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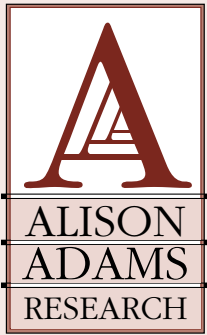
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Week 38: September 30, 2010

The wall of money chasing too few assets in emerging markets: *There are good reasons for American politicians to wring their hands about the high rate of unemployment and the anemic rate of growth in the United States. But money is going where it can make money—to emerging markets and higher interest rate environments. In Asia and Latin America, technocrats are looking to use any and all policy tools to help stem the volatile appreciation of the currencies.*

Currency volatility is on the mind of every politician from Thailand to Brazil, Japan to France, and everywhere in between. I have had some questions regarding emerging markets and policy risk. There is in general a rising risk of unorthodox, ad hoc policy interventions in emerging markets. With the Federal Reserve signaling a low interest rate environment for the foreseeable future, the “wall of money” problem for emerging markets is back on the front burner.

In Asia, the problem of too much money chasing too few assets is appreciating currencies everywhere except in China. In Thailand, the government is loosening its controls on the outflows of money in a failed repeat of a 2006 measure designed to mitigate the appreciation of the baht. The Malaysian ringgit hit a 13-year high on expectation of further internationalization. But the central bank has tried to dampen these expectations. The won is under serious pressure as well.



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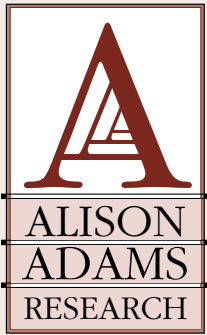
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In Brazil, the minister of finance stated that the sovereign wealth fund could be used to buy dollars and help stem the rapid appreciation of the real. Some are now arguing that the government could increase the IOF tax designed to dampen hot money inflows. Surely the government will wait until Petrobras has completed its planned offering and possible bond offer. Colombia's central bank is buying dollars to stop the peso from appreciating. Chile is warning that it too might have to intervene. In the emerging market universe, currency appreciation is being driven by strong flows and solid growth.

In a strange ironic twist, Japan's PM is threatening to buy up natural resources in emerging market countries to help depreciate his country's currency. It's another example of big money chasing too few assets in EM.

Will a stronger yuan be better? *It's clear that in the U.S. the issue of the strong yuan has a domestic political audience. It is not clear that a stronger yuan will create jobs in the U.S. But there is some serious economic justification for China's measured appreciation of the yuan.*

The comparisons with the Plaza Accord and the failure of Japan to control the bubble that broke its banks seem to be in every new forum. I would like to argue that these are thought provoking, but largely a poor comparison. Japan was already a fully industrialized country with high employment rates when the Plaza Accord was signed. The Plaza Accord enacted a coordinated measure to help depreciate the dollar against the yen and European currencies. Some want to



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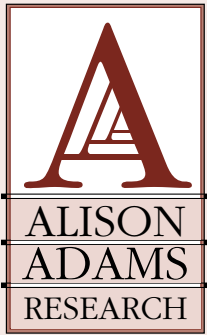
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argue that the Plaza Accord hurt both Japan and the U.S. The U.S. did not get its exports and the Japanese got a massive real estate bubble. Japan gets the blame for the failure—it didn't open enough, it let the real estate bubble happen, and then it let its zombie banks carry bad loans for years. But the U.S. continued its poorly chosen path to deindustrialization and exports sagged.

But China is not fully industrialized. It is still a country dominated by rural agricultural employment. In relative terms, China is much more like the Japan of the 1960s than the Japan of the 1980s. China's strong social trends towards urbanization and mechanization have yet to mature. On a per capita basis, China is much poorer than Japan was in the 1980s. Then there is the question of whether China will remain a low or high interest-rate economy. There are concerns about asymmetry in borrowing and investing in the yuan. Both India and Brazil know they are high interest-rate economies.

