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Booming world economy, new players, many opportunities, substantial risks

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1. In a **cooperative solution to the problem that the world economy's major imbalances might unwind in a disruptive and thus costly way**, the US would promote saving via higher interest rates and tighter fiscal policies, the euro area and Japan would keep interest rates low and allow for more expansionary fiscal and wage policies while Asia's and Latin America's economic policy makers would reduce or stop interventions in support of the dollar while stimulating domestic demand. A further significant devaluation of the dollar would be part of the strategy, just as higher taxes on all forms of energy use.
2. In other words, **all players would have to agree to policies which they do not particularly like**. The US, for instance, hate to slow down the economy in a meaningful way, the Europeans are strongly opposed to lower taxes and faster government spending or, horrible dictu, higher wages. The Asians have been basing their economic expansion on an undervalued currency and booming capital expenditures, a policy mix which has been extremely successful so far and which they are not going to give up voluntarily. Also: Who would dare to raise energy taxes at a time when energy prices are already at unprecedented levels?

Real GDP growth, % y / y

	10-year averages						
	1988 -1997	1998 -2007	2003	2004	2005	2006 ^e	2007 ^e
World	3.4	4.1	4.1	5.3	4.8	4.9	4.7
Euro area	2.3	2.0	0.7	2.1	1.3	2.0	1.9
US	3.0	3.2	2.7	4.2	3.5	3.4	3.3
Japan	2.9	1.3	1.8	2.3	2.7	2.8	2.1
Other adv. economies	3.6	3.3	2.5	3.9	3.1	3.5	3.3
Africa	2.3	4.3	4.6	5.5	5.2	5.7	5.5
Central & E. Europe	0.9	4.0	4.7	6.5	5.3	5.2	4.8
CIS	-	5.7	7.9	8.4	6.5	6.0	6.1
Dev. Asia	7.9	7.3	8.4	8.8	8.6	8.2	8.0
Middle East	3.7	4.8	6.6	5.4	5.9	5.7	5.4
W. Hemisphere	2.9	2.7	2.2	5.6	4.3	4.3	3.6

3. **As it is, the world is not yet ready for a cooperative solution that deserves the name.** The increase of US interest rates, the recent appreciation of euro, yen and, to a much lesser extent, the renminbi against the dollar are steps in the right direction, but the hiking of euro rates and the end of quantitative easing in Japan are not, just as Germany's planned VAT hike by no less than three percentage points next January. And FX market interventions continue.
4. Imbalances are still getting bigger rather than smaller. **The world economy is in one of its best phases ever**, and the incentive to take away the punch bowl right now is quite low. In its latest Outlook, the International Monetary Fund predicts a world real GDP growth rate of no less than 4.9% this year and a consumer price inflation rate of about 2% (pp. 170, 177, 189, 190). Going by these data alone, we almost live in the best of all possible worlds – why worry about some distant risks such as a costly unwinding of asset price bubbles, possibly followed recessions or deflation, or about the implications of misaligned exchange rates?
5. The table on the front page shows that **world economic growth has accelerated in recent years**, from an average of 3.4% annually in 1988 to 1997 to 4.1% in the following ten years. In the so-called advanced economies, growth rates had actually declined, and had it not been for the strength of the US economy, the decline would have been even more pronounced. The main growth engine have been emerging markets and developing countries. Even Africa has done much better than generally perceived. The largest positive swings were recorded in the formerly Communist world, but **in absolute terms the countries of developing Asia continued to be the best performers.**
6. **These countries are also very big. The IMF calculates that on the basis of purchasing power parities (PPP) rather than market exchange rates China's share of world GDP is 15.4%**, more than that of the euro area and already hot on the heels of the US (see second table). If recent growth differentials persist, China will overtake America within five years. To be sure, at actual exchange rates China's nominal GDP has been just 18.2% that of the US last year and thus remains quite small. The differential between PPP and today's market rate of 8.0063 renminbi per US dollar is an indication of where the equilibrium exchange may lie – far away from where it is now.
7. **Emerging Asia as a whole has a PPP share in the world economy of 27%, has been growing at an average rate of 7.3% in recent years, and does not seem to slow down yet** - just the opposite. Given that the share of these countries in world population is no less than 52% and that as a group they have very high savings and investment rates, it is likely that they will continue to grow fast. In other words, the catching-up process is by no means finished, and it rests on solid fundamentals, in particular a rapid expansion of the supply side of their economies. There seems to be a lot of waste, ie a misallocation of resources and a steep increase of non-performing bank loans, but since capital spending accounts for more than 30% of GDP this has been, and will probably continue to be absorbed. Most OECD countries are characterized by a sub-optimal allocation of resources as well.
8. **It is likely that in spite of the loss of purchasing power caused by the recent steep increase of commodity prices high growth will continue for the foreseeable future, not only in Asia, but also in the former Communist area and in other developing regions.** Countries are increasingly opening up to capital inflows. They usually install state-of-the-art technology and modern processes and thus achieve high productivity growth. This implies that wages are under downward pressures. Wage growth is moderate for another reason - the large pool of underemployed labor in most emerging economies. Taken together, the two effects

translate into falling or stagnating unit labor costs and thus into low inflation. Russia is a major exception from this general trend (more about Russia at a later point).

