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The New IMF and Christine Lagarde: ***The G20 has expanded the role for the IMF—the old model of the developed West bailing out the rest is over! Global capital, global banks, shadow banks, and the rise of EMs all mean that the IMF cannot go back and must go forward.***

Challenges abound for the IMF and its new powers, authority, and mandate granted last year by the G20. The new IMF chief will find ample support from emerging market governments if she continues to move the IMF towards a new global role. Going back to a propagator of technocratic orthodoxy under the guise of the "Washington Consensus" will do little to restore the IMF's lost credibility. If it has indeed lost its credibility. Moreover, the massive amounts of global capital, huge global banks, shadow banks, and financial innovation will force the IMF to reorient its bunker mentality and expand its technocratic expertise.

More capital and liquidity mean that the IMF will need more cash to stand as lender of last resort for the whole global economy. The IMF chief will have many new masters and political pressures. And as we have seen in 2008, it looks increasingly likely that nearly all national financial crises will have significant contagion ramifications. The IMF will need to be more political and international than ever before.

The *Financial Times* ran an op-ed piece by PIMCO's El-Erian where he outlined the five ways in which Christine Lagarde could repair the IMF. His wish list for reforms seems willfully idealistic

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and completely disregards the past history of the fund and its recent empowerment by the G20. El-Erian argues that the IMF needs to be less political, as it was in the past. The whole point of the IMF was to facilitate the triumph of U.S.-styled capitalism. That sounds political to me. Bailing out creditors and speculators and bankers over voters around the world is also political.

The personal political ambitions of IMF chiefs have perhaps been more overt in the past few years, but no one gets to the head of such a multilateral without being a political animal. To assert that technical ability alone is the best policy seems absurd. The IMF deals with governments and their financial institutions, not companies. It seems that political ability—and the wherewithal to bring together politically unpalatable arrangements—is the most important skill an IMF chief ought to have. Data crunchers would not be suited to such tasks. (Is El-Erian still sweating away over financial models between his stints pontificating on the vagaries of world politics and "spinning" the PIMCO view? I doubt it.)

Has the IMF lost credibility in its dealings with the PIIGS? I don't think so. The IMF was never designed to bail out its home-base economies (the EU and the U.S.). Nor has there ever been such an acutely political economic crisis where a currency adjustment is not possible and there are massive cross-border banking risks. It's one thing to get all of Thailand's government to agree to austerity and a currency adjustment and align foreign creditors. It is quite another to do this in Europe within the same currency system. Moreover, despite some of the "emerging market criticism" of favoritism for Greece, the truth is that the IMF is defending big bank

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interests as it has always done. There are protests and costs enough in Greece to satisfy any comparison with the IMF's role during the Asian crisis.

El-Erian completely glossed over the fact that the G20 has already given the IMF the mandate (an order, really) to reinvent its role and expand its analytical focus. But more importantly, the G20, and not the G3 or the G7, gave this new mandate. The changes he wants are already underway. The IMF cannot go back to being the lender of last resort for small, undisciplined countries. It will now have the mandate (from the G20 and not PIMCO) to be lender of last resort to the developed world, as well. Emerging market countries have seen their financial obligations increase along with their voting rights in the IMF.

An Arab Spring for crude? Saudis, OPEC's laggards, and $100 oil: *At the end of the day the IEA release may not bring down the price of crude (especially with the risk on trade) but Iran and Venezuela must realize that the coordinated global action in conjunction with the Saudis' and Gulf States' production increase will make for very tough OPEC negotiations going forward. Iran and Venezuela simply cannot increase production (even if they wanted to) between Russia, the Saudis, the IEA, and a disgruntled China. Iran and Venezuela's obstructionist policies are increasingly untenable; they will face political consequences.*

After the OPEC decision and the last-minute push by the Saudis to increase production, I wrote that I hoped that the Saudis would increase manufacture, if only to teach Iran and Venezuela a

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lesson. But I worried that such an action would be foolhardy if taken alone. The Saudis did not act by themselves. The Gulf States have joined them and the IEA released some SPR. I would not go so far as to say that OPEC is broken. But there has been a shot across the bow. Iran and Venezuela cannot count on OPEC unanimity. Nor can they abuse oil importers at will. India and China, while not members of IEA, have certainly been suffering the most from higher oil prices. If there is an Arab Spring in the energy markets, this is certainly a good beginning.

It is far from clear that the IEA move will lower crude prices in the long run. “Risk on” trade is a powerful driver of crude prices. I have argued that the end of QE2 would inevitably favor EM assets and commodities in the search for yield. But the political ramifications are huge. We used to believe that all of OPEC would want ever higher prices because of their expensive populist habits at home. There was unfair speculation that the Saudis would need extremely high oil prices to pay for their plans to buy more political peace at home. Since the launch of AAR, I have argued that the Saudis are in fact far more sensitive to the needs of their oil importers and the negative impact of very high oil prices on emerging markets than is usually thought. Their own restraint in production supported oil prices when collapse was imminent, and they are ready to increase production when global growth and recovery is threatened. The Saudis will not hurt their most important clients—in particular, emerging Asia and China.

The Saudis’ move gave the IEA the political opening to themselves act. The IEA was in close consultation with the Saudis and the Gulf States, and they could not let this opportunity go to

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waste. The IEA can act in concert. Libya's shortfall gave them the needed "cover" for an action that will in the long run be largely symbolic. Iran and Venezuela must have taken notice. Between Russia, the Saudis, the IEA, and a disgruntled China, their obstructionist policies are increasingly intolerable.

