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Davos Diary

During the just concluded Annual Meeting of the World Economic Forum in Davos, Switzerland, Mr. Roach was invited by the Financial Times to contribute to their Davos blog. His five dispatches, all of which elicited vigorous feedback, follow below and the feedback can be found at http://blogs.ft.com/davosblog/

Will the Fed Rate Cut Work

22 January 2008

Timing is everything, I guess. No sooner had I arrived in Davos, when my Blackberry started chirping with alarms over an emergency 75 basis point Fed rate cut. No new news on the state of the US economy was evident. The only breaking development was a swoon in global equity markets that was likely to be reflected in the form of a similar plunge in the US. And so the Fed jumped into action. Borrowing a page from the market-friendly script of the Greenspan Fed, Bernanke & Co. offered up a market-friendly action of its own.

Will it work? That's undoubtedly the question that will be hotly debated this year in Davos – a question that I certainly plan to tackle at the opening session on the global economy tomorrow morning. The answer lies in the unique character of this recession. There are two triggers – a bursting of the US house price bubble and a bursting of the credit bubble. I do not believe that aggressive Fed rate cuts will resolve the extreme imbalance between supply and demand in the US property market that will be pushing housing prices lower for some time. Nor do I believe that recent Fed actions will restore the functioning of credit markets to their pre-crisis state. As a result, pressures are likely to remain intense on housing- and credit-dependent US consumers – a sector that accounts for a record 72% of US real GDP.

In essence, the Fed is "pushing on a string" here – unable to stop the recessionary dynamic now unfolding. But there will be consequences in the next recovery: Unfortunately, the US central bank can't seem to break out of the market-friendly trap it fell into nearly a decade ago. Panicking over the possibility that yet another bubble is bursting, the Fed is once again injecting liquidity into an asset-dependent US economy. That won't arrest the recessionary dynamic now unfolding but it could well set the stage for the next asset bubble in America's bubble-prone economy. Have we learned anything from the mess of the past seven years?

Decoupling or Globalization – But Not Both

23 January 2008

Dreams of decoupling danced in the air on this first official day of meetings at Davos. Decoupling, of course, is the latest macro fad – a scenario where the world no longer sneezes when the US catches a cold. The decoupling enthusiasts were out in full force at the kick-off session on the global economy on Wednesday morning. As a long-standing panelist in this session – with the exception of last year, when only optimists were invited – I didn't offer much support for this view.

My case is relatively simple. Developing Asia – where the growth dynamic is the strongest and the hopes of resilience are the deepest – remains very much an externally-dependent economy. For the region as a whole, exports hit a record high of 46% of GDP in 2007 – more than double the 19% share of 1980. At the same time, private consumption fell to a record low of 48% of pan-regional GDP in 2007 – down sharply from the 66% reading in 1980. If the fast

growing economies of East Asia were truly decoupled, these trends would be the opposite – exports would be falling and domestic consumption would be rising.

The decoupling crowd also dreams of alternative sources of global consumption arising from Asia's two new giants – China and India – that would be more than sufficient to offset a shortfall in US consumption. Don't count on it. The US consumed over $9.5 trillion in 2007 – fully six times the combined consumption totals for China ($1 trillion) and India ($650 billion). It would be almost mathematically impossible for "Chindia" to fill the void that is likely to be left by a consolidation of the American consumer. For externally-led developing Asia, the proverbial sneeze in the face of a US cold is more likely than not. Maybe that's what the recent sharp correction in Asian equity markets is all about.

In the Q & A part of the session, howls of protest came from representatives of Latin America, Central Europe, and even Asia. The European decoupling advocates accosted me in the halls outside the session. Yet globalization, long the mantra of Davos, is all about increased integration of the global economy through trade and capital flows. As I said to one of the more hopeful, "You either believe in decoupling or globalization – but not both."

Being Right on the Economy – At Last

24 January 2008

At the end of a long first day in Davos, one phrase is ringing in my ears: "Well, you're finally right." The subtext, of course, is a thinly veiled critique of my long-standing bearish view on the US economy – an economy that I have characterized repeatedly as unbalanced, income-short, overly indebted, saving deficient, bubble prone, and all those other lovely attributes of a nation that I believe has long been living beyond its means.

Of course, the jury is still out on whether this is that proverbial moment of reckoning. It certainly feels like the Great Moderation is now giving way to the Great Unraveling. But I've been through enough of these situations over the years to know that you can never under-estimate the inherent resilience of a Teflon-like US economy. America has dodged tough bullets before and it could certainly happen again. But in the aftermath of the simultaneous bursting of monstrous housing and credit bubbles, my macro framework is finally flashing something darn close to a breaking point.

Small consolation, some might say. After all, for traders and short-term oriented investors, being early is often judged as the functional equivalent of being wrong. On that basis, I would be the first to concede that my bearish call on the US has been lacking in one critical respect: While the events that are now unfolding suggest that my basic macro framework appears to have been correct, I have hardly distinguished myself in getting the timing right.

