[Panic about world deflation](#) + dossier de presse
Immanuel Wallerstein, *aljazeera.com*, February 1, 2014

Not so long ago, the pundits and the investors saw the "emerging markets" — a euphemism for China, India, Brazil, and some others — as the rescuers of the world economy. They were the ones that would sustain growth, and therefore capital accumulation, when the United States, the European Union and Japan were all faltering in their previous and traditional role as the mainstays of the world capitalist system.

So it is quite striking when, in the last two weeks of January, the Wall Street Journal (WSJ), Main St, the Financial Times (FT), Bloomberg, the New York Times (NYT) and the International Monetary Fund (IMF) all sound the alarm about the "collapse" of these same emerging markets, worrying in particular about deflation, which might be "contagious." It sounds like barely contained panic to me.

First, a word about deflation. A "calm" market is one in which nominal prices do not go down, and only creep up slowly. This enables sellers and buyers to predict with reasonable confidence what decisions are optimal for them. World markets have not been calm in this sense for some while. Many analysts date the decline of such calm from the 2008 turn in U.S. mortgage markets. I myself see the decline of such calm as beginning in the period 1967-1973 and continuing ever since.

The market is not calm if there is either significant deflation or significant inflation. These are really the same thing in their impact on real employment figures and therefore on world effective demand for production of all sorts. Whether real world employment goes down for one or the other reason, there is both acute real suffering for the vast majority of the world's population and a vast increase in uncertainty, which tends to freeze further productive investment, which leads to more suffering and more freezing. It is a vicious circle.

To be sure, some large capitalists are able to take advantage of the situation through canny financial manipulations involving speculation. Their problem is that they are taking a big gamble — either massive appreciation of their assets or bankruptcy. Still, at the very least these manipulators have a chance to gain massively. The majority of the world's population are fairly sure to lose, often massively.

What is in these panic reports? Michael Arnold in the WSJ asks, "Will selloff push emerging market central banks to raise rates?" He says that the turmoil was caused by "disappointing growth figures" for China and Argentina's devaluation of its currency. Arnold particularly worries about India and Indonesia, which have "large debt loads and heavy dependence on foreign lending," and therefore are moving to curb inflation. He mentions Turkey as another problem zone.

Everyone seems to proffer good advice, sure that it will somehow palliate the situation. Few seem to be ready to admit that global effective demand is the real problem.

Hal M. Bundrick in Main St emphasizes contagion. He cites both shifting U.S. monetary policy and concerns for the Chinese economy plus political turmoil in Turkey, Argentina, and Ukraine as "hastening the decline." He cites a Russian banker about the fall of the ruble and an atmosphere "close to panic." He says this panic is "crossing over from emerging to developed [markets] in terms of sentiments."

Gavyn Davies in FT headlines his story, "Will the emerging world derail the global recovery?" He says that emerging currencies have been "in free fall." He too sees Chinese slowdown as the key issue, in particular via its impact on "supplier economies" (that is, countries that sell primary products to China) — in particular Brazil, Russia, and South Africa. He says the "pain of a credit bubble" is not only China's problem but that of Turkey, India and Indonesia. If the Chinese decrease in growth goes much further, it would threaten "renewed global recession." Ending on a mildly optimistic note, he immediately takes it back by saying that his simulations (the basis of his mild optimism) are based on old patterns that may no longer hold.

Ralph Atkins in FT talks of "the spectre of deflation. "Deflation, even if positive in the short term, is "definitely negative for equities" over the longer run. His particular worry seems to be the euro zone. Having cited the reasons of others to see the brighter side, he ends by saying, "the spectre of deflation wore its invisibility cloak."

And none less that Christine Lagarde, managing director of the IMF, told the assembled Establishment figures at the World Economic Forum in Davos that there is a global market threat as the United States cuts back its cash stimulus. There is a "new risk on the horizon and it needs to be closely watched." She cites the "spillover effects...in emerging markets."

