WEBLOG

Wermuth's
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Commodity crash: importers win, producers lose

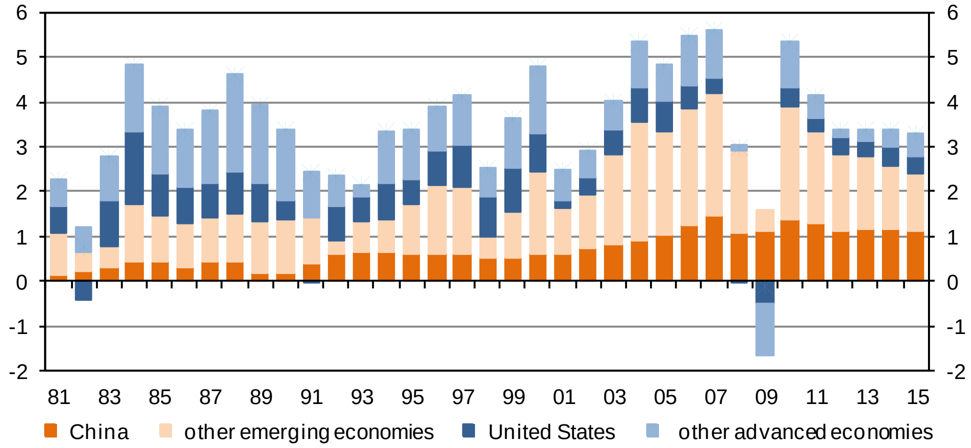
by Dieter Wermuth*

1. **Emerging countries and commodity producers whose purchasing power parity share in global output has reached 55 percent by now are still the main drivers of world growth, but momentum is fading.** Earlier than expected, state-controlled capitalism and authoritarian systems may have reached the limits of what they can achieve. The economies of China, Brazil, Russia, Turkey, South Africa and the member countries of the OPEC oil cartel have begun to stutter or to shrink. Commodity markets are almost in a free fall.

2. Since stock markets around the globe had been fairly expensive relative to corporate earnings – reflecting expansionary monetary policies -, financial investors decided it was time to reduce their exposure, ie, to sell. They remain more nervous than usual which suggests that stocks have not yet bottomed out. **Risk-off strategies mean a shift towards safe haven stocks, bonds, real estate and currencies.**

contributions to global GDP growth*)

percentage points



*) purchasing-power paritiy; 2015 forecast
sources: IMF; own calculations

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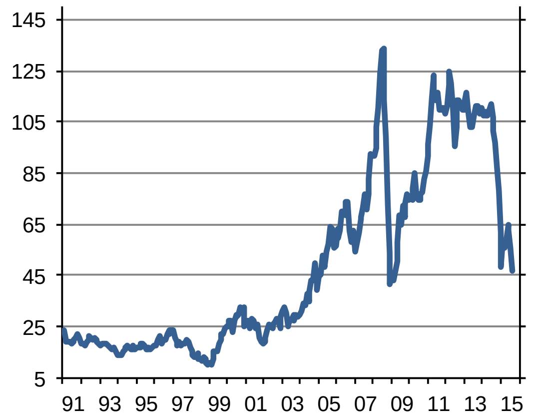
3. **While emerging economies as a group had expanded at rates of around 5 percent in recent years, their growth rates have come down to 3½ percent in the first half of 2015 which in turn must have caused excess capacities.** Overinvestment in real estate, infrastructure and commodity production seems to be taking its toll, at least for now. As in most business cycles, the downturn begins when expected returns on investment fall, as they must if there is too much of them. The longer investment booms last, the likelier it is that there will be a rising share of unprofitable projects, a misallocation of resources and defaults.

4. The impressive catching-up process of the poorer part of the world seems to have taken a break. Because growth there has been very energy and commodity-intensive the slowdown of demand from these countries has caused severe stress in oil, gas, metals and industrial food markets. Demand from rich countries has been weak for several years already – they still suffer from large output gaps. **What has happened in recent months can fairly be described as a global commodity crash.** For the time being, it looks more like a return to normal conditions, after years of inflated prices, rather than a panic. But a full-blown sell-out is still a possibility.

Brent

US$ per barrel



source: International Monetary Fund

industrial input prices*)

2005=100

*) includes agricultural raw materials and metals price indices (in dollar terms)

for commodity prices, a weaker China spells trouble

5. Where will commodity prices go from here? Given the role played by China these days it all depends on whether that country is in for a hard or a soft landing, for a genuine recession or a temporary slowdown. **The contribution to global growth has been two to three times bigger than that of the US or the rest of the rich countries, and about a third of the total.** When China sneezes, the world catches pneumonia. I do agree with most western analysts that officially reported real GDP numbers are probably too high, perhaps by two or three percentage points, which means the true growth rate is likely somewhere between 4 and 5 percent today, not at 7 percent.

