Working Without a Net: The Failure of The IMF & The Real Risks of Emerging Market Investing (13/08/19)

Like No. 3 Lothian Buses from Edinburgh to Dalkeith and performers handing out flyers on the capital’s streets, The Solid Ground seems these days to ‘come not single spies but in battalions’. It’s a pace of paper issuance perhaps only previously bested heretofore by our central banks, but should not be taken as ‘maestro’ envy. The need for further issuance of The Solid Ground is not to support the status quo at all costs, the aim of the real ‘maestros’, but importantly to correct an error in the last newsletter and also, yet again, to point out to investors, following the events in Argentina on Sunday, that so-called ‘populism’ is a much greater risk to investors in emerging markets than in the developed world.

For those readers who already believe this to be the case, believe me you are in a small minority of investors. The vast majority of investment managers I speak with remain so shocked by the election of President Trump and the vote for Brexit that they have almost no conception that political risk rests anywhere except Washington DC and Westminster. The result from the primary poll in Argentina will focus the minds of investors on where the ‘populist’ risk truly lies. This has implications for EM local currency assets, the USD exchange rate and, of course, the financial health of the yield-hungry developed world investors who have ploughed into those illiquid emerging market assets.

Let us begin first with mistakes. Many of you will know that your author also wears other hats: teacher, director of two listed companies, but also Keeper of the Library of Mistakes at www.libraryofmistakes.com. As Keeper I curate mistakes of ‘human decision-making under uncertainty’, the phrase used by the committee for the Sveriges Riksbank prize in Economics, sometimes referred to as the Nobel Prize in Economics, when awarding the prize to Daniel Kahneman in 2002. As someone who has been publicly forecasting the economic and financial future for twenty-four years, the Keeper has also made some very direct contributions to the Library’s collection.

So, as the Keeper, the time has come to admit to a mistake in the last Solid Ground newsletter. In that paper I mistakenly classed all the assets in Monetary Financial Institutions (MFI) as the assets of commercial banks. However, in computing the growth in MFI balance sheets I mistakenly used the line of data that includes both commercial bank assets and central bank assets. In trying to show the impact of ultra-low, long-term interest rates on commercial bank balance sheets this was clearly an error. The Aggregated balance sheets of MFIs (excluding the Eurosystem) is what I should have been analyzing and that data does not show a balance-sheet contraction for these institutions in 2019.

What the data shows is growth in both total assets of these institutions and growth in credit to Euro-area residents in the first five months of this year. In this period they thus continued to create money and, as a result, monthly M3 growth over those first five months of the year averaged 4.4%. While this is well below long-run historical levels, it is very clearly an expansion and not a contraction. As of June things slowed and while total assets did contract from their May level, credit to the Euro-area private sector grew at an annual rate of 3.2%. Once again very low by historical standards but an expansion nonetheless.

Your analyst’s opinion on the impact of the negative nominal yield curve across the Eurozone has not changed and the continued decline in bank share prices over the past week suggests that the market shares that concern. However, the data, at this stage, shows that banks have been able to expand their balance sheets in 2019 despite those low-level interest rates and the collapse in their share prices. Whether the contraction in total assets from May to June is a new trend, following the recent dive in interest rates to new record lows, time will tell. The facts need correcting, but the forecast remains the same - that the ever-lower level of Eurozone interest rates will stop the growth in commercial bank balance sheets and lead to a tightening in monetary policy. Unmentioned in the last newsletter, but just as important, is the negative impact on the life insurance and pension fund industries (see The Solid Ground February 2019 “German Bund Yields & The Cost To Solvency: What Fresh Hell Is This?”) from these new lows for interest rates.
There are numerous factors acting to slow Eurozone economic growth, whether it be structural changes in the automotive industry, political uncertainty or slowing exports to China. To add to this list now comes another problem - a hit to emerging market growth due to the high likelihood of the failure of the IMF’s largest ever bail-out programme in Argentina. This failure signals the end of a safety-net that benefited a generation of investors in emerging markets. Thus a major re-assessment of risk is under way and the ensuing shift in capital will tighten monetary conditions in emerging markets and further slow global growth.

The Solid Ground’s inaugural issue hit the press, for those were the days when few people used e-mail, in May 1995. Those early reports focused on the unstable funding of what was widely labeled ‘The Asian Economic Miracle’. The forecast was that this unstable funding would lead to the boom turning to bust. It seemed like an eternity to wait but, by the middle of 1996, some of the issues discussed by The Solid Ground were very apparent in Thailand and, of course, on July 1st 1997, when Thailand devalued the Baht on the very day Hong Kong was handed back to China, the unstable nature of the funding for the growth miracle became very apparent.