That same week, Bloomberg had an editorial that began, "Emerging-market economies had a brutal week." They see the emerging markets as too tied to the U.S. dollar and therefore "unduly sensitive to fluctuations — real or imagined —in U.S. monetary policy." So they preach to the U.S. Fed not to "taper too soon" and predictably to the emerging countries to "improve their policies."

And not least, Landon Thomas in the NYT informs us that the latest buzzword on Wall Street, replacing BRICS, is "the Fragile Five." This list includes three BRICS members (Brazil, India, South Africa), plus Turkey and Indonesia. It leaves off both China and Russia, whose geopolitical clout seems to weigh heavily on the scales.

Everyone seems to proffer good advice, sure that it will somehow palliate the situation. Few seem to be ready to admit that global effective demand is the real problem. But one senses that, just below the surface, they understand this. This is why they panic, because then their whole emphasis on "growth" — a cardinal faith — is undermined. In that case, the crisis becomes not cyclical but structural, to which one has to respond not with palliation but with inventing a new system. This is the famous bifurcation in which there are two possible outcomes — one better and one worse than the existing system, one in which we are all involved as players.

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Will the emerging world derail the global recovery?

Gavyn Davies, *Financial Times*, August 25, 2013

The financial markets' love affair with emerging market assets, which peaked in 2010, has plumbed new depths during August. Emerging market equities (in $ terms) are now down by 12.2 per cent so far this year, while developed market equities have risen by 11.2 per cent.

Emerging currencies have been in free fall. As a result, interest rates have been tightening as GDP growth expectations have been persistently marked downwards, which is usually a toxic combination for risk assets.

Two major questions arise from these events. First, when will the underperformance of emerging assets, relative to the developed world, hit bottom? Second, and more important, will the near-crisis in the emerging world spill over to the developed world, bringing the nascent recovery in advanced economies to an end? If this were to occur, the bull market in risk assets in the western economies would surely be over.

The answer to both of these questions will depend on how serious the emerging market economic slowdown becomes in the next few quarters. The miracle of the BRICs in the 2000s was largely driven by a single colossus, China, with many other emerging economies becoming supplier-economies to its massive appetite for commodity imports. As I have argued here, the workout from the Chinese credit bubble may not develop into a full-blown crisis, but it is likely to be difficult and prolonged. This suggests that the supplier-economies, like Brazil, South Africa and Russia will not enjoy a rapid rebound in growth.

Furthermore, China is not the only economy which is suffering from the pain of controlling a credit bubble. Some emerging economies, with Turkey, India and Indonesia prominent among them, have old-fashioned balance of payments crises triggered by expansionary fiscal policy and over-accommodatory monetary policy.

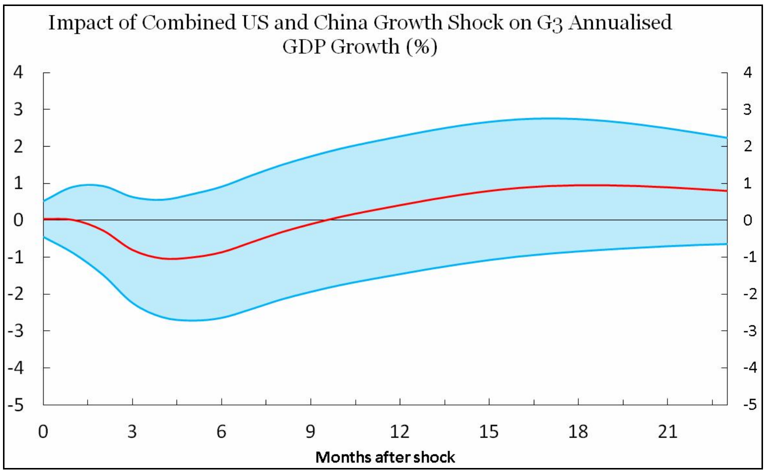
The plight of these economies has of course been heightened by the likely tapering of asset purchases by the Fed in September. But it has now become clear that many emerging economies, including China, adopted excessively expansionary fiscal and monetary policy in response to the global financial crisis of 2008, and they are now paying the penalty. It would be surprising if none of them ends in the hands of the IMF, where Christine Lagarde is clearly preparing to help. John Authurs argues that it is too early to go bottom fishing in emerging market assets, and I agree with him.

