

THE GLOBAL SETTING: CURRENCY WARS, QE2 AND OTHER RISKS

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KEY THEMES – GLOBAL

Is global environment really positive?

- Geo-political risks to growth
- G-3: Episodic not sustained recovery
- China: monetary overhang
- Global inflation: more serious
- Currency tensions not wars likely
- Capital flows into EMs not a given
 - Risk aversion, policy moves impede flows

KEY GLOBAL THEMES

GEO-POLITICAL RISKS

GEO-POLITICAL RISKS UP

Risk appetites will be hurt

- **Mid-East tensions → global impact**
 - Pre-Egypt/Tunisia: Mid-East simmering
 - Risk premium in oil prices to rise
- **North Korea will up ante**
 - Wants concessions, China cannot stop it
- **Pakistan is teetering on brink of crisis**
 - Could affect risk perceptions of India

KOREAN PENINSULA

More fireworks likely

- Escalating provocations by North
 - Artillery fire on South Korean island
 - Maritime boundary: *Cheonan* incident
 - Confiscation of South's assets
 - Missile and nuclear tests
- Now North is offering talks
 - US/ROK distrust North, hard to agree

KOREAN PENINSULA (2)

Why North's strategy is risky

- **Context: North's domestic travails**
 - Kim Jong-il ill, unconvincing succession
 - Jong-Eun not credible to rest of elite
 - Economy limits regime buying support
- **Uneasy ties with China**
 - North distrusts China
 - China - no love lost

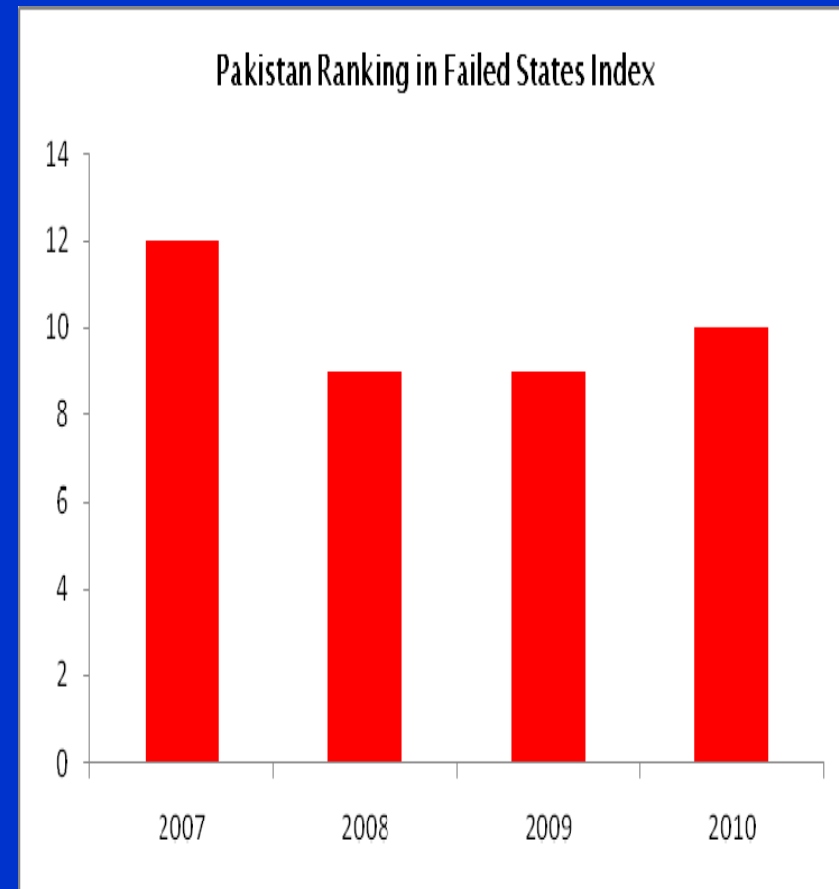
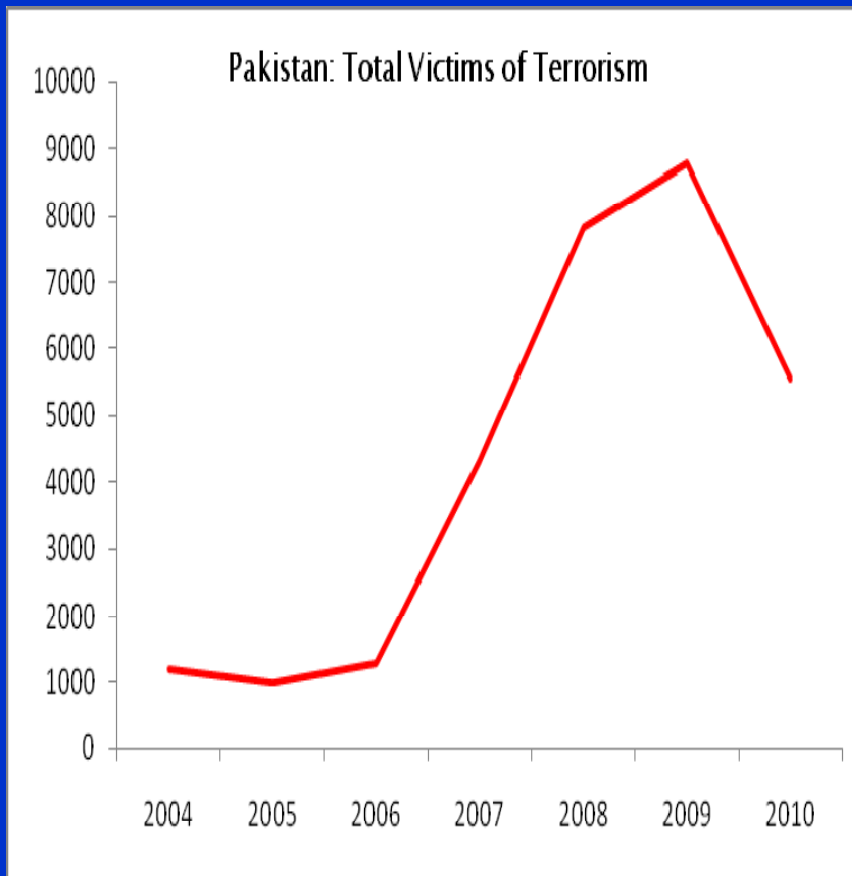
PAKISTAN IN DISTRESS

