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Europe Fails to Resolve the Main Issue – Growth

- We think European policymakers failed to resolve the most critical issue for markets: how Italy and Spain will shrink their deficits without economic growth and a mechanism to lower their long-term cost of funding sufficiently to make inroads into their deficits. Following the summit, Italian 10-year bond yields are back over 6.5%. European debt levels are generally not much different from those in the US, but what has created the crisis is that the troubled countries do not control their monetary policy. Thus, in the midst of economic contraction, they are forced to raise taxes and cut spending because they cannot print money to finance their deficits. This is not a recipe for a return to prosperity. Once a country like Ireland, Portugal, or Greece goes on the life-support of subsidized lending from the IMF or a European stabilization fund, their sovereign bond interest rates rise along with their risk of default. This, in turn, increases their deficits, degrades the balance sheets of European banks, and creates the vicious cycle of potential defaults, bank write-offs, reduced lending and economic contraction.
- We have long argued that there must be a buyer of last resort with an infinite balance sheet to restore private confidence in European bond markets. If the US had to borrow 10-year funding at 6%, it would add about $400 billion annually to our deficit, an increase of approximately 30%. Ten-year rates are now above 6% in Italy (6.5%), Ireland (8.5%), Hungary (8.5%), Portugal (12%) and Greece (25%). Spain is not far behind at 5.8%. Had the summit been a success and investors believed that “no sovereign will default,” then these rates would be substantially lower. We continue to believe that only the ECB has the wherewithal to end this crisis, and they remain stubborn in their view that it is not their role to do so.

Emerging market central banks have ample room to cut rates, but policy still too tight

Emerging markets have begun to selectively ease monetary policy as inflation appears to be leveling off and global financial market strains have intensified. The most prominent rates cuts have come from Brazil and Indonesia. Since the summer, Brazil has lowered its benchmark lending rate to 11% from 12.5% in three half-point increments, while Indonesia has reduced rates to about 4.5% from more than 6%. This occurred as inflation has fallen in Brazil to 6.2% from 7.4% (in August) and in Indonesia to 4.2% from 7% (in January). When assessing the potential for further cuts, along with inflation’s direction — less inflation, more cuts — we think the level of real interest rates, that is, policy rates minus inflation, provides guidance. Equally important, in our view, is how policy is affecting bank lending and the supply of money – M2 money supply growth is plunging in India, falling in China, and still strong in Brazil (see Weekly Chart). The sharp declines in China and India show how effective policy tightening has been and argue for a reversal in 2012. China has already loosened its reserve ratio guidance to banks, which has been the central bank’s main policy tool.

