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Downunder Daily

A Squeeze

Developed economies face something not seen before: commodity price pressure that is *not* a by-product of their own economic strength. It's happening because the fast-growing emerging economies increasingly dominate commodity demand. This is likely to squeeze real incomes in the developed world, produce the 'wrong' sort of inflation, and hence exacerbate the tricky post-crisis adjustments.

It is a new world. EM will soon overtake DM in global GDP share (exactly when depends on the GDP measure and the exact EM/DM split). This transition has already occurred in commodity markets. The emerging economies now consume more than half the world's energy (Exhibit 1). Their share of base metal consumption is even higher (China alone accounted for 40% of base metal use in 2009 – see Exhibit 2).

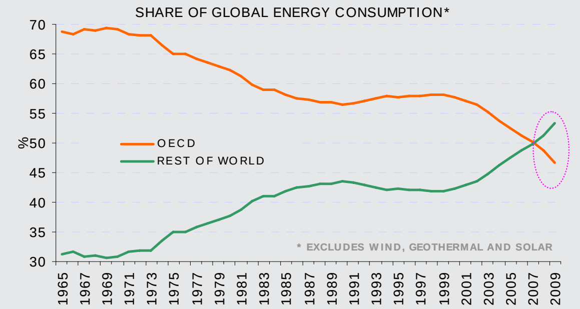
This matters, for both micro and macro. I'll focus on macro. (On the industry side see the recent Morgan Stanley Blue Paper, *Petrochemicals: Preparing for a Supercycle*, 18 October.)

Our macro team continues to expect a pronounced two-track global economy: tepid DM, robust EM. (For details, see the macro team's *Global Forecast Snapshot*, 16 September.) EM's weight in commodity markets, combined with robust growth, points to further solid commodity price gains. (For forecasts, see the commodity team's *Global Metals Playbook*, 11 October.)

This implies that the developed world will face something not seen before: commodity price pressures due to someone else's macro strength. Historically, rising commodity prices have been a symptom of developed-world growth (exempting, of course, the OPEC supply-side crunches). While rising commodity prices 'cost' commodity consumers, that cost was affordable as it went hand-in-hand with DM growth. Not so now.

Exhibit 1

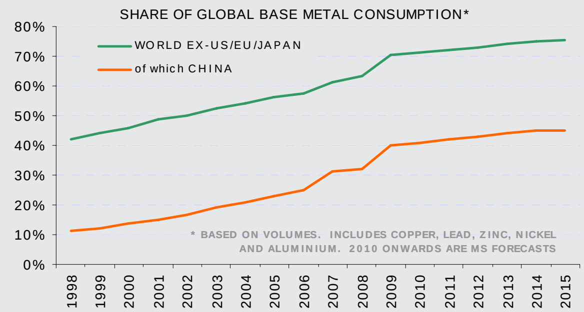
EM Now in the Energy Driving Seat…



Source: BP; Morgan Stanley Research

Exhibit 2

…And Taking Over in Other Commodities

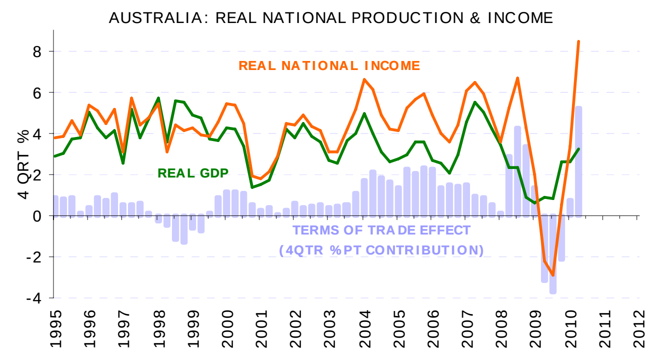


Source: ICSG, WBMS, INSG, ILZSG, CRU; Morgan Stanley Research

Let me explain why this matters. Real GDP measures the volume of goods and services produced in a country. Often that's a reasonable measure of national income. However, GDP ignores the effect of a change in a country's terms of trade on a country's *real* income. The terms of trade measure the ratio of export prices to import prices. How can a ratio of prices affect *real* income? Because a country's effective purchasing power rises if, for example, its export prices rise relative to import prices. If the terms of trade rise, it requires a lower volume of exports to buy a given volume of imports.