Emerging markets remain attractive regardless of the developed world's trajectory: Trichet's Soft Patch versus Bernanke's muddle-through optimism. *Global problems of food and fuel price inflation are everywhere. Yet in spite of policy tightening, banks in emerging markets have higher capital provisions and healthier balance sheets. With higher growth and access to a nearly endless supply of cheap money from the U.S., emerging markets could perform better than expected. U.S. companies are scaled for profitability, but most of the profits still come from overseas! Maybe EMs are healthier than the markets think!*

The power of cheap money should not be underestimated. In the United States, the IMF's 3% growth might seem like bad news. And it *is* very bad news for those who are looking for work and politicians who want to get reelected. But the good news for corporate America is that 3% growth means that they won't have to spend a lot of capex and hiring to meet demand. They are scaled perfectly for moderate growth. Hiring will remain anemic. Consumer spending will limp along. And we will have our "L-shaped" recovery. Good for corporate profits, bad for the real economy. But even if U.S. companies are scaled for profitability, most of the profits are coming from overseas. I would argue that in EMs, headline growth is still strong.

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<u>China's "debt fears": China looks much better than developed markets; the politics of China's managed soft-landing.</u> *China has its problems, but is the local debt problem in China really any worse than that of Spain, or for that matter, Florida? Broad local government debts, whether through SIVs or bond offers, would negatively impact any country's creditworthiness. But China will risk a hard landing if by so doing it can engineer an economic upswing in 2012. From a policy risk perspective, I continue to prefer Brazil and India to China, although the FAI cycle and growth in China is a powerful driver for all EM performance. China proxy plays remain attractive, in spite of policy tightening.*

Local governments nearly always make bad financial decisions. Empty private prisons, REITs for pensions, empty convention centers . . . . the list of unprofitable local government projects abounds globally. At least in China the very high savings rate, high reserve requirements, and the political chokehold on local officials mean that the downside for the debt problems should be contained. There is waste to be sure and the PBoC has taken policy steps over the past year to help mitigate some of the most egregious examples.

While in Europe, PM Wen indicated that Beijing could both win its fight against inflation and promote strong growth. Some experts thought that meant Beijing would attempt to achieve both objectives simultaneously. I continue to believe that Beijing will fight inflation first and then focus on growth. Beijing builds policy as it goes. Old policies are shed when they are no longer effective or have become destructive. New policies are added as needed. Given the very

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immature state of China's capital markets, Beijing has little choice. I take Wen's statements to indicate that both growth and inflation are on the agenda. That growth will be the 2012 objective, but political stability through falling inflation will be the immediate focus.

World Bank: Only fourteen years to a multi-currency world? Sound ideas keep chipping away at the dollar. *By 2025 (if not sooner) Brazil, China, India, Indonesia, South Korea, and Russia will deliver over half of the world's global growth. Why would the dollar remain the single reserve currency? U.S. treasuries and the dollar (regardless of any debt ceiling or growth prospects) will lose their liquidity premium over time.*

Justin Yifu Lin, the head of development economics at the World Bank, predicts the emergence of a multicurrency world by 2025 at the latest. In that year, if not sooner, the major economies in emerging markets will deliver over half of the world's growth. To be honest, I believe his estimate is conservative. But it's a good starting point. You don't have to hate the dollar to love EM currencies. You don't have to be a follower of Bill Gross to see that other forms of government debt might be desirable. You don't have to be an EM central banker to see that diversifying some reserves away from the dollar just might be a reasonable idea.

I have had many questions about the dollar, gold, and treasuries over the past year. I still believe that the single currency system won't change much from "an inevitable U.S. decline," but that there will be other attractive options emerging over time. Diversification—in itself a healthy

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investment operation—will naturally lead to more money flowing into new assets. I actually believe that the U.S., while struggling now, has good potential. The only problem is that U.S. politicians don't seem to realize that the country will have to be more than the liquidity option for global capital. Moreover, the U.S. will have to address the fact that most of its savings will be global hunters for value and return!

Thailand: Risk of military intervention is possible. *Thailand's dysfunctional democracy is still propped up by the military—now empowered with a constitutional mandate to intervene. The military may prefer strong action behind the scenes to direct action on the streets. But I would favor the buying of exporters and local currency bonds on volatility related to a strong showing by Thaksin supporters in the Puea Thai Party.*

Although the technocrats in the minority government led by the urbane Democratic Party (DP) have many positive qualities, the leadership has completely failed to address its main weakness—it cannot win a national election. Without the heavy hand of the military, the minority government would not be in power at all. Former Prime Minister Thaksin may have been a populist and a corrupt businessman, but he was also popular. Moreover, he had a singular talent for winning national elections! The DP deserves to lose this forthcoming election in July, if only because it failed to expand its voting base.

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The military's general chief of staff gave a long speech to the armed forces on military TV that preached non-interference, but stressed the support of the monarchy and made many disparaging remarks about Thaksin supporters and undesirable elements. Local experts believe that the speech did more harm than good and probably primed the armed forces to prepare against the potential victory of the redshirts and Thaksin's sister.

During past electoral conflict asset prices have fallen to attractive entry points. For the dedicated investor, this might be a good time to look for deals. However, banks and consumer plays have not performed as well in the aftermath of the political conflicts; export sectors were more resilient.

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