ALISON ADAMS RESEARCH

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Week 39: September 30, 2010

Plaza II versus Bretton Woods III: The G20 and coordinated currency policy: *It's possible that the finance ministerial meeting ahead of the G20 will produce more understanding and cooperation between central banks than the actual summit. The United States should be a leader in establishing a grand bargain of historical significance regarding global imbalances. Instead it is going its own way with a shortsighted fixation on the CNY/Dollar exchange rate.*

Currency war? It took a Brazilian finance minister to openly declare what has been obvious to all—though too few wanted to call it such. But from an emerging markets point of view, it is less clear who is causing the war. China is Brazil's number-one customer. The issue of competitive currency depreciation between the two countries is largely academic. Brazilians aren't accusing China of stealing Brazilian jobs with a low exchange rate. Most of EM is quietly concerned about China's currency policy, yet obliged to do the same as China and manage currency appreciation with intervention in the currency markets and sterilizations. From an emerging market point of view, the developed world running record low interest rates is driving money into emerging markets in its search for yield. Brazil, while it might recognize a currency war when it sees one, has indicated that it has no interest in participating in Geithner's plans to shame China at the G20.

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There are a host of excellent reviews of economic history regarding the Plaza Accord of 1985 and the Bretton Woods agreement of 1944. But there has never been such a maladjusted and imbalanced economic and trade relationship as there exists now between the United States and China. This relationship is simply without precedence. The global reserve currency is locked in a dance of death with a non-traded currency of the world's second largest economy. The distortions are massive and will get worse over time. Political action is required. The multilaterals are hard at work preparing the recommendations regarding the issue for the G20. Lipsky from the IMF said there was still a great deal to be done to ensure balanced and sustainable economic growth. That is IMF-speak for global imbalances. The BIS has just published a paper that advocates coordinated managed appreciation for Asian exporters against the REER of a traded weighted basket of currencies of their trade partners.

Global cooperation has worked quite well. The G20 Pittsburgh Agreement ensured that CAD countries would do more to boost savings and exports while CAS countries would undertake the opposite and promote domestic consumption and investment. Work from the World Bank indicates that trade imbalances have been improving since that summit. Global trade has stabilized and recovered from its collapse in 2008. In spite of a surge in WTO cases, protectionism has been kept at bay. U.S. exports have done well and the U.S. is importing less. But 18 months is too long to wait for U.S. politicians anxious about their futures. OPEC, largely

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through Saudi leadership and restraint, has kept the price of crude stable and relatively affordable for importing countries, allowing profits for exporters.

There seem to be two approaches. One focuses on the currency issue alone and appears to advocate some sort of Plaza-II style resolution wherein the U.S. will get the employment and investment it wants by China revaluing its currency and reducing its competitiveness. Plaza I did nothing to help ease the unemployment situation in the U.S. in 1985 and set the stage for Japan's lost decade after the property bubble collapsed. The dollar weakened against the yen, but the unintended consequences were disastrous. The other camp seems to be one in which the imbalances are recognized as being the result of complex factors that include savings rates, fiscal discipline, and factor costs. Like the Bretton Woods agreement of 1944, the broad issues underlying the imbalances were addressed in a general understanding that debtor countries would spend less and save more and that creditor nations would spend more and save less. The fixing of national currency value to gold relied on this fundamental understanding. But the system demanded capital controls to keep it in line.

The United States should be a leader in establishing a grand bargain of historical significance. Instead it is going its own way with a shortsighted fixation on the CNY/Dollar exchange rate. There is a limit to what the technocrats can do by themselves. To be certain, they have done more than their leaders have since the great recession began. I fear that it will be left up to them to solve a problem they cannot solve without political consensus and international cooperation.

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The EC was able to address the issue with its semester and budget peer-review process, which could have actual sanctions attached. The G20 Mutual Assessment Process (G20-MAP) is intended to deepen global cooperation and risk management. The United States Congress seems blissfully unaware of what is happening.

