ALISON ADAMS RESEARCH

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The rise of a regional currency: yuan cross-border trade settlement, yuan denominated FDI, and Hong Kong: *Even as the euro and the dollar lose some of their luster, Beijing has accelerated policies to promote regional trade settlement in yuan and all Chinese companies may now settle trade in yuan. Bank of China president expects yuan settlement to reach CNY2tr by year end. Hong Kong, after a high profile visit from Beijing officials, has been tapped to facilitate and develop financial products to promote yuan settlement in the region by 2013.*

Since the financial crisis, China has been steadily adopting trade and currency swap agreements with most of its major trade partners---excepting the United States. From Brazil to Belarus, countries have agreed to settle trade in their respective currencies. Most of these moves have been dismissed by those who argue that the US dollar will remain THE RESERVE currency for many years to come. Since, 2009 we have argued that there will be increasing room for a multi-polar world with regional currencies playing a growing role and Beijing has been assiduously laying the ground work towards such an outcome. I want to be clear, I am not arguing that the US dollar will be displaced by the yuan. Rather, I do argue that emerging markets will rationally seek to diversify their forex reserves to match their trade interests. According to economist Barry Eichengreen, the dollar has gone from 70% or global forex reserves held by central banks to 60% over the past ten years.

Beijing has signed 36 new agreements with Hong Kong in which the Hong Kong Monetary Authority will support the development of more yuan denominated financial assets and products. The future premier of China---Li Keqiang---was present at the signing of the agreements in which Hong Kong pledged more

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cooperation. Beijing hopes that more Dim Sum bonds will be issued and that yuan trade settlement will increase.

While Hong Kong has accepted a new and expanded role in offering yuan denominated products to investors, the PBoC has launched a nationwide yuan cross-border trade settlement program. Since China already has in place a regional trade agreement with all ASEAN countries to settle trade in respective currencies, the reach of yuan-settled trade will be increasingly significant. With only a regional trial program in place—yuan trade settlement reached $149.62bn in the 1H2011. Some analysts now expect that as much as 30% of regional Asian trade between China and its partners will be in yuan.

But why would companies want and central banks want to hold yuan? Beijing has also started a program whereby international holdings of yuan –obtained through lawful means—may be used for FDI back into China. Yuan denominated FDI would help establish a “backflow” passage in a step towards liberalization.

Food price inflation could be back sooner than you think: Corn, Sugar, Inflation: Bio-fuels and Bad Weather: *As part of Brazil’s attempt to cool inflation, it has cut its ethanol blend. Brazil will need to import more gasoline and more ethanol if cane harvests disappoint. But global food stocks will suffer as the US corn crop is less than hoped.*

The cross currents of lower global food stocks, damaged harvests in the US, and more demand for ethanol could be a dangerous mix, if next year’s crops in EM disappoint. High sugar prices and rising demand in Brazil made sugar ethanol more expensive than gasoline. The ethanol component in fuel price inflation contributed significantly to headline inflation pressures. Along with a reduction in government spending, higher interest rates and tighter credit rules the Brazilian government also cut the ethanol blend from 25 to

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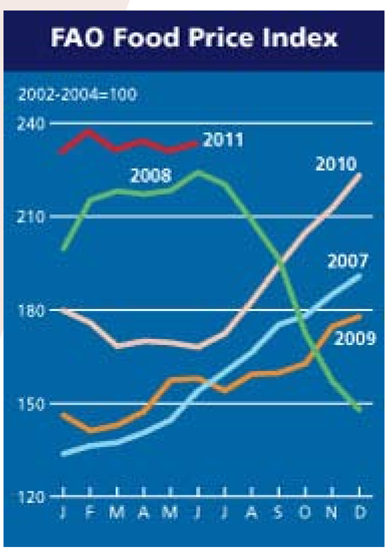
20% starting this October. Long touted as more economical than corn based ethanol, the surge in sugar prices allowed US corn ethanol producers to export to Brazil!

There should be a question in the US congress regarding the necessity of tariff protection of the corn ethanol industry if it is competitive in a global market. But I doubt that in the run up to 2012 election there will be any appetite to repeal the rule. But there are much more significant consequences to the world's emerging markets. The US corn crop, and indeed most of our cash crops, are very important to global food markets. Bad weather in the US combined with global demand for corn ethanol and a weaker US dollar do not bode well for a reduction in global food prices.



The Food and Agriculture Organization of the United Nations continues to issue warnings regarding high food prices. The political trials and tribulations in the EU and the US are nothing compared to the high level of food prices around the world. Like the currency wars, the food price crisis is on-going and hurricane Irene and the drought and heat wave in the central US will materially hurt US crop production.

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For emerging markets, monetary tightening has slowed the rate of increase in food price inflation. But the level of food prices remain high and a very likely to continue to be high. Even as industrial production in Brazil and China has slowed and the economy is slow in India, food prices have not corrected.

