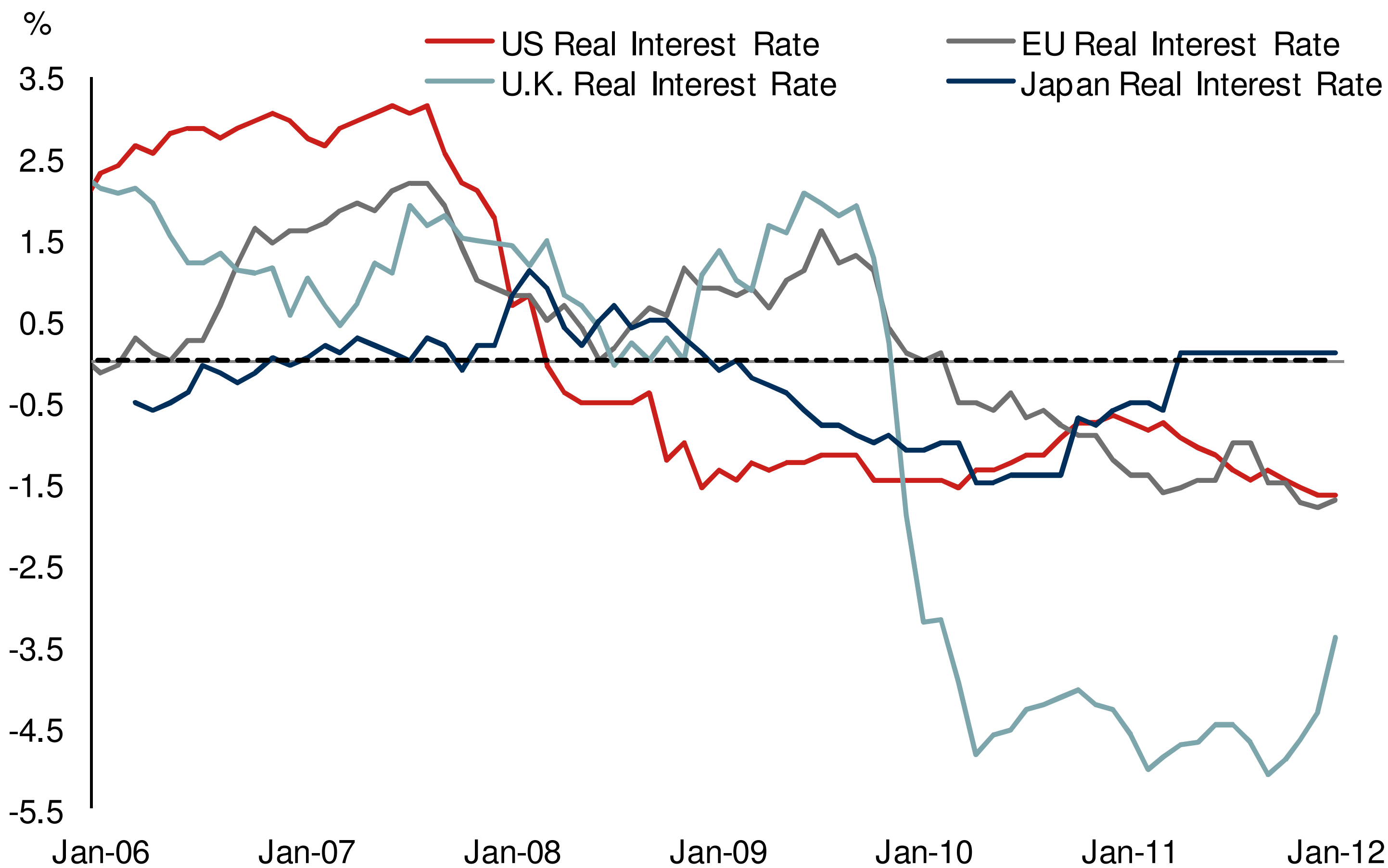

Source: Bloomberg; Nomura Global Economics

# Inflation monitor

| Country | Target Inflation Rate (%) | | | Central Bank Policy Rate (%) | | Output Gap(%) |
|---|---|---|---|---|---|---|
| | Target | Actual | (+/-) | Nominal | Real | |
| Denmark | -- | 2.8 | -- | 0.7 | -2.1 | -3.6 |
| Euro Area | <2.0 | 2.7 | 0.7 | 1.0 | -1.7 | -3.3 |
| Japan | 1.0 | -0.2 | -1.2 | 0.1 | 0.3 | -4.0 |
| New Zealand | 1.0-3.0 | 1.8 | In Range | 2.5 | 0.7 | -1.3 |
| Norway | 2.5 | 0.5 | -2.0 | 1.8 | 1.3 | -1.5 |
| Sweden | 2.0 | 1.9 | -0.1 | 1.5 | -0.4 | -2.5 |
| Switzerland | <2.0 | -0.8 | In Range | N.A. | 0.8 | -1.0 |
| U.K. | 2.0 | 3.6 | 1.6 | 0.5 | -3.1 | -3.9 |
| U.S. | 2.0 | 1.9 | -0.1 | 0.3 | -2.7 | -3.8 |

