ALISON ADAMS RESEARCH

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"The weakness of the inducement to invest has been at all times the key to the economic problem."*

J.M. Keynes, The General Theory

**and by investing, he did not mean synthetic ETFs, CDS, commodity speculation, dark pools, high frequency trading, or Delta 1 trading desks*

When headline growth is strong, does political uncertainty matter less? *The balance sheet recession, wherein U.S. households still swim in debt, is the main reason U.S. businesses of any size are not investing aggressively in this country. Arguments about the relative size of government, soaking the rich, and healthcare costs are a distraction. If any kind of strong headline growth possibilities were visible in the U.S., companies would put their money to work. Operation Twist—according to Plossner of the FOMC—would only reduce the yield on the 10-year by about 20bps. It's difficult to believe that this would "unleash" the animal spirits of corporate America into a job-creating frenzy.*

Investment call: *I continue to believe that U.S. corporations are scaled for a low-growth environment that would help shore up profit margins. Moreover, if commodity and energy prices continue to decline, that will also help support earnings in a weak growth environment. A pessimistic view on the U.S. recovery does not necessarily warrant a pessimistic view on all U.S.*

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companies. Banks are an exception because no matter who wins the presidential election, they will have little political support before November 2012.

Political, regulatory, and tax risks abound in emerging markets, but nearly every Fortune 500 company is putting their money to work in EMs despite these obvious perils. The truth of the matter is that businesses large and small do not much care much about political risk if it appears that profits are likely. If political and regulatory risk really made the difference, then companies like Coca Cola would not be investing in Russia. Or General Motors and Ford in China and India, for that matter. And American pharmaceuticals would not be investing in generics in emerging markets, where distinctly socialist notions about healthcare still prevail. American companies are not investing aggressively in the United States because those households are still swimming in debt from before the crisis, if they are lucky enough not to have filed for bankruptcy already. Bernanke's speech at Jackson Hole specifically identified the need for U.S. households to pay down their debt.

Plossner (one of the two dissenting votes on the FOMC) gave an interesting speech at Villanova University in which he outlined the very real problems of the U.S. economy and why he voted against Operation Twist. Plossner's comments are refreshingly candid—and in my opinion, accurate. He noted that "some sectors, such as financial services and construction may never return to their prerecession shares in our economy."

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<u>IMF-lender, government, and regulator of last resort?</u> *While the IMF continues to give the EU special treatment—including buying bonds in the secondary market—the new Plan of Action for Europe has fresh promises for emerging market members. These include a clear schedule for including EM currencies in the SDR basket and special bystander lending facilities for European fallout. However, IMF members have been extremely slow to implement the new expanded voting quotas for emerging market members. I expect that these members will be asked to contribute significant amounts of new capital to finance the IMF at the G20. Even if the IMF sold more gold—which I expect that it will—it does not have nearly enough capital to deal with Europe and the economic slowdown. North Africa, the Middle East, and emerging Europe could be beneficiaries of new flexible lending facilities.*

I argued last week that the IMF could act to provide special liquidity provisioning for troubled European countries as it did during the crisis. Indeed, the IMF's chief Lagarde outlined special facilities in her plan for Europe. But emerging market members, who still are waiting to have their increased shares voted into reality, will be more than a little upset. Not only have the Europeans held up their new broader inclusion in the Fund, these same countries will expect more cash from emerging markets and more special treatment from the Fund, since they are incapable of saving themselves.

In her Action Plan, Lagarde lamented the very slow progress in the quota reform at the IMF. "Progress in implementing the 2010 quota reform and re-composition of the Executive Board is

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moving slowly. At roughly half-time to the agreed deadline (2012 Annual Meetings), only 20 members with 19 percent of voting power have consented to the 2010 quota reform." That means that none of the big voters, like the U.S., the U.K., France, and Germany have voted for a more inclusive executive board. It also means that the promises of a better SDR basket mechanism could be delayed. Why would China, India, and Brazil give additional cash to a multilateral organization that favors itself both politically and financially?