As we saw in 2008, rice producers and millers in Asia are holding back stocks in anticipation of higher prices. According to the WSJ and some local press in Asia, middlemen and farmers had good crops, but are willing to wait for higher prices. In Thailand, the government policy of higher wages and buying rice at higher prices is also having an influence on regional rice trade dynamics. The total crop available for export is now 12% lower than originally anticipated. With the government willing to buy rice at higher prices, supply for export is lower. In India, non-basmati rice exports have been held up by a court case. For now rice prices are not nearly as high as they were in 2008. But grain prices and food prices are moving in concert with each other across markets and categories. Ample supply may have little impact on lowering prices.

Brazil's government shows resolve: *The economy is clearly slowing, but the government is willing to act to cool inflation and work with the Central Bank. Brazil raised its budget surplus target to help cool inflation even at political cost. Brazil remains my favorite BRIC.*

If only elected politicians in the United States and the European Union could set ideology aside and roll up their sleeves like the government in Brazil. But I will write more on that elsewhere in today's note. Despite a strong leftist background and the prospects of even slower growth in 2012, the government of Dilma Rousseff raised its target budget surplus by $6.3bn. Even with higher revenues, the government is prepared to spend less! Not only will this help cool inflationary pressures it might also mean that the

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central bank can pause on its series of rate hikes. Rousseff took office after a growth spurt of 7.5% and record low unemployment levels. The Lula miracle extended beyond Brazil's ability to emerge unscathed from the global financial crisis, but also to deliver good growth.

Now President Dilma has been faced with a steep increase in inflation and higher interest rates and lower growth. But rather than push growth or risk even higher rates, the government settled for less spending and lower growth! This is certainly not politically "popular", but lower inflation and a return to normal monetary policy is essential for long term stability. The move by the government, as I see it it is entirely consistent with a mature view on macro-economic stability. Lower growth and lower inflation might deliver less than spectacular headlines, but it does show that Brazil has one of the best governments in EM. If Dilma had wanted---there would have been plenty of appetite for more government debt and more government spending. But she and her government refrained. From a policy perspective Brazil remains my favorite BRIC.

Letters of credit and rising overdue loans: China's tightening targets work-arounds and off-balance sheet lending: *Over the summer, I have been highlighting some unorthodox activities by Chinese banks as banks work to meet demand for credit when official channels are closed. The latest tightening over the weekend is more than just monetary policy---it is a disciplining measure. The new margin requirement is equal to 3 (rounds) of additional RRR tightening according to PBoC memo. Overdue loans are rising and even large banks are seeing a deterioration in their loan portfolio---most of the increase in bad loans happened in the second quarter related to high commodity prices and slow growth.*

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Last May, we highlighted the new rules for loan deposit ratio compliance. The PBoC ordered banks to meet the loan to deposit ratio target every month, rather than every quarter. The result was a steep increase in competition for deposits and a scramble for interbank loans at the end of the month. Other sources of cash and credit remained, including wealth management products and capital pools offered to bank clients as a means of providing financing for borrowers. The PBoC demanded that the practice stop and promised new rules for such products.

Over the weekend, the PBoC issued a new round of tightening. The rules required banks to hold more capital against margin deposits---the collateral offered by customers for letters or lines of credit and other guarantees. These lines of credit had not been included in the structure of reserve requirements before. However, the official press stated that the memo believed that the measure would remove another CNY800bn to CNY900bn out of the system. These lines of credit must have been substantial. To remove that much money from the system which is already at record levels of reserve requirements is remarkable. The China Daily estimated that $133.83bn more of bank capital would be frozen. The PBOC stated that it regarded this latest “tightening” to be equivalent to 3 rounds of RRR hikes.

CFTC and commodity prices: New Rules by September 22? Where have the shorts gone?

Disaggregated data and econometric scholars offered the CFTC their insights last week: Most agree that in an environment of presumed sustained growth in aggregate demand from emerging markets, managed money---particularly hedge funds and index funds do impact price volatility in the commodity space. Increasing correlations between stock market indexes and across commodities reflect the increasing financialization of commodities and proximate distortions in price discovery.

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Its not the fault of speculators. But rather, that all speculators and investors and physical users and producers all work off of the same assumptions. Nearly all managed money, in the commodity space, relies on the exact same investment theme-- that EM demand for commodities is insatiable and inelastic and supply is constrained---. In such an environment, the role of managed money and commodity ETFs, in keeping with rational economic theory, behave almost as a herd. (my summation: the papers are available on the CFTC website). Since managed money is all moving in one direction, the price volatility is exacerbated. One noted economist Kenneth Singleton found that the R-squared predictive regression for excess returns was 20%. Singleton's paper is worth a read—he highlights that information in imperfect for all players, but they work off of the same assumption and their supply demand models are the same---but neither the financial interest nor the physical players adequately account for the role of the financial investors in the space.

Given the sclerotic political atmosphere in Washington DC, it should be fairly easy for investment bank lobbyists to stave off any punitive changes to existing CFTC rules before September 22. Good news for banks and "speculators" but price discovery in commodity futures will continue to be distorted. Moreover, physical users of commodities will suffer from price volatility. Commodity prices will remain elevated even though consumer demand in the U.S. remains weak.

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