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Most imbalances continue to get worse but the world economy powers on, regardless

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1. In the introduction to its latest annual report, the Bank for International Settlements admits that it was **surprised that a whole set of global imbalances which could have threatened the very benign high growth / low inflation environment had still not done so**. The situation had looked quite dangerous one year ago at the time of the previous report, but the reversion to the mean of important variables that had been moving beyond their historical norms did not take place. The BIS, as the central bank of central banks, is more aware of the risks to global economic stability than any national central bank, and had been warning more than almost anyone of the dangers of a violent unwinding of those imbalances.
2. The number of imbalances has not shrunk - several of them have actually become larger since the BIS issued its warning one year ago:
 - **The main risk**, the mother of all imbalances, so to speak, is still the **record high and rising US household debt**, reflected in an average personal saving rate of -0.4% in 2005. Yet American private consumption has held up well so far. It expanded by no less than 5.1% in real seasonally adjusted annualized terms in Q1. So in spite of a lack of savings, the explosion of energy prices and steeply rising interest rates American consumers happily accumulate further debt.
 - **After many years of rapid increases, house prices did not show any sign of collapsing either** – in the US last year they advanced by 13%. Even in slow-growing euroland, residential property price inflation had been 7.2% y/y. In the UK on the other hand, high interest rates have helped to cool down house prices (+2.2%) but commercial property prices had still raced ahead at a rate of 13.4%.
 - **China's investment boom had been another candidate for a major correction**, but the country has so far shrugged off the suggestion that an average growth rate of real capital spending of 9.4% over the past 14 years and an investment ratio of 44.1% of GDP, twice the OECD norm, will inevitably result in overinvestment, followed by downward revisions of profit expectations, a decline of capital spending and possibly a recession.
 - **The easy flow of funds to borrowers in emerging markets and to countries running large balance on current account deficits** did not come to a halt either, and risk premia are still very low, too low from the perspective of the BIS. This could cause disruptions the moment markets decide to reduce their exposure to risky assets.

- Finally, “an unexpected further leap in what were already **unprecedented external imbalances did not lead to disorder in exchange markets.**” In other words, the dollar remained surprisingly resilient and tended to rebound after each bout of weakness. The combination of buoyant economic growth in the US and a fairly strong dollar will probably lead to a widening of the current account gap in coming quarters and an increased risk that dollar holders may at some point decide that they want to diversify into other currencies. So far market participants have decided not to pay attention. Some of them point out that the **US’ net investment income account** has been positive until recently. This is about to change quickly now as interest rates on foreign liabilities (12 ½ tr \$) approach the yield on foreign assets (10 tr \$).
3. Not all imbalances have become worse. Japan’s economy has been growing robustly for the fourth year in a row and euroland’s economy seems to be gaining momentum by the day, while growth rates in emerging countries have remained high. Therefore the **world economy is getting less dependent on the US consumer and America’s high house price inflation. The growth differential which had been one of the drivers of external imbalances is losing some of its impact.**
 4. The steady and by now quite significant increase of the Fed Funds rate also works in the right direction: it makes saving more, and borrowing less, attractive for Americans. Together with the slight depreciation of the dollar, the flattening of the yield curve and the loss of purchasing power resulting from energy price inflation this contributes to a cooling down of domestic and import demand and an adjustment of relative prices in the US. Tradable goods and services become more expensive relative to non-tradables which boosts exports and reduces imports. The coming slow-down of domestic demand also means that capacities will be set free and can be used for exports. As a result, **the American current account deficit should be coming down at some point which would reduce the flood of dollars and the liquidity-driven asset price booms that characterize the global economy. In the near-term, the deficit will probably increase, though. The US terms of trade continue to deteriorate.**
 5. **For the BIS, US consumer demand, and domestic demand in general, need to be restrained further.** The adjustment process so far has been very slow. Without stating it explicitly, a Fed Funds rate of 5½%, as expected by the market, should therefore not be the end of the story because demand growth remains robust, excess capacities have virtually disappeared and the balance on current account deficit is still at a historical high - 6.4% of nominal GDP in Q1. The situation has not been helped by the fact that until quite recently the US economy continued to expand faster than the rest of the world, or that the trade-weighted depreciation of the dollar had de facto ended in late 2003, followed by stagnation over the next two and a half years until a few weeks ago.
 6. Something more decisive must happen in order to cool US demand. It would **be helpful if the Bush administration cut the budget deficit** which, according to the OECD’s latest forecast for 2006, is running at 3.6% of nominal GDP and thus exerts strongly expansionary effects at a time of near-full employment. Under the Maastricht rules, the US would not qualify for membership in the euro zone (just as the UK).
 7. It is unlikely that the BIS proposals will be taken up by the Americans who are concerned about growth more than anything which for policy makers mainly means that consumers must be kept happy. While this is a worthy goal, it is probably not feasible to achieve it in the medium term. **At some point US consumers will capitulate.** Higher interest rates make

housing assets less attractive at a time when raising rents has become difficult, both because of an ample supply of housing and cooling demand. Borrowing against rising home prices for consumption purposes thus won't be an option for much longer. This eliminates one key driver of US household spending.