The mention of a firm process and schedule for including new currencies into the SDR basket is surely an offer for the BRICs. But progress on SDR reform cannot proceed without a new composition of the executive board. I am skeptical that the Fund will make much progress on the SDR basket. The only way that the current executive board (mostly the United States) would allow a meaningful reform of the SDR basket is if the global economy approaches another sudden stop and BRIC cash is absolutely necessary. It's clear that the financial technocrats in Washington are uncooperative at the moment.

The Plan of Action also included a promise that lending programs would reflect the needs of its members. The basis for new lending programs will be expanded from existing facilities, the FCL and the PCL. The flexible credit line was used in 2008 and 2009 as a potential lending program that could be accessed as needed for credit-worthy countries. More than anything, the very existence of such a program was an important anchor for countries with sound fundamentals but which faced rollover and liquidity risks related to external shocks. For the IMF, regions like

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emerging Europe, North Africa, and the Middle East would be likely “crisis bystanders” deserving of such facilities. Poland, Egypt, Tunisia, and possibly Turkey might qualify. Though the IMF is unclear, such expanded facilities could also be available for countries like Belgium, Austria, and even France.

Dexia: It’s one of the top 20 banks and it passed stress tests in 2010 and 2011. New EU trans-national financial regulators, the EBA and the FSB, have had little impact. A new round of stress tests ought to be treated with caution. *Dexia passed the EU stress tests in July! And it’s the first to be bailed out. But whose bank is it? It’s split between three sovereign guarantors, their regulators, and the feeble newly minted financial regulators. With issues of concentrated loan risk, cross borders, and avoiding regulatory scrutiny, Dexia could be the tip of the iceberg.*

Investment Call: *Even though bank share prices might be attractive, they have yet to completely price in the full risks. There are substantial risks for recapitalization that might trigger more deleveraging in the sector. There is still no proper resolution of a cross-border bank in the EU. Although the joint effort to recapitalize the banks for an estimated 300bn euros is a positive step, it doesn’t diminish the appalling lack of cross-border regulation and supervision. The ECB’s liquidity provision is pushing the limits of its legal authority; while it’s vital at this point to keep banks liquid, the ECB still has no specific legal authority to do so. (Hence the resignations of Germany’s ministers to the board.)*

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The European Banking Authority did not list Dexia as one of the at-risk banks in July. Rather it met their "criteria." Where are the regulators? The regulators of the new EBA and the ESRB are quite open about their inability to regulate or enforce rules on member states. In a recent speech, Lars Nyberg from Norway's central bank commented on his role in the young ESRB. He diplomatically highlighted that banks are uncooperative and the implementation of reforms and regulation has been woefully slow. National regulators are equally uncooperative, as the regulators of the EBA discussed when they released the stress test results in July. Liquidity from the ECB is certainly helpful, but there is no clear rule for cross-border bank resolution within the EU. But as Deputy Governor Nyberg pointed out, even after the 2008 crisis there is still no procedure or format for a cross-border bank resolution. Only national guarantees of EU banks support cross-border lending and resolution.

The political malaise in Europe continues while "legacy" bad loans are set aside in a special bad bank and more sovereign guarantees issued for a bank that was bailed out just two year ago. Belgium's risk rating immediately rose. This past summer, Dexia was not listed as a potential risk. Do European regulators know anything at all about their banks? Dexia passed in 2010 and in 2011!

The IMF has been especially anxious about the likelihood of a clear "cross-border bank resolution." Like the European technocrats that now work at the Financial Stability Board and the European Banking Authority, the fund has been warning about the very weak state of cross-

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border regulation, supervision, and resolution capabilities within the European Union. And, it has included these steps in its Action Plan: "Repairing banks. Assess capital needs and advise on how these can be met without triggering further deleveraging. Propose modalities for cross-border bank resolution (a very difficult topic that the FSB too has been trying to tackle) and macro-prudential tools for systemic stability."

Asia double risk: Support growth in global slowdown and vigilance on inflation. *"What we learn from our models is that were there to be a drop of 1 or 2 percent in growth rates in advanced economies, the effect on Asia would be significant . . . and this would come from both financial and trade channels."*

The above quote comes from Anoop Singh of the IMF discussing his company's regional outlook for Asia. Although the Fund expects domestic demand to remain healthy in emerging Asia, the risks have "increased in recent weeks." The fund's estimates for regional growth depended a great deal on many things going right. The troubles in Europe, once confined to the Mediterranean, could now hit emerging Asia.

