



# FEAL Review

A former economic advisor to the White House, Pippa Malmgren spoke to FEAL members at the Fund Executive Forum in March 2008 about **'Global Financial Markets 2008 and Beyond'**. Following is a transcript of her presentation.

Good morning. I'm particularly glad to be here today, and very grateful to Deutsche Bank and DWS for bringing me down at this time for two big reasons. One there is just so much going on to talk about, even just in the last week. Things that are materially influencing the global outlook have occurred and also because everywhere I go in the world, one of the first questions I get is what are those Australian pension funds and superannuation funds going to do with their money? I think everybody in the global community understand what the Americans and the Japanese are going to do with their money, but they're not so clear what you are going to do. So it's very interesting to have the opportunity to talk to you.

In the work that I do, I basically spend my life on airplanes and I run around the world and I talk to policy makers and people who are managing money at the front end of the financial markets, hedged funds, traditional fund managers, corporate treasuries and pension funds. And so I'm in the middle of a very interesting conversation and I'm finding that right now there are a lot of disconnects in that conversation. The perception of what reality is requires discussion. That is what I'm going to do in the next 25 minutes, very, very quickly race through a lot of material with you about what is the nature of the problem we're in, what's the diagnosis and where do we go from here so you can make some better judgments about where to deploy your capital.

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I think the first thing is that there is a clear disconnect on the nature of the problem we currently face.



Most people in the market, and certainly in the media, think that we're looking at a sub-prime problem that's related to mortgages in the United States.

This is not how the Federal Reserve sees it; it's not how any of the central banks I know see it. They see it in the following way: what has occurred is a profound change in the cost of capital.

You can try and identify what caused the cost of capital to suddenly rise; I would personally date it to the May US Treasury Auction where the Chinese did not come. Everybody knew the Chinese were going to diversify away from US dollars, US treasuries but to not come at all was quite a shock. It was the moment that I see the financial markets began to reprice capital.



But whatever you identify as the kick-off, it happened about in the Spring and it slowly gained momentum until it really showed by August when we had the crisis that was reported globally. This is a critical element of your thought process because if the diagnosis of the problem is that the cost of capital has gone up, and it is not going to go back to where it was, then the impact is very different than if it's a contained sub-prime mortgage problem.

### ***The media wrote about the mortgages because everybody understands what a mortgage is, and the media understands what a mortgage is.***

This is one reason why we saw the first impact was in the mortgage arena but also in the low-grade corporate debt. Naturally when the cost of capital goes up, it affects the most leveraged elements of any financial market and those two areas happened to be where all the leverage was. The media wrote about the mortgages because everybody understands what a mortgage is, and the media understands what a mortgage is.

But probably the bigger damage has occurred in the realm of low-grade, highly leveraged corporate debt and that is where most of the big financial institutions have incurred their greatest losses rather than the sub-prime arena, but that's harder to write about. It also explains why we're now moving way beyond losses in these two areas and we're beginning to see losses occurring in places like we've seen in the last week, a meltdown in the municipal bond market where there's just no bids. And that has to do with, again, the cost of capital rising.

If the cost of capital has gone up, then it affects not just financial institutions, it affects the dry-cleaner on the corner, their ability to raise capital to build another dry-cleaner shop or to even rollover the debt that they currently have.

I think starting in about mid-December most of the big banks started to call their customers. I think here in Australia, certainly in Europe, in the UK, definitely in the US, to say if you're a retail customer, if you've got an overdraft, you have got to cut it in half within six months. So we won't know for another four months at least whether people have been able to pay down that line of credit or not. The same thing applies to the corporates. If you've got a line of credit, you've got to really cut it the line in half within six months. So we're only just at the beginning of the process where you can begin to assess and realise what kind of losses are really involved. That's another reason the financial markets are seizing up somewhat with that degree of uncertainty. This puts the Federal Reserve in particular, and I'll talk about them in particular, but it affects a lot of central banks obviously, puts them in a very awkward position. On the one hand they know that this is an insolvency problem, it's not an illiquidity problem. In other words, rate cuts may not save a lot of these entities where the whole business model was built on the assumption that capital cost a certain price and that it was freely available.