Source: Bloomberg; Nomura Global Economics. Note: Core PCE price index used as “actual” inflation rate for the US. Data through January 2012.

# Real interest rates: G-4




Source: Bloomberg; Nomura Global Economics

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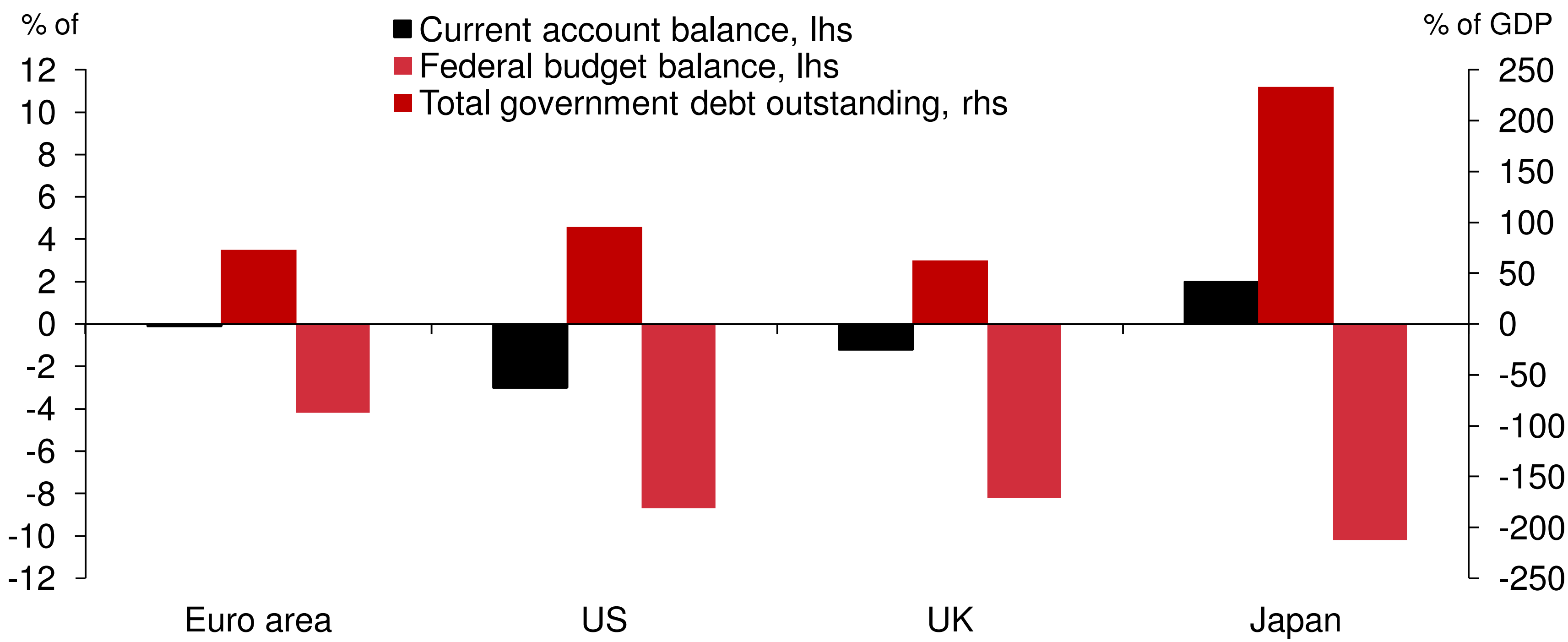
# A "United States of Europe" would not be facing a fiscal crisis