In the ensuing panic many investors feared not just low asset prices but that law and order might break down. People were indeed murdered in riots in South East Asia, but ultimately law and order prevailed and that included the laws on property rights. In ensuring that the rules of engagement particularly between foreign investors and local administrations remained largely intact, the IMF played a crucial role. Equity investors in the MSCI Asia ex Japan lost almost two thirds of their money in USD terms during this collapse, but it could have been much worse had the political system reacted by trashing property rights in their search for economic solutions. Supporting the IMF in this crisis was ‘The Committee To Save The World’ - as so named on the front page of Time. Notably this committee consisted of three Americans - Alan Greenspan, Robert Rubin and Larry Summers.

So the safety net put in place to protect investors in emerging markets in the Asian crisis was not just in the form of the IMF pursuing neo-liberal ‘Washington consensus’ policies but also in the form of the three key US economic policy-makers with the full support of President Clinton. If the largest ever IMF programme now fails in Argentina, investors need to ask where the safety net is to protect their property rights in emerging markets today.

Can there really be such downside protection from a weakened IMF, now under even greater criticism from its largest shareholder the USA? Can such downside protection for emerging market investors come directly from US policy-makers finally forced into abandoning their belligerent approach to international relations? Without such support, what provides the downside protection for emerging market assets that a generation of shareholders have previously enjoyed? And if such support exists somewhere can it come in a form that puts property rights first and foremost in the plan for recovery?

The IMF package in Argentina is failing because the people of Argentina are voting against it. Under an Argentinian law passed in 2011, all political parties seeking to run a candidate in the presidential election must first run a candidate in an earlier primary election. Only parties whose candidates achieve more than 1.5% of the vote then progress to run a candidate in the presidential election. In the process leading up to the Presidential election on October 27th of this year Argentinians went to the polls in the primary election on Sunday. Presidential incumbent Mauricio Macri, who agreed the bail-out package with the IMF, gained just 32% of the vote in Sunday’s poll. The main opposition candidate Alberto Fernandez gained 48% of the vote.

The surprising scale of this victory is important for global investors because Fernandez’s running mate is Cristina Fernandez de Kirchner, a former President widely agreed to have pursued the unsound policies that necessitated the IMF bailout for Argentina in the first place. Few if any can believe that Argentina will honour its agreement with the IMF should Fernandez and Kirchner come to power in October. The biggest IMF package in history will have failed and investors, whether foreign or local, will be subject to policies that may include the appropriation of assets whether through formal or informal means. The safety net for emerging market investors just failed and this was no ordinary safety net - this was the biggest safety net ever deployed by the IMF.
Many investors will fail to understand why a people can choose a policy so clearly likely to lead them to sub-par economic outcomes. These will be the same investors that failed to understand the election of President Trump and Brexit. What those who have benefitted from the structural changes since the early 1980s do not appreciate is that the general population does not see the new structure as fair.

This disgust at a lack of fairness strikes at the very core of what it is to be human, and it is ultimately even more important to most people than their economic well-being. *Homo Economicus*, as constructed in economic theory, may trade concepts of ‘fairness’ to promote their economic self-interest, but real human beings do not. As long as we continue to assess the behavior of human beings at the polls as simply acting as *homo economicus* in the political sphere, we will continually fail to understand what is happening.

So while the vested interests who benefit from the current system lament what they see as ‘stupid’ decisions, they need to prepare for many more such decisions by a people who place their desire to get what the Australians call ‘a fair go’ above their current economic well-being. For those not living with the injustice of inequality of opportunity, such an ordering of preferences seems perverse; they need not even consider such issues when they go to the polls, having had more than ‘a fair go’ themselves. For those who see those injustices prevailing down the generations, the time has come for change - regardless of the short-term pain.

The vested interests may wonder just how President Trump, Brexit or President Fernandez can help with this issue of fairness, but what the electorate know is that they have to vote, based upon the candidates before them, with a view to destroying the inequality imbedded in the status quo. It is the purpose of this newsletter to point out that the sweeping changes to that status quo, with the most likely negative impacts for asset owners, will occur in emerging markets. The ‘Washington consensus’, which through the IMF enforced property rights to the benefit of investors, is now not prevailing. Welcome to the ‘new normal’ and the structural rise in risks in emerging markets.

The collapse of Argentina is ultimately more important than the collapse of Turkey. Foreign investors’ exposure to Turkey far surpasses that of Argentina, and the direct impact of defaults by Turkish corporations will have a much greater impact on the financial system, particularly the European financial system, than the minor direct impact of Argentinian default. That said, the reason why the default by Argentina is more important for investors is because of the indirect impact which shows that the IMF safety net has been withdrawn, there is no other international ‘committee’ that can come to the rescue, and that ‘populism’ is at its most dangerous for investors in emerging markets with weak constitutions and institutions.

As we saw in the Asian economic crisis, the key trigger for any stress-testing of emerging markets is the capital flight that occurs when investors fundamentally change their risk assessment of emerging-market assets. Just such a reassessment is under way, partly due to the actions of President Erdogan of Turkey but now more importantly because of the likely revolution that will follow the election of Fernandez to the Presidency of Argentina. If this was not enough to trigger capital outflows from emerging markets, we are increasingly close to the time when the rule of law in Hong Kong crumbles under the need for the Chinese Communist Party (CCP) to increase its authority in the Special Administrative Region.