6. If Chinese capital spending stops expanding, the main support of final demand would disappear and push overall growth into negative territory. The share of investment in GDP has been in excess of 40 percent since 2003, a truly breathtaking number, and usually a very volatile number for that: if necessary, you can stop investing in a crisis. Household

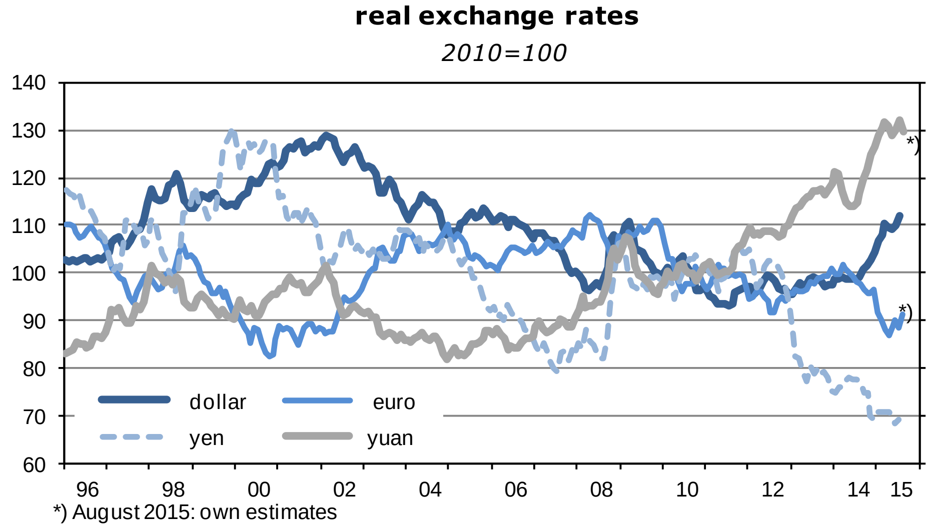
consumption is a much steadier component of demand. **Negative growth rates of imports and car registrations suggest that China's economy is struggling these days.**

7. Another reason for the slowdown is probably the need to reduce debt levels. In spite of a very high national saving rate **China's total debt has exploded: since 2008, the private sector (excluding finance) has increased its borrowings from 120 percent of GDP to 190 percent last year.** In relative terms, it is now higher than in Japan and in the US, and a lot higher than in Germany (110 percent). This would not be a problem if borrowers and lenders were the same, but this is not the case.

8. In other words, **if the prices of real estate and equities continue to fall, as seems likely, millions of market participants would find themselves under water financially and be forced to deleverage. They will aggressively reduce spending in order to repair their balance sheets** (compare UniCredit: China und der Einfluss auf die heimischen Bondmärkte. FI/FX Research. 24. August 2015). As we have learned from Japan, balance sheet recessions are extremely difficult to fight with the traditional tool kit of policy makers. Such recessions may last for decades and are likely to be accompanied by very low inflation - if not deflation.

9. **The Chinese administration has some trump cards up in its sleeve, though.** At last count, foreign reserves were $3.65tr, government debt was only 15.1 percent of nominal GDP in 2014, budget deficits were at 2.4 percent, and the balance on current account surplus will be about 3 percent of GDP this year. In July, consumer prices were up a modest 1.6 percent from one year ago while producer output prices were down no less than 5.4 percent.

10. In many ways, the country is financially very sound and **will probably respond favorably to pump priming measures such as deficit spending, tax cuts, subsidies, lower policy rates and lower minimum reserve requirements - and to a further devaluation of the (overvalued) yuan.** To be sure, Japan had also very impressive economic fundamentals when, in 1989 and the early 1990s, the big equity and housing bubbles burst. It has not helped. To this day, Japan has not succeeded to return to those pre-crash potential GDP growth rates of 4 percent, nor has deflation been conquered for good. For China, as for old Belsazar, the writing is on the wall.



*) August 2015: own estimates
source: Bank for International Settlements

11. **Another mechanism that acts as a circuit breaker which stabilizes markets, including the oil market, is the significant increase of China's purchasing power**, ie, its terms of trade in the wake of collapsing commodity prices. It has the same effect as a large tax cut (without a simultaneous increase in government debt) and will thus stimulate overall demand which in turn helps to prevent a recession and an oil price crash.

