ALISON ADAMS RESEARCH

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Is the IMF urging emerging markets to abandon strict inflation targeting? Perhaps structurally higher inflation will be the new normal for EMs. *The latest World Economic Outlook from the IMF urges EM central banks to "target what you can hit" in the face of high and volatile food and fuel prices. We could see higher official inflation targets, targeting inflation expectations, and even "core" inflation targeting in emerging markets. The problem with this technical position is that keeping wages low even as food and fuel prices soar is a recipe for political discontent or a return to bigger government subsidies. Lower interest rates and higher headline inflation could be the new normal for emerging markets. Technocrats may have abandoned any hope that commodity prices will respond to monetary policy or local harvests.*

Although the IMF readily admits that the pass-through effects from high food and fuel prices are much more significant in emerging markets, they nevertheless advocate that central banks ignore these immediate impacts and target other inflation measures. The IMF seems to think that managing inflation expectations in the face of double-digit cost of living increases would be a way for central banks to maintain credibility. I doubt very much that the poor of the world can tolerate such high rates of inflation. Emerging market governments will have very little room to advance social spending programs and invest in infrastructure without adding to inflation pressures.

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Over the past couple of weeks I have been taking a close look at the ability of emerging markets to support global growth as they did in 2009 and 2010. To be sure, domestic demand is robust. Monetary policy has normalized and most governments have acted to remove fiscal stimulus. But with inflation already near or above their official target rates and very high capacity utilization, further stimulus either from interest-rate cuts or fiscal stimulus must wait until there is a true correction in global commodity prices.

Looking over the IMF's *World Economic Outlook* (WEO), released yesterday, we can see that across emerging markets lower growth is expected along with higher rates of inflation. Political pressure is building for emerging markets to do more to stimulate domestic demand in order to support global growth and aid rebalancing. The WEO forecasts that in Russia growth will slow from 4.3% to 4.1%, but inflation will remain above target at 7.3%. In developing Asia, growth will slow but inflation will remain elevated. The average growth for countries in the region will slow from 8.2% to 8%, but inflation will only fall to 5.1%, which is still above most Asian central bank targets. India's inflation is expected to fall from 10.6% to 8.6% in 2012—well above the RBI target. China's inflation is expected to fall to 3.3%. ASEAN-5's inflation is expected to fall from 6.1% to 5.6%. In Latin America the regional inflation rate is expected to fall to 7%. Brazil's inflation is projected to fall from 6.6% to 5.2%, which is above target for 2012. Brazil's CB governor recently stated that Brazil will face lower growth and higher

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inflation in acknowledgement of the recent inflation print from the IPCA-15 showing that inflation surged in August above expectations.

Lower growth and higher inflation will be a challenge for emerging market governments. There will be increasing pressure for more subsidies and more social spending. Central banks might worry about credibility but focusing on low-wage growth in the face of higher consumer prices is a dangerous recipe for social stability.

The G20, the IMF, the Financial Stability Board, and other key multilateral organizations are currently working on new ways to coordinate central bank monetary policy around the world. The integration of financial markets and the era of global price setting are forcing policy technocrats to deal with the realities of truly global capital markets. As with the IMF recommendation for alternative inflation targeting, there will doubtless be more "innovative" ideas that will undermine traditional anchors of credibility and policy.

BIS Quarterly Review: Asset bubbles in emerging markets track dollar lending. *According to the latest BIS statistics on cross-border bank lending, asset bubbles have mostly formed where dollar lending has accelerated above the local rate of credit expansion in emerging markets. For example, in Hong Kong and China, dollar-denominated loans doubled between 2009 and 2011, but local credit expanded at less than 50%. China, Hong Kong, Thailand, and Brazil merit close*

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scrutiny by financial regulators, according to the BIS, on the basis of strong credit growth in local and dollar currencies.

The dollar carry trade has replaced the yen carry trade. "Since the crisis, U.S. dollar credit has grown faster outside the United States, but in only a few economies is it contributing disproportionately to rapid credit growth." Cross-border lending is accelerating either by directly accessing U.S. banks or through banks that borrow from wholesale dollar funding. The BIS notes that this trend will only increase over time, encouraged by interest-rate differentials and the expectation that the dollar will continue to depreciate. At this time, "The stock of dollar credit to borrowers outside the United States amounted to $5.8 trillion or 12% of global GDP (less the U.S.). In the first quarter of 2011, dollar credit to non-U.S. borrowers grew by $1.1 trillion. Half a trillion of that increase was lent to Chinese non-financial borrowers. In addition, in 2010 banks in Hong Kong increased their loans to non-bank mainland firms . . . by 47%—a rise that the Hong Kong Monetary Authority has dubbed unsustainable. Thailand and the Philippines also saw dollar credit grow faster than the pace of local credit expansion. India and Malaysia saw dollar borrowing fall below domestic credit growth. In Latin America, Mexico and Brazil saw their rates of dollar borrowing drop below the pace of local credit. And in Brazil, new rules on foreign borrowing helped cool dollar borrowing considerably.