Barry Eichengreen has done some of the best work on looking at the relationship between currency and trade. In his most recent series, he and coauthors argued that currency asymmetries provoke trade wars and protectionism—that it is the currency mismatch and beggar-thy-neighbor policies that provoke governments to protect domestic industry and jobs. But when he looked at the history of currency and trade as countries exited currency pegs, he found that there were few historical examples where countries exited a peg to let a currency appreciate.



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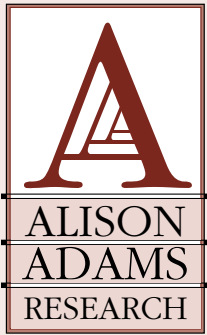
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They found that in those instances where countries exited a peg to allow appreciation, countries with relatively high growth rates did experience a loss of 1 percentage point of average GDP growth rates over 5 years. Policy preference or gradual currency appreciation is “well founded.”

All other things being equal, there was little or no impact on FDI, the stock market, or decline in the capital account. Eichengreen recommended that the government boost spending to help offset the loss of growth and support domestic consumption.

But Beijing lives in a relatively narrow world where growth must stay above 8 percent or unemployment will quickly rise, leading to protests. Yet, inflation needs to be quite low, especially headline inflation, or there will also be discontent. While I am sure that China is more than capable of engineering double digit GDP through command bank lending and FAI, the inflation problem is a stalking horse that prevents strong, continued stimulus. Ten percent growth is optimal. It's comfortably above the 8 percent, but not so strong as to push core and headline inflation higher. But the +/- 1 percent GDP growth impact from a strong currency appreciation, as cited by Eichengreen, puts China near its danger threshold of 8 percent.

The Global Policy Calendar: *In the run-up to the G20 Summit, where Geithner has threatened an international intervention with China, there will be several multilateral meetings where much of the current disagreement can be worked out or coordinated. The beaters are flushing out the tiger, but the result could be anticlimactic as minister and deputies work behind the scenes.*



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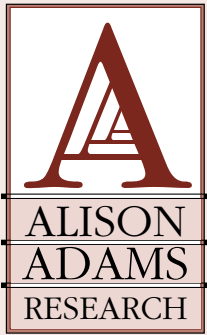
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- October 5–6: ASEM Asian-European Summit, Belgium—The 27 member states will discuss currency with China and with other Asian countries.
- October 7: G20 Deputies Meetings, Washington, D.C.—G20 deputies will set the agenda for the G20.
- October 21–23: G20 Ministerial meetings for G20, Gyeongju, South Korea—The high-level meets of the central bank governors and the ministers of finance from member countries will be extremely important.
- November 2: Mid-term elections in the United States—The Obama administration has no reason to let up on the China issue before the elections. Depending on the outcome, there could be more flexibility. But the more aggressive trade activism in the WTO process will continue.
- November 11-12: G20 Summit, Seoul, Korea

More on the G20 Summit, China, and the yuan:

South Korea in a bind as host for the G20; it is hosting just as its 3 biggest trading partners are embroiled in a scorching currency dispute. Japan, a low interest-rate country, with a low growth rate and a high savings rate, has a serious appreciation problem. China, a low interest-rate



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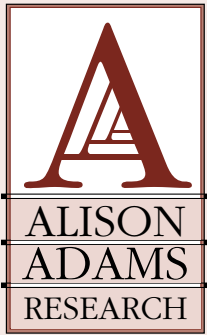
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country and a high savings-rate and high-growth nation, is fighting appreciation. And the United States has low interest rates, a modest savings rate, anemic growth, and high unemployment.

1. President Sarkozy, who will lead the G20 in 2011, has forcefully stated his intention to bring up the subject of currency volatility at this next G20 as ground work for significant progress ahead of France's G20 next year.
2. The European Union is signaling that it too will advance the appreciation of the yuan in both its ASEM Summit and the G20 Summit.
3. President Obama has stated that China has not done enough.
4. The White House indicated that it will support legislation from Congress if it is WTO-compliant and promotes U.S. economic interests. The WTO-compliant condition is a bit of a ruse. There is doubt that any congressional action on the currency issue would be compliant. But it is a threat against China nonetheless.
5. Secretary Timothy Geithner on China:

“This process of adjustment in their exchange rate is going to have to happen over time and it's not going to happen in a week or three months and we're not going to really know in a week or three months or six months or 12 months or 18 months whether we're going to see enough. This is something that we're going to have to be pursuing over a sustained period of time.