## Europe's fiscal crisis is a self-manufactured one: a product of an imperfect (monetary) union

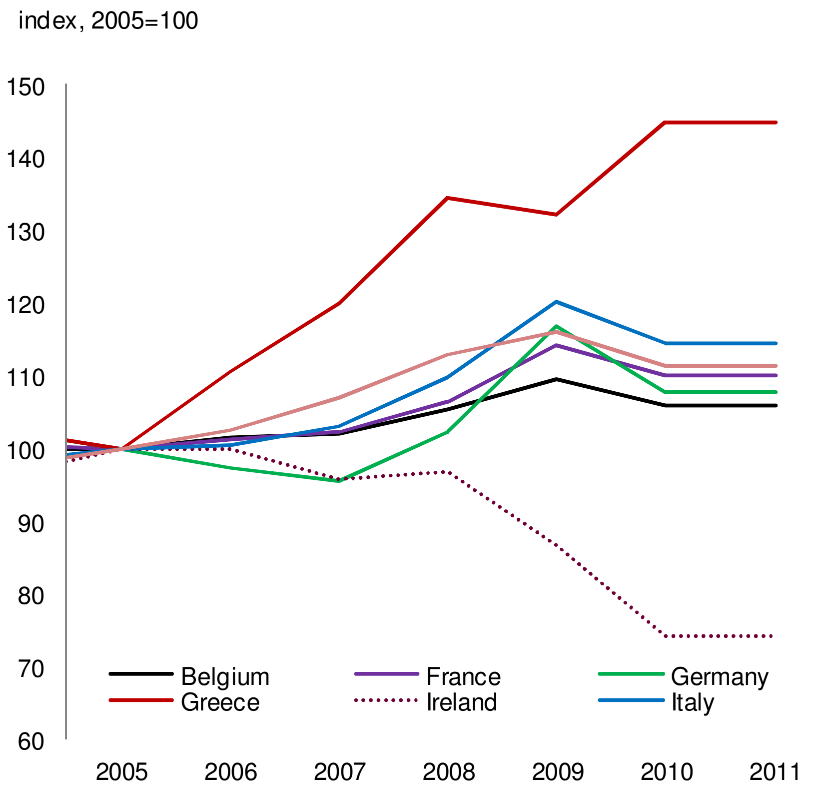
### Key macro indicators of fiscal conditions: Euro area, US, UK and Japan



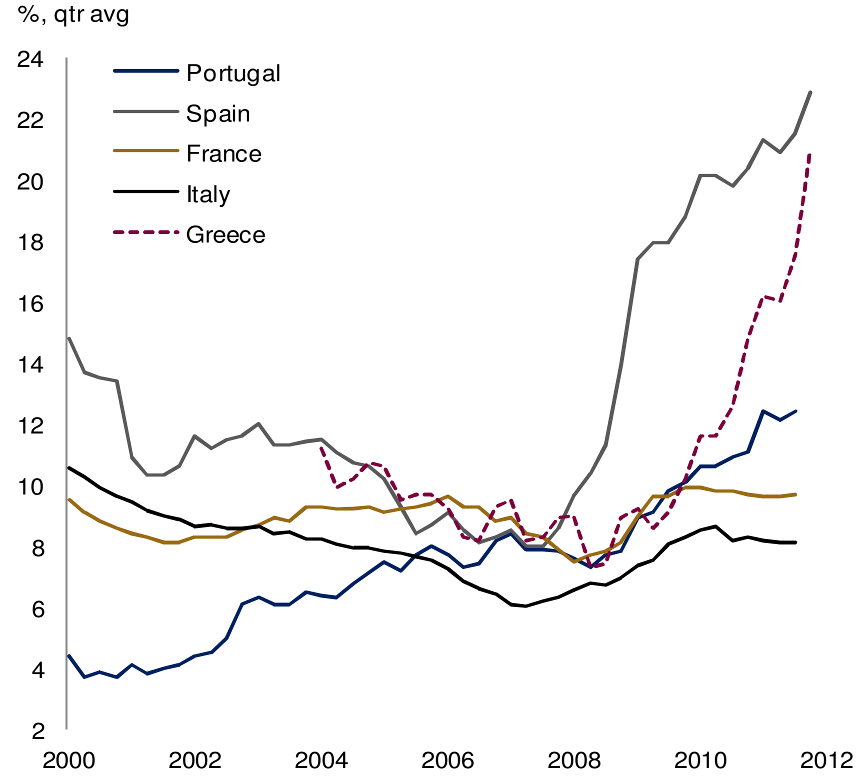

Source: Bank of Japan; US Treasury; Eurostat; Nomura Global Economics
Note: Current account and federal budget numbers are Nomura forecasts for 2011; government debt outstanding is actual data through Q2 2011 for US and Japan; Q1 2011 for Euro area.