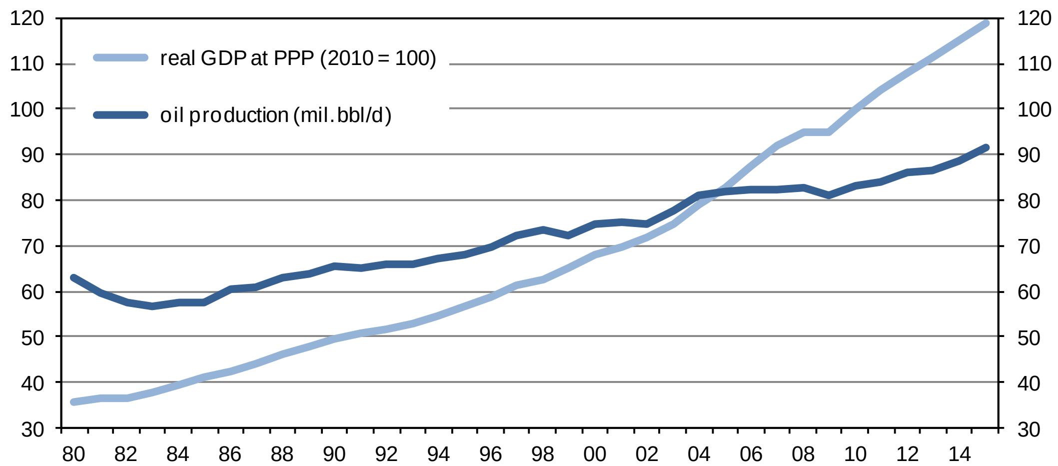
12. **Overall, I am not too pessimistic about China, though. It has the means and the will to avoid a recession**. Asset markets have corrected a lot but have not tanked. Compared to Japan 25 years ago, the decline of stock and housing prices has been mild. Most important is perhaps the fact that the country is still quite poor, with nominal GDP per capita less than 20 percent that of the US or Germany. It remains very much in catching-up mode and can do useful things with its excess savings. The country's oil demand may weaken further as the asset price correction has not yet run its course, but will not disappear. Rising living standards will go along with rising energy inputs.

oil prices will stay low for several years

13. Remember 1998 when the price of a barrel of Brent fell to less than 10 dollars? This will not happen again, **but I find a floor of 30 dollars sometime next year a possibility**. Keep in mind that the trend growth rate of oil consumption is still positive: at times, as today, oil production may outpace demand for a while, but in the end it is a foregone conclusion that any disequilibrium will disappear.

14. Over the past five years, global real GDP growth has averaged 3 ½ percent (PPP terms) while oil production has been up by an average of 2 percent, and oil consumption by an average of 1 ¼ percent. This shows that the demand for oil keeps rising, even in a difficult economic environment – and with it the willingness to pay a price for it. **Where precisely the new equilibrium price will be established cannot be predicted with any degree of confidence.** Multiple equilibria are conceivable. Put differently: economists are at a loss here.

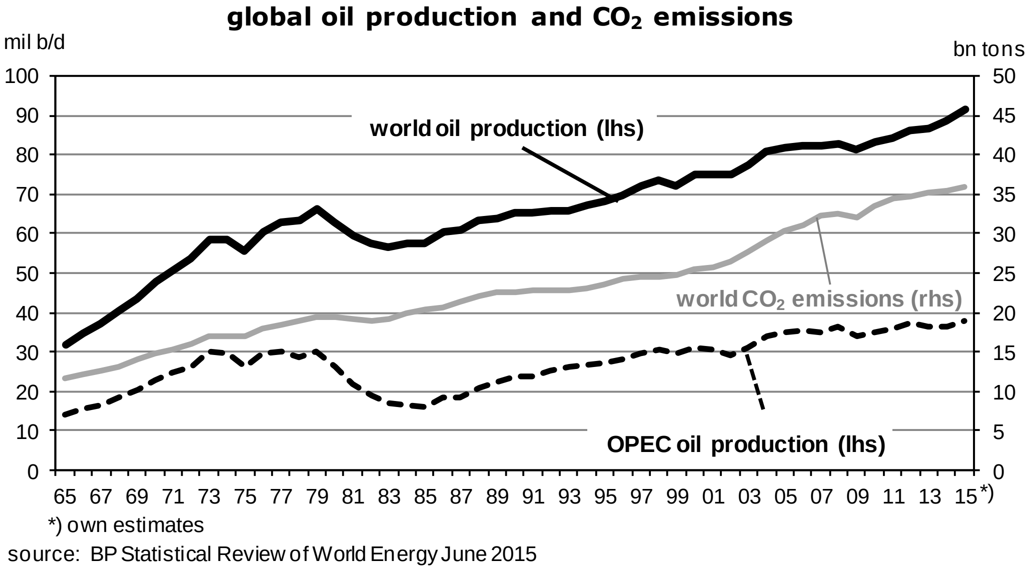
global oil production and GDP



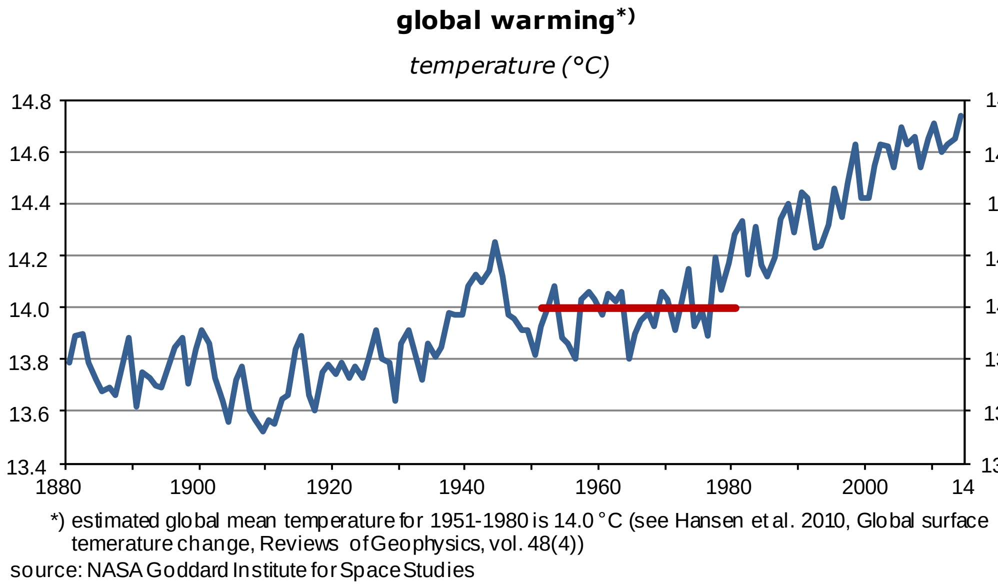
sources: BP Statistical Review of World Energy, IMF; own calculations

