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Today's note is largely focused on emerging markets and their outlook for rate cuts and a second run in growth. As Australia's central bank governor observed, demand in EMs is still robust and there is room for interest-rate cuts to stimulate demand, provided that inflation can roll over. Today's rally in commodity prices and Brent above $115 does not bode well for inflation rollover.

Commodities and China stocks rally on easing rumor: China's PBoC rumored to be planning a reduction in the reserve requirement for banks in the beginning of policy easing. *The* China Securities Journal *reported that bank easing might be forthcoming. I have maintained that Beijing would prefer to enter 2012 promoting growth rather than fighting inflation as a economic backdrop for its big political transition. Rather than a general policy easing, I expect that targeted stimulus measures (like the recent massive rollout of subsoiler financing for farmers) would be more likely. Without a substantial correction in commodity prices, high rates of growth in emerging Asia will be elusive. In 2009, Brent crude oil was below $65 a barrel; it's at $155 a barrel now, which is not conducive to high growth.*

If there was any correction in commodity prices from the turmoil in August, that moment is gone. The cheap money policy out of the U.S. and rumors of more stimulus in China were enough to spark a broad rally across commodities. But with structurally higher inflation

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developing in India and China—and with Thailand, Korea, and Indonesia all printing high inflation rates—Asian central banks will have to look past inflation pressures and hope that slower demand from the EU and the U.S. will help moderate commodity prices. Corn, cotton, wheat, nickel, copper, and oil all rallied today. Low crop yields from bad weather are a risk from Korea to Australia to the United States. Bad weather in Brazil will mean yet another poor sugar crop, higher ethanol prices, and more inflation. Robert Zoellick of the World Bank was speaking in Beijing and highlighted that high food and fuel costs continue to be a threat to the growth of EMs and to poor people around the world.

The U.S. and the EU: Hobbled by debt and vulnerable banks, weak growth seems certain.

The G7 ministers of finance met this week and it seems that their solution is to continue ultra-loose monetary policy and press emerging markets to carry the burden of growth. Denial in the EU and the U.S. is a poor substitute for political will to solve difficult problems. For investors, the good news is that large EU and U.S. corporations are scaled for slow growth and have plenty of cash on their books. Sovereign uncertainties in the EU will support U.S. treasuries, gold, and EM currencies.

Former Prime Minister Gordon Brown wrote an interesting op-ed piece in which he encouraged the G20 to revive its pro-growth platform of late 2008 and early 2009. Brown reminded readers—and hopefully some policy makers—that global cooperation and the promotion of trade and global rebalancing could lift global growth prospects considerably. As I argued in early

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August, following the IMF research and from the G20, the solution to stagnant growth, very high debt levels, and high unemployment in the G7 is more cooperation among the members of the G20. The G7 no longer has any room to move.

The ECB is still maintaining that growth will slow but that recession is not likely. Trichet continues to deny that a recession is on hand in Europe and told the EU parliament that he expected moderate growth to continue. But markets are betting that the ECB could change its inflation outlook. Moreover, Trichet insists on further austerity from Greece and Italy. EU President Barroso continues to deny the threat of recession in Europe, even as he calls for additional austerity in Italy and Greece. Apparently steep increases in taxes and massive cuts in government spending will not affect growth in the near term. (I do not find this a credible argument, btw).

But as the world waits for the German parliament to vote on the EFSF expansion after the supreme court ruled against challenges to the fund, European banks remain dangerously vulnerable. Gordon Brown pointed out that German banks are perhaps the biggest risk to the whole system. “Europe’s banking sector liabilities are nearly five times higher than in the U.S., at 345% of GDP. German banks are leveraged at 32 times their assets. So, not only is bank recapitalization essential for financial stability, but so is a reformed euro, built on fiscal and monetary coordination and an enhanced role for the European Central Bank in supporting individual governments (not individual banks) as lender of last resort.” (*Caijing*, 9/6/11)

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And it's not just an unpopular former prime minister who is highlighting the vulnerability of European banks. Deutsche Bank's Ackerman stunned markets when he frankly stated that European banks might fail if they were forced to book losses on EU government bonds whose depressed values were not included in the stress tests of this summer. "Numerous European banks would not survive having to revalue sovereign debt held on their banking book at market levels." The IMF's Lagarde has called for a capital injection into EU lenders to stop the contagion.