Making Matters Worse: The Currency Manipulator Bill. *It's difficult to discern how much noise on the Hill is noise for the mid-term elections. But it is clear that the U.S. has lost its way on the global stage in promoting the growth of the U.S. economy.*

The U.S. is falling out of step with the G20. It seems determined to go its own way. In D.C., the blame is all on China. Does the Hill really understand that they are driving money away from the U.S. with higher taxes, tax incentives for outsourcing, and tax breaks for leaving corporate earnings offshore? Rather than beat up on China, why not change the corporate income tax rules? That actually might create jobs. The Hill could learn some lessons from emerging markets—rationalize the tax system, incentivize FDI and job creation, establish a VAT, and reduce the tax burden on businesses (the entities that create jobs and growth), attract repatriation of profits with attractive tax breaks, and invest in infrastructure. In case the Hill hasn't heard, it's a global investment universe and government should realize it's competing for global investment.

Still, beating up on China seems less difficult. Secretary Geithner's comments could be seen as a domestic political ploy to keep the House Bill from reaching the Senate ahead of the G20. But

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the U.S. is not the leader it ought to be on the issue of currency imbalances. The lack of inspirational leadership threatens to worsen these imbalances—not address them. The emerging market members of the G20 are showing only polite interest in Geithner's plans.

Asia-Europe Dialogue Next Week: *There is a lot of "unofficial" diplomatic work to be done in Brussels next week at ASEM. Political noise could get worse before it gets better in the run-up to the G20 in November.*

Tensions between China and Europe are high over trade and the yuan. But tensions between Japan and China are worse. Japan wants to talk with China about tensions in a multilateral setting. PM Wen has said that there will not be a Japan-China summit. The fishing boat incident is troubling. But I am sure that PM Kan and his Cabinet are far more concerned about Beijing's massive JGB purchases over the summer. Was it just friendly rebalancing or an attempt to sabotage Japanese competitiveness? Kan had originally planned to skip the ASEM meetings, but instead decided to represent Japan in an effort to check China's dominance. For Kan financial, economic, and currency troubles at home make the Senkaku Chinese fishing trawler spat a way to boost domestic approval ratings. There might not be a summit, but there will certainly be behind-the-scenes diplomacy on the issue.

The EU will be talking to China about the currency issue at the October 6 Summit. There have been indications that the EU is willing to horse trade more power and votes in the IMF in

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exchange for more "responsible" handling of the yuan. China wants the EU to grow more. But that's difficult to deliver when fiscal austerity is now the order of the day from the EC and its semester budget review. The EU and Washington are both anxious for more flexibility in the yuan. However, Washington and Secretary Geithner might find that the EU will be fickle allies in the fight to push China to revalue its currency.

Systemically Important Financial Institutions and the G20. *As if Basel III were not enough trouble, the Financial Stability Board and the IMF will present recommendations to the G20 to increase "loss absorbing capacity" for systemically important financial institutions (SIFI). And the multilaterals are not just focused on banks in their recommendations. An extra layer of supervision, regulation, and capital could be in store for the world's SIFIs.*

The Financial Stability Board issued a press release that indicated that the board, which now includes major emerging market government representatives, would be presenting its recommendations to the G20 for further regulation and capital provisioning for SIFIs. The board's recommendations will include proposals to protect taxpayers from further bailouts of these financial giants. Their proposals will also include recommendations for additional special supervision and peer-review processes. For now it appears that the FSB recommendations for the SIFIs will be an additional layer of risk management and capital provisioning beyond the Basel III requirements.

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The IMF's John Lipsky gave a presentation at the Depository Trust and Clearance Corporation and indicated that the IMF shares the views of the FSB, of which it is a board member, and that the IMF will also be presenting the G20 with its recommendations for further regulation of SIFIs.

What is a SIFI? Well you probably own them in your portfolio. It seems that both the FSB and the IMF have in mind companies like AIG as well as Citi. Sheer size and global reach with regard to the volume of financial services is the most obvious definition. But the IMF also includes interconnectedness and degree of substitutability. Lehman and Bear Sterns would have also qualified based on the complexity and interconnectedness of their market functions. If an institution holds the majority share of financial operation of functions, then that would also qualify as an SIFI.

What will the IMF recommend? The jury is still out and the usual suspects outlined included surcharges, levies, and the Volker rule. But the FSB wants more ability to absorb losses. That means more capital requirements as well as more prudential requirements (including capital surcharges and contingent capital instruments and provisions to convert debt into equity). The IMF is also recommending systemic levies for resolution funds or for them to be paid into general revenue. The IMF calls this the "financial stability contribution." Capital charges and risk-based taxes should be used in concert, rather than favoring one or the other. But the IMF is most interested in boosting regulatory oversight and "learning to say no" for regulators.