15. Please allow me **a short digression at this point**. The next graphs show two things:

    Globally, oil production continues to rise – high prices have made exploration of oil fields in difficult places and the development of new techniques financially attractive; one can say, the higher the price, the larger the reserves that can profitably be exploited; as a result, **CO2 emissions are also increasing**, in spite of progress on the energy efficiency front and the advance of renewables.



There is no denying that **the world's average temperature is not only on a clear upward trend, the speed at which this happens has accelerated.** Over the 135 years shown in the next graph the globe has got warmer by almost a full centigrade, and by about 0.8 centigrades in the 45 years since 1970. The world is running out of time.



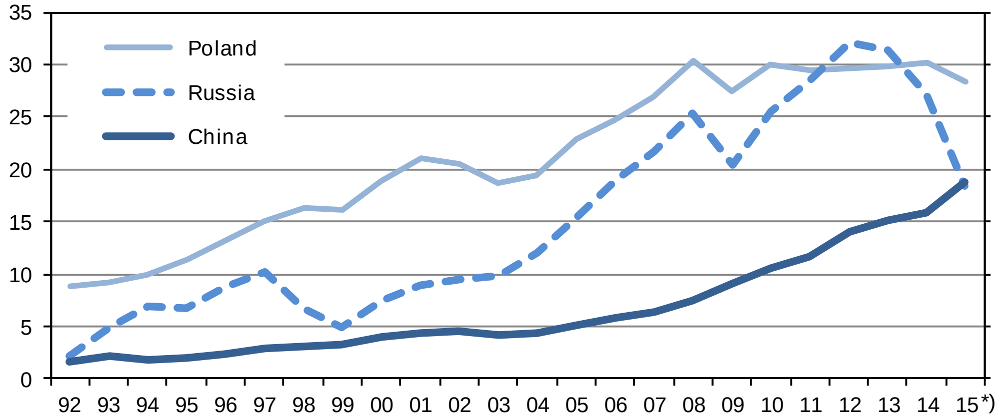
16. To return to the near term outlook for oil prices, it all depends on the data-driven assessment of the state of the global business cycle. Fairly robust US GDP growth – of perhaps 2.5 percent year-on-year in 2015, and a rebound of the euro area growth rate from 0.9 in 2014 to 1.4 percent this year must be held against the slowdown of the Chinese and other emerging economies. China is key, though. The monetary easing that is under way there and the support of asset prices by government purchases are probably not enough, and come too late, to put the economy on a steeper growth path again. **I would therefore put my oil money on falling prices. Other commodities would be affected as well**, because for most of them China is the world's main importer. Signs of slower economic growth tend to push down their forward prices, and cash prices in their wake.

Purchasing power shock in Russia

17. In effect, China and the net importers of oil and other commodities in general, such as Western Europe, Japan, South Korea, Turkey or India receive a gift from the producers, ie, the **net exporters of commodities. These experience a purchasing power shock, a reduction of real household and business income. Russia is the prime example in this regard**. The failure to diversify its economy away from "dumb" products such as oil, gas, coal, steel, nickel, basic chemicals, fertilizers and so on has now produced a deep recession as the prices of all of them have fallen a lot. The country has not even managed to develop a competitive farm industry during the quarter century since the end of communism.

Russia, China and Poland compared

GDP per capita in percent of German GDP



*) 2015: own estimates; exchange rates of Sep. 1, 2015

sources: IMF; own calculations

18. It may sound harsh, but **the management of the Russian economy has been a total failure,** especially in comparison to Poland and China, countries which also had to overcome legacy problems inherited from communism. The performance is so poor that in a normal democratic system the government and the bureaucracy would have been kicked out long ago. At today's exchange rate, Russia's nominal GDP expected for 2015 is just 18.5 percent of Germany's on a per-capita-basis, while Poland, a member of the EU, has reached 28.3 percent. Even China which had been dirt poor in the aftermath of the cultural revolution is now at 18.7 percent and has thus overtaken its northern neighbor. China's total GDP at current exchange rates is about ten times larger than Russia's.