% Shares in World GDP and Population

	GDP	Population
Euro area	14.8	4.9
US	20.1	4.7
Japan	6.4	2.0
UK	3.0	0.9
Canada	1.8	0.5
Other advanced economies	6.2	2.2
Africa	3.3	12.7
Central Eastern Europe	3.3	2.9
Russia	2.6	2.2
other CIS	1.2	2.2
China	15.4	20.6
India	5.9	17.1
Other developing Asia	5.7	14.4
Middle East	2.8	4.1
Brazil	2.6	2.9
Mexico	1.8	1.7
Other Western Hemisphere	3.0	3.9
	100.0	100.0

Source: IMF World Economic Outlook, April 2006, p. 170

9. **Following the post-war strategy of Japan and Germany, and having learnt from the 1997/98 financial crises, the monetary authorities of most emerging economies hold their exchange rates stable (in real terms they often depreciate) and thus protect their competitiveness.** Their capital stock increases rapidly in the process which lays the foundation for future wealth and income. The emphasis on exports helps as well because the opportunities for exploiting economies of scale are much better if clients come from all over the world rather than just from the home market. It keeps these countries also up-to-date about the latest trends in demand and technology.
10. **One almost inevitable result of these policies is rising trade surpluses.** Together with direct investment inflows this creates a strong demand for their currencies which would appreciate if left to themselves. Interventions aimed at preventing this lead to the accumulation of foreign reserves, dollars in particular. **Low inflation, ample reserves and usually sound government finances mean that monetary policies can be accommodative, and the risk that the IMF will once again be needed to rescue them and then interfere in their economic policies, ie force them to tighten policies, has virtually disappeared for the key countries.** In the end, it can be expected that housing demand and private consumption will also accelerate which would reduce the dependence on external demand and turn the expansion into a self-sustained one. This is still some years ahead, though.

11. **Another group of emerging markets is also doing well these days, resource-rich countries** such as Russia, Brazil, Venezuela, Nigeria, Algeria or South Africa. They mostly run large trade surpluses (South Africa is the major exception) and accumulate reserves in an unprecedented manner as they intervene in FX markets. Their rating has risen as well and they can afford easy monetary and fiscal policies. **In general, their inflation rates would get out of hand, but by maintaining a quasi-fixed exchange rate, they import price stability from the newly industrialized countries and the OECD.** Since they are so cash-rich, they have become large importers of goods and services from advanced and from other emerging economies and thus boost export and GDP growth there.
12. The novel feature of the present oil crisis is the fact that the **oil exporting countries are also big spenders** which alleviates the effects of the loss of purchasing power in the importing countries. The share of low-absorbing OPEC countries in world oil output has steadily fallen to 34% over the past decades.
13. One key driver of world economic growth have been the English-speaking OECD countries which for many years have been characterized by consumer booms and very low household savings rates. Easy monetary and fiscal policies in response to the 2000/2001 stock market setback had led to rising house prices and to a consumer borrowing binge on the back of them. This, and overvalued exchange rates from 2003 onwards, had resulted in strong import demand which has been a major support for other countries' export-driven expansion. **So far, the US economy remains robust: fiscal policies are still very expansionary, employment growth is almost 2% y/y and household incomes are about 6% y/y while house prices are holding up so far. The British economy is quite resilient as well.**
14. Last but not least, the **euro area and Japan have finally emerged from their long-lasting below-par growth period** and will expand by between 2% and 3% over the next couple of years. The two previous laggards benefit from competitive exchange rates, low interest rates and very high growth rates of corporate profits. There will be no all-out boom in Europe though: the expansion is held back by restrictive fiscal policies and stagnating real wages. Due to the effects of globalization and a firming exchange rate workers are in a weak negotiating position.
15. Even so, all regions of the world are presently growing. **The world economic expansion has gained considerable breadth.**
16. **To return to the theme that we are living in the best of all possible worlds, there are two main reasons for the surprisingly low inflation rate** (see table on next page) at a time of record-high output growth. One is the fact that central banks in the OECD area have become very independent from elected politicians and their short-term goals. They have mostly a clear mandate to bring about price stability, usually defined as something like 2% annual consumer price inflation. Over the years, they have achieved a high degree of credibility which has resulted in stable and low inflation expectations. Labor unions have learned the painful way that monetary policy makers are no longer willing to accommodate high wage settlements in order to keep down unemployment. So policies can afford to be much easier than in previous high-growth periods which de facto promotes rather than slows the economic expansion.
17. **Another reason for low inflation is the intensification of the international division of labor, a trend which is very well established.** As mentioned above, the new players in Asia, South America and Eastern Europe have accepted that the best way to promote growth is to

open up to foreign capital, grow their supply side as fast as possible, hold down unit labor costs and keep exchange rates undervalued. These countries exert downward pressures on prices for tradable goods and services everywhere. **Easy monetary policies in the OECD area have therefore not yet led to accelerating consumer price inflation.**

