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Corn, ethanol, and meat: A rerun of 2007? Corn at $6 a bushel will make for very expensive pork, poultry, beef, and beer. Soy prices in Argentina are up 4% to 20-month highs. Headline inflation risks are to the upside. *Emerging market headline inflation could challenge central banks, which will resist currency appreciation while trying to curb inflation led by food prices. Argentina and Brazil agricultural plays will benefit, as will fertilizer and transport. But interest rates could rise more quickly than expected. This is very bad news for China's headline inflation prospects as it heads into the crucial 2012 presidential transition. We could see the spillover effects on rice and soy with substituting and hoarding problems.*

A good trade is worth repeating. If it worked once, then it will work again. It seems like everyone who missed the play last time around is getting in early. There is staggering volatility in both the corn price in the CBOT and the general performance of soft commodities since the USDA issued its latest report highlighting the poor U.S. harvest. The price of corn rose $1 dollar in less than a week on the news. Japan and South Korea are buying now ahead of price increases. Orders are being secured but final prices are delayed because of strong volatility says *WSJ*. "Traders say that more than 40% of January–March feed corn import requirements of around 3 million tons have so far been purchased, on a premium basis. They said less than 2% of the requirements have been priced."

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BIS Issues Supervisory College Guidelines: More supervision for lending into emerging Europe and FSU countries. *Basel III will have its most direct impact on bank lending in emerging Europe and former Soviet Union countries. Prior to 2008, the growth rate in these countries was fueled by heavy bank lending flows. The new layers of supervision will mean bank lending into the region will not recover to former levels. These colleges will be instrumental in the early warning process for capital buffer requirements. New forms for monitoring private foreign liabilities will aid in monitoring sovereign risks.*

Basel III will work to mute excessive risk-taking by banks and financial institutions. But for emerging markets, I have been particularly interested in cross-border capital flows and the supervision and monitoring of these flows. The recent BIS data has demonstrated that financial institutions in mature markets have shifted lending away from emerging Europe and the former Soviet Union countries. Asia and Latin America have been the direct beneficiaries of this change. Bank lending to China and India has been particularly strong.

The BIS has just released its rules for the supervisory colleges that will play an important role in its early warning system designed to monitor private capital flows and concentration of risk. The colleges will each be assigned to major multinational banks and track bank lending across borders. The supervisors are charged with informing the home country and host country officials of the flows and concentration of risk.

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The supervisor's observations will also be part of determining additional capital buffers. Capital buffers can be activated not only in banks' home countries but also in host countries. For example, bank lending into Hungary in the past would have trigged the credit-to-GDP growth warning and European banks and their branches in Hungary and Hungary-based banks would all have been required to increase their reserve capital.

Although the colleges will be national, one of their major functions will be cross-border cooperation and information sharing. This is intended to help domestic regulators understand the degree of concentrated risk from foreign lenders and address the issues locally.

For emerging markets, the crisis in 2008 was largely experienced as a liquidity crisis rather than a solvency crisis. EM corporate had borrowed heavily from mature market banks and had trouble rolling over the principal. Turkey and Russia were prominent examples of these troubles. From a sovereign risk perspective, the colleges will help ensure that liquidity risk is mitigated and that concentration of risk will be identified before it becomes a problem.

An argument could be made that this only addresses yesterday's problem. But the strong flow of capital into emerging markets attracted by the private sector ought to be monitored more closely in future. The net creditor status of most emerging market countries makes private capital flows a more immediate risk to sovereign stability than classic "ability to pay." Taken together with the Financial Stability Board's early warning system and new real-time tracking of the private

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sector's cross-border borrowing means that investors will have a better idea of the true liquidity risks of each country.