19. State intervention in all walks of life, centralized decisions, a lack of stable and independent institutions as well as a lack of checks and balances in general have dramatically **sapped the strength of market forces in Russia**. Poland had the good luck that it was forced to adopt the 31 chapters of the EU's "acquis communautaire", its comprehensive body of laws and regulations, in order to join the Union. Nothing comparable has been undertaken in Russia – it remains an unreformed basket case.

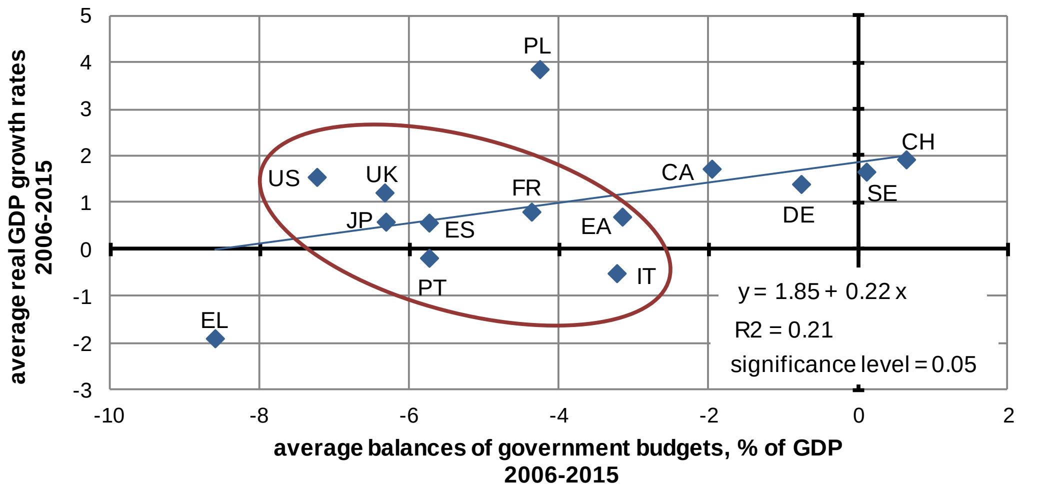
20. As most of the time, Russian assets are characterized by low valuations. 10-year rouble-denominated government bonds yield no less than 11.4% (inflation is 15.6 percent) while the price-to-earnings ratio of the stocks in the RTSI$, the main index, is a little less than 6 and thus close to a world record low. To be sure, the p/e ratio is low for a reason: as long as the rule of law is no more than wishful thinking, financial investors are hard to convince that this is a good time to take the plunge. **Russia is the odd man out among the world's capital markets. There is no trust. Only Ukraine is worse.**

low inflation is here to stay

21. **Even before the big decline of commodity prices and their additional deflationary effects, inflation rates in advanced countries were far below "normal".** The fear that low inflation might morph into deflation had kept central bankers awake at night. Since late 2008/early 2009 they have tried to stimulate spending and inflation expectations by zero and sometimes negative policy rates, by buying long-term government bonds and selling shorter-term ones ("operation twist") and by flooding the markets with central bank money generated by quantitative easing ("QE"), the large-scale net purchase of government paper. So far, the effect on inflation has been miniscule. To put it bluntly, **the Fed, the ECB, the Bank of Japan, the Bank of England, the Swiss National Bank and the Swedish Riksbank have been pushing on a string all these years.**

22. That fighting deflation could be an issue at all was considered totally inconceivable only six or seven years ago, in spite of the **Japanese role model** which was there for everybody to study. The attitude was that the Japanese central bankers had simply blundered – the enlightened colleagues in the other rich countries would not repeat their mistakes. But they did. Or more precisely, they were faced with the same problems and also lacked the means and the understanding to overcome them.

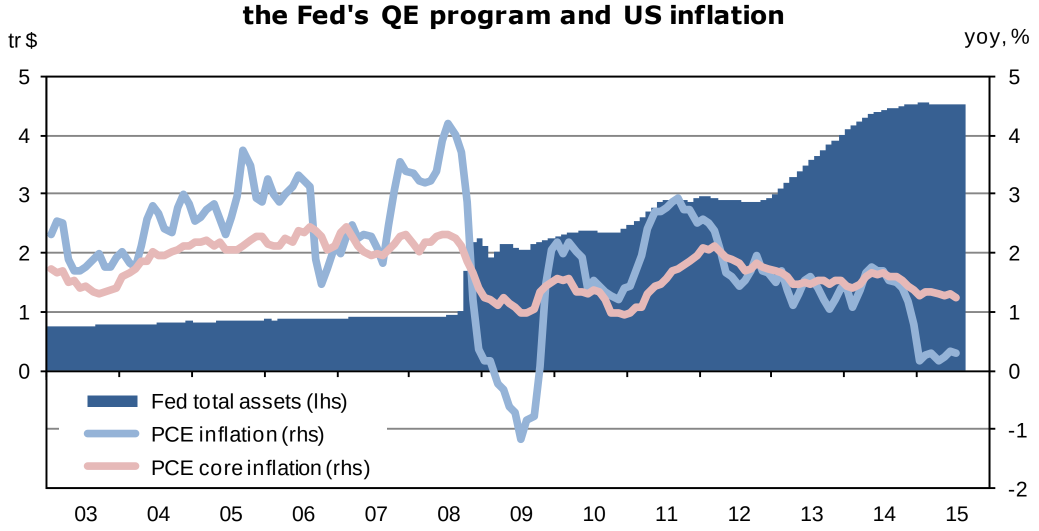
23. The catch word is "balance sheet repair". **It is perhaps not impossible but certainly very difficult to stimulate private sector spending by offering cheap credit if the target audience has one priority: to reduce its debt and thus restore its creditworthiness and financial independence. Central banks were asking people who were, and are, intent on repaying their borrowings to borrow more. Difficult!** They could have asked governments to fill the gap – the Japanese solution! –, but more aggressive deficit spending is regarded as a taboo, especially in the countries of the euro area. The Americans and British who were more pragmatic in this regard were rewarded with relatively faster GDP growth.