How bad would the emerging economies need to get before they could threaten the health of the developed world? In the past, this has never really been a major issue, since the scale and trading patterns of the emerging world clearly meant that they lagged the cycle in the developed world, with little fear of significant feedback in the other direction.

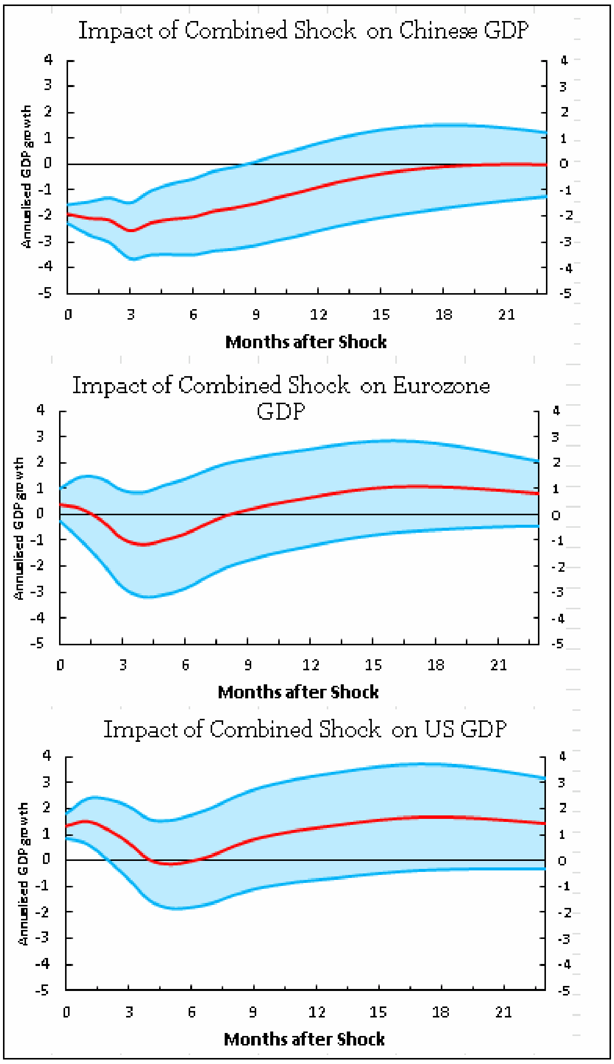
There was no doubt about which was the dog and which was the tail, even when a major crisis like the 1997 Asian shock erupted in the emerging world. But the Chinese economy, measured in PPP exchange rates, is now similar in size to that of the US and the eurozone, so there is much greater danger that the developed economies will be badly affected by trouble in China.

In order to gauge the risk of a spillover large enough to take down the entire global economy, my Fulcrum colleague Juan Antolin-Diaz has estimated a VAR model which shows how the three largest economies (the US, the eurozone and China) have related to each other in recent years. We have then applied two separate shocks to the system: a downward shock equivalent to 2 per cent of GDP in China, reflecting the work-out from the credit bubble; and an upward shock equivalent to 1.5 per cent of GDP in the US, reflecting the rise in private expenditure and the decline in fiscal tightening expected in the near future [1].

According to the model, this is how the world economy would be affected by these two shocks:



The graph shows that the initial impact of these two shocks is to reduce the global growth rate by about 1 percentage point for a couple of quarters, with the impact turning positive about a year later, presumably owing to the easing in macro policy which would follow the initial slowdown. (The central estimate is shown with the red line, with two standard deviation bands shaded in blue.) The model therefore suggests that the kind of shock which is currently underway in China will slow the global growth rate by a modest amount for about a year, but that it will not cause a major global recession, as long as the positive shock in the US actually does materialise as expected.