Now it's not freely available and it's cost us up here, it blows up the business model not only for some banks, but some dry-cleaners. The whole range of economic activity in between, and not just in the US but globally. But can they say, well sorry, you know, it just ... wrong place, wrong time, you know, you've got to face the music? No, the Federal Reserve cannot do that, and they do want to try to protect the real economy from the damage that's been caused by this leveraged situation. But do they think that rate cuts alone will fix it? In my judgment they absolutely do not believe that.

There is a political dynamic here I'd like to spend a moment with you on, because this is the one piece of the puzzle I think most financial players are missing.



It's probably the most important part of what we're witnessing. Congress in the United States is of course in the midst of a major election process which has been on your TV screens this week, it's not just the presidential race, it's also all of Congress and one-third of the senate are all up for re-election at this next opportunity in November.

If I am a Member of Congress, here's how I see the landscape right now. I say wait a minute, who received the sub-prime loans? Those were mainly African-Americans and Hispanics in urban areas, right? That is the sub-prime community in the United States and so these guys have been deprived of the American dream of home ownership. This is my single most important constituency for the next election, and who has deprived them of this dream? That would be Wall Street and financial institutions who have been making record bonuses over the last few years. Politically this is a nightmare from a market point of view.

When I worked in the White House during the last crisis, when we had the dot com bubble burst and we had seven of the nine largest bankruptcies occur in 12 months in American history, it was a very traumatic period. And I remember learning firsthand what politics are like when you go from a boom to a bust, and we should understand the context of this. Let's go back a couple of boom and busts, because the pattern is incredibly clear although people aren't necessarily seeing it.

If we think of the Savings and Loan crisis, boom to a bust, lots of innocent people got hurt. The politicians felt a need to then get engaged, to protect the public from this ever happening again. So the New York State Prosecutor, who's important because all the financial institutions are based in New York for the most part, so the New York State Prosecutor at that time is Rudy Giuliani and Rudy Giuliani, identifies who caused this, who facilitated the SNL crisis? That would be Mike Milken in the high yield bond market. So he goes after Mike Milken, who ends up in jail, the high yield bond market hits the wall for a period of years, which in my view prolongs the subsequent slow-down. Rudy Giuliani is launched onto a path that allows him to run for the Presidency, that's how it starts.

Fast-forward to the next big crisis, 2001 dot com bubble, bankruptcies, who's in the job? Elliot Spitzer and Elliot Spitzer says who made this happen? And his focus is on chief executives who have not revealed properly in the accounts what they've been doing. So he goes after Ken Lay at Enron in particular, who would've gone to jail but he dies of a heart attack first (laugh). We know that corporate executives stop taking risk for a period of time partly because we have Sarbanes-Oxley which makes it so difficult for them to be risk takers, which in my view prolongs that slow-down as well.

***The problem is, once the financial regulators enter your institution, they find all kinds of things that they were not looking for.***

So here we are today, who is in the job now? Andrew Cuomo is the New York State Prosecutor. For those of you who don't know, Andrew Cuomo's father was the Mayor of New York. He was married to one of the Kennedy grandchildren. He is very politically ambitious. If you don't think he's sitting in his office saying this is a home run to the White House, think again. This is easy too, because do I think that during the boom some financial institutions crossed the line? Of course I think they did, so I'm going to go after those that I think may have crossed the line. That office has now issued subpoenas to all 14 of the largest banks in the United States. All of them have acknowledged receipt of those subpoenas. This is not getting a lot of press coverage because subpoenas doesn't sound very interesting to the media, it's only when the prosecution begins. But there's a discovery process that takes time and we're at the beginning of that whole game.

The problem is, once the financial regulators enter your institution, they find all kinds of things that they were not looking for. So this is going to be a period when the process of extending capital is weakened not only through financial market uncertainty but also now we've got a litigation and political process in motion.