sources: AMECO; own calculations

24. **Aside from providing massive fiscal stimuli, the two other solutions for overcoming the unwillingness of supposedly over-indebted households, businesses and governments are debt forgiveness and the so-called helicopter money**. Creditors are usually hard to convince that it is in their long-term interest to reduce their claims against borrowers, but it is a sensible solution when the debt service becomes so heavy for the borrower that it does not make sense anymore to produce anything and earn money – only to hand it over to the creditors. Greece and Ukraine have just received such debt relief. For creditors, it is generally preferable to get back at least some of their money.

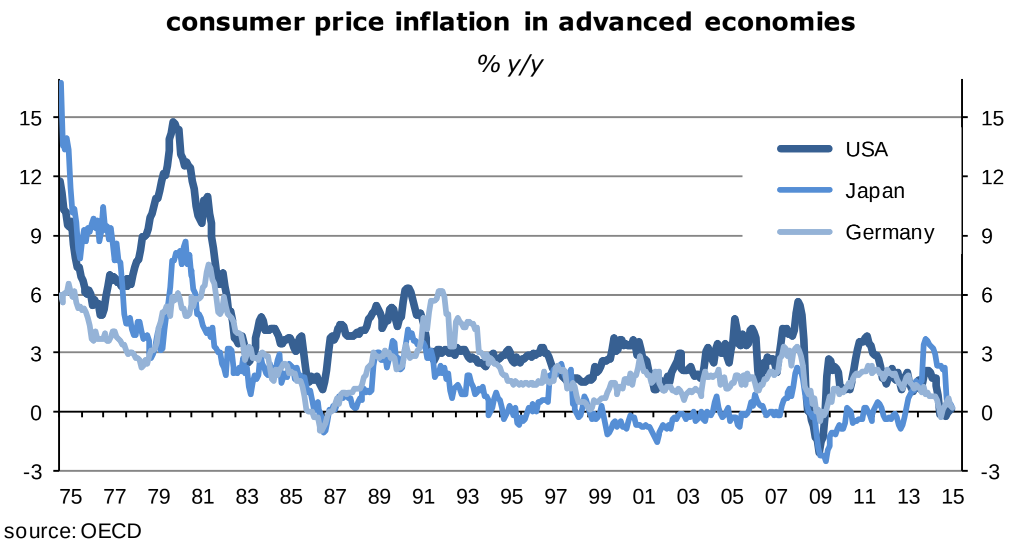
25. Quick mortgage debt relief at the expense of lenders has been one of America's institutional provisions which have speeded up the resolution of the potentially dangerous and time-consuming deleveraging process of households. These were granted a clean financial slate after a relatively short while. To nationalize banks, insurers and companies such as General Motors had been motivated by the same considerations. To have a powerful central Treasury which could do this is one of the big advantages of the US compared to the euro area.



source: Federal Reserve

26. **In spite of these actions, America's deflation has not yet really been defeated**. Reliable data on the status of the deleveraging process are hard to come by, but it looks as if it has not yet been completed. Consumer prices are still near zero after all these years and efforts, while wage inflation, the main driver of general inflation, is still only in the order of 2 percent, in spite of an almost buoyant labor market. This is why the Fed keeps postponing the day when it will begin to raise rates.

27. **Theoretically, deflation could effectively be wiped out by issuing "helicopter money".** Central banks would distribute freshly printed cash (bank deposits) to all households, and keep doing this until so much money is chasing goods and services that their prices will finally start to rise. Cash is a liability on central bank balance sheets while the corresponding asset consists of claims against euro area governments, perhaps proportionally to a country's population or nominal GDP. These claims would never be called. The whole operation would be outside of banks' multiplier processes. I call this a theoretical possibility because it has never been tried and because there are some tricky distributional issues. It is an intriguing proposal whose time may come if deflation simply does not go away over the next ten years or so.