The twin shocks would, however, have a large effect on the distribution of growth between the major three geographical blocks in the global economy. The adverse effect on Chinese growth peaks at -3 per cent, and stays continuously negative for around 18 months.

In the eurozone, the adverse effects of the Chinese shock dominate for a while, but this disappears after a couple of quarters, after which the positive effects of the US boost tend to dominate.

Finally, in the US itself, the GDP benefits stemming from domestic events (with the expansion in private consumption and investment gradually overtaking the effects of fiscal stringency) are almost exactly offset by the Chinese slowdown for about 6 months, but after that the annualised growth in real GDP is boosted by about 1.5 per cent.

Conclusion

Overall, then, the markets seem to be broadly correct in their assessment of the two significant shocks which are currently hitting the global economy. These are likely to have a marked effect on the relative growth rates of the major regions, with the emerging world being hit while the US gains, but the net effect on the entire global economy may not be very large.

The outcome would, however, be different if the size of the shock hitting China were to increase significantly. For example, if the initial shock were to increase by one half, from -2 per cent of GDP to -3 per cent (which would take Chinese GDP growth down into the 5 per cent region for a while), then the overall adverse impact of the two shocks on global GDP growth would peak at about -2 per cent for a couple of quarters. This would probably be enough to threaten a renewed global recession, even assuming that the expansionary shock in the US remained intact.

In other words, the emerging market malaise could indeed take the global economy down with it, but only if the Chinese shock turns out to be much larger than currently seems likely.

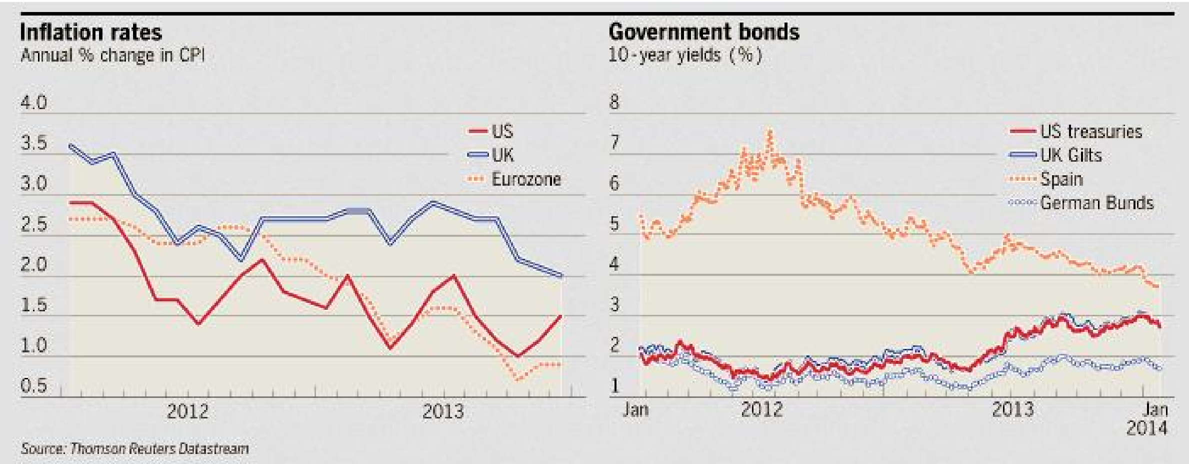
Investors wrestle with spectre of deflation

Ralph Atkins, *Financial Times*, January 24, 2014

Politicians conjure up imagery seemingly out of a Harry Potter book when discussing deflation. The phenomenon of sustained price falls is a monster that can wreck economies. It is an "ogre that must be fought decisively", says Christine Lagarde, the International Monetary Fund's managing director.

So far financial markets have refused to be spooked. For investors deflation is a beast that, like Harry Potter characters, takes many forms – some not so scary and others benign. If deflation became dangerous, there is confidence it would be combated by fresh central bank wizardry.