Fed Chairman Ben Bernanke remained optimistic about continued growth in the U.S., even at a slower rate than the Fed had anticipated. I admit that I was confused by Bernanke's reasoning. He stated that households and businesses would continue to deleverage their balance sheets by increasing savings and paying off debt. And somehow this would be good for growth in the near term. I agree that such deleveraging will—in the long run—be positive for growth, but it will not be good for growth now.

And now the Federal Reserve has asked U.S. banks to perform a new round of stress tests. The Fed has been telling U.S. banks to be careful about their exposure to the EU banking/sovereign crisis. The stress tests might be a way of ensuring that U.S. banks are protected against a credit event in the EU. But with the Federal Housing Authority suing U.S. banks over mortgage losses at the GSEs, state actions against banks for losses, and the Attorney General suing for discrimination, U.S. banks have more to worry about than just EU exposure.

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Brazil's rate cut gamble on slower global growth: *Brazil's COPOM cut rates and blatantly ignored the highest inflation hike since 2005! The rate cut is a reaction to substantially weaker growth in the main economic blocs. In Latin America weak global demand is the new driver for anticipated rate cuts. In Chile and Mexico, bond markets seem to anticipate rate cuts on slower global demand. But inflation drivers are still healthy, including weak global grain production, high wages, low unemployment, high input prices, and a bad sugar crop forecast for Brazil.*

"Reassessing the international scenario, the Copom considers that there was substantial deterioration, materialized, for instance, in generalized and significant reduction in growth projections for the main economic blocks. The Committee understands that there was an increase in the chances that restrictions to which today several mature economies are exposed prolong for a period greater than previously anticipated. It also notices that, in these economies, the scope for the use of monetary policy seems limited, and a scenario of fiscal restriction prevails. Therefore, the Committee evaluates that the international scenario shows disinflationary bias in the relevant forecast period." (*Copom statement 8/31/11*)

Brazil's unprecedented interest-rate cut came as a surprise to nearly everyone. But what is even more surprising is that the monetary committee's decision was largely based on the sputtering growth in the EU and the U.S., and the fiscal retrenchment that will further drag down growth outlooks. The statement didn't mention local inflation pressures. Instead, the decision is a reaction to the global economic outlook. The COPOM has almost no faith in further policy

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easing in the U.S. and believes that contagion risks to Brazil will be based on external factors. The committee believes that trade, credit, and investment could all be materially damaged by the slowdown. Brazilian business and consumer sentiment would also suffer.

But the latest inflation data show that not only is inflation coming from food prices, it is also spilling over into core inflation and retail prices. Consumer prices have risen over 7 percent in the past year. The latest acceleration in consumer price inflation dynamics indicates that there could be considerable inflation pressures to come. The move by the central bank is truly risky and I am afraid that they have overestimated the “pull back” in commodity prices associated with a slowdown in the EU and the U.S.

In Mexico, some are now expecting that the central bank could pull back on further rate increases due to the slowdown in the U.S economy. But as in Brazil, domestic demand and global commodity prices are the primary drivers for inflation, rather than exports to the United States. In Chile, some local players are expecting that the central bank might also be done fighting inflation based on bond yields. I suspect that global demand for Chilean government bonds is very high and the compressed yields reflect global buying rather than local economic factors pointing to recession.

Rate cuts in China? Persistent inflation in Asia. *In Asia, inflation seems entrenched with new highs in Indonesia and Korea and concerns in Thailand. In India, 18 months of inflation above*

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the target has policy makers looking at structural rather than temporary factors for high inflation. Without a serious correction in commodity prices, it will be difficult to unleash a new round of growth in emerging markets like we saw in 2009.

Thailand's central bank governor is openly concerned about inflation pressures in Thailand. Inflation is too high and government programs, while good for farmers, will only drive inflation higher. Planned wage increases will mean that there will be more demand and more need for further tightening (good for local currency speculators but bad for sustainable growth). In Indonesia, inflation is getting ahead of expectations, as well. As one of the best China proxy plays, Indonesia has been favored by strong FDI and equity flows. In South Korea, bad rains have damaged the harvest and the central bank is blaming weather, rather than loose monetary policy for the latest high inflation print.