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<u>Global Green Bonds with Multilateral Backing in EM Currencies.</u> *The ADB launched its first green bond sale and raised $232m. It hopes to raise $2bn by 2013. Could the IMF's proposed $100bn Green Fund be next?*

The ASEAN trade pact countries have an agreement to buy a share of each other's bonds. The Asian Development Bank's first green bonds offer was met with strong demand. The tranches in Australian dollars, the Brazilian real, and the Turkish lira indicate that the demand for such instruments is global rather than regional. All currencies on track for appreciation might have been an additional attraction. The ADB plans to sell $2bn worth of green bonds over the next couple of years. The ADB will match funds raised by the bonds in its support of green energy technology in the region.

Although the markets largely dismissed the Copenhagen Accord, the agreement outlined $100bn a year from private and public sources to address climate change and help developing countries. The success of the ADB Water Bond and Green Energy Bond could refocus IMF attention on the Green Fund.

> Green Fund would use an initial capital injection by developed countries in the form of reserve assets, which could include SDRs, to leverage resources from private and official investors by issuing low-cost "green bonds" in global capital markets. Contributors could agree to scale their equity stakes in proportion to their IMF quota shares, making these the "key" for burden sharing among the contributing countries.
>
> The Green Fund could cover its subsidy needs from bond proceeds, interest

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income on its reserve asset capital base, and/or revenues from other innovative international tax schemes. Resources mobilized by the Green Fund could be channeled through existing climate funds, or via newly created special-purpose disbursement facilities.

Venezuela: Executive Powers Beyond the Congress. *Chavez still controls the budget, the central bank, monetary policy, foreign loans, PDVSA, the army, and his informal national guard. His powers of decree carry the force of law prior to assembly approval. The opposition "victory" is a small positive for a return to political normalcy in the long run. But from here to there is a treacherous path of currency risk and political upheaval. As I have written in the past, there is little reason to own the long end in Venezuelan debt. Only 2 days after the election, Chavez promised to build 25,000 homes in Caracas for $1bn. Autocratic populism is alive and well in Venezuela.*

I am not sure why the bonds rallied on the opposition showing. Political risk in Venezuela just went up, not down. It's true that the opposition won the plurality of votes, but the malapportionment of the voting districts gave Chavez the majority in congress. The dissolution of the senate in 1999, without the redistribution of districts, was intended to dilute the political clout of the opposition. The dissolution of the senate also means that Chavez's executive powers are more extensive than one would expect.

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According to Venezuela's constitution (ratified in 1999), the executive can issue decrees "with the force of law prior to the adopting enabling legislation" and manage the public treasury. The president is also responsible for the negotiation of loans and can order extraordinary budget items with prior approval of the National Assembly. The president also formulates the national development plan and directs its implementation with approval from the national assembly. But Chavez would need a 2/3 approval from the national assembly to declare a state of emergency.

Can the opposition stop Chavez? It can definitely prevent Chavez from modifying the constitution further. But Chavez has enormous executive powers that were written into law in such a way that he hardly needs a 2/3 majority to continue his rule as it is.

Nigeria: *The presidential elections have been delayed by three months. Elite political consensus is elusive. The electoral law, the constitution, and the date of official power transfer are all up in the air. The voting booths might be ready, but the legalities are getting more complicated. It's a bad combination if the election is contested.*

There have been concerns about electoral preparedness for a national election. The Independent National Election Commission (INEC) has been issuing warnings about troubles with its voting machines and voter registration since the death of President Yar'adua. The National Assembly voted to postpone the election for 90 days to allow INEC more time to prepare. The law states that the actual swearing in of the president should occur 120 days after the election to allow time

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for transition and the resolution of potential disputes. This means that President Jonathan could be in power until August. But if the normal transition period is observed on May 29, then there would be less than a month to facilitate the transition. In the absence of elite political consensus around Jonathan's candidacy, the postponement of the election adds to the uncertainty and risks. As in Pakistan and Ukraine, questions regarding the constitutionality of an election or an electoral challenge can bring about popular unrest and protests, not to mention financial disruptions.

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