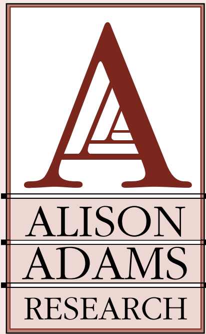

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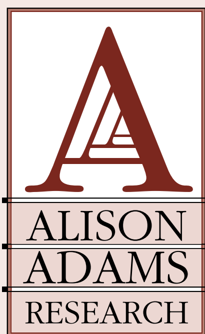
Week 37: September 24, 2011

Today's note looks at the possibility of coordinated policy response between emerging markets and the G7. Hopes might be high in developed markets that emerging markets can deliver more support to global growth. I have argued that emerging markets deserve continued overweight allocation based on more orthodox monetary policy, sound macroeconomic fundamentals, and robust domestic demand and better governance. But, I believe that policy support too soon from emerging markets would only spark a renewed "risk on trade" and inflation dynamics would return immediately in emerging markets. The BRICS are more likely to use the European crisis as an opportunity for more political concessions.

The G20 in November will make little progress on energy/food price volatility: Global Coordinated Monetary Policy will be insufficient to reboot global growth without meaningful fuel and food price correction: *The risk for coordinated policy response will be that the price of commodities will remain very high as markets put on the "risk-on" trade on a second round of BRIC stimulus. On the eve of global coordinated policy intervention during the financial crisis oil was below $40 a barrel---in that environment policy stimulus could work magic. Brent at $111, interest rate cuts of 50bps will do very little. The G20 Summit in November is scheduled to implement policies to mitigate crude price volatility. I doubt that much progress will be made. (good news for oil companies and banks)*



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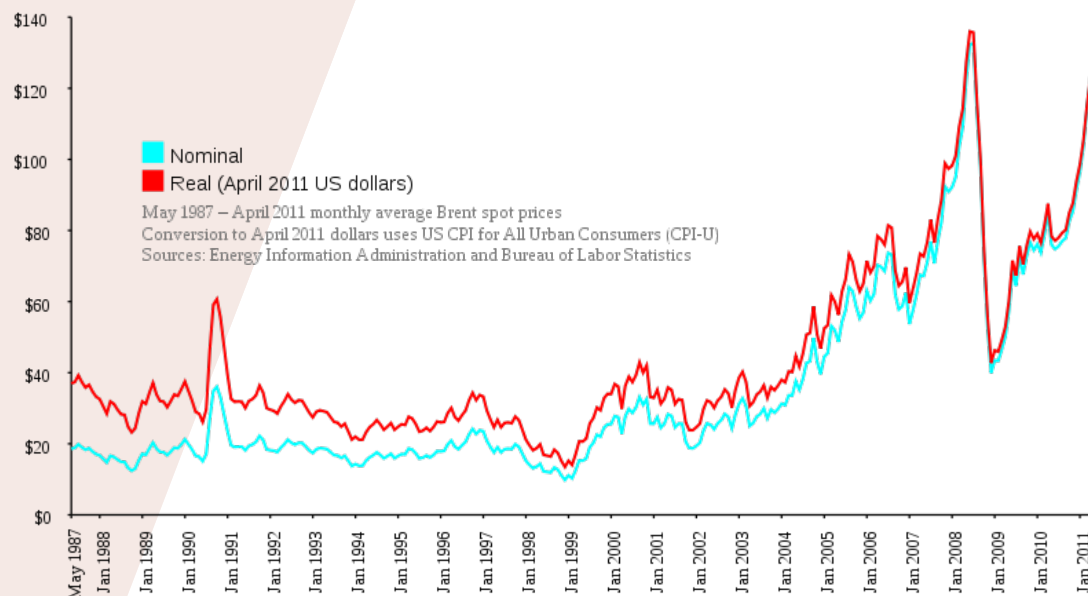
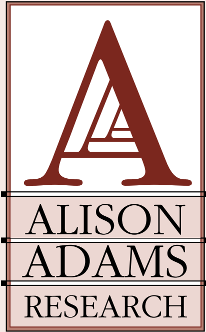


The heads of G20 member states will meet in Cannes at the beginning of November. Perhaps the most important item on the agenda will be the policy recommendations from OPEC, the IEA, JODI, and other multilateral organizations on resolving price stability in the energy markets. Food prices and supply will also be of particular interest. But the fiscal and banking crisis in Europe might undermine any progress on commodity prices.

