ALISON ADAMS RESEARCH

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What can the G20 do? Reinstate programs that worked in 2008 before the crisis spreads to emerging markets. The IMF rolls out a new flexible credit line facility for troubled EU states. The Federal Reserve could reinstate its dollar swap agreements with key emerging market countries. *We argued in August, a BRIC-only rescue looks very unlikely and global coordinated action will need to wait until the G20 in November. But there are measures that might not cost much upfront cash and which could be implemented to mitigate contagion vectors from the EU to the rest of the world. The Federal Reserve could preemptively offer dollar swap deals before stress in the global system gets worse and help calm EM currency volatility. And the IMF could look for new member donor financing (possibly in EM countries) for credit line facility for countries like Spain and Italy (in case they need liquidity).*

As India's RBI Governor Duvvuri Subbarao argued, emerging market countries are not immune to the current crisis. And while most EME countries enjoy significant foreign exchange reserves, they are also fighting inflation, credit and asset bubbles, and facing a potential sudden stop in global trade and a collapse in commodity prices. Brazil's Mantega has repeatedly pointed out that the longer the EU takes to solve the crisis, the more expense it will entail. But worse from an emerging market perspective is that the longer the EU takes to resolve the crisis, the deeper the vectors of contagion go in the global capital markets. The IMF and the Federal Reserve could act now by reinstating emergency measures that were put in place in late 2008.

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The IMF's current funding level, while significantly higher than it was before the 2008 crisis, is insufficient to fully fund a European rescue. However, as in 2008, the flexible credit line for credit-worthy countries has proven remarkably effective in shoring up market confidence. If European member states are forced to partially recapitalize their banks, an IMF credit facility might be an effective backstop for sovereign debt.

IMF Managing Director Lagarde has been arguing for a massive recapitalization of Europe's banks as a way to mitigate contagion ahead of a potential bond haircut on Greek debt of 50%. But with bank loss estimates nearly as large as the fund's total capital, the money for bank recapitalization must come from other sources. There are now persistent rumors that France might consider a possible partial nationalization of its banking system if banks cannot raise adequate capital in the private markets. Spain and Italy could consider similar action. *In the event that European member states might be forced to help recapitalize their own banks themselves, a new IMF credit facility could aid in stabilizing national debt dynamics. France and Italy could qualify.*

Moreover, such a new facility would be easier to fund through individual member state pledges from the cash-rich BRICs without undo political wrangling. China and Brazil might be persuaded to put up cash—vis-à-vis the IMF—to backstop credit worthy sovereigns in the EU for liquidity. For example, Mexico's economy was severely impacted by the situation in the

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U.S., though it was otherwise credit worthy. The IMF facility helped assure markets that the Mexican government would have the cash it needed to meet its obligations.

Russia has spent an estimated $6bn defending its currency since August in spite of still quite high oil prices. Turkey, South Africa, and Poland have also suffered strong depreciation of the currencies related to the crisis in Europe. Korea, China, and Brazil were all surprised by the sudden strength in the dollar and were forced to intervene to stabilize their currencies. Given the very high rate of dollar lending into emerging markets by European and U.S. banks, a Greek default or an extended rally in the dollar could undermine EM corporate ability to roll over debt. Dollar scarcity was a major vector of contagion for emerging markets in 2008. The spectacular buildup in dollar cross-border lending over the past two years means that this will be an issue once again. And the Federal Reserve should not wait for severe stress in the system to emerge. A preemptive dollar swap facility would do a great deal to help soothe foreign exchange markets for the EMEs.

Russia: Still Our Least Favorite BRIC. *Putin's comeback is not news, but the very public falling out between President Medvedev and former Minister of Finance Kudrin is unprecedented. Medvedev wants to boost military spending above $800bn so that Russia's military will rise above the level of a "Banana Republic"—to use his words. Meanwhile, Russia's central bank has spent an estimated $5bn shoring up the ruble, in part related to capital outflows. Political discord in the Kremlin will fuel this trend.*

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We can look forward to many, many more fear-mongering cartoons about the return of President Putin. Before 2008, it seemed that Putin was a regular feature on the cover of the *Economist* magazine. Even Kremlin insiders do not always know what is going to happen or what promises will bear fruit. MoF Kudrin was a key part of President Putin's "continuity" plan, wherein Putin encouraged investors through long-range planning and targets for price liberalization and reforms in 2007–2008 as he left office to become prime minister. Perhaps Putin promised Kudrin the plum job of prime minister once he left office. Perhaps he promised Medvedev that Medvedev would be president for two terms. Both Medvedev and Kudrin, Putin's men to the last, were natural rivals. But Putin did not "save Kudrin." And there were several high-profile defeats of Medvedev's reforms in the Duma.

The public scandal is unprecedented. Tensions within the Kremlin have been notoriously opaque and offered endless fuel for speculation regarding the Siloviki hardliners and the reformers. We can now all be assured that there are few, if any, political ideologies in the Kremlin and that fiscal restraint and orthodoxy are unwelcome. Kudrin's ouster for his defense of Russia's fiscal and monetary health is more than troubling. The fact that President Medvedev cut him off, even as global markets are in full flight and money is leaving Russia, gives me pause. And it ought to worry foreign investors as well. Surely this is precisely the time when Russia ought to be acting to shore up foreign investor sentiment and encourage more FDI.