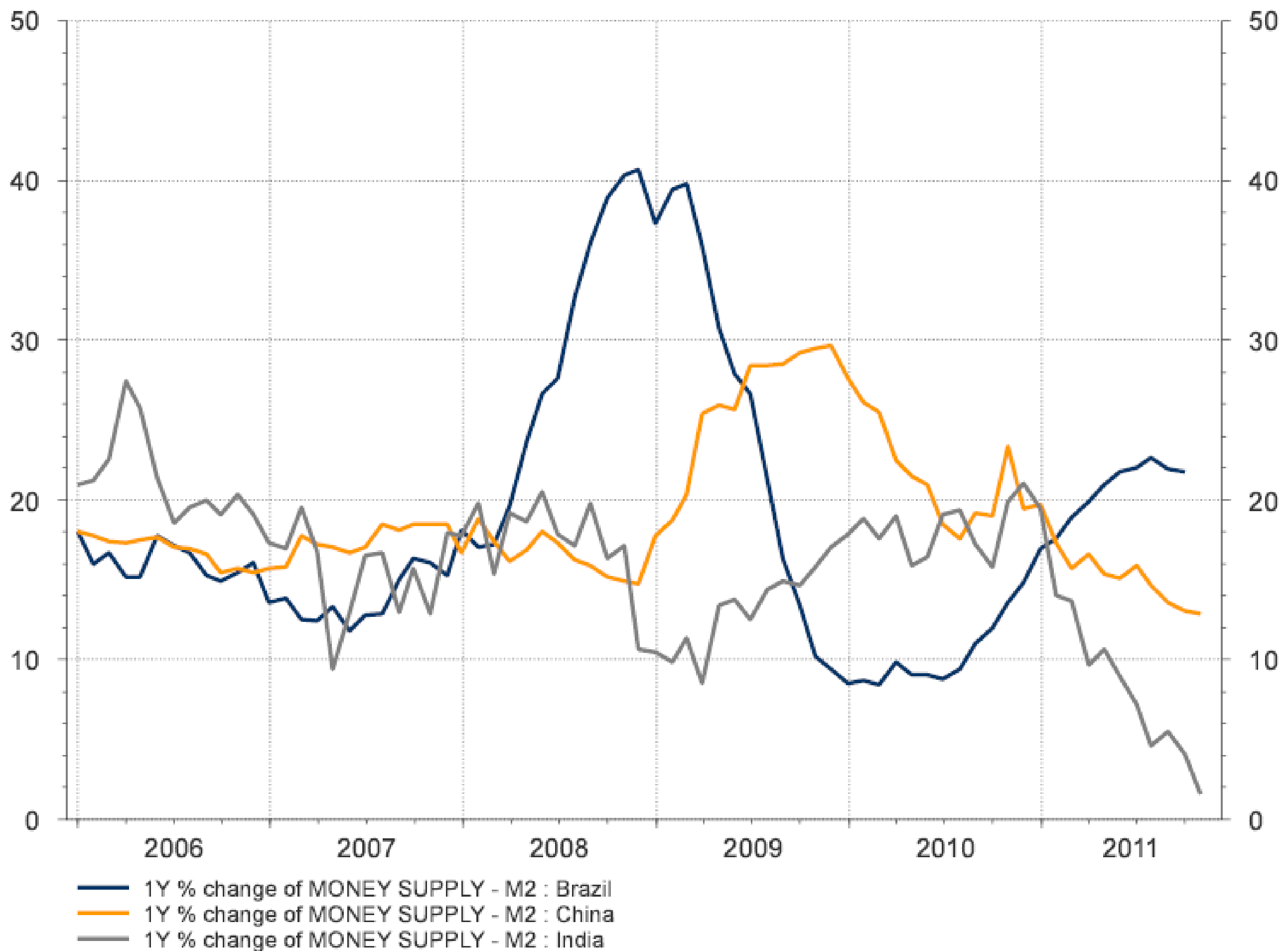
Brazil’s real rates are at about 4.8% (11% policy rate minus 6.2% inflation), which leaves substantial room for more cuts if inflation falls towards its target of 4.5%. Brazil’s policy rates have been restrictive enough to dampen economic activity – real GDP growth decelerated rapidly to 2.2% year-over-year from more than 9% at the beginning of the year – and rein in inflation. However M2 growth has remained strong, probably because money has flowed into the Brazilian currency and its banks, attracted by one of the few high real interest rates in the world. As Brazil reduces real rates, M2 growth may fall, but only back to more sustainable levels. By contrast, Indonesia’s real rates are only about 0.4% (4.6% policy rate minus 4.2% inflation), which has been supporting real economic growth of around 6% all year. Further rate cuts in Indonesia are likely limited, unless growth and/or inflation fall more.

Both Chinese and South Korean inflation appear to be leveling off. Chinese inflation has fallen to 4.2% from 6.5%, whereas in South Korea it is now 4.2% from 4.7% earlier in 2011. With policy rates at 6.1% and 3.3%, respectively, China’s real rate is 1.9% (and negative if one believes, as we do, that inflation is understated) and South Korea’s is -0.9%. With both Chinese and Korean purchasing managers’ indexes (PMIs) for manufacturing falling below 50 (indicating

contraction) in recent months, the case for policy ease is strengthening, but China's is likely to continue to be in the form of less stringent bank reserve guidance.

India is challenged by one of the highest inflation rates among emerging markets at 9.4% (although down substantially from a 16.1% peak in early 2010). India has had to play catch-up throughout 2011, raising policy rates to 10% from 7.5% last year. India's real rates turned positive in May for the first time in almost two years and are now at 0.6%. With M2 growth at close to zero, money is very tight, especially with real GDP still growing at a fairly robust 6.7% year over year (down from 8%-plus growth over most of the last two years). Moreover, India's is one of the few countries still showing manufacturing growth – India's PMI remains above 50. India is trying to manage a typical growth cycle. Judging by the Indian stock market and currency, which have together fallen some 40% in 12 months, policymakers may soon be able to become less restrictive.

The Weekly Chart: BIC money supply growth reflects tight policy



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