8. **Moreover, American consumers are hit severely by the explosion of energy prices**, reflected in a headline inflation rate of 4.2% y/y, a number which exceeds the 3.9% y/y growth rate of hourly wages. In other words, **real wages are falling**. Consumers may increase their working time in order to maintain spending levels but there are limitations to this given that American workers are already putting in much longer hours than anybody else in the developed world except the Japanese. So the future of US consumption looks somewhat gloomy which means that the outlook for exports to the US and thus the world economy has deteriorated.
9. **The BIS does not only call for tighter policies in the US, it would also like the ECB to tread cautiously with regard to interest rates.** It argues that globally the appropriate path for monetary policy should be towards tightening, for two reasons: rising inflationary pressures in the near-term, and the threat from imbalances to sustained growth in the longer term. As to the latter, the BIS argues that it is better to restrain demand too much in the face of low consumer price inflation than to allow asset price bubbles to reach dangerous proportions. Having said that, the **need to tighten is clearly less in the euro area than in the US**. For one, levels of excess capacity are still large, witness the high unemployment rate and the substantial gap between actual and potential GDP. There is also less evidence of financial imbalances. If countries with external deficits need less domestic spending and higher interest rates (see page 146), the reverse must also be true, ie more domestic spending and lower interest rates in economies which have no problems on the external front, such as euroland.
10. As it is, the ECB **does not intend to contribute to a cooperative solution to the unwinding of the world's imbalances, just as the US side does not care about the international implications of its policies.** The latest euro area surveys among business leaders and, more reliably, the new data on German orders to manufacturing (+10.9% y/y in March to May, volume terms) and production in the manufacturing industry (+5.8% y/y for the same 3-month period) show that euroland's real GDP may presently be growing at an annualized rate of around 4%. The substantial order backlog points to a continuation of that unusually rapid economic growth.
11. This, combined with headline inflation of 2.5% y/y, M3 growth of 8.9% - compared to a reference value of 4.5% - and a booming loan business with the private sector (11.4% y/y), has made the **ECB very nervous. It is afraid its anti-inflation credentials are at stake.** According to the so-called inflation linkers, government bonds whose yield is tied to the inflation rate, 10-year inflation expectations have crept up to 2¼% which is clearly above the critical 2% mark. One goal of the ECB has always been to anchor inflation expectations firmly below 2%. So the last thing the central bank would consider is to go easy on interest rates and help to stimulate domestic demand. God forbid.
12. The **next 25 basis point rate hike, to 3%**, has more or less been announced to take place on August 3 rather than on August 31, as had been the intention until not long ago, and the fifth hike in the present cycle will follow in due course on October 5.
13. This borders on the hysterical. **The inflation rate ex seasonal food and energy is just 1.3% y/y and wage settlements have lately been 2.1% y/y** – they have been in that neighborhood for years by now. Since productivity is increasing faster than that, unit labor costs are either

stagnating or falling. Moreover, the euro has recently begun to resume its upward trend against the dollar. In all scenarios that model the unwinding process of global imbalances, a stronger euro is an essential part, and markets are more than willing to go long the European currency. This will keep euroland's imported inflation in check and suggests that the energy and commodity-led acceleration of headline producer and consumer price inflation is only a transitory phenomenon. A 10-year government bond yield of 4.06% is proof of that – it shows that among financial investors trust in the ECB is strong.

14. **China, the third key player on the global stage, does not care about global imbalances or about the potentially disastrous consequences of their eventual unwinding.** The 3 ½% appreciation of the renminbi against the dollar over the past year has been no more than a gesture of goodwill. In inflation-adjusted terms the bilateral exchange rate has almost not moved and the competitiveness of the Chinese manufacturing sector has thus not suffered. The current account surplus is now on par with the Japanese one (US\$160bn) and swiftly moving towards \$200bn and beyond. Foreign direct investment in China remains strong as well. Under normal circumstances this would lead to a large appreciation of the exchange rate - it can only be avoided by massive dollar purchases. These have been in the order of 18 bn per month over the past two years. Foreign reserves are now close to \$1tr, the world's largest.
15. Even though China's most recent ratio of gross fixed capital formation to GDP has been no less than 43.8%, there is so much excess saving that the country has become the world's largest capital exporter, ahead of Japan, Russia and the OPEC countries. This group, incidentally, is the main counterparty to the US borrowing binge. **If the renminbi exchange rate were left to the market forces, as everyone proposes, a major contribution to the world's payments imbalances would disappear.** If the end of interventions were combined with a further liberalization of the capital account, an appreciation in excess of 50% would not be a surprise. The purchasing power exchange rate is in the order of 2.50 RMB per US\$ compared to the present intervention rate of close to 8 RMB.
16. **China is quite happy with economic trends as they are** (even though it should worry about the rapid destruction of the environment): real GDP is growing at a rate of 10.3% y/y, industrial production at 17.9% y/y while producer and consumer price inflation rates are just 2.4% y/y and 1.4% y/y. Money supply must be exploding, growing far in excess of the nominal GDP's growth rate of 17%, but so far it seems that the velocity of money will remain on its steep downward trend as the banking sector becomes more important in daily life. Inflation is thus not yet an issue. Together with Japan, China is the world's main exporter of price stability. Since excess capacities are massive (steel, cars), the situation is not going to change for the foreseeable future.
17. Average wages are 14.3% y/y which means real wages are also growing at double digits. Chinese consumers must be fairly well-off – on average, that is – and they are becoming big spenders: the volume of retail sales had been up no less than 12.6% y/y in May. **So there is neither an imminent threat of inflation nor a lack of domestic demand, developments which would suggest that a significant revaluation of the exchange rate is called for.** Never change a winning team, in this case an extremely successful economic model. No one can prevent the Chinese from buying all those dollars and thereby keeping their exchange rate undervalued. Given that the population is aging as a result of the one-child policy, it is also understandable that the administration does not mind accumulating foreign assets. The children of today's Americans will one day be surprised to find out that their foreign debt service contributes to the standard of living of Chinese pensioners.