My personal view is that having been through Sarbanes-Oxley, although I personally fought very hard against it at the time, for which I was labelled a friend of the corporate criminals (laugh), but I felt it was going to go too far and it was going to damage the willingness to take risk, it was a necessary event to restore the political balance. I think now we're in a similar situation, there will have to be some kind of political conclusion to where we are right now. That process is being delayed by the election, but you can see what's coming.

This is not only going to be about prosecuting those who have crossed the line, it's going to be about moving the line. I want to emphasise this strongly because this is exactly what John Kenneth Galbraith writes about in his book about 1929. It's exactly at the moment when you need the markets to function efficiently that politics tries to move the line so that markets don't function as efficiently.

And we can see this in the rhetoric in the election, this last week Barack Obama was quoted saying, ... "what we've witnessed in the mortgage problem, the sub-prime problem is not a normal part of the business cycle, it is a failure of leadership". And he's not talking about political leadership alone, he's talking about the financial community leadership as well. So I think we have to build into what we're looking at, this kind of shift in the playing field and the rules of the game are going to change. Because too many people have been hurt by what's happened.

***"What we've witnessed in the mortgage problem, the sub-prime problem is not a normal part of the business cycle, it is a failure of leadership" Barack Obama***

Now, let's take this to the Federal Reserve level. So now the Fed knows, okay, this is going to be a political nightmare, rate cuts alone are not going to fix the insolvency problem, so what else do we need to do? And this is one of the reasons why I think they have been at the forefront of encouraging the White House and the Treasury to come up with a fiscal solution, because their view is the market can't clear these broken assets all by itself.

There is going to need to be some kind of fiscal response. This is very difficult if I am a Member of Congress. They have to say oh, okay, so these institutions have hurt the people I care most about and you want me to take their taxpayer dollars and give it to the guys who hurt them? This just politically doesn't play, so that's another reason why it intensifies the pressure for litigation and prosecutions to begin.

Again, as an aside on this, watch these legal cases. We've already seen one of the mortgage originators has settled, basically turned states witness for Andrew Cuomo's office against one of the biggest players in the financial market, you know, people are going to be trying to save themselves and so we're going to see a lot of cases that ... where the parties are not necessarily aligned in their interests.

Back at the Federal Reserve, the other big issue is Congress is bearing down on them. I'm going to put this in incredibly simple terms, but if I am, let's say, Bernie Frank, the Democratic Head of the Financial Services Committee in the Congress and I'm talking to Ben Bernanke when he's giving us testimony, the essential message that I am saying is, "Mr Bernanke, do not tell me you are even thinking about the word inflation which is a hypothetical issue that I once read about in a textbook, tell me you're going to save my constituents".

There is one view that part of the reason the Fed is cutting rates so hard, so fast now is because Ben Bernanke realises he is up for reappointment one week after the new President arrives in office, and the new President many people think might be a Democrat, and therefore there is a certain pressure there. Personally I don't think that that's right, but I know that perception exists and it's very, very important.

I'd say the bigger issue is if the Fed doesn't keep cutting rates, Congress is going to scrutinise them much more heavily, which equals an erosion of their independence, and that is one thing they don't want.



So there is a political dynamic in spite of the fact the Federal Reserve is independent. So this is the broad landscape.

Let me quickly say the election process is going to be very material to the outcome, because what we're seeing is essentially two options being presented to the American public. One option is what the Republicans are putting on the table, which is yes, we've got a problem, yes, we may need to have a fiscal solution, but the rules of the game are not fundamentally wrong and don't need to be changed. Whereas the Democrats, whichever one we're going to end up with, and it's very, very close, where they're saying we must absolutely change the rules of the game. This is going to change ... depending on the choice America makes, it's going to change the cost structure for business, so it's a very big issue for international investors.