# Europe’s internal competitiveness crisis

## Comparative European unit labor costs



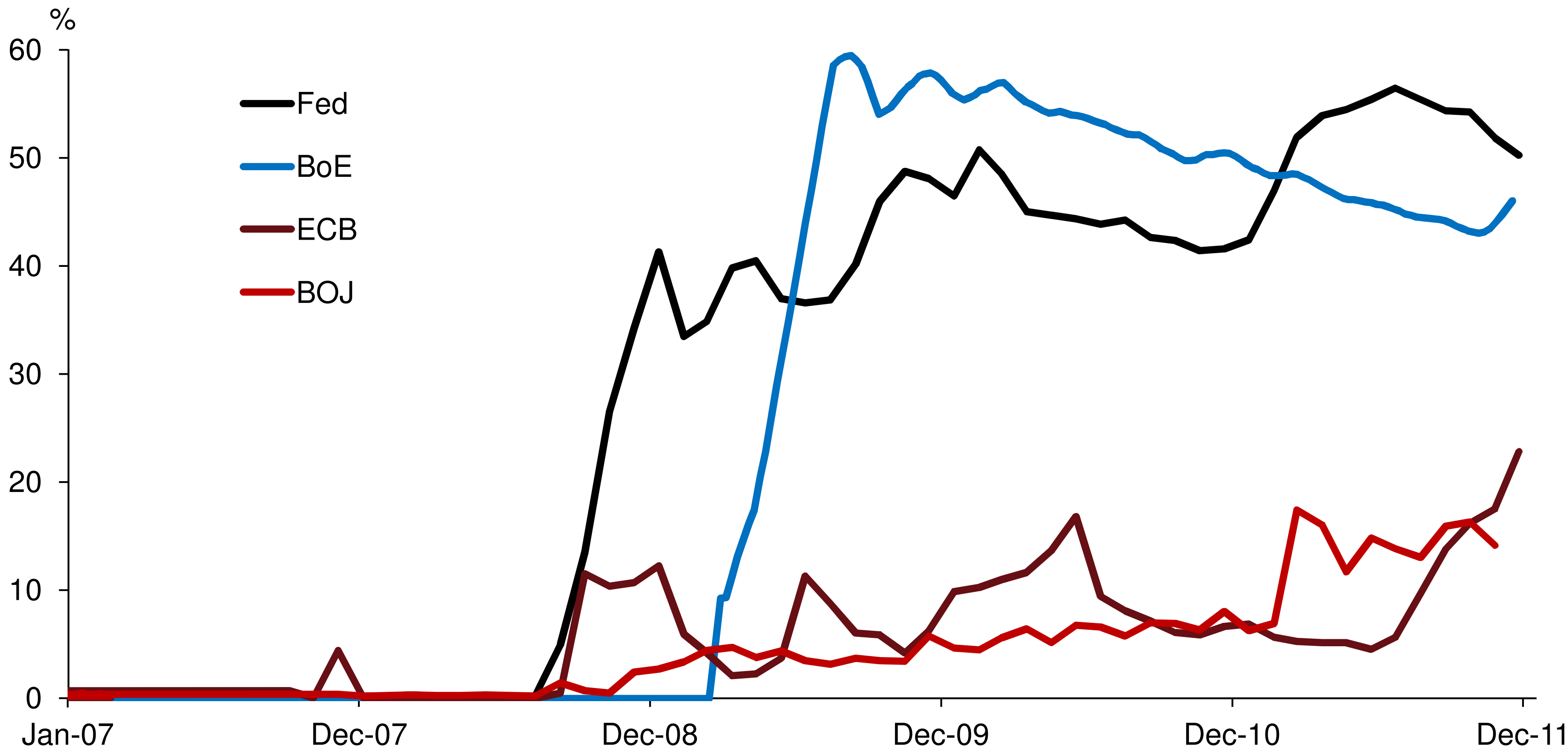

## Unemployment rates




Source: OECD; Nomura Global Economics

# ECB has room to engage in large-scale