Bond markets are expensive – but well supported

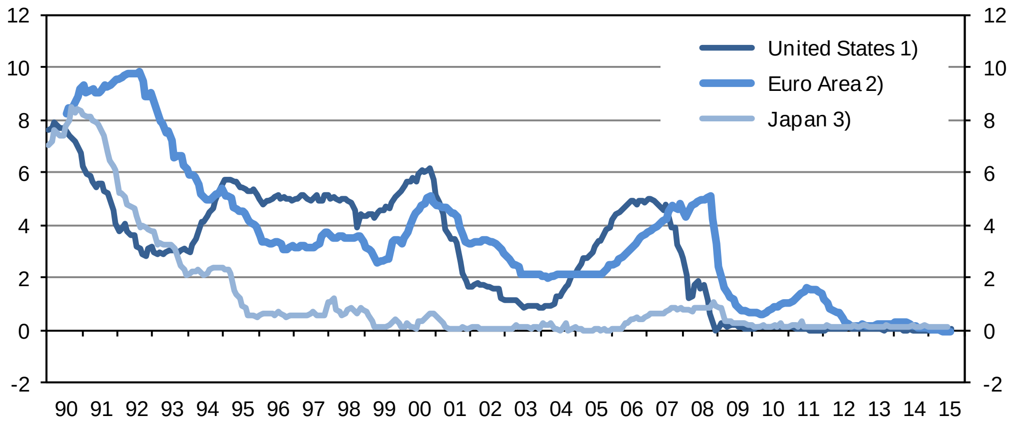
28. For investors, the **main assumption remains that low inflation is here to stay in advanced economies.** In the euro area, the likelihood is higher than in the US: output gaps and unemployment rates are bigger, the deleveraging process is less advanced, especially in the government sector and the household sectors of the so-called crisis countries, while the euro is so undervalued that it may start to appreciate any time, given the region's large current account surplus and relatively modest government budget deficits. Euroland would be importing even more deflation.

29. For these reasons **euro area bond yields will remain low**. It helps that the ECB has announced that it will keep zero policy rates for an extended period of time. If short-term rates are in this way anchored at the lower bound, longer-term interest rates cannot rise very much. If they do, bonds become a buying opportunity. It is probably still profitable to

bet on a narrowing of spreads of Portuguese, Spanish, Italian and French bonds vis-à-vis Bunds, not least because the euro crisis has successfully been laid to rest. Greek government bonds anybody? They still yield 9.00%.

short-term interest rates

%



1) 3m T-Bill - 2) until 1998 3m FIBOR , from 1999 on 3m EURIBOR - 3) 3m Call rate

sources: Federal Reserve, Bundesbank, Bank of Japan

30. **The quantitative easing program of the ECB which runs until September 2016 and has a total volume of €1.1tr net (€60bn per month) has failed to raise actual and expected inflation rates. There is now speculation that monthly bond purchases might be stepped up.** Consumer prices have stagnated for about one year while import and producer prices are on a downtrend that may become steeper in response to the recovery of the euro exchange rate and the fall of commodity prices. Worryingly, these numbers move in the wrong direction. In any case, the prospect of more aggressive monetary policies is good news for the holders of euro area bonds but probably negative for investors who are long the euro.

31. A topic whose time has come is the **establishment of a euro area treasury**. I had recently addressed the issue in my blog at ZEIT-online. On August 27, French ECB board member Benoît Cœuré had suggested that "the institutional framework is not yet sufficient to complete the Economic and Monetary Union …". Cœuré thinks big: "I have spoken out in favour of the creation of a finance ministry for the euro area under the oversight of the European Parliament. This ministry could be responsible for preventing economic and fiscal imbalances, managing crises in the euro area and managing the budgetary capacity envisaged by the Five Presidents' Report, as well as representing euro area governments in international economic and financial institutions."

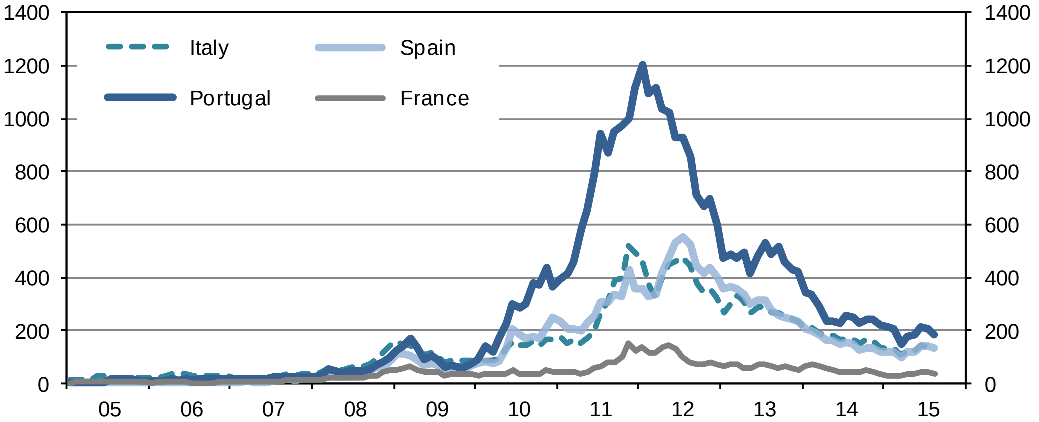
32. Some other important jobs have to finished simultaneously: "I think it is **vital in the short term that the banking union be finalized**, with, in particular, an early agreement on a common backstop for the Single Resolution Fund and the progressive implementation of a European deposit insurance scheme, accompanied by reforms uncoupling once and for all the solvency of banks from that of governments."