During the height of the financial crisis, politicians around the world managed to act in a coordinated manner that has not been since WWII and Bretton-Woods. But perhaps the biggest contributor to the strong rebound in emerging market growth in 2009 and the spectacular returns for investors lay in affordable cheap and plentiful crude oil.



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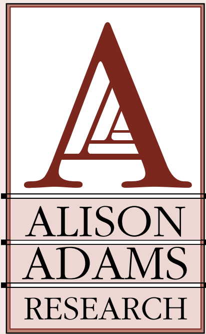
As we have seen in the last few months of 2010 and the first half of 2011, high crude prices are extremely damaging to price stability in emerging markets and the pass-through of even subsidized fuel costs into core inflation dynamics. High transportation and fertilizer costs have contributed to record high global food prices so that high oil prices impact CPI inflation through transportation and food costs.

Since the financial crisis, most emerging markets have worked to reduce their energy subsidies so that domestic fuel prices have moved in sympathy with global price increases. But with Brent above $100, popular discontent and strikes have slowed energy price liberalization. The Reserve Bank of India might be able to cut interest rates so that buying a car is more affordable for the Indian consumer, but with liberalized gasoline prices and higher prices for subsidized diesel, operating a car will be increasingly expensive. In China there is ample anecdotal evidence that new car owners are having difficulty buying fuel to drive their new cars. In Brazil, the model of biofuel has been undermined with the soaring price of ethanol so that imported US corn ethanol and gasoline—very expensive in their own right- are being imported to offset the costs of sugar ethanol and substitute for gasoline shortages.

The multilateral energy agencies have been charged with recommendations for dealing with extreme price volatility in crude and energy prices. Their recommendations—the product of two-years of work and research—will be presented to the G20 at the Summit. President Sarkozy and his administration have been quite clear in their animosity towards the “financialization” of commodities through the proliferation of commodity derivative trading and ETFs. But meaningful progress on this issue will doubtless fall victim to politics and bank lobbyists.



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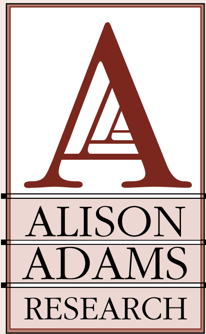
I sincerely doubt that any progress can be made in reforming international energy markets and the financialization of commodities given the building tensions between different financial centers. The ECB could be sued by the City of London for its rules that could force a clearing house to move locations. In the United States, former Mitch McConnell staffer O'Malia and now outspoken board member of the CFTC is fanning the flames of extra-territoriality disputes on the harmonization of international regulation of CDS and derivatives. Industry experts estimate that the total global market for CDS is $600tr. It is not clear if this estimate includes all synthetic CDS where underlying assets are not owned by either party. The CFTC is scheduled to post new rules for position limits, margins, and clearing houses in October as part of its mandate from the Dodd-Frank Act.

Europe and the G& want more help from Emerging Markets: Brazil's Mantega says BRICS (and S. Africa) are planning to help: *Like in 2008, only a massive global sudden stop and imminent collapse of the global financial system made politicians in the developed world work together. I am afraid that there is not nearly enough fear in Europe and the US for tough and coordinated policy implementation. If emerging markets act too soon, their policy and financial support could be wasted. No matter what EM governments due, they cannot undo the necessary and painful process of deleveraging that must continue to unfold in the US and the EU.*

Even Tim Geithner admits that the mess in Europe and the US is due to a lack of political will to act. The problem for politicians is that they believe that they have time to play politics. As we saw in 2008 when the first TARP plan failed to pass and hundreds of billions of value were lost on the stock market. The crisis in Europe is playing out slowly---but the effect is the same. The fear of total collapse is not big enough for politicians to act together. The G-7 meeting of ministers was predictably anticlimactic, where



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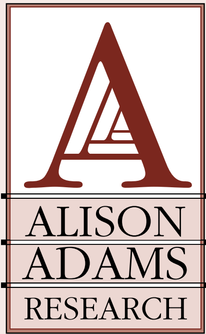
they asked emerging markets to do more to stimulate domestic demand and promised accommodative monetary policy from the G7.