Beijing admits that 10% of local government's $1.5 tr in SIV debts are probably bad! *The bad loans that can be counted by Beijing can be covered. However, the anecdotal evidence of excessive leverage, off-balance sheet loans, foreign borrowing, unregulated lending by SOEs, and common usury point to much larger risks in the system. I have little doubt that Beijing will*

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underwrite and restructure "official" bad debts. But the uncounted risks could easily exceed official NPLs and proliferate beyond the official banking system.

Investment call: *I continue to believe that Beijing will endeavor to support a growth upswing in 2012—I think there could be significant headwinds for additional commodity demand before the Chinese New Year. There is little reason to catch a falling knife either in China or in proxy plays in the near term.*

Over the summer we focused on the efforts by the PBoC to prevent banks from engaging in off-balance sheet lending and speculation. The hikes in reserve ratios were traditional monetary policy. But there were other targeted measures to reduce speculation. These included a monthly accounting balancing loan-to-deposit ratios, rather than every quarter or semester. The trouble with looking at China too closely is that it is easy to see just how many things could go very wrong. However, I am not ready to join those who say that China is the "biggest risk" out there. There are big risks in China to be sure, but there are just as many in Europe and the United States. And if I have learned anything, it's that the fat tail that will be our undoing is the one we are not expecting. The move where each individual European government backstopped their own banks saved the crisis in 2009, but is the current vector of contagion for the EU crisis now.

Is the U.S. House of Representatives misguided enough to declare China a currency manipulator? *Although I am cautiously hopeful that the House of Representatives will demure*

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and not pass the Currency Manipulator Legislation, their recent dreadful handling of the debt ceiling gives me pause. Mr. Bernanke seemed to give them undue encouragement when he blamed China's currency policy for hurting the global economic recovery. (Mr. Bernanke might like to doublecheck with emerging Asia, Latin America, the Middle East, Canada and Australia about how "weak" their recoveries have been.) According to IMF research, the best the U.S. current account would improve is 1% of GDP if all of emerging Asia's currencies appreciate 15% against the dollar. (Well most of them already have, and our current account has not improved al all.)

The yuan-dollar issue never fails to ignite political grandstanding and self-serving rhetoric from both sides of the Pacific. Never mind that the yuan, up until recently, had been steadily appreciating against the dollar. (Or should I say that the dollar has been depreciating against the yuan?) I can hardly add much to the prolific number of academic and quasi-academic reports (produced from politically affiliated think tanks) regarding the potential impact on U.S. job creation and the trade deficit if the yuan appreciated 10–20%. But perhaps my favorite white paper came from the IMF and it argued that the whole of the Asian trade block must be taken into consideration when looking at the potential impact of a yuan appreciation against the dollar. Regional trade between emerging Asia and China is growing rapidly under the ASEAN-China trade pact. "Current Account Rebalancing and Real Exchange Rate Adjustment Between the

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U.S. and Emerging Asia" by Méjean, Rabanal, and Sandri is worth a read because it takes into account the whole of emerging Asia.

A currency adjustment by China must also be met with a currency adjustment in all of emerging Asia. ASEAN members and their trade partners, China, Japan, and S. Korea, all have mutually supportive currency swap agreements. They all hold each other's bonds. They are so interconnected that the Asian Development Bank tracks member bond prices daily. The paper also highlights major structural differences between the United States and China that cannot be overcome by a currency adjustment alone. The whole of emerging Asia must sustain a currency appreciation of 15% against the dollar for a 1% of GDP improvement in the U.S. current account.

"A reduction in global imbalances has to involve lower U.S. consumption and higher consumption in emerging Asia. Given the consumption bias towards domestically produced goods, this generate[s] a relative increase in demand for emerging Asia's tradable goods and a reduction in the demand for U.S. tradables. Therefore to shift demand back towards U.S. tradables and keep production quantities constant, a relative appreciation of Asian goods is needed. . . . We find that a reduction of the U.S. current account deficit by 1% of GDP vis-a-vis emerging Asia must be associated with an improvement in the terms of trade for emerging Asia by 15% and with a similar depreciation of the U.S. real exchange rate. However, if the countries resist appreciation, China would need to bear a much larger appreciation."

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