QE

**Excess reserves as a percent of central bank's balance sheet: ECB, Fed, BOJ, BOE**

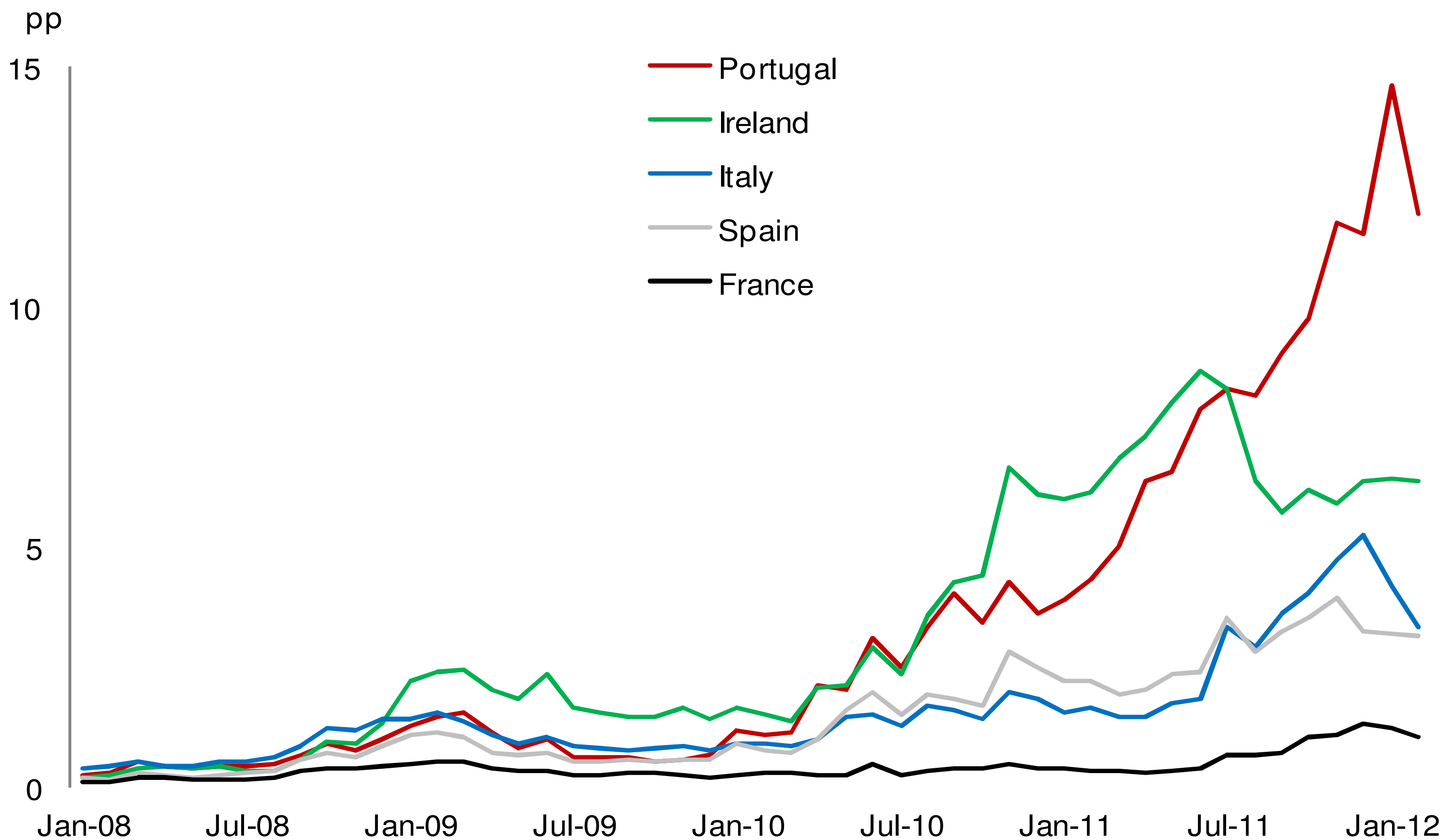



Source: Bank of Japan; Federal Reserve; Bank of England; European Central Bank; Nomura Global Economics