Also, I would point out that America remains a country with a massive current account deficit and traders all over the world in recent years have said to me you know, you Americans, you spend more than you earn, you're going to have to tighten your belt and stop buying so much stuff, right, in order to fix it. Well that's one choice, that's one possibility for fixing it, but there is another and I think it's the one America's choosing, and that is to opt for inflation. Now inflation, in my view, won't help the people who've just been hurt, the people who have lost their homes, who are not able to access the credit markets but politically it's a much nicer choice than the "you must stop buying stuff" option, the slowing GDP option. Look at the price action now in the markets, the price of gold, the price of commodities, and the falling value of the dollar, all of which are signals that we're in a more inflationary environment. And there, in my view, is quite a big punch-up going on in the Fed right now between those who are genuinely concerned about inflation, currently being led by Richard Fisher, and those who are saying we cannot worry about inflation for the time being, we've got to do what's necessary to prevent a recession.

You need to make a choice about which is it that you think is correct? Because I think on the one side, you need to think about the mathematical calculation of inflation in the United States currently doesn't include food and energy.

We stripped those items out of the calculation back in the early 1990s, when these prices were very volatile, which was messing up the final number. But now those prices are no longer volatile. Those prices go up and they just stay up, they keep going higher. This is why Alan Greenspan says, we ought to put these items back into the calculation.

If you do this you get interesting results. I direct you to a website run by, John Williamson called Shadow Government Statistics. You can Google it and it'll pull up his work. He's the guy who's been working in the US Government for years, calculating this number. Now he runs his own firm and he says based on the old methodology, if you keep these items in the equation, the current rate of inflation in the United States is nearing 8% which is a rather terrifying number. If that is true, then we are looking at a negative real interest rate environment right now. This tells you to buy assets, and perhaps that's one reason the equity market remains strong in spite of the belief that we're about to go into a recession.

***India and China are no longer exporting deflation, they're exporting inflation. We are seeing this in lots of different ways. You see a lot of upward pressure on wages in both places, but across the emerging markets.***

But it's kind of one or the other. Either we're in that environment I've just described; negative real interest rates and looming inflation or we're on the edge of a recession. It's kind of hard to be in both.

So, that's a big decision that everybody needs to make because all your investment decisions will arise from this initial choice.

I also want to spend a second or two talking to you about inflation globally. After the fall of the Berlin Wall, we had the entrance of billions of new people into the world economy.



This pushed down wages and prices, and that must still remain so because not everybody in the emerging markets has fully entered the world economy. So we can rely on a downward pressure for a while yet at least. This is the commonly held view.

But that is not the view being held at the Federal Reserve and among most central banks. Their view, and I think Alan Greenspan described it best recently, where he said once you plug them in, the billions of new workers, the game is over, the benefit is gone. He said in fact, once the rate of new additions of workers begins to fall, new additional people in the workforce, that's when it's over, you don't even have to wait 'til they're all plugged in, it's the pace that matters. And in his view, that came to an end last year.

So now, India and China are no longer exporting deflation, they're exporting inflation. We are seeing this in lots of different ways. You see a lot of upward pressure on wages in both places, but across the emerging markets, this week alone Vietnam has announced they're going to have significant wage increases because they're so worried about strikes and civil unrest because wages are not keeping pace with the official 12.5% inflation rate or if it's really higher than that.

***These things are important in the puzzle because they reveal that the geopolitical landscape is not quite as take it for granted as it used to be.***

In China yesterday, Wen Jiabao announced that the main priority for the new political leadership that's installed this week is inflation because there is nothing that will rip apart the social fabric of a nation faster than that, especially when globally we've got such a big spread between the wealthy and poor, or wages as a percentage of GDP are at an all time record low and profits are at an all time record high.

I would draw your attention to what happened in Burma. This was reported in the press as a democracy movement, but that's not how it started.

It started with the price of rice pretty much trebling in a very short period of time. People do not wake up at 2 o'clock in the morning and say you know, "tomorrow I've got to have democracy". What happens is there's a big movement in a very important price and that's where it gets people in the streets and then the bullets start flying and then it's about democracy.