South Africa still growing, even after the World Cup and union strikes. *In spite of union and wage hike issues and a tense ANC Congress, South Africa continues to grow as trade indicators point to a tentative recovery. A pending wage settlement might boost domestic consumption and benefit mining stocks with a temporarily weakened rand.*

The civil servant wage negotiation has yet to be finalized. But the South African Chamber of Commerce and Industry is reporting that trade terms are improving: "All the components for physical trade activity enjoyed marked increases last month." Even though unemployment remains stubbornly high, sales volumes rose from an August reading of 50 to 59 in September—a level not seen since the run-up to the World Cup. The supplier index is in now in positive territory at 52 over August's dismal 44. The overall trade activity index recovered strongly, going from 45% to 51%. Although there is political uncertainty regarding the eventual settlement of the Public Sector Union Wage agreement, the unions will enjoy some increase in pay and housing subsidy, which would be positive for more consumption down the road. A temporarily weaker rand on the wage agreement would be healthy for mining stocks and exports.

Turkey's Akbank signs agreement with the China Development Bank to settle trade without third-party currency. *The strategic partnership between Akbank and the CDB moves*

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private-sector cooperation on yuan trade settlement beyond central bank agreements. The strategic partnership will also facilitate infrastructure deals for the two countries. Look for many more such partnerships in the Middle East, Africa, and Latin America.

Perhaps investors could be skeptical about the real implications of the country agreements to settle trade in EM currency and bypass the dollar. These agreements, mostly minted during high-profile meetings by political leaders, might have been dismissed as performance politics. But there is a growing movement in emerging markets to settle trade in their own currencies among themselves. It does take time to work out the legalities and establish the rules. But the trend is rising and promises to be the "next big thing" for emerging market financials and trade.

This could mean that the currency risk for exporters and importers could shift substantially over time. It will not happen overnight. But it is clear that the big Chinese banks have been given directions that these kinds of strategic partnerships with EM banks and the promotion of yuan settlement for Chinese companies has Beijing's full support. Ten years from now there could be headlines that read something like, "Who needs the dollar?"

Turkish banks—Isbank, Ziraat, and Vakifbank—are looking to buy cheap European and FSU banks. Brazilian banks have formed a conglomerate to buy stakes in Angolan and other African banks. China is on a buying spree in emerging markets. The financial networks are shifting.

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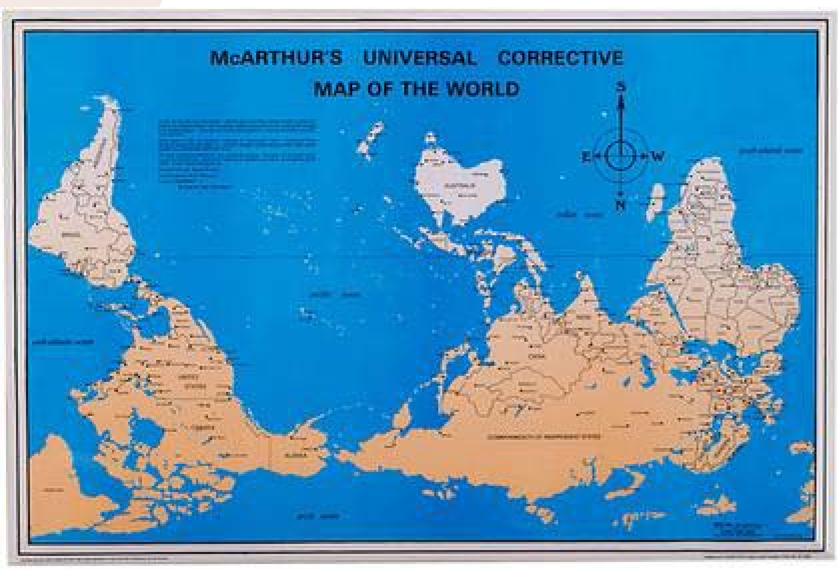
From the point of view from emerging markets, this is all positive news. U.S. politicians are asleep at the wheel.