# Financial conditions have eased somewhat

## but remain a "significant" downside risk

### Sovereign debt spreads around Europe



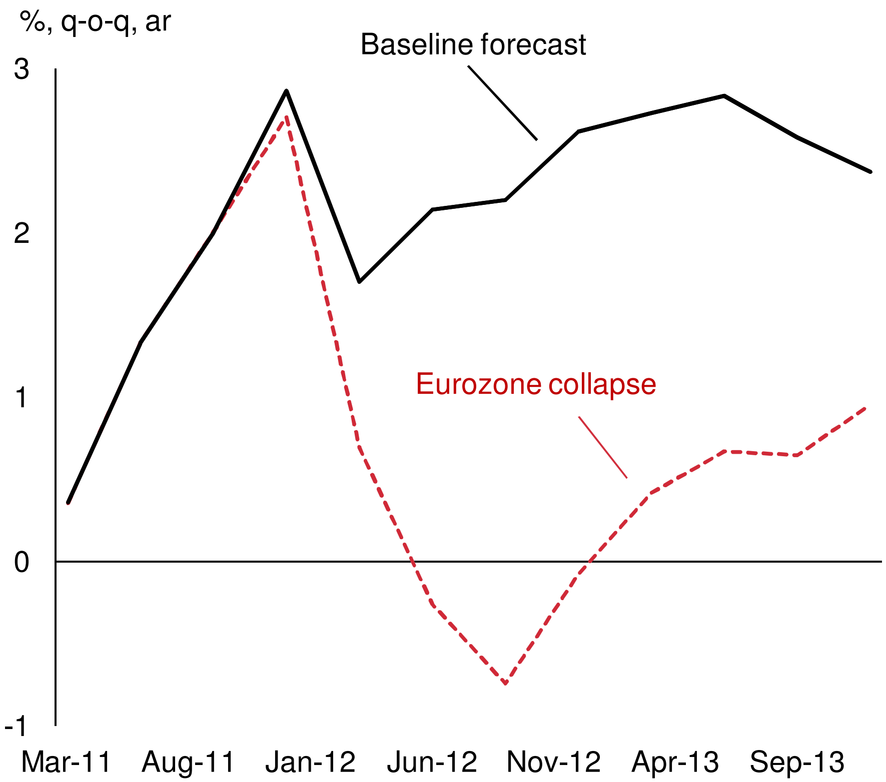

Source: Bloomberg; Nomura Global Economics

# Europe remains a tail risk for the US

- ECB liquidity injections have:
  - Eased pressures on financial institutions
  - Reduced borrowing cost for sovereigns
- But the euro-area economy is slowing
- Policy is still behind curve in delivering growth.
  - All the crisis countries, including Spain and Italy, face the challenge improving fiscal performance as the economy contracts
  - Greece has made significant progress, but much is unresolved
- The biggest risks to the US are financial
  - Spillovers to asset markets will be a restraint on growth
  - Net exposures of US financial institutions look manageable
  - But gross exposures are very large, posing additional risk in an extreme scenario

# Alternative forecast scenario: eurozone shock

## Baseline vs. alternative forecast



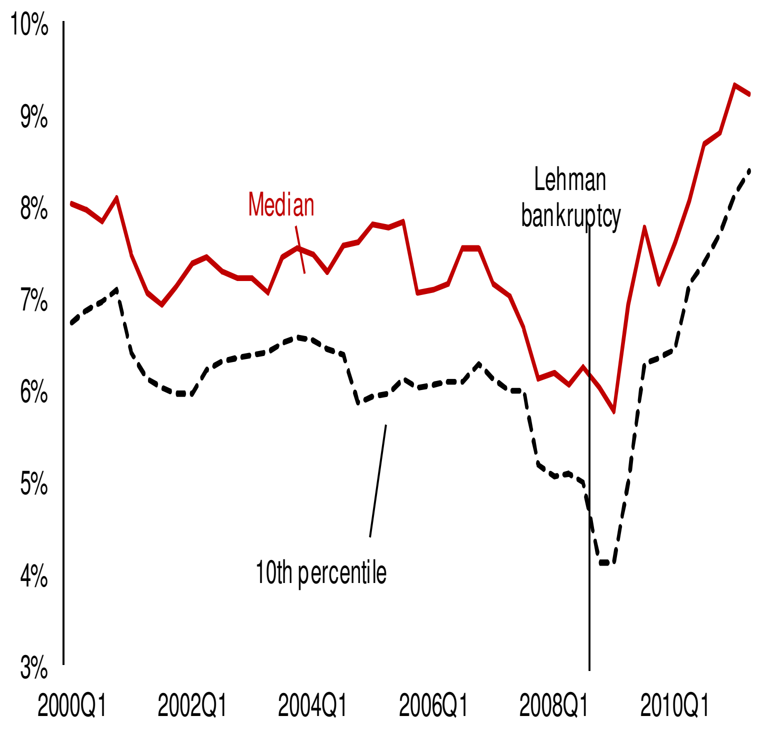

## Impact of euro shock on 2012 growth

| | |
|---|---|
| Baseline 2012 growth forecast (%, Q4/Q4 ar) | 2.2 |
| *Sources of reduced growth* | |
| Global GDP (pp) | -0.3 |
| US financial conditions (pp) | -1.1 |
| Stronger $ (pp) | -0.9 |
| US growth in Euro shock scenario (%) | -0.1 |

