Signalling cycle as explanatory of the financial crisis

Patrick McNutt

Union Bancaire Privee (**UBP**) hosted its annual Hedge Fund Conference in Geneva, May 28-29 2008 with an assembled audience of over 400 attendees from the world of hedge funds and private equity. As an invited speaker, Professor Patrick McNutt of Patrick McNutt & Associates, Dublin, and Visiting Fellow at Manchester Business School, participated on the panel on distressed opportunities for PE in the financial crisis.

He presented an interesting and novel take on the crisis by introducing a game theory dimension. A signalling cycle, he argued, may have begun March 12th 2007 with the suspension of shares in New Century Financial Corp., subsequent filing for Chapter 11 bankruptcy protection. Panic ensued as the SEC investigated some Bear Sterns' hedge funds in the summer of 2007 and with asymmetry in information spreading through the financial markets, with 'sub-prime' entering the lexicon of financial analysts, traders continued to short financial stocks, a trend that has continued into Q2 2008.

Arguing that the cycle may have begun with a history or starting point circa March 12th 2007, oscillations continued into Q4 2007 with a liquidity crisis morphing into a crisis on convoluted debt, panic set in as increasingly more evidence of financial illiteracy outside the US was revealed by Q1 2008, he intimated a length of 4 years, with an end date in 2011.

The end date was explained in terms of two catalysts *viz* (i) a ***paradigm shift*** in macroeconomics with less of a reliance on consumption as the determinant of GDP growth but more of an emphasis on exports and FDI. Across the EU economies exports are increasingly explaining GDP growth and the emerging markets have expanded in terms of their macroeconomic significance to the world economy to include **ASLEEP** economics {acronym: **As**ia, **L**atin America, **E**astern **E**urope and the **P**acific Rim}. As they decouple themselves from the US and to a lesser extent the EU, the ASLEEP economies will account for 30% of world exports and 50% of world growth by 2011. It is in the ASLEEP economies, he argued, that PE opportunities do exist across the different sectors - including next generation antibiotics and biosential crops.- and companies identified by McNutt in his discussion.

A second catalyst was expressed in game language as (ii) ***credible threats***, that is, signals, between ECB and the US Fed at one level and between ECB and BoE at another level; signals on both the magnitude and direction of likely interest rate movements. Tracing the hawkish signals of Mr Trichet to a speech he had made at Jackson Hole, Wyoming in August 2005, he argued that ECB will <u>not reduce rates</u> in 2008 and may signal <u>no decrease</u> in rates in Q1 2009, and that the Fed may have reduced rates so far that the probability of a further rate reduction, and a consequent weakening of the US dollar, may have already been discounted by FX trades.

His FX conclusions are based on the beggar-thy-neighbour outcome of the signalling game; in other words, we can all easily observe that the outcome via a weak US dollar has led to an increase in US export competitiveness. But how far will the dollar fall? The answer: until a point of Nash Equilibrium can be achieved. Such an equilibrium, can be expressed in terms of the best outcome that the US Fed can hope to obtain given the likely reaction of the ECB and of the BoE. Working on the assumption that a trade deficit of 2% of US GDP is sustainable then a falling dollar can help to restore the US trade deficit to that sustainable level. That is exactly what is happening as the dollar falls. However, the US trade deficit currently stands at 6%, so working some back-of-the-envelope numbers, McNutt argued that reaching a sustainable level of US trade deficit may require a dollar fall against Sterling to within the $2.20-$2.40 range in 2008. The last time that happened was when Harold Wilson was PM in the late 1960s.

Alternatively, he predicted another option, a coordinated equilibrium, a possible pegging of FX rates similar to the Louvre Accord in 1987 when the issue back then was a weak dollar and a strong Yen. In 2008 the FX noise is in terms of a weak dollar and a strong Euro. But the 'what ifs' include: what if Japan increased interest rates in 2008? What if the ASLEEP economies continue to recycle funds into Euros to trade, and thus strengthening the Euro, and undermining national competitiveness in Euroland? This confirms the wider perspective of the emergence of a new international economic order in the 21st century focusing on the redistribution of world resources and world trade and income to ASLEEP economies.