Currency and Trade War Upside Down. *Brazil announced the global currency war and the dollar is not the only currency in the world. And for EM technocrats, the strong appreciation of their currencies is causing domestic troubles. Their problem is not so much China, but the U.S. dollar. Their war is primarily with Bernanke and global capital flows.*



Source: www.gisweb.massey.ac.nz

In the 1950s, the Latin American artist Joaquin Torres Garcia drew a famous map of Latin America upside down. The image symbolized a view of the world that Latin Americans wanted for themselves; it was uniquely their own rather than a derivative of U.S. imperialism. It is easy

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to get lost in the U.S.-China tensions. But emerging markets are experiencing a great deal of the fallout from the U.S. exporting its monetary policy. There is no way that emerging market countries can generate the kind of Forex reserves needed without a printing press in the U.S. dumping dollars into the global market. And now it seems likely that the dollar machine will keep going. It is little wonder that Thailand decided to tax foreign profits and capital gains on local debt. President Santos of Columbia has ordered an investigation into the possible benefits of capital controls and currency intervention.

<u>Some people are finally beginning to point out that the United States is the one causing the volatility in the currency markets. Emerging markets would probably prefer not to be actively managing the volatility of their exchange rates. Korea smartly answered Japan's criticism by saying that it was not weakening its currency—rather, it was trying to manage the volatility and pace of the appreciation.</u> Just as it is very difficult for a CB to defend against a currency's depreciation, it is even more difficult to stop strong appreciation. In emerging markets, central banks can only mitigate the pace of appreciation without an outright peg for the currency. So far, I have yet to hear of an outright argument for a pegged EM currency, other than those that are already pegged.

<u>**Vietnam pushes back coal imports, but orders early import sourcing.**</u> *Delays in the construction of coal-fired power plants mean that Vietnam will not import coal on a large scale for another couple of years. However, intermediaries are already aligned to "facilitate" coal*

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deals with foreign countries, even before the regulations for such activity are established. Russia and Indonesia are thought to be the most likely sources.

Vietnam seems to function in spite of itself and its government has a rather disorganized approach to state-led development. There are serious delays in the construction of power plants, which have delayed plans for the physical import of thermal coal. The demand for thermal coal is expected to reach between 21–40 million tons annually by 2020. However, the original plan called for coal imports to begin in 2011. That has now been pushed back to 2013. But it looks like intermediaries are ready to cut deals now. The Ministry of Energy reports that a private intermediary has signed a 20-year agreement with a Russian coal producer. Other groups like An Vien Group and Vincom Group are working to help the government source coal imports. Strangely, these deals are going ahead although the government has yet to draft rules and regulations for such activity. Perhaps I am too cynical, but it seems likely that many of these "private intermediaries" are in fact moonlighting government officials who will write the rules after they have made their fortunes.

<u>**Egypt's parliamentary elections take place November 27:**</u> *64 seats allocated to women in the People's Assembly could look like progress. But high food prices and the repression of the Muslim Brotherhood make it seem like little has changed. However, there are reasons to be optimistic about political progress in spite of the repression.* <u>*For now, the real political risk for*</u>

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Egypt would be the untimely death of President Mubarak and not the composition of the People's Assembly.

Although food price inflation seems to be a perennial problem for Egypt and the ban on Russian wheat exports has only increased worries of future food price tensions, the economy seems to be recovering. The newly created electoral commission and the 64-seat allocation to women in the People's Assembly point to some democratic reforms. However, the Muslim Brotherhood is still suffering from overt and covert political repression from Mubarak's government. Although there are elections, the government in Egypt is still an autocracy in which Mubarak holds all the power.

Economic openness and growth are leading the way to more political openness—not the other way around. Economic growth, strong foreign investment, and the resiliency of the Middle East make Egypt attractive, in spite of its political intransigence. I would ignore most of the hand wringing by democracy advocates about exclusion of candidates and the inadequacies of the electoral commission. These are normal failings in the establishment of democracy. The real risk is the unexpected death of President Mubarak rather than the composition of the People's Assembly.

Taiwan's municipal elections take place November 27. *The municipal elections will matter most for the opposition DPP party as it attempts to recapture political relevance. Some argue*

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that these elections could shape the crucial 2012 national elections, but I am skeptical. Even if the KMT were to lose in 2012, the cross-strait openness will be too developed by 2012 for the DPP to roll back.

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