Negative trends overwhelming positive

- **Army had made progress in 2010**
 - Violence still high but was falling
 - Extremists flushed out of key bases
- **Renewed tensions in 2011**
 - Killing of Punjab Governor
 - Zardari regime under pressure, can't last
 - Underlying negatives too strong?

PAKISTAN – PROGRESS IN 2010

Some signs of stabilisation – until recently



KEY GLOBAL THEMES

GROWTH PROSPECTS IN G-3

G-3 PROSPECTS

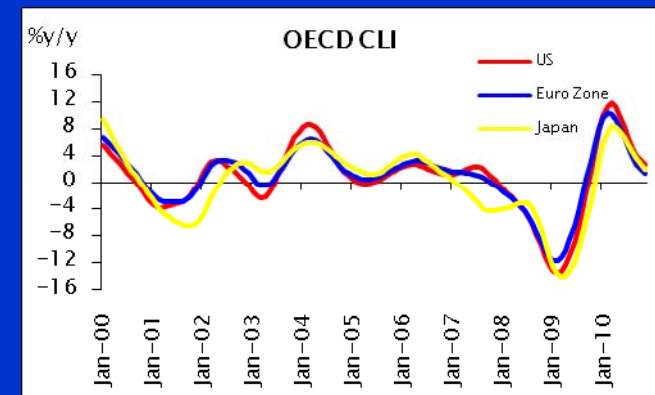
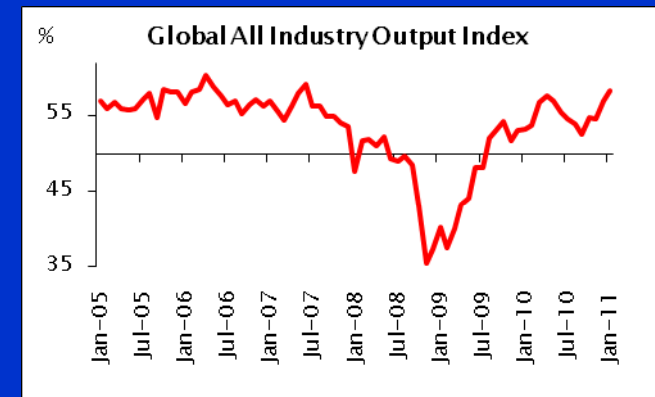
Current upturn facing headwinds