33. Since the German and French governments have decided to love each other again, Berlin will probably listen. Cœuré is the ultimate insider of French politics. The proposals certainly

have the imprimatur of the ECB board and the French government. As they say in Brussels: the EU project is like a bicycle – if it does not move forward it will fall down. **There is a strong sense that the euro area needs stronger common institutions and a vision about the future. 11 percent unemployment is like a time bomb.** For many problems, only a new sense of solidarity will provide durable solutions. The question is how to overcome the suspicion of many Germans that all this will lead to a transfer union. They know who the paymaster will be. So it's not easy, but it is good that the discussion about the so-called finality of the euro area is now intensifying.

yield spreads over Bunds*)

basis points



*) 10-year maturities

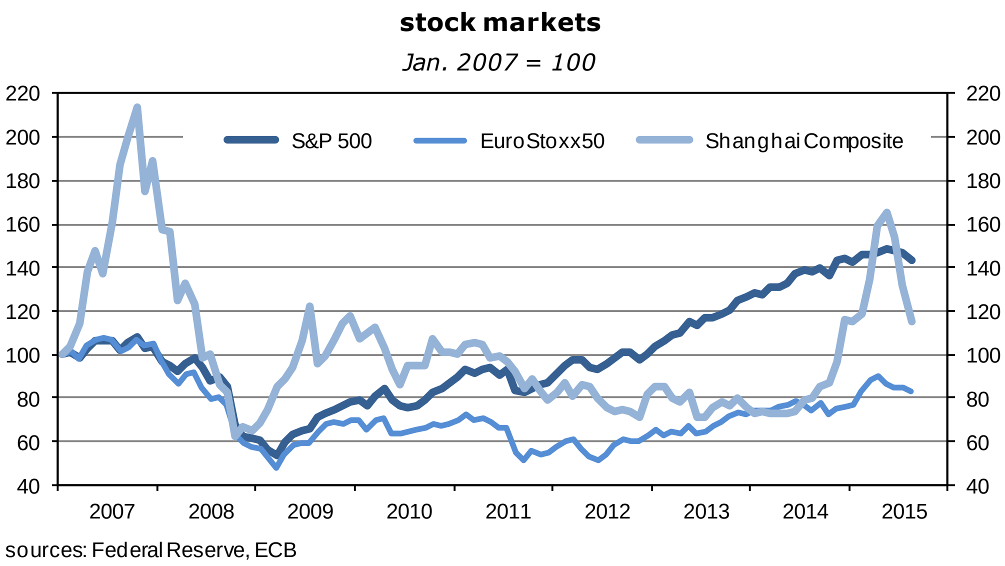
source: ECB; own calculations

34. For investors, the prospect of closer financial cooperation and the completion of the banking union mean that yield spreads will narrow, that euro assets will get a larger weight in international portfolios and that capital markets become more liquid. Another effect would be the appreciation of the euro's real exchange rate. So it is worthwhile to watch how the debate evolves. On balance, the news is very positive.

stock market correction not yet finished

35. Back to a question which is more relevant in the near-term: will **the correction of stock markets** around the globe turn into a rout? So far, it **has been mild, with the major exception of the Shanghai Composite index which has fallen by 39 percent** from its high on June 12. To put this into perspective, the index had increased by no less than 152 percent in the previous twelve months – at a current-year earnings p/e ratio of 13.2 it is still quite high and could thus drop further once the Chinese government withdraws its price support. It intends to liberalize the country's capital markets; this does not sit well with asset price controls. I guess that these interventions will soon stop. In the final analysis they are nothing but a new nationalization of the corporate sector.

36. In general, the major stock markets have been quite expensive. **Equities had been bought because dividend yields were often a lot higher than bond yields**, because of a lack of alternatives and because investors had access to unusually cheap funds. Low interest rates can have the undesirable side effect of distorting the allocation of resources – investors are tempted to accept risks which they would shun in a more normal environment.



37. To put this differently: if the so-called risk-free interest rate, represented by the yield of, say, 10-year German government bonds (rated AAA), is only 0.5 or 0.7% - and even less in real terms -, the difference vis-à-vis the earnings yield of stocks can be very large indeed. Now assume a p/e ratio of 10: it translates into an earnings yield of 10% (the inverse of the p/e ratio). In that case the resulting **risk premium** of that stock would be 10 minus 0.6 minus the inflation rate of 0.3, or 9.1 percentage points. Since **a risk premium of 5 would be more than generous, such a stock would be regarded as a strong buy**. Only if the p/e ratio rises to about 18, which gives