Inflation rates



But bond markets at least have been swayed since the start of the year by unexpectedly weak inflation globally, which has sent US and UK government bond yields tumbling. Investors may misunderstand disinflationary forces at work as the world emerges from the financial crisis years, analysts warn.

"Central banks have not done enough to explain the disinflation and deflation of last year – let alone what is happening this year," says Steven Major, head of fixed income research at HSBC. "Policy makers have to be very careful. If the sign changes on inflation numbers, and growth rates do not improve, debt sustainability will become a real challenge in the eurozone."

This week the IMF sounded the alarm. An update to the Washington Institute's forecasts observed that "risks to activity associated with very low inflation in the advanced economies, especially the euro area, have come to the fore". Lower than expected inflation would increase debt burdens and real interest rates.

What economists fear is that "disinflation", or slower inflation rates, could turn into a dangerous form of deflation, with sustained falls in general prices persuading consumers and businesses to delay spending because they expect goods or services to be cheaper in the future. Japan's economy has been dogged by two "lost decades" of deflation.

Yet deflation is not the IMF's "baseline" forecast, even in the eurozone; it remains a "tail risk", an unlikely event that, although potentially serious, is hard to price in. Swaps markets see a 16 per cent chance of annual eurozone inflation below zero in October. But Hans Lorenzen, credit strategist at Citigroup, says: "I don't think anybody has full-blown deflation as their central scenario."

At least initially, disinflation can lift share prices. The inflation trough that typically follows recessions often coincides with a peak in price/earnings ratios, notes Graham Secker, European equity analyst at Morgan Stanley. Lower inflation boosts real wages and allows central banks to maintain loose monetary policies – both of which are good for shares. In the UK and US, the focus remains on when a pick-up in the threat of inflation will force central banks to lift interest rates.

"Big picture, over the longer term, deflation is definitely negative for equities," says Mr Secker. "In Europe profits would contract and sovereign default risks re-emerge. But, bizarrely perhaps, it may even be positive in the short term."

Falling prices can also be healthy when economies are restructuring. By slashing costs, Spain and other crisis-hit eurozone periphery countries have boosted their export competitiveness. Periphery equity markets have outperformed northern European rivals so far this year.

But the eurozone turnround remains fragile, notes John Wraith, strategist at Bank of America Merrill Lynch Global Research. "There are a lot of uncertainties in the eurozone, such as the stress testing and asset quality review of the banks, and that is holding back the economies and the markets. The problems are structural and a Japanese-style deflationary situation cannot be ruled out."

With fiscal situations still precarious, and eurozone countries unable to control their currency, the situation could quickly become critical. "If deflation risks became real, you would have to start pricing in a greater chance of defaults and debt rescheduling," says Christopher Iggo, senior investment manager at Axa Investment Managers.

In Europe profits would contract and sovereign default risks re-emerge. But, bizarrely perhaps, [deflation] may even be positive in the short term

- Graham Secker, Morgan Stanley

Still, if deflation did become a serious risk, "it would increase the chances of the ECB doing something else in terms of monetary policy", adds Mr Iggo. ECB policy could be loosened further via lower interest rates or fresh offers of cheap long-term loans. In the worst case, the central bank could launch US-style "quantitative easing" or large-scale asset purchases. If it bought eurozone government bonds, yields would fall.

Prospects of further ECB easing may have been part of the reason eurozone bond markets have also rallied this week. On Friday 10-year German Bund yields fell below 1.64 per cent, the lowest since last August.

But investors have not been running scared of a eurozone deflation monster. Appetites for periphery debt have reflected revived confidence in the region's stability – reducing the risk premiums they have demanded over ultra-safe German Bunds. Spain secured €40bn in orders for a €10bn offer of 10-year bonds this week. Boosting confidence further, purchasing managers' indices this week showed eurozone growth starting the year at the highest pace in more than two years.

The spectre of deflation wore its invisibility cloak.