- **Near term: improving growth**
 - Impact of policy, slow healing
- **Strong headwinds still at work**
 - Fiscal austerity
 - Higher oil prices
 - Adjustments: deleveraging, housing, ...
- **Net: episodic not sustainable recovery**

G-3 PROSPECTS

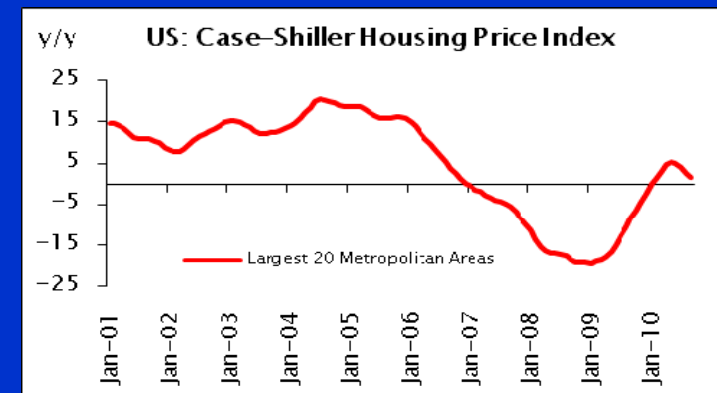
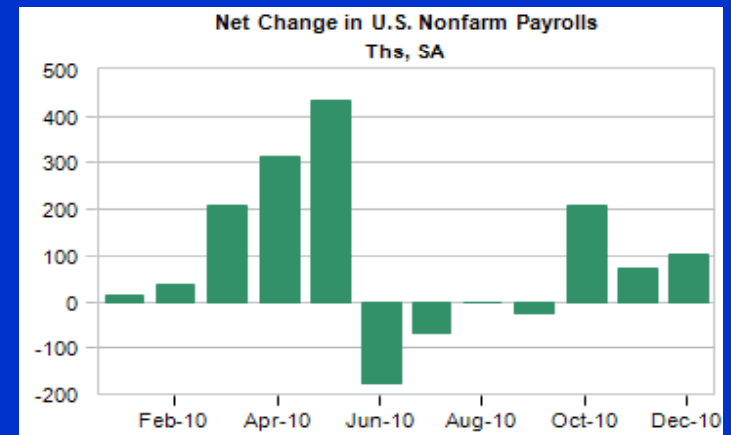
Lead indicators → moderation

- Strong rebound underway
 - Depends on policy
 - Policy unsustainable
-
- Lead indicators weakening
 - G-3 slowing
 - Emerging economies also



DOWNSIDE SURPRISES IN US

- Market bet: recovery solves underlying issues
- Recovery is episodic
 - Depends on stimulus
- Housing, labour markets still weak
- Slow EU, Japan will hurt
- Adjustments remain slow
 - Savings rate, consumer debt
- Political gridlock → shocks
 - Fiscal time bomb in focus



G-3 PROSPECTS

Eurozone Sovereign Debt Crisis

- More shocks before resolution
- Key issues: solvency, liquidity, confidence
- Solvency: orderly default process needed
- Liquidity: funds and processes
- Confidence: structural changes/reforms
 - Euro-wide fiscal mechanisms
 - Budget targets, structural reforms

G-3 PROSPECTS

Eurozone: crises will force change

- **Huge debt raising: Close to USD1 tr**
 - → episodes of financial stresses
- **Political will**
 - Elite level: yes, will exists
 - Voters unwilling: elections, protests–risks

G-3 PROSPECTS

Japan: when will the drift end?