Consumer Prices, Wages, ULC, % y / y

Consumer Prices	10-year averages						
	1988 -1997	1998 -2007	2003	2004	2005	2006 ^e	2007 ^e
Euro area	3.4 ^e	2.0	2.1	2.1	2.2	2.1	2.2
US	3.5	2.6	2.3	2.7	3.4	3.2	2.5
Japan	1.5	-0.2	-0.3	0	-0.3	0.3	0.6
Non-Japan Asia	5.3	1.9	1.4	2.4	2.2	2.2	2.3
Hourly Earnings							
Euro area	5.5 ^e	3.5	2.6	3.1	2.6	2.9	3.1
US	3.3	5.3	8.3	2.2	6.6	3.5	4.0
Japan	3.9	0.7	1.0	0.4	1.2	2.6	2.5
Non-Japan Asia	12.9	6.5	7.1	7.6	4.1	6.4	6.3
Unit Labor Costs							
Euro area	2.0 ^e	0.3	1.4	-0.8	0.1	0.5	0.6
US	0.3	0.9	2.5	-3.1	1.8	0.2	1.0
Japan	1.1	-1.7	-4.1	-4.7	-0.6	-0.6	-0.2
Non-Japan Asia	6.4	0.3	0.8	-0.1	-1.6	0.4	1.0

18. **Excess liquidity has been channeled into housing, stocks and commodities whose prices have mostly increased a lot.** In the advanced economies, house price inflation and stock market strength have supported private consumption and overall growth, in the commodity-rich parts of the world the same effect has resulted from resource-related income growth.
19. **Commodity prices will remain well supported as long as the unwinding of the world's various imbalances can be postponed, ie as long as the benign environment of high growth and low inflation persists.** The structure of world growth differs from previous instances in that it is driven by emerging economies with a strong demand for goods rather than services. When the OECD countries still dominated the world economy there had been a trend toward services and away from things one can touch. The demand for housing, consumer durables such as cars and household equipment, for infrastructure and capital goods is a commodity and energy-intensive demand.
20. **As a result, the prices of metals such as steel, copper, nickel or aluminum have rocketed up. Oil production continues to expand at a rate of only about 2% a year while the world's real GDP grows by almost 5% - the adjustment parameter is the price of oil. The price elasticity of other commodities is surprisingly low as well. Having said that, it is still likely that we will see a major correction of prices because commodity markets have been too exuberant for too long, and bear positions have generally been given up.**

21. The main question keeping policy makers and investors awake at night is **how much longer the benign environment can last**. Bubbles, another word for imbalances, typically develop when optimism runs high. Low consumer price inflation is usually a key feature or prerequisite because central banks are seen to be under no pressure to tighten the reins. Borrowing is therefore perceived as a low-risk activity.
22. **At the heart of the world's imbalances is the US savings shortfall** which has produced a current account deficit of 7% of GDP. This, together with low real dollar interest rates, has resulted in downward pressures on the dollar exchange rate which in turn has forced those central banks which are pegging their currencies to the dollar to intervene and to issue their own currencies in exchange. **The world's monetary base has expanded by more than 16% annually over the last three years**. There is a surplus of liquidity, even in the euro area by now. So even though asset prices are very high already, they can go up still more. **Bubbles, be they in housing, equities or commodities, usually get bigger than seems rational**.
23. Yet, in the end they either deflate gently or they burst. The **longer the imbalances continue to build the likelier becomes the second scenario**. It will take place when the expected risk-adjusted returns on assets fall below the cost of funding, for instance when overbuilding reduces rents so much that they do not cover the cost of the mortgage and the maintenance of the house any more, or when bond yields and equity earnings yield become too similar, or when substitutes become attractive alternatives, or when investors realize that they have put all their eggs in just one basket and decide that they have to diversify.
24. In a new **working paper (BIS No 205), William White, the Bank for International Settlements' chief economist**, actually argues that in order to ensure macroeconomic stability consumer price stability is not sufficient. "Past experience is replete with examples of major economic and financial crises that were not preceded by inflationary pressures." He points out that surges in credit frequently occur because central banks tend to tolerate them – because CPI inflation is on target. Asset prices can thus be pumped up, and the eventual correction will cause a sharp economic slowdown. Japan is the role model in this respect. So he argues that central banks have an obligation to prevent asset price bubbles by holding down credit growth via higher interest rates. As far as this represents a shift in OECD central banks' paradigm, it can be expected that interest rates may rise by more than is presently priced in, and that the end of the imbalances may come earlier.
25. Right now, we are in an uneasy dynamic equilibrium: interest rates are rising gradually, commodity markets remain buoyant, stock markets are strong in the sense that risk premia are approaching historical lows, especially in the US (where they are now in the neighborhood of only 2 ½ percentage points), and the American current account deficit shows no sign of getting smaller. The world will remain awash with liquidity which tends to fuel asset price inflation around the globe. **Risks are therefore still on the rise that we will experience a disruptive adjustment of relative prices of currencies, commodities and the main asset classes, ie a non-cooperative solution**.
26. **Elements of a disruptive unwinding of imbalances are: an end of interventions in support of the dollar, a significant decline of private capital flows into US assets, a much weaker dollar, a further increase of dollar interest rates along the entire curve, a collapse of the US housing boom, much slower growth of household spending, less imports in the US, less exports to the US in the rest of the world, a slow-down of growth everywhere, a steep fall of commodity, equity and house prices, and balance sheet problems of households**