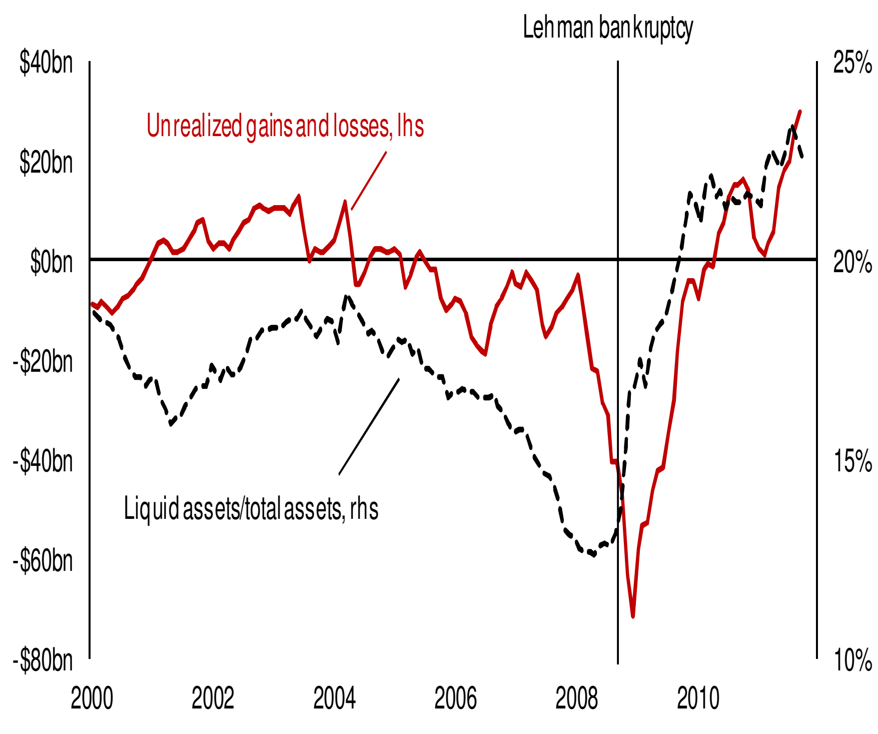
Source: Nomura Global Economics

# US banks are better prepared than in 2008

## Tier 1 common for large US banks




## Liquid assets & unrealized gains for large US banks




Source: Nomura Global Economics

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# Direct exposure to Europe looks manageable, but …

## Reported net exposure to high spread euro-area countries*, 2011-Q3

| Net Exposure to High-Spread Euro-Area Countries* | *(US$, billions)* |
|---|---|
| Citi | 16.3 |
| J.P. Morgan | 15.1 |
| Bank of America | 13.0 |
| Morgan Stanley | 3.4 |
| Goldman Sachs | 2.5 |
| **Total** | 50.3 |

* Greece, Ireland, Italy, Portugal, and Spain

## Gross exposure of large US banks (total claims, $bn)

| | Public sector | Banks | Other sectors | Total |
|---|---|---|---|---|
| **Greece** | 3 | 3 | 4 | 10 |
| **Portugal** | 2 | 3 | 2 | 7 |
| **Ireland** | 2 | 13 | 46 | 61 |
| **Sub-total** | 7 | 18 | 53 | 77 |
| **Spain** | 8 | 30 | 47 | 84 |
| **Italy** | 27 | 22 | 16 | 64 |
| **Sub-total** | 41 | 70 | 115 | 226 |
| **Belgium** | 11 | 18 | 10 | 39 |
| **France** | 30 | 204 | 58 | 292 |
| **Total** | 82 | 291 | 184 | 556 |

Source: Company Reports, Nomura Equity Research; FFIEC; Nomura Global Economics

# The policy tools for containing financial stress have changed.

The passage of Dodd-Frank, and the demise of TARP, mean that the government will not be able to replicate the policy response of 2008-09 if the financial system faces another crisis.

One objective of the Dodd-Frank Act was to make "bailouts" less likely.

- Dodd-Frank created new "Orderly Liquidation Authority" (OLA) under the FDIC to make it "easier" to wind down large financial institutions.
- Dodd-Frank also eliminated, or severely restricted, some of the policy tools that were important in 2008-09.
  - The Federal Reserve's emergency authority (under Section 13(3) of the Federal Reserve Act) was restricted.
  - The FDIC's authority to provide "open bank" assistance and issue non-deposit guarantees was restricted.

The absence of fiscal resources, with the expiration of TARP authority, also restricts what is possible.