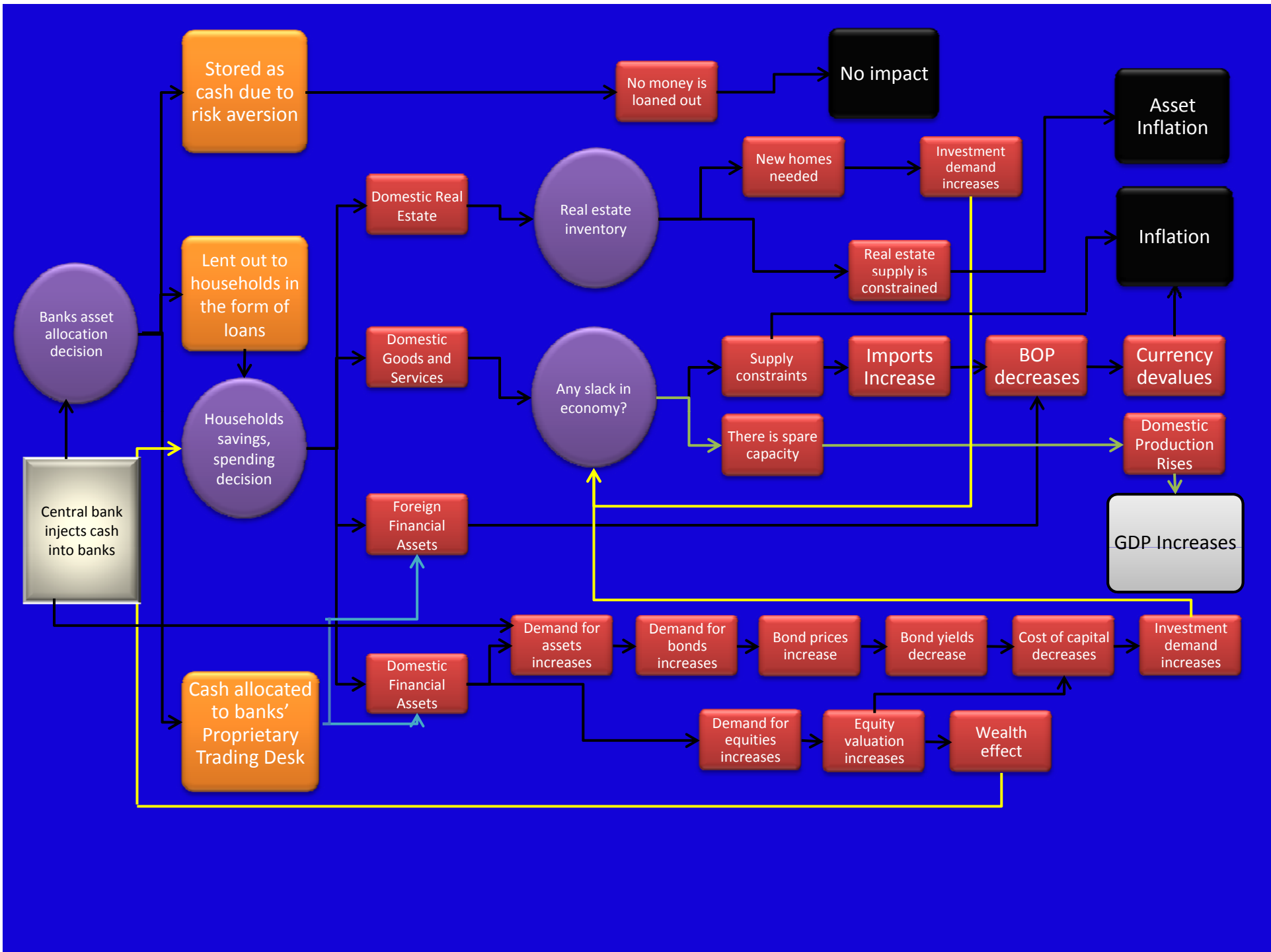
- **A new consensus needed**
 - Reforms: Fiscal, trade opening, services
 - Slow to form consensus: political change
- **Highly dependent on external demand**
- **Risk of rising bond yields**
 - If food/energy prices spike up

**QUANTITATIVE EASING:
CAN IT WORK?**

CAN QE2 WORK?