What's Behind the Emerging-Market Meltdown

Bloomberg, Jan 25, 2014

Emerging-market economies had a brutal week. For years, during the crash and its aftermath, they did well as the advanced economies slumped. Recently, not so much. Many developing countries are seeing their currencies drop and their bonds and equities hammered. Just as the global recovery appeared to be strengthening, a fresh source of instability has presented itself.

The issue now is how to keep the turmoil from derailing the global expansion. In a way, this was not an unexpected development: The recession in the advanced economies caused central banks to push short-term interest rates to zero and buy assets to drive long-term rates down as well. Capital flowed to the developing world in search of better returns. As investors prepare for a resumption of normal monetary policy, demand for emerging-market assets is bound to fall. The question has always been whether this adjustment would be smooth or abrupt.

The problem is that two things are amplifying the adjustment of capital flows: first, the dependence of global capital markets on the dollar, and hence on the policies of the U.S. Federal Reserve; and second, policy mistakes in some of the most-watched developing economies. In the short term, there's little to be done about the dollar's destabilizing pre-eminence. But economic reform in some of the main emerging-market economies, desirable in its own right, would help calm nerves.

Paradoxically, the U.S. market crash of 2007 and 2008 entrenched the dollar's global dominance. Investors sought safety, and U.S. government debt remains the world's safest asset. Despite tremendous federal borrowing, U.S. debt was soon in short supply. The Fed's quantitative easing took trillions out of the market, and emerging-market governments bought dollars as a cushion against bad news and to hold their currencies (and export prices) down.

As a result, the emerging markets are unduly sensitive to fluctuations -- real or imagined -- in U.S. monetary policy. The Fed has recently begun to pivot away from quantitative easing, signaling that the era of extraordinarily loose U.S. monetary policy will come to an end. This is making investors think twice about putting their money in developing countries.

The Fed has begun to taper QE too soon -- inflation in the U.S. is still low, and the labor market is still slack. On the other hand, the reduction in the pace of asset purchases is gentle (some would say to a fault), and at some point winding down the Fed's unorthodox measures was going to be necessary.

The remedy for undue global sensitivity to U.S. monetary policy isn't a different approach by the Fed; rather, it's burden-sharing. Eventually, other currencies, such as the euro and the renminbi, need to function alongside the dollar as reserve currencies. In the meantime, better U.S. fiscal policy - - less budget contraction now, when the economy needs stimulus, and more later -- would also lighten the Fed's load.

There's also more emerging-market governments can do. They should recognize that this week's financial-market turmoil was, to varying degrees, their own fault. Argentina, which felt the full force of the storm with collapsing bond and equity prices and a steeply devalued peso, is a textbook case of economic mismanagement. No mistake has been left unmade -- including cooking the books about the true rate of inflation.

There's news to concern investors in other and more important emerging markets, too. Growth in China has been expected to slow for years: It now appears to be happening, and the government's ability to manage the necessary economic restructuring is in doubt. The world's second-worst-performing currency lately is the Turkish lira: Political protests, corruption scandals and flailing leadership are calling the country's economic prospects, and its place in Europe, into question. Russia is stumbling. So is Brazil.

We'll have more to say about these emerging economies in the coming days as we look at the stress points of a post-QE world. For now, suffice to say, the best way for emerging-market governments to restore confidence would be to improve their policies. In this week's financial turmoil, factors beyond their control were in play, but they aren't innocent bystanders, and they aren't powerless.