and firms which are faced with significant reductions of their net wealth. Monetary policies would soon have to turn expansionary again and there would have to be a shift from export-led to domestic demand-led growth. For countries with large FX reserves this is a viable strategy, and there are many of them by now. This would alleviate the pain and shorten the adjustment process.

27. In other words, **cash and bonds issued by governments in countries with appreciating currencies would be king.** If investors increasingly adopted such a view, this would be like a self-fulfilling prophecy, bringing about the event against which they wanted to protect themselves against.
28. **Finally, a word about Russia.** Investors are riding high and some of the stocks are no longer cheap. But in a scenario similar to the one described above, certain Russian assets are still fairly safe alternatives. The country is the world's major energy and commodity producer. While imports are rising very fast, export revenues have boomed even more – the trade surplus has reached no less than \$120bn last year. The central bank tries to hold the exchange rate in a narrow range and therefore buys all the dollars and euros on offer at a relatively stable rouble rate. Foreign reserves have reached \$225bn and exceed official foreign liabilities by far. **The country has become a major a major net creditor to the rest of the world.**
29. The interventions result in a very fast issuance of roubles. **Money supply M2 is presently 38% y/y.** Since the Russian government taxes oil production and exports at high rates, revenues have been rising at rates of around 50%. So even though expenditures are also increasing at very high rates (35%), the budget surplus reached 7.4% last year. Ratings have improved continuously.
30. Ample liquidity, low real interest rates and an increasingly liberalized capital market have led to booms in equities and housing. However, the combination of 23% hourly wage growth, a GDP deflator of 20%, a stable exchange rate and therefore import price inflation in the neighborhood of zero has made the non-commodity parts of the economy uncompetitive which are exposed to foreign competition. This is **a case of Dutch disease.** It means the manufacturing industry suffers and shrinks considerably, depending on how long the process lasts. Investors should stay away from this sector, unless there is a local or national monopoly situation (such as companies which are regarded as national assets).
31. **Key features of the Dutch disease are the steep increase of structural unemployment, fairly slow growth of industrial production and a negative contribution of real net exports to GDP growth. On the other hand, domestic demand continues to expand briskly. In euro or dollar terms, no major country's nominal GDP is rising as fast as Russia's (27.9% y/y in Q4 '05, real GDP was 7.9% y/y).**
32. So it makes sense for investors to **focus on stocks which benefit from the boom in domestic demand.** Given that average wages are around \$300 a month, there is a lot of catching-up potential. Sectors that come to mind are retailers, domestic service providers, airlines, utilities, importers, or banks (even though inflation is high). Another possibility are dollar-denominated government bonds which yield 100 basis points than US treasuries (in the 10 years). The euro-denominated Aries bonds which are an even better idea because of the exchange rate aspect have attractive yields but are not sufficiently liquid. **There are still many small companies with price to earnings ratios in the order of 2 or 3 which wait to be discovered.** Even Gazprom and Lukoil, the heavyweights of the market, which do not look so attractive going by their p/e ratios, are quite cheap, even very cheap, on the basis of their reserves in the ground.

33. On balance, the country is financially rather sound and could weather a storm. If needed, the government could pump-prime the economy. Letting the rouble float up is another possibility if inflation gets too much out of hand. And long-term, the on-going catching-up process in other emerging economies will keep up the prices of Russia's main export products. The major disappointment so far is the slow transition to an information and technology-based economy. This is so because the most attractive earnings and growth potential has been in commodities. This has turned Russia into a sort of petro-economy. Corruption is therefore still a major issue. Russia is a high-risk place - but still with considerable opportunities, and a hedge when the world's imbalances unwind.