But isn't Asia just in denial? Hasn't higher inflation become structural rather than cyclical? Higher wages, higher commodity prices, higher demand, cheap foreign capital, and nearly insatiable demand from China are all contributing to more permanent inflation drivers. Chinese economist Andy Xie has argued convincingly that while China might prefer a lower level of inflation, wage pressures and the rising incomes of farmers and interior cities will mean that inflation dynamics will be more persistent than in the past and that Beijing would do well to adjust to its "new normal." If a rumored slight easing in monetary policy in China can lift all

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commodity prices around the world in a day, then Beijing will have more to contend with than the price of pork in 2012.

In a very interesting speech last week, the executive director of India's central bank explained the persistent inflation dynamics in India that have continued to resist policy tightening over the past 18 months. For over a year and a half, inflation has been above the RBI's official interest rate target. In the first phase, a poor monsoon season produced a very meager harvest so that food prices spiked. Then as new harvests and the release of food stores ought to have eased inflation pressures, higher wages and increased demand for animal protein kept food prices high. Higher fuel costs and the liberation of gasoline prices helped drive inflation further. Then very high input prices moved into core inflation and put further upward pressure on WPI and wages. Indian workers are getting paid more and have more work, and companies are passing on the costs of production. But high input and fuel prices are persistent and structural. He concluded by admitting that inflation in India needs to be rethought. The national government must reduce its fuel subsidy burden and diesel prices will rise over time, adding more inflation pressure.

Shadow banks and the Financial Stability Board (FSB): Everyone supports the effort, but denies that they are a shadow bank. *The FSB will launch a new surveillance of shadow banking capital flows this fall. The board has solicited comments and responses from financial institutions and organizations. As one would expect, all types of banks, hedge funds, and money managers denied that they were actually part of the shadow banking system. The FSB will*

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include money markets, hedge funds, insurance companies, and private equity funds and derivatives and securitization markets as part of their early warning surveillance system for cross-border risk monitoring.

Blackrock wrote to the FSB and declared that it was highly unlikely that money market funds would ever “break the buck” and require additional government support. JP Morgan denied that the securitization markets needed additional regulation and supervision, because they had already been subjected to new and sufficient regulation. Groups representing hedge funds denied that hedge funds were shadow banks but even if they are, they’re too small to make a difference.

The Financial Stability Forum, as part of the IMF’s early warning system, is preparing new forms for monitoring cross-border capital flows. The IMF has documented the systemic importance of the shadow-banking global capital markets; shadow banks (broadly defined) were a significant vector of contagion during the financial crisis and remain largely unregulated and unmonitored. Most developed countries now regulate their local financial institutions and the global banking system is currently rolling out implementation of BASEL III. But given that the estimated size of the shadow banking system dwarfs regulated banks, the need for better monitoring and oversight is pressing.

The Financial Stability Board—which now has a broad membership that includes representatives from EM countries—has been anxious to address the lack of transnational oversight of shadow

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banks. But there is already considerable resistance from representatives of various banks and asset managers from developed markets. BASEL III is a step to limit cross-border risk concentration. The unintended consequence could be that more and more risk will be transferred to the shadow-banking realm.

Nigeria and Kazakhstan: the yuan is a reserve currency, diversification and the dollar.

Nigeria's central bank governor announced that Nigeria will allocate 10% of its forex reserves to the yuan. Kazakhstan will be diversifying into the Korean won, the Russian ruble, and the Brazilian real and plans to add the yuan once it is part of the IMF's SDR.

You might say who cares that Nigeria—hardly an upstanding citizen in the global community—is using the yuan as part of its forex management strategy. But when I read that Kazakhstan's CB governor Marchenko (a University of Chicago trained economist) was diversifying forex reserves into EM currencies and planned to include the yuan, I took notice. If oil- and gas-producing countries are beginning to seriously diversify their forex holdings, then the multipolar world of regional currencies is closer than many U.S. experts might like to imagine.

In the articles regarding Nigeria's announcement there was a throwaway comment by a Nigerian official to the effect that Nigerian money traders are already trading yuan on the street. That is very interesting. Wherever China sends its engineers around the world, demand for yuan will surely follow. China has major global infrastructure projects that include ports, mining, and oil

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exploration. Could we see Venezuela start holding yuan? Its lines of credit from China might be settled in that currency.

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