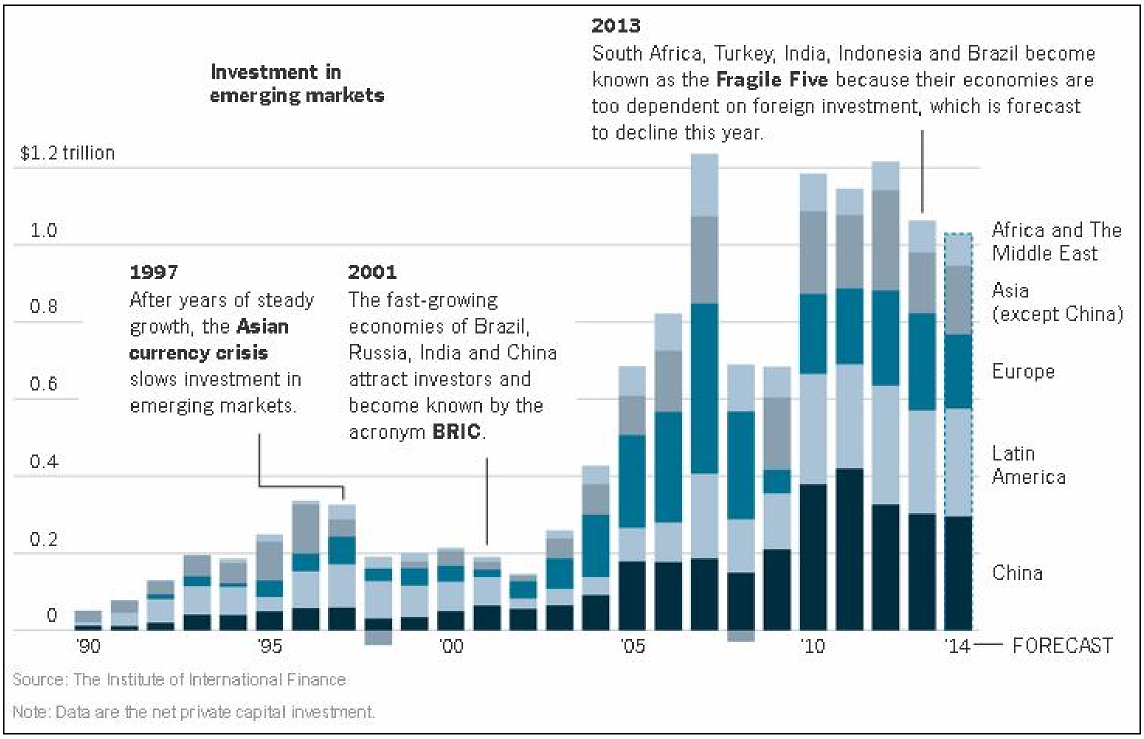
'Fragile Five' Is the Latest Club of Emerging Nations in Turmoil

Landon Thomas Jr., *New York Times*, Jan. 28, 2014

The long-running boom in emerging markets came to be identified, if not propped up, by wide acceptance of the term BRICs, shorthand for the fast-growing countries Brazil, Russia, India and China. Recent turmoil in these and similar markets has produced a rival expression: the Fragile Five.

The new name, as coined by a little-known research analyst at Morgan Stanley last summer, identifies Turkey, Brazil, India, South Africa and Indonesia as economies that have become too dependent on skittish foreign investment to finance their growth ambitions.

Emerging Problems



The term has caught on in large degree because it highlights the strains that occur when countries place too much emphasis on stoking fast rates of economic growth. The new catchphrase also raises pressing questions about not just the BRICs but about emerging markets in general.

The Morgan Stanley report came out in August, when there were reports that the Federal Reserve would soon reduce its bond-buying program. The term that report coined became a quick and easy way for investors to give voice to fears of a broader emerging markets rout, propelled by runs on the Turkish lira, Brazilian real and South African rand.

These fears were realized this week when Turkey, seen by most investors as the most fragile of the Fragile Five, raised interest rates 4.25 percentage points on Tuesday.

The sharper-than-expected increase by the country's central bank — which previously took a fairly passive approach to defending its currency — was intended to persuade foreign investors, as well as corporate and household savers, to hold on to their lira instead of exchanging them for dollars.

As with other members of the Fragile Five, Turkey relies heavily on fickle short-term investment from foreigners to finance gaping current account deficits — the result of which has been a currency that many investors say is overvalued.

Investment analysts love to come up with catchy names that simplify their views and, ideally, capture the market spirit of the moment. During the early period of the euro crisis, PIGS, unkindly, came to describe Portugal, Ireland, Greece and Spain. And when the focus turned to Greece and its future in the euro zone, Grexit became the term of art.

