

Crisis Temperature Readings Mixed

There are mixed signals emanating from the money markets. On one hand short-term interbank rates have eased. On the other hand rates remain high. Similarly while some unsecured interbank lending is being reported, it seems the size remains small and limited to a handful of participants.

Weekly data from the Fed is similarly mixed. Total borrowing from the Fed fell by almost \$19 bln dollars in the week ending Wednesday. Of note, funds used for the asset-backed commercial paper program and money market fund fell by \$15.4 bln and lending to primary deals fell by almost \$20 bln. These were partly offset by an increase in lending to primary dealers and AIG. However, the level of borrowings overall and by individual facilities remains high. In some ways the borrowings are among the measures of the temperature of the crisis along with excess reserves. (The \$145.7 bln increase in excess reserves over the past two weeks is greater than the previous eight weeks combined.)

This underscores in some ways the difference between the US now compared to Japan during both Japan's financial crises in the 1990s and the US now compared to the US in the Great Depression: money supply is growing. M2 is growing 6 percent year-over-year. The monetary base growth is accelerating. The Fed's balance sheet has doubled to 1.8 trillion from the start of the year.

Many people are worried about the inflationary implications of these developments. Indeed the 5yr-5yr forward (a measure of inflation expectations) has risen sharply in the past two weeks. It bottomed on Oct 8 near 168 basis points before rising to almost 223 basis points earlier this week.

Inflationary fears, it seems though, are exaggerated. First, the money is not chasing goods. It is being taken out of circulation (see rise in excess reserves). Many monetarists take velocity as constant. It is not. Velocity appears to have slowed.

More importantly, the growth in the quantity of money most likely does not offset the incredible destruction of wealth that has taken place or the massive de-leveraging that appears to be continuing.

The risk remains that policy makers are still in denial. We have noted the IMF economists' study of crisis and see the average (with admittedly great variance) cost of a banking crisis is 16 percent of GDP.

Sixteen percent of the combined GDP of the US, UK and euro-zone is about \$4.5 trillion dollars--roughly the size of Japan's GDP. How much have officials paid down to this arguably more realistic estimate, especially because there is good reasons to believe this financial crisis is worse than average?

What should not be counted are guarantees or backstops or short-term lending (which is really just an asset swap). What should be counted is what was called 'real water' during Japan's banking crises, which were real new expenditures.

The real risk in the current situation is not that officials are doing too much, but too little. The risk is that officials continue to be slow to appreciate the magnitude of the deflationary winds that are blowing.

In the foreign exchange market the dollar's strength is a function of the de-leveraging process, though it does appear that some opportunistic momentum traders have jumped aboard the dollar express. The yen of course is also a major beneficiary of the de-leveraging process. The emerging market currencies have been hit exceptionally hard. Consider that in the past month the Icelandic krona has fallen about 22 percent in the past month. The Turkish lira has fallen almost 27 percent in the same time. The Polish zloty has fallen almost 25% as has the Hungarian forint. The South African rand has lost a bit more than 26 percent of its value against the dollar over the past month and the Mexican peso has lost over 20 percent.

The G10 currencies, save the yen, have fallen against the dollar and, excluding the Swiss franc, another financing currency, have fallen by more than 10 percent over the month.

As the de-leveraging process continues, so will dollar strength. (A 50 bp rate cut by the Fed is likely to be delivered before the end of the month is also a symptom of the crisis and thus may not be as dollar negative as a focus on policy rate differentials might suggest in other circumstances. Moreover, early next month, a matching 50 bp cut by the BOE and ECB appear to be the most likely scenario. That said BOE Governor King's recent candidly gloomy speech and his penchant for surprising the market, support speculation of a larger cut.

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