“The combination of the semiannual exchange rate report and the meetings of the G20 that happen at the ministers' level three or four times a year, at the heads of state level one or more times a year provide other benchmarks, timetables, things we can help use to advance progress. We are using every approach we can find, using the IMF to reinforce



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the basic case that this is a global problem . . . to make sure that China understands that this is something that the world economy has a great stake in.”

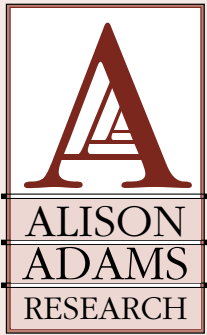
6. From The European Commission to the G20 in June 2010:

“All major economies need to do their part to achieve the agreed objective of strong, sustainable and balanced growth. We strongly support the G20 framework for growth in which the euro area will play fully its role. There is a need for credible medium-term fiscal policy strategies to bring down deficit and debt ratios, greater exchange rate flexibility, as appropriate, and a sharper focus on pushing forward structural reforms that can increase labour utilisation and productivity, thereby also supporting domestic demand on a lasting basis and counteracting crisis-induced fall in potential growth. In this respect, we welcome China’s decision to proceed further with the reform of the RMB exchange rate regime and to resume the RMB exchange rate flexibility.”

7. The president of the European Commission, Herman Van Rompuy has indicated that the 27 member states of the European Union have urged him to take up the issue of currency appreciation during the October ASEM Summit.

On June 17, only days ahead of the Toronto G20, hawkish and threatening statements from Beijing seemed to indicate that it would not give way. Then two days later, the yuan moved and greater flexibility was announced. It is interesting to note that Van Rompuy’s comments about the EU and the yuan received a lot more attention in the Asian press than in the U.S.

Are emerging markets a bubble? *The cynical answer is that there is nothing wrong with a bubble as long as you are on the right side of it. In the long run, emerging markets cannot be a bubble. In the near term, valuations seem unsustainably high. It seems more likely that the definitions of core holdings and diversifiers will eventually be reworked. Is Greece really more developed than South Korea? Does Portugal offer more investment security than Brazil?*



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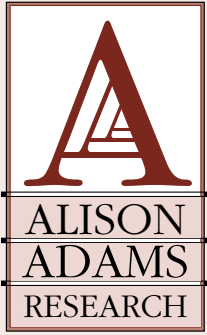
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But unsustainable can last a lot longer than you think. The wall of money problem means that valuations could go even higher.

I had a client ask me this bubble question the other day. It was a good conversation and kept me thinking about high valuations in EM versus attractive valuations in the developed world. With global growth on a two-speed setting—the developed world is hobbling along and EM and the frontier markets are racing along—it’s difficult to make the argument that EM is really a bubble. It is certainly far more than a diversifier, which ought to be the new role of the frontier markets. But if Goldman Sachs is correct and EM’s market cap will exceed the developed world by 2030, then it’s difficult to see how the currently high valuations can continue as risk appetite supports more issuance.

For EM to be a bubble, the end of the bubble needs a new attraction. Where will money flow in order to make money? A turn-around in Spanish real estate? Oil goes to \$147 again and excess liquidity sloshes back into Russia? It seems unlikely that a breakthrough in technology would draw sufficient bubble-like drivers. When a political basket case like Ukraine can issue debt at lower yields than Greece, one could consider government debt in the developed world a “new yield” vehicle. When India hit an average PE of 21x it seemed like EM valuations had become exceedingly rich. But unsustainable valuations can last a lot longer than you think. The wall of money problem means that valuations could go even higher.



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