Not all of them catch on. In September, Deutsche Bank analysts came up with Biits, which covers the same countries as the Fragile Five, but it graced hardly any analysts' reports.

The countries in the Asian financial crisis of 1997 never got saddled with a nickname. As in that and other emerging market blowups, foreign investors and lenders pulled their money out because of broader concerns about political and economic uncertainty.

And while there have been sharp outflows from Turkey and some of the other members of the Fragile Five, broadly speaking, foreign investors have retreated from the asset class as a whole.

None of which surprises Jim O'Neill, who, as an economist at Goldman Sachs in late 2001, came up with the phrase BRICs as a way to highlight the long-term growth potential of large emerging market economies.

"I still believe these are the best investment opportunities in the world," said Mr. O'Neill, who acknowledges being irritated at having to defend his thesis every time there is an emerging market wobble.

Mr. O'Neill, who recently left Goldman and now works independently, has just come up with yet another, similarly dynamic club. This one, of populous countries with high growth potential, he calls MINTs, for Mexico, Indonesia, Nigeria and Turkey.

When Mr. O'Neill coined the BRICs phrase, foreign capital inflows into emerging markets were about $190 billion a year, according to data from the Institute of International Finance, the trade group for international banks.

His timing could not have been better: The Federal Reserve was moving to a policy of very low interest rates and China's growth engine was revving up, driving what would become a long-running commodity boom.

Yield-starved investors began pouring into Mr. O'Neill's markets and their economies. Since 2010, annual net inflows into these markets have averaged a little over $1 trillion a year.

As a result, Mr. O'Neill became quite the global man about town. He has been celebrated by investors and the BRIC nations themselves, which even formed a BRIC-development bank.

All this changed last summer, when the Fed's announcement that it would eventually reverse its bond-buying program panicked giddy emerging-market investors. Other concerns, like a slowdown of growth in China, political uncertainty in Russia and Turkey and most crucially, vulnerable currencies in Brazil and South Africa, spurred concerns over the possibility of a broader market panic.

So in early August, when James K. Lord, a fairly junior currency analyst at Morgan Stanley sent out a research note warning of the risks within the "fragile five," the name spread quickly, especially among investors already nervous about their emerging-market holdings.

Turkey, more than any of the others, has been the primary target. Since May, foreign investors have sold, in net terms, $3.9 billion worth of lira-denominated bonds, according to data from the Institute of International Finance, a substantial amount for such a short period.

Although Mr. O'Neill, while at Goldman, aggressively marketed his BRICs notion, Mr. Lord and his team at Morgan Stanley have been more circumspect, avoiding for the most part public statements in the news media.

In response to questions about his Fragile Five thesis, Mr. Lord, who this year was promoted from vice president to a more senior position, asked that he be quoted playing down his original thesis.

"We have been using the term less and less in our research," he said, explaining that responses by policy makers in these countries have to some extent addressed the issues he raised.

That is not surprising. Banks are always wary of promoting critical investment calls, especially when important, fee-generating nations like Brazil and Turkey are concerned.

But more skeptical investors remain less inclined to view currency-stabilizing steps taken by Turkey and other Fragile Five members in such a sanguine light.

"People made mistakes investing in these markets just because of the headline G.D.P. and demographics," said Stephen L. Jen, a former economist for the International Monetary Fund who now manages a hedge fund based in London. Important issues like corruption and governance, not to mention excessive lending in urban areas that favored the political and economic elites, have been ignored, he pointed out.

"Istanbul does not need 100 malls," he said. "There is a reason these people are poor."

Mr. Jen did make a stab at crafting his own catchphrase and considered adding Russia to transform the Fragile Five into the Sorry Six, before ditching the notion.

Better to keep it simple, he said, and steer clear of currencies with four letters: the Mexican peso, the South African rand, the Brazilian real and, of course, the Turkish lira.