Your analyst lived in Hong Kong from 1995 to 1998. I was there for the handover of sovereignty to China in 1997. For years in advance we had all scoured out copies of “*The Basic Law of the Hong Kong Special Administrative Region of the People’s Republic of China*”. My then employer, Credit Lyonnais Securities Asia, published a report ahead of the handover called “*Goodbye To All That: 97 Questions About 97*”. The focus of that document, and all thoughts, was on the rule of law - both the criminal law and particularly, given the commercial nature of Hong Kong and of CLSA clients, the civil law. Roll on over twenty years and there is now a daily focus upon the operation of the criminal law in Hong Kong in both its scope, particularly in terms of extradition to China, and in its enforcement in relation to the actions of the Hong Kong Police Force. At this stage there seem to be few questions about the operation and enforceability of the civil law in Hong Kong. That will change.
There are no de facto limits upon the power of the Chinese Communist Party in China. Whatever the constitution may say, and the civil and criminal law may proclaim, the CCP is not subject to control by either its citizens or politically independent institutions. When the CCP decides to abide by the law in China, as it does in almost all cases, it is because it chooses to do so and not because it has to do so.

When the maintenance of the CCP’s power coincides with the force of the rule of law, the rule of law can pertain. However, if there is a conflict between the maintenance of power and the rule of law, then investors must realise that the rule of law will not prevail. The protestors in Hong Kong now threaten the maintenance of power by the CCP. Whether they threaten it enough to warrant a move to a de facto one-country one system, only time will tell. Should any intervention in Hong Kong be necessary, however, to enforce the criminal law or perhaps even use force beyond the criminal law, investors need be assured that the administration of the civil law will also suffer.

More power for the CCP in Hong Kong will result in a meaningful and permanent decline in the force of property rights in Hong Kong. In the local fashion investors will no doubt dive for cover in investing with those Hong Kong families thought to have the tiger that is the CCP ‘by the tail’, thus protecting legal title to their assets. However, most investors, both local and foreign, will seek to shift their funds out of Hong Kong and thus out of the HKD.

Any net capital outflow from a currency board system, such as Hong Kong, tightens monetary policy and thus adds to the downward pressure on asset prices already instigated by the initial liquidation. When investors fearful of the decline of their property rights and thus the return of capital, not just the return on capital, move their funds, this can be capital flight on a grand scale. Once again investors will pay the price for ignoring the consequences of political shifts in emerging markets and the risks of investing in such regimes will be more accurately priced in elsewhere. (Subscribers will know that The Solid Ground also expects a major change in how the currency board system itself works, with profound implications for HKD asset prices.)

It turns out that Christine Lagarde is moving on from the IMF at a good time, at least for her. It will most likely be Kristalina Georgieva, Europe’s nomination to take over from Lagarde, who has to deal with the fall-out in Argentina and from the impact of the capital outflow from other emerging markets. Just how much support the US administration will provide for another European to write large cheques on such bail-outs is now subject to considerable doubt. The Solid Ground has long pointed out, mainly through quoting from published IMF papers, that the ideology of the organisation is shifting and that capital controls are increasingly seen as a legitimate policy tool for countries in crisis. The arrival of Georgieva after such a big failure in Argentina, and a likely constrained cheque-book due to less funding from the US, will increase the chances that capital controls form a part of any future IMF attempt to rescue failing economies. For the portfolio investor in particular, the IMF will go from hero to villain given how such measures will destroy the already limited liquidity that underlies the stability of many of the funding structures, primarily mutual funds, which hold emerging market risk.

Christine Lagarde, fresh from the debacle in Argentina, arrives at the ECB just in time for the next Eurozone recession and, if recent Solid Ground newsletters are correct, the next financial crisis. Together with AKK, the likely new Chancellor of Germany and Kristalina Georgieva, a new committee formed of European women, and not American men, will be tasked with saving the world. Whatever their talents, they face a huge task as they are unlikely to be supported by the policy-makers of the world’s largest economy.

‘Saving the world’ is never easy, but it was a lot easier in 1998 when short-term policy interest rates were near 5.0% and it was a long way to zero. It was a lot easier when the IMF had deeper pockets and strong support from US policy-makers. Expect the new committee to use blunter new tools and do not expect similarly benign consequences for asset prices as it was when Summers, Greenspan and Rubin decided where the pain of economic adjustment would fall. As The Solid Ground has long asserted, we have begun a long bull market in the word ‘control’ and a long bear market in the word ‘market’. Whether spoken in French, German or Bulgarian - ‘controle’, ‘steuerung’ or ‘kontrol’ - all lead to the same thing: a bull market in gold.
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