- It seems extremely unlikely that Congress would appropriate funds to support the financial sector in the current environment.

# Major Programs: Pre-Lehman

| | Program | Federal Reserve 13(3) | FDIC | | TARP |
|---|---|---|---|---|---|
| | | | “widely - available” guarantees | “Systemic Risk” Exemption | |
| Aug-2007 | Federal Reserve Lowered the Discount Rate | | | | |
| Dec-2007 | Term Auction Facility (TAF) | | | | |
| Dec-2007 | SWAP lines with foreign central banks | | | | |
| Mar-2008 | Maiden Lane I (Bear Stearns) | ✓ | | | |
| Mar-2008 | Term Securities Lending Facility (TSLF) and Primary Dealer Credit Facility (PDCF) | ✓ | | | |

Source: Nomura; Department of the Treasury; Federal Reserve; Federal Deposit Insurance Corporation
Note: Yellow shading indicates programs that could not be implemented, as is, under Dodd-Frank.

# Major Programs: Post Lehman

| | Program | Federal Reserve 13(3) | FDIC | | TARP |
|---|---|---|---|---|---|
| | | | "widely - available" guarantees | "Systemic Risk" Exemption | |
| Sep-2008 | Federal Reserve Loan to AIG | ✓ | | | |
| Sep-2008 | Treasury's money market guarantee program | | | | |
| Sep-2008 | Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) | ✓ | | | |
| Oct-2008 | Commercial Paper Funding Facility (CPFF) | ✓ | | | |
| Oct-2008 | Capital injections to nine large banks | | | | ✓ |
| Oct-2008 | Temporary Liquidity Guarantee Program (TLGP) | | ✓ | | |
| Oct-2008 | Money-Market Investor Fund Facility (MMIFF) | ✓ | | | |
| Nov-2008 | AIG Loan Restructured (Maiden Lane II&II) | ✓ | | | ✓ |
| Nov-2008 | Term Asset-Backed Securities Loan Facility (TALF) | ✓ | | | ✓ |
| Nov-2008 | Citi "ring fence" | ✓ | | ✓ | ✓ |
| Jan-2009 | Bank of America "ring fence" | ✓ | | ✓ | ✓ |
| Feb-2009 | Treasury's Financial Stability Plan – Stress Test, expansion of TALF, HAMP, auto programs, etc. | | | | ✓ |

# Orderly Liquidation Authority (OLA)

## How OLA Works

- The Secretary of the Treasury, with the concurrence of Federal Reserve and FDIC Boards, can put a firm into FDIC receivership.
  - The Secretary must find that the firm in question is either in default or on the verge of default and that its failure would have serious adverse effects on financial stability.
- Once in receivership the FDIC takes over responsibility for running the firm.
  - Senior management is replaced.
- Once a firm has been put into receivership the FDIC can establish one or more bridge financial companies .
  - The FDIC can transfer assets and liabilities of the firm into the bridge financial companies.
  - Assets and liabilities that are not transferred remain in receivership.
  - The FDIC can fund the bridge financial companies in a number of ways, including by drawing funds from the Treasury and guaranteeing debt of the bridge companies.
- Counterparties with qualified financial contracts – derivatives, repos, etc – with the firm are prohibited form exercising their special rights under those contracts for two days.
  - This is designed to give the FDIC the opportunity to transfer those contracts to a bridge financial company thereby avoiding a messy unwind of those contract.
- The bridge financial companies can be wound down in an orderly way and/or they can be sold.
- Creditors with residual claims in receivership are paid out in order of priority.

## Key Points

- The FDIC has considerable discretion under OLA.
  - Dodd- Frank directs the FDIC to minimize losses and moral hazard.
  - But the FDIC also has a mandate to mitigate risk.
  - With these mandates, and the FDIC's near-complete discretion, a considerable range of outcomes are possible.
- OLA is intended to build on the FDIC's experience in dealing with troubled banks.
  - But the FDIC's experience with today's large, complex, global institutions is limited.
- OLA is likely to be less disruptive than bankruptcy largely because of the new powers to deal with qualified financial contracts.
- But there are a number of problems.
  - For the moment an important part of the system is missing.
    - OLA was designed to work with pre-determined resolution plans, a.k.a. "living wills."
    - Final rules for "resolution plans" have been adopted.
  - The biggest problem with OLA relates to cross-border issues.
    - Foreign regulators may be tempted to ring-fence operations within their jurisdictions if a US firm is put into OLA receivership.
    - US and foreign regulators are working on this problem but little progress has been made, in large part because different countries approach this problem very differently.

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