In his Op-Ed in the *Financial Times*, Geithner concluded that, "this was a terrible crisis. Recovery was always going to be slow, fragile, and take time. We have more work to do. We are better off doing it together." But emerging markets cannot deleverage the US households and businesses anymore than they can deleverage European banks. In July, the world was worried about asset bubbles and inflation in emerging markets, now they want even more stimulus of domestic demand. Frankly, EM cannot do much nor should they rush in. Emerging markets still have asset and credit bubbles to correct, record levels of capacity utilization, and troubles related to the currency wars. Inflation might roll-over later, but it is still above official targets in many emerging markets.

A lone voice of experience has argued that Greece ought to default big and funds and time are being wasted in Europe. The BRICs should listen to him and wait for Europe to deal appropriately with their banking and fiscal crisis. Former Central Bank governor of Argentina and advisor Mervyn King, Mario Blejer created quite a splash this week when he recommended that Greece default big! But Blejer's analysis on Greece has been clear-eyed for months. The debt is not payable---Greece cannot pay its debt. The longer the policy makers delay, the higher the costs. Blejer was quick to point out that Argentina's workers suffered unduly as the government tried to delay the default. A small or partial default is worse than no default. Only a big default will help.

According to Blejer European banks must be recapitalization. He suggests that the ECB and the EFSF ought to redirect their funds intended to prop up PIIGS debt and use their monies to capitalize the banks.



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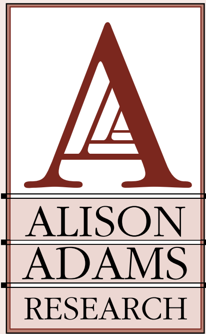
Even the head of Deutsch Bank has publicly acknowledged that that many banks in Europe would fail if they had to mark their reserves at market prices.

Frankly, emerging market policy makers ought to wait for the banks to be recapitalized and for Greece to default before they waste their fire power trying to prop up global growth. Commodity prices are too high. Inflation is still is risk in their home markets. European and American households will only spend a at an anemic rate for the foreseeable future. I would prefer that they wait. Talk of support, but wait to deliver.

Moreover, with Italy asking for financial backing, China will use its economic and financial firepower for the greatest political concessions. Beijing understands that the ECB and the FED cannot do much more to stimulate consumer demand in the EU and the US. But the G7 can give political concessions and guarantees. With the economic data from Europe and the United States heralding a further slowdown in consumer demand for Chinese exports, Beijing will be unwilling to let loose monetary policy as it did in 2008-09 when loan allocation rules were suspended and banks were ordered to lend!

Premier Wen has visited Europe and promised support for the PIIGS---but the promises were far larger than the actual support. Greek ports and shipping were of particular interest. China might have an interest in the survival of the euro. But they would be just as happy to see Greece leave the euro but remain in the trade zone. (they now own key port installations). Support for the euro as a currency does not necessarily mean that Beijing wants the euro zone to remain intact. The Balkanization of its most rancorous trade partner—the EU---might be just want Chinese exports needs.



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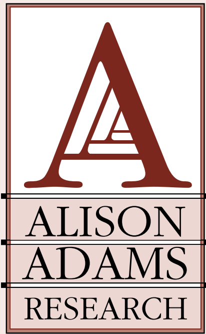
<u>China: PBoC Governor says M2 growth matches growth and price stability is the priority:</u> *Off balance sheet loans, ponzi schemes, and shadow banks have thwarted PBoC loan to deposit ratios too long. The threat of inflation is still troubling the central bank even as inflation moderated to 6.2%. New rules for reserve requirements for letters of credit, guarantee and structured wealth management products will be rolled out in 3 phases through February! (Perhaps interest rate cuts will have to wait until the New Year after all) The bank regulator has warned corporations about P2P loans where companies borrow from other companies instead of banks.*