18. The above arguments imply that China and the rest of developing Asia, which is also characterized by rapid growth, stable dollar exchange rates and reserve accumulation, will continue to expand their demand for energy and other commodities at high rates. This year, their oil demand will account for 15.7 mn bpd, out of a world total of 84.53 mn, and in terms of growth it has become far more important than the OECD whose demand for oil will be about 50 mn. **One effect of Asia's, as well as Eastern Europe's, Middle Eastern and Latin America's fast GDP growth is that commodity prices are well supported in the medium term. This does not mean there won't be the occasional crash:** as supply catches up with demand, followed by supply exceeding demand for a while, in reaction to attractive prices, prices will collapse, only to reduce the incentive to expand supply, which in turn leads to a new round of commodity price inflation. This is the famous hog cycle which is a defining characteristic of all commodity markets.
19. **Growth of liquidity will also remain buoyant for some time in this fixed exchange rate / high GDP growth environment, if not as buoyant as it used to.** According to the BIS, reserves and private credit, two measures of global liquidity in emerging market economies, have increased at average annual rates of 17½% and 15½% over the past seven years (p.77), compared to an average inflation rate of less than 7% in that part of the world (3.4% in developing Asia). This also continues to contribute to the various commodity, equity and housing bubbles. Risks of a disruptive unwinding of these are rising.
20. **Summing up, there are no signs that the key players of the world economy are too worried about imbalances. They all pursue policies which suit their domestic needs. Cooperative solutions for the common good are not high on their agendas.** The US are not willing to restrain fiscal policies and to raise interest rates much further, euro area policy makers are not contemplating to go easy on interest rate and tax hikes, and China is not willing to slow the economy by raising interest rates and letting the renminbi appreciate. **Bubbles are thus bound to get bigger still.** Rising asset prices in turn encourage more speculation and provide the collateral for more borrowing, leading to a boom and bust cycle which always ends in tears, ie in falling asset prices and slow or even negative economic growth for an extended period of time.
21. **On a more optimistic note,** the two-year monetary tightening in the US may have the desired effects on saving and house prices with the usual time lags after all. The ECB and the Bank of Japan are also determined to reduce liquidity growth. Market forces are another factor that prevents imbalances from getting bigger all the time. The key in this respect is the relationship between the price of an asset and the assessment of its future income streams, relative to alternative assets. The pricier an asset the closer one gets to such an inflection point. **A benign outcome is still a possibility,** but this requires that the increase of the US savings rate, the decline of house prices in the AngloSaxon countries and emerging Asia, the slow-down of the Chinese economy, the re-evaluation of risks in emerging markets and the depreciation of the dollar all take place in a gradual manner. Disruptive incidents can always happen, though, followed by a general rush for the exits. History tells us that such incidents are never anticipated correctly and always come as a surprise. Hoping that all will turn out well is not enough.
22. **For investors this means that they have to keep a sizable portion of their funds in assets which would survive the "bust" part of the cycle.** Top of the list are UK, euro area, Swedish or Japanese bonds, perhaps even dollar denominated Russian government bonds. Russia has almost become a safe haven given its high level of reserves. Some property markets are still

fairly cheap, such as the German or Japanese ones. Yen assets which are not exposed to international competition are generally quite attractive as well because the yen will appreciate most in any major currency realignment. As to equities, look for companies which pay a high dividend, which dominate a market niche and which produce something people will always buy, no matter how bad their income situation. Commodity-related stocks have become very volatile as investors realize that many of them have moved far beyond historical trends, but could be worth another look as long as liquidity remains ample, which is the case in the near-term. Some are still cheap on a reserves basis. Gold is not a hedge, though, when bubbles burst because it is a hedge against inflation, not deflation..