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A country's creditworthiness is more than any one technocrat can carry. But taken together, it's clear that the top political leadership in Russia is at odds with itself, and frankly with the outside world. Top leaders from the communist party to the head of the central bank have offered public comment on the falling out. Such a thing would not have happened four years ago. Putin's presidency was marked by political discipline. This sort of openness amongst the political elite is a sign of confusion, not democracy. *Recent events do not bode well for the ruble. I expect that the central bank will have to continue its defense of the ruble as Russians vote with their cash by sending it out of the country.*

China: Revisiting the hard landing? *The PBoC has admitted that short-term capital inflows are a major problem. It has also warned that property markets could see an unintended "sharper-than expected" correction. The IMF estimates that domestic credit now equals 173% of GDP (which is very high). And although monetary conditions are tight, lending has continued to grow.*

This summer we have been covering the proliferation of "unregulated" lending practices in China. (Sound familiar—à la Countrywide?) Big banks now have a mandatory reserve requirement of 21.5% and other capital requirements besides. But the scope of local government borrowing during China's massive countercyclical spending program in 2009 is still unknown. A few local government SIVs are thought to be insolvent. China's regulators are currently mounting a thorough audit of these SIVs and some numbers have been published. Though, to be

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fair, as with bank balance sheets, it's not the loans you can count that are the problem, it's the undocumented and off-balance sheet risks that are a serious threat. The IMF wrote that growth, fueled on credit expansion since 2008 and local government losses would lead to writedowns in the SIVs.

A good deal of this unofficial loan activity has surely been related to asset and commodity price speculation, which could have more room to unwind. Cash-rich state-owned enterprises have been lending out cash at near usurious rates. Middlemen of nearly every commodity borrowed heavily in 2009 to build inventories in anticipation of further price increases. Many lost money, as the NDRC delayed increases in diesel and gasoline in the first half of the year. Bullish price expectations for copper, iron ore, steel, and oil have all been disappointed by the global correction in commodity prices and anemic growth in the U.S. and the EU.

Credit growth in Brazil remained healthy even before rate cut: salary negotiations will push wages higher. *Foreign bank lending increased 1.9% in August despite additional tax barriers. BNDS continued to lend regardless of government cap. According to the central bank, credit expanded at 19.4% in August over last year.*

Credit has been growing steadily in Brazil. But when compared to China, the numbers look quite manageable. Loans for housing were up 3.7% in August and credit cards rose 2.2%. But export lending also remained relatively healthy in spite of turmoil in Europe and went up 3.3%.

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However, the biggest area of growth was in the *cheque especial* area—where borrowers can borrow against their paychecks. Brazil's regulators have tried to keep the balance of borrowing in healthy territory. But local media is full of stories regarding the very high rates of interest being charged and how most Brazilians are spending a significant portion of their income on interest payments.

Will Turkey follow Brazil? Turkey's monetary policy committee notes focus on global economy. *The decision to keep interest rates on hold in spite of an expectation that core inflation might continue to rise is in keeping with growing emerging market expectations that global growth and commodity prices will fall considerably.*

Markets might take Turkey's position on rates with more equanimity than they did with the surprise rate cut in Brazil. But as with Brazil, the most recent monetary policy statement is clearly signaling that external, global forces will cool inflation more than monetary policy. Like Brazil, Turkey's monetary committee sees that the core inflation will continue to rise in the short run, but that second-round effects will be offset by substantially lower global demand. The committee also noted that it did not expect that its decision to keep rates on hold would negatively impact the lira. "All policy instruments may be eased should global economic problems further intensify and the slowdown in domestic activity becomes pronounced." It may not be time to bet on lira appreciation any time soon, even at these levels.

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Brazil moves to cool inflation and reduce imported gasoline tariff: *Gasoline and sugar ethanol demand are up significantly, but sugar planting has failed to keep up. The result is more imported gasoline and corn ethanol and more inflation pressures for Brazil. Starting in October the gasoline import tariff will be reduced but the price Brazilians pay at the pump will remain constant. Other inflation pressures will soon arise as Brazilians begin their annual salary negotiations.*

Sugar takes three years to mature. Older, dryer cane makes the best ethanol. Younger cane is mostly suitable for sugar. Traditionally most Brazilian sugar ethanol mills were designed to handle this divergence in the quality of the crop and harvest volatility. Mills produced sugar and ethanol. But the global crisis meant that the boom in sugar ethanol collapsed and cane plantings and mill construction lagged. Yet the global crisis gave the central bank unprecedented room to cut interest rates so that many more Brazilians could buy a car on credit! Two years later, demand for fuel has soared but ethanol production lags considerably. And poor weather contributed to already insufficient plantings. Crop production fell over 10% and ethanol production was down around 30%. This is good news for American refiners and corn ethanol producers, but bad for Brazilian inflation dynamics.

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