This is critical because we've got the head of the UN Food and Agriculture Organisation warning very sternly, we're going to see much more of this kind of unrest across emerging markets. I was recently in India and Indians are very worried about this. Malaysia they're already rationing cooking oil. In China they've had riots in grocery stores, people trying to get their hands on food items where the price is rising so rapidly. I hardly need to tell this audience about what's happening even in the industrialised countries with regard to food prices and how people are feeling that as it hits their pockets. And of course, energy and food are directly related through the fertiliser chain and in the energy markets we're not seeing any subsiding of that upward pressure.

Which takes me to my last topic, and I am running as fast as I can through the material here so that we can stay on our schedule. The very last thing is geopolitics. The geopolitical picture I think is going to be extremely important. It is a piece of the puzzle that fund managers tend not to think about too much, mainly because it hasn't been a serious enough issue to affect prices.

But I think that in the same way that when we saw the fall of the Berlin wall and the entrance of these billions of new people into the world economy and that brought about the great moderation of inflation, which is now ending if not over, simultaneously we also had the peace dividend. And the peace dividend seems also to be coming to an end as well. We see a significant rise in stress in the global geopolitical environment. From one end of the spectrum we now have the Russians and the Chinese both regularly getting into military incidents with the United States or NATO.



We recently saw the headlines probably the Russians were flying their jets 2,000 feet above a US aircraft carrier, the Nimitz, the Chinese denied the Americans access for the USS Kitty Hawk in Hong Kong.

These things are important in the puzzle because they reveal that the geopolitical landscape is not quite as take it for granted as it used to be. The events this week alone are very interesting with Hugo Chavez and Ecuador and Columbia having some stress which is affecting the oil price. Is this in part a function of the fact the Chinese have been aligning with Chavez and saying we're going to build you refinery capability so that you're not so dependent on the United States, and that has encouraged them to move in this more confrontational direction? Maybe, maybe not, there are mixed views on this, but it's certainly a topic of discussion.

In the Middle East, is part of the reason OPEC is not agreeing to any production cuts, something to do with the fear about Iran going nuclear? As Iran goes nuclear, that's quite a mortal threat to Saudi, Turkey, Egypt, all of them have announced they have to go nuclear themselves. And I'm not talking nuclear energy, I'm talking nuclear weapons. They have already announced acquisition programs for that, how are you going to fund that? We need a higher oil price.

So we have a geopolitical environment that is tricky. Now some people think that when George Bush leaves office and the new President comes in, all of that will subside. But there are others who say the reason that we're seeing more of these incidents is precisely because of the perception that the US is going to move in a less tough direction. Some argue that the signal that the US political environment is sending is; this is the time to increase your spending on defence and military issues because the US isn't going to engage going forward. It's an open question, but it affects the cost and price structure internationally. Are we going to continue to see the Russians turning off the gas supply to the Ukraine because they want to join NATO? Probably so. That will affect inflation and prices internationally.

So I think these are three areas: politics, policy and geopolitics. The politics of the current financial environment are very, very profound. The policy choices being made are very serious, and either those policy choices are going to avert a recession and/or create a inflation. I am personally, a little concerned that as the market begs for more rate cuts, they should be careful what they ask for, because it may bring consequences that are much more difficult to manage later.

And third, in the geopolitical environment, the things we've taken for granted for some time may turn out to be quite important. Again I would draw your attention to the fact that in our political race in the United States, the Democrats are much tougher on China, much more confrontational with China than the Republicans have been. So if you think that having the Republicans leaving will mitigate the stress there, my view is it's the opposite and we can already see that in play.

Now, this is a huge amount of material I have given you and that is my 25 minutes. I have to stop. But I hope I've thrown out some controversial ideas that will give you something to chafe against and then we stop for a bit and then we're going to do questions which will be much more fun for both of us. Thank you.

***FEAL would like to thank Deutsche Asset Management for making Pippa Malmgren's visit to Australia possible.***

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