It turns out that banks have been using off-balance sheet operations to circumvent loan to deposit ratios. The "scam" would be that a bank would lend cash to a business, who would use the mandated 20-22% of that cash to make a deposit in that lending bank. I will lend you 100 yuan if you deposit 22 of that 100 in my bank. According to *Caijing* the practice included a kind of ponzi scheme where companies would use the remaining 78 yuan to borrow another 500 from another bank! The new rules on margin deposits were especially targeted to eliminate this pervasive practice. The trouble with off-balance sheet lending is that it is very difficult to track. The PBoC has an especially difficult task since national champions are using their cash to lend to other businesses beyond the control of regulators. Shadow banks---like Blackrock---are also targeting large companies in emerging markets and possibly China-- who have been locked out of bank loans but need capital.

Commercial banks will be setting aside 20% mandatory margin requirements for their letters of guarantee, structured wealth products, letters of credit, and banker's acceptance The first phase will be between September 5th and October 4th where big banks will deposit funds upto 20% of the total required. The second phase, between October and November will require 40% of the original required and



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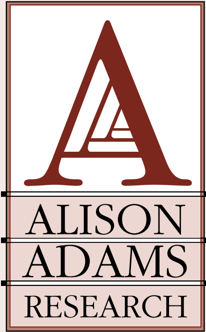
completion of the remainder by February 2012. I believe that the extended period of compliance is intended to give commercial banks time to consolidate and reduce lines of credit and raise capital in an orderly fashion.

The comments by the PBoC governor quoted in official state media seem to indicate that Beijing is currently pleased that M2 growth is in line with underlying real economic growth. I believe that Beijing has a domestic demand stimulus plan in mind---but it has every reason to wait a bit longer. To stimulate domestic demand before commodity prices have corrected would be highly counter-productive. Affordable housing and more loans for farm equipment will be more likely than an accelerated lending program.

Corn, Wheat, Sugar, Hogs—biofuels and EM Inflation: *The FAO World Food Price Index shows food prices around the world remain high. The latest corn and sugar crop estimates point to more pressures to come in 2012. The global food index remains well above the early 2008 peak, even after a slight moderation in August. The US will deliver a corn crop that is billed to be the 3rd largest on record even after the bad weather revisions. But experts estimate that as much as half of the crop will go to ethanol production. Hog and poultry farmers are using wheat to feed their animals. Even though the troubles in Europe roiled markets---food prices have remained elevated and supplies are tight.*

According to the FAO global sugar prices are still 50% higher than they were in August last year, even though the price corrected downwards by 2% in August. Rains in Brazil point to yet another weak sugar crop. The FAO grains index also corrected down in August by 2.2%, but the price of grain is still 36% higher than it was in August of 2010. In 2008, during the financial crisis, the FAO food index was 150



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points. In 2009, the index rose to around 180 points. In August, the index is still above the early 2008 peak of 220, and has averaged 253 points! In Mexico, corn prices are at record highs. In China pork prices continue to push inflation higher.

Like crude oil, the high price of food means that EM policy makers might have room to cut interest rates but demand will remain muted as long as food costs remain elevated. Looking at 2009, the collapse in the price of food probably did as much good as interest rate cuts and government spending to stimulate domestic demand and free up household income to buy white goods and cars.

American farmers deserve a great deal of credit. In spite of very bad weather, they will deliver a bumper corn crop—though smaller than originally hoped. The high price of corn certainly stimulated production. The US is now exporting corn ethanol to Brazil taking advantage of the strong Brazilian currency and the spike in sugar prices which have made sugar ethanol extremely expensive.

But it is not good news for all. Demand for corn ethanol and corn for animal feed has lifted corn prices around the world. Even in South Africa where harvests have been good, the demand for corn is keeping prices high. Mexico and Central America have high corn prices. High corn prices will mean that pork, poultry and beef and dairy prices will remain high around the world. And the high price of corn will push demand for wheat higher, as animal producers switch to wheat for feed.

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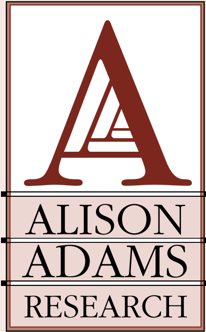

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