Australia is a good example because its terms of trade are volatile and it is a relatively open economy. The commodity boom lifted Australia's terms of trade. It now takes a lot fewer tonnes of coking coal exports to buy an imported BMW. Real national income captures this enhanced purchasing power. Exhibit 3 shows how the swings in Australia's terms of trade have added and subtracted to Australia's income.

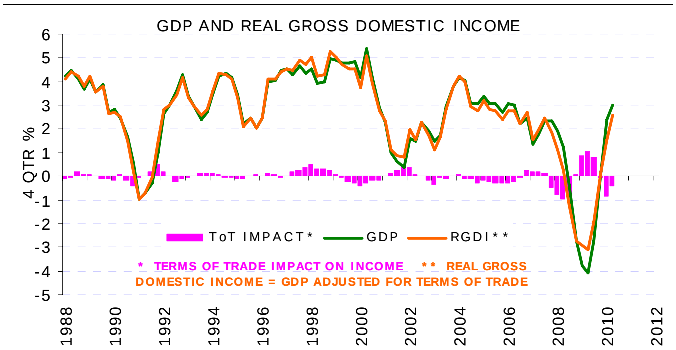
Exhibit 3
What You Make Versus What You Earn



Source: ABS; Morgan Stanley Research

Other developed countries' terms of trade are less volatile, and larger countries tend to be less open. However, the effect still exists. Exhibit 4 shows the terms of trade effect on US income.

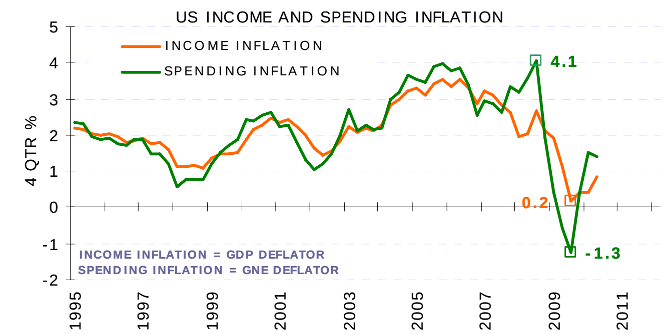
Exhibit 4
Terms of Trade Cushioned America's Downturn



Source: BEA, Morgan Stanley Research

The fall in America's terms of trade has effectively reduced real national income by 0.5% over the past four quarters. That's an added headwind for a tepid recovery.

Exhibit 5
Not All Inflations Are Created Equal



Source: BEA, Morgan Stanley Research

This is another way of looking at something I've mentioned before: the distinction between inflation in things a country produces, versus inflation in things a country consumes. Policy-makers now fear deflation But it's helpful if the price of something a country consumes, but doesn't produce (that is, it's imported), falls. This boosts real incomes (and so makes it easier to service debt). As Exhibit 5 shows, the US saw this 'good' deflation in 2009.

Conversely, it's unhelpful to see inflation in the things consumed but not produced. That reduces real incomes, and increases real debt burdens. That, at the margin, is the sort of inflation commodity importers now face. Simply put, 'importing' inflation does not reduce the debt-deflation tail risk.

So here's the point: the EM-driven rise in commodity prices will likely lead to weaker terms of trade for many developed economies (Australia and Canada the clear exceptions). Moreover, currency weakness can worsen the terms of trade. (This is because developed world export prices tend to be 'stickier', while commodity prices, set globally, quickly reflect currency adjustments.) While this effect may be relatively minor for the big developed economies, it's another headwind in a tepid base case.

Finally, commodity prices will remain solid in a world with at-trend growth (which is our macro team's base case). It would be best for the strong EM countries to respond by letting their currencies appreciate, muting the inflation pressure, but maintaining solid growth. Yesterday's Chinese rate increase points to a less investor-friendly response: domestic tightening, while keeping its currency low.

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