The Crisis: International Financial Linkages and Lessons

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Outline I: Issues covered

1. Money market crisis returns.

2. Roots of money market crisis in European bank dollar funding problem that has developed in train with surges in gross and net international capital flows.

3. Resolution of global imbalances not occurring as it normally does after financial crisis; this poses risks ahead
Outline II: Some lessons we have learned (or relearned) from the crisis

1. Bad things can happen suddenly, massively, with lasting impressions. Consider money markets.

2. Free flow of capital desirable, but abnormal increase in gross flows should be a warning sign.

3. Uptrends in net capital flows (global imbalances) not necessarily a good thing.

4. Financial crises can happen to the best of US (and the worst may be yet to come).
Bad things can happen quickly, with lasting impressions

Source: Bloomberg, DB Global Markets Research
Money market crisis flaring up again

Source: Bloomberg, DB Global Markets Research

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Long-term euro funding for European Banks has dried up too

Issuance of term debt by European FIs

Source: DB Global Markets Research
FX Swap line reopened but little used

Central bank liquidity swap line

Reopened May 2010

Source: FRB, DB Global Markets Research
Roots of European Banks’ dollar funding problem

European banks' assets (foreign claims) in US dollars

Source: BIS, DB Global Markets Research
US banks have relatively small euro assets

U.S. banks' assets (foreign claims) in European currencies

Source: BIS, DB Global Markets Research
European banks heavily into cross-border lending

Cross border lending (all countries): by nationality of reporting banks

Source: BIS, DB Global Markets Research
Gross capital inflows soared and then plunged around crisis

Gross capital inflows

- World (% of World GDP)*
- US (% of US GDP)


*Note: World capital inflows include US, Canada, Japan, UK, Euro Area and Emerging & Developing countries

Source: IMF, BEA, DB Global Markets Research
Bank related capital inflows

Gross capital inflows: bank reported

US (% of US GDP)

World (% of world GDP)*

*Note: World capital inflows include US, Canada, Japan, UK, Euro Area and Emerging & Developing countries

Source: IMF, BEA, DB Global Markets Research
Gross portfolio investment inflows

Gross capital inflows: portfolio investment

- US (% of US GDP)
- World (% of world GDP)*

*Note: World capital inflows include US, Canada, Japan, UK, Euro Area and Emerging & Developing countries

Source: IMF, BEA, DB Global Markets Research
CDO bubble

Global CDO issuance

% of World GDP

Source: SIFMA, DB Global Markets Research
Gross capital inflows: reserve assets

- US (% of US GDP)
- World (% of world GDP)*

*Note: World capital inflows include US, Canada, Japan, UK, Euro Area and Emerging & Developing countries; US data are official reserve inflows

Source: IMF, BEA, DB Global Markets Research
Global imbalance grew substantially over past decade

Source: IMF, DB Global Markets Research
US external imbalance has driven the global total

Source: IMF, DB Global Markets Research
Share of US financial assets owned abroad doubled in past decade

Source: FRB, DB Global Markets Research
US external imbalance expected to widen again

Current account balances

Emerging Asia & Oil Exporters
Japan & Euro Area
US
IMF Projections

% of World GDP

Source: IMF, DB Global Markets Research
External imbalances normally reverse following financial crises

Current account balances during systemic banking crises*

*Includes Sweden (1991); Mexico (1994); Indonesia (1997); Thailand (1997), Korea (1997); Russia (1998); Argentina (2001) **Includes Euro Area periphery (Greece, Ireland, Portugal, and Spain), IMF 2010 forecast used as 2010Q1 figure

Source: BEA, Haver Analytics, DB Global Markets Research
Currencies normally plunge in financial crises

Exchange rate during systemic banking crises

Index, crisis month=100

US 2008

Avg of past crises

Crisis begins at period "0", months

Note: Includes Sweden (1991); Mexico (1994); Indonesia (1997); Thailand (1997); Korea (1997); Russia (1998); Argentina (2001)--- exchange rate vs USD; decrease in all lines indicates home currency depreciation; US is broad nominal TWI

Source: BEA, Haver Analytics, DB Global Markets Research
Conclusions: Policy Implications

1. Stresses in bank funding raise risks globally and augur for caution in policy exit strategies; Fed’s backstopping via FX swaps appropriate.

2. Abnormal increases in global flows augur for increased supervisory vigilance.

3. High premium on fiscal adjustment in the US and a phasing out of Bretton Woods II.