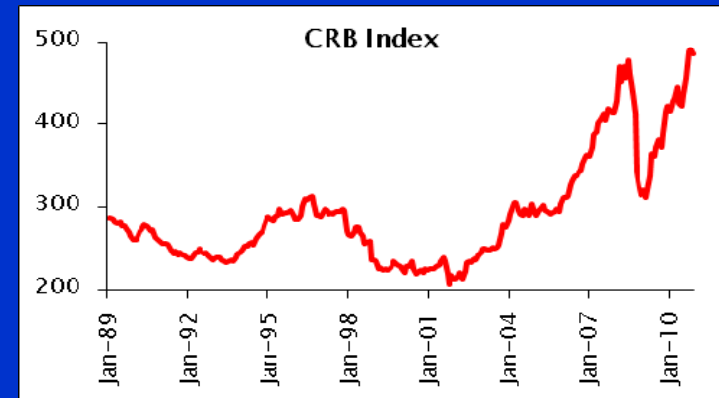
Not a convincing case

- **Will banks lend?**
 - Credit mechanism healing but slowly
 - Base money may not → broad money
- **Will asset prices rise?**
 - Real estate: double dip
 - Equities up and down
- **Will consumers spend and if so on what?**
 - Savings rising, imports up
- **Adjustments are painful but necessary**



GLOBAL INFLATION UPSIDE

- Global liquidity easy
 - Rising again
- Supply–demand finely balanced
 - La Nina effect
 - Supply disruptions
→ price spikes

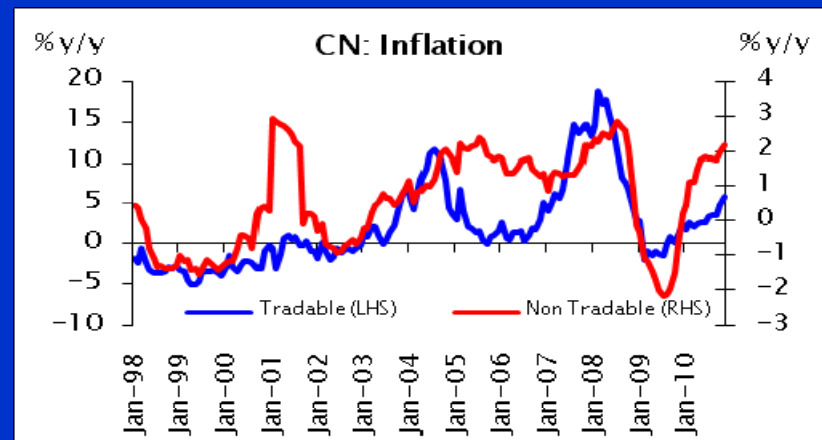
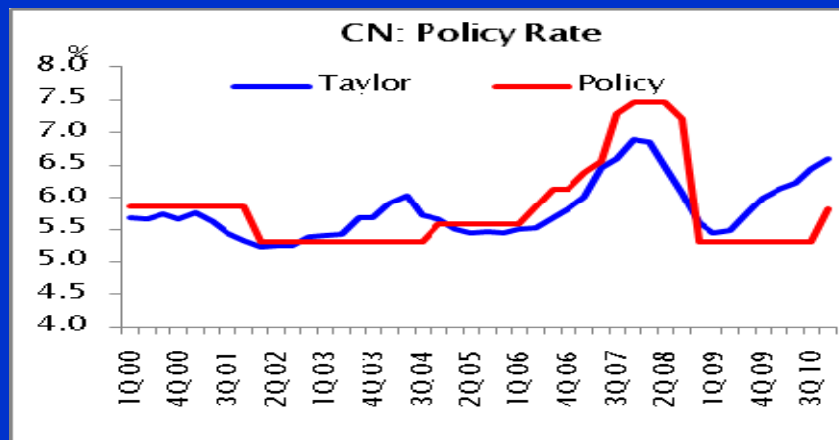
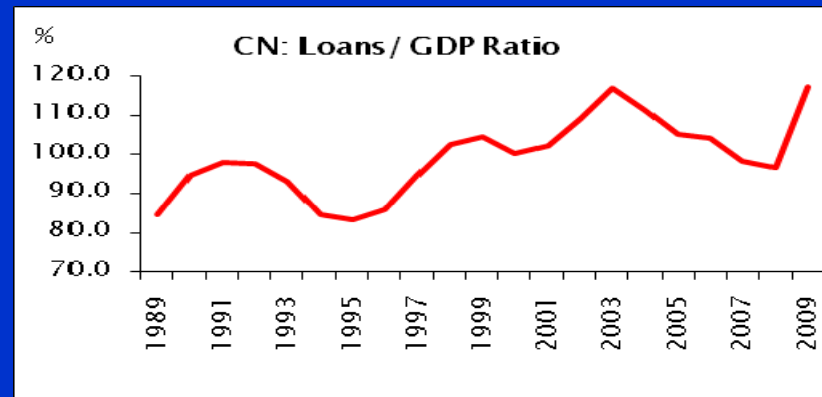