In the past, the build up in foreign borrowing has been associated with the economic crisis over the past 50 years. The BIS is concerned that private and non-financial borrowing is fueling credit

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binges in a few countries and authorities ought to be focused on measures to address the mounting risks. The report points to both China and Brazil as places of potential risk where credit growth has been especially strong. Although the growth rate of dollar credit has moderated in many emerging markets, the total amount of outstanding dollar loans is quite high. Exchange rate appreciation in emerging markets will only encourage more offshore wholesale borrowing, so financial authorities will need to implement targeted measures to address private and wholesale dollar funding if future crises are to be avoided.

Brazil proposes WTO-currency depreciation anti-dumping rule: Building support for targeted weak-dollar anti-dumping formula. *A currency- related anti-dumping rule through the WTO will be difficult for the U.S. to block. The rule calls for a 35% import tariff on prearranged dollar value fluctuation! (Brazil may have more in mind than cars—corn ethanol, airplanes, farm equipment, technology, and steel could also suffer tariff adjustments.)*

The currency wars are not over. The Fed's operation twist—which will buy most of the Treasury's long-dated issuance next year—might help housing but will not be well received in emerging markets. As Brazil's Minister of Trade Pimentel argued, the whole world is facing dollar depreciation. The members of the WTO might welcome Brazil's proposal. I doubt that the planned meeting between Brazil's MoF Mantega and Secretary Geithner will go that well. Geithner might want Brazil's help to bail out Europe. But it is clear from President Rousseff's United Nations speech that Brazil views "excessively loose monetary policy" as a form of

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currency manipulation. Most experts believe she was striking out against the U.S. dollar policy as being an ominous threat to global stability. She also criticized those who pegged their currencies to support trade, which would apply to several Asian tigers, including China.

But the mechanism proposed by Brazil to the WTO will find ample support around emerging markets. Rather than unilateral trade protectionism, it could allow for some flexibility and diplomatic discernment for U.S. trade partners. But a formulaic, pre-negotiated range for the value of the dollar would also permit countries to defend certain sectors and national interests on a selective basis.

Emerging market domestic demand plays a better bet: *Regional and bilateral trade agreements between emerging market countries have worked to support growth after the crisis, but IMF projections for trade are troubling. However, IMF's Blanchard has frankly admitted that the latest WEO counts on many things going right. Trade will not stop, but it could be worse than the IMF has projected. Investing in domestic-oriented EM equities will be a better bet for the next six months.*

Here in the United States the latest news from our ports in Long Beach and Los Angeles show that retailers are turning more cautious and are willing to run with lower inventories. The *Los Angeles Times* reported that imports fell 5.8% in August compared to last year. The news from Long Beach is worse, with imports falling 14.2%. Exports are rising, from a very low base, and

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frankly still only represent a small portion of our overall GDP. But even with exports on the rise, retailers don't believe that Americans will be spending more. According to the article, both ports handle 40% of Asian exports to the U.S. The Asian tigers might be manipulating their currencies to support trade, but their policies are not working. The U.S. is still importing fewer goods now than it did a year ago.

The IMF's projections for global trade point to a similar trend going forward. Advanced economies will import less and emerging markets will be able to export less. Advanced economies are expected to import fewer goods in 2012. Imports will only grow by 4% in 2012, while they grew at a pace of 5.9% in 2011. Emerging markets will also see a similar contraction in the rate of growth in trade, which will fall from a 9.4 percent expansion of exports in 2011 to a 7.8% expansion in 2012.

Beijing supports fuel-efficient cars, tractors, farms, and affordable housing and R&D!

Although the Five-Year Plan mostly seems like propaganda, 2012 will see a push in a new direction: Farming, agriculture, health care, and affordable housing will be rolled out over the next five years on a massive scale, according to PM Wen. The new Five-Year Plan has many positive goals that will support higher wages, more domestic demand, and more energy efficiency.

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PM Wen spoke at the World Economic Forum and in his speech he outlined many of the tenants of the new Five-Year Plan for China. The plan will also serve as a political platform for Beijing's major political transition next year. Perhaps more than ever before, Chinese will be watching the Five-Year Plan and its implementation. It will be more than rhetoric and it must be if Beijing is to maintain political legitimacy and continue to deliver growth and improved living and working standards for the Chinese people.

- Pension schemes have been rolled out since 2008 and I expect that Beijing will do more to quickly implement them. Rural workers and illegal migrants to cities will also benefit. PM Wen stated that Beijing will provide basic medical and health care for all Chinese citizens. There are currently test plans in targeted locations ready to be rolled out once operational issues are sorted through.
- Beijing wants to extend affordable housing to 20% of urban populations over the next five years! We have already heard a great deal about the push for the construction of affordable housing. Beijing has ordered the banks to lend to local government financing vehicles for the real estate development of affordable housing. Even though Beijing has finally seen the cost of real estate fall in some major cities, the new push for more housing construction ought to be supportive of steel, copper, and cement prices.
- Beijing has clearly moved to do more to support farmers and ensure higher crop yields. I expect that we will see renewed support of the farm sector with equipment and fertilizer

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subsidies and incentives. If fuel costs remain high, I would expect to see farm subsidies or offsets for higher diesel costs.

- Green energy continues to feature in Beijing's long-term plan, cutting CO2 and pollutants while reducing the overall dependence on fossil fuels.

Unlike many advanced economies, Beijing might actually be able to deliver its plans for better education, more green energy, new technologies, and a larger social safety net. Even though the EU does not recognize China as a market economy, it is THE economy that matters for global growth.

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