Confession time. At the risk of sounding overly defensive, my own experience is testament to one of the greatest flaws of macro – the timing dimension of any call. Let's face it, with few exceptions, we macro folk are not good traders. My approach has always been grounded in analytics – focusing more on the tensions that arise from economies in disequilibrium. My basic supposition is that these tensions can eventually reach a breaking point, triggering corrections that return an economy to a more sustainable equilibrium. The hows and whys of that breaking point, or trigger, are invariably the stuff of exogenous shocks – the bolt from the blue that I find almost impossible to predict with any accuracy.

The key for me is the framework and the tensions. Get those right and you stand a much better chance of nailing the big macro calls. The risk is that you're always early. But when the turn finally comes, you are in a much better position to understand it and to be prepared for the consequences. Being "finally right" has its benefits too.

SWFs: Can Beggars Really Afford to be Choosey?

25 January 2008

Why all the fuss about Sovereign Wealth Funds? This is one of the thorniest issues being debated in Davos this year. And there was plenty of tension in the air in a packed session on Thursday morning, when representatives from several leading SWFs came face to face with an anxious West.

It's not so much the scale of this new class of investors – with SWF assets under management currently estimated at around US$2.9 trillion and likely to climb to US$12 trillion by 2015. It's simply the fear of foreign ownership posed by this increasingly powerful group of state-controlled asset managers. Sadly, it boils down to nothing more than a thinly veiled manifestation of financial protectionism.

The pushback on SWFs from the United States is especially disconcerting. A saving-short US economy is the world's largest external borrower – still requiring roughly US$3 billion of foreign capital inflows per business day to fund a massive current account deficit. Traditionally, those inflows have been lodged primarily in low-yielding US Treasuries. But America's foreign lenders – largely poor developing

countries – have become rightfully convinced in recent years that they need higher yields on their investments. And, so, following the basic precepts of modern portfolio theory, diversification into higher-yielding assets is now under way.

This is the red flag for protectionists. The experiences of the ill-fated foreign acquisition attempts of American assets by China's CNOOC and Dubai Ports World still ring in the air of an increasingly xenophobic body politic in the US. Yet this is not the template for SWFs. In fact, there is not one shred of evidence of an SWF recently deploying its capital for strategic or geopolitical purposes. Their interests are largely in minority, nonvoting stakes that provide relatively high and safe rates of return. As one representative of a leading SWF from the Middle East protested, "These fears are based purely on assumption." Fair point.

Some Western politicians are demanding that, at a minimum, SWFs agree to a new code of conduct that establishes their collective commitment to basic principles of transparency, potential conflicts, and other dimensions of corporate governance. Rather interesting that the same demands have not been made on hedge funds and private equity investors. But an even deeper question emerges for saving-short Washington who seems quite willing to dictate both the terms and the form of capital that is received from America's foreign lenders: Can beggars really afford to be so choosey?

You Can't Keep a Good Optimist Down

26 January 2008

It's hard to keep a good optimist down. And they didn't stay down for long. Over the course of this year's World Economic Forum, there was a distinct mood change. As I read the Davos crowd, the sentiment seemed to shift from despair on Wednesday to guarded optimism by Friday.

I have to confess that I don't always trust myself as an objective barometer in reading the collective mindset at such a large gathering. So I checked out my assessment with a few trustworthy and objective observers, and they corroborated my observation.

As one of the kick-off speakers on Wednesday, I guess I played a role in setting a rather dour tone at the beginning of this year's events. For a few hours, I encountered no pushback whatsoever from those passing in the halls. But then the crowd started to get more aggressive in challenging my case.

The main reason behind this mood swing was trust in the authorities. The combination of a shockingly aggressive Fed easing, together with quick US congressional agreement on a $150 billion fiscal stimulus package, left the Davos crowd feeling that not all was lost on prospects for the US economy after all. Suddenly, the recession call that seemed so convincing on Wednesday seemed far more unlikely on Friday. And if the US is able to skirt a downturn, went the argument, then the global decoupling debate was suddenly irrelevant.

I was quick to counter. Arresting the recessionary dynamic now under way in the US is not like stopping a washing machine in mid-cycle, I argued.

The two powerful forces now at work – the bursting of property and credit bubbles – are not likely to be arrested by aggressive monetary and fiscal easing. As the support from asset markets and easy credit wanes, housing dependent American consumers still seem likely to bring consumption into closer alignment with income generation. This rebalancing should, in turn, lead to a meaningful reduction in the record 72% of US real GDP that is currently earmarked for personal consumption – the critical ingredient in the Recession of 2008.

In part because of lags, Washington's policy package should have more of an impact on the next recovery. And there are no guarantees that such impacts will be quite the ray of sunshine the Davos crowd was starting to envision.

Aggressive monetary easing sets the stage for yet another bubble-led recovery. And fiscal stimulus for a saving-short US economy puts the onus, once again, on foreign lenders to pick up the tab. In short, it's "same old, same old" in Washington – hardly a comforting sign that US authorities have learned much of anything from another bubble induced implosion.

As I was leaving the Congress Centre for the final time this year, one of my oldest central banker friends pulled me aside. "You were too hard on Ben (Bernanke)," he said. "He really had no choice other than to act in support of the markets. I would have done the same." Around the world, market-friendly central bankers stand shoulder to shoulder in their penchant to keep the magic alive for an asset-dependent world. Time to get out of town.

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