CHINA – MORE RISKS

CHINA: RISKS RISING

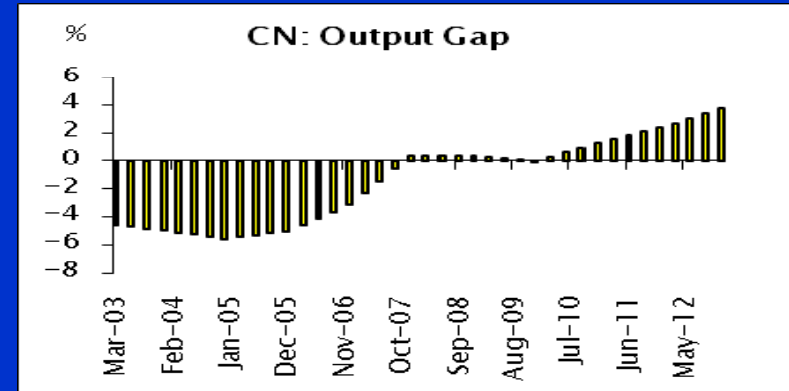
Dangerous confluence of problems

- Monetary overhang
- Huge spike loan/GDP
- Non-tradable inflation up



CHINA: RISKS RISING (2)

- Output gap is inflationary
- Inflationary expectations rising
 - PBOC survey
 - Household deposits falling
- Policy signals weak
 - Loan target high
 - Inflation target up



Asset markets

- 11 of 35 cities 30–50% overvalued

Result: more tightening

- Blunt measures → risks

CHINA: RISKS RISING (3)

Effectiveness of policy is constrained

- Blowback to previous policies
- Excesses not cleared
 - Real estate precarious
- Over-done population policies
 - Labour force declining, wages surging
- Over-use of fertilisers in past
 - Acid soils: Food supply down, prices up

CURRENCY WARS?

Still a risk but a diminishing one

- **Key issue: RMB is being managed**
 - Nominal appreciation being stepped up
 - Real appreciation already happening
- **No appetite to cause wars**
 - Rational policy calculations
 - Risk: domestic US politics

CAPITAL FLOWS TO EMs?

Implying: spasmodic flows to EMs

- Risk aversion
- Controls in EMs
 - Intensifying restrictions on capital inflows
 - Recent examples → harsh measures likely

CONCLUSION

Consensus views questionable

- **Geo-politics: worse than expected**
- **G-3 growth: up then down**
 - QE2: weakly effective but will distort
- **Global inflation: higher than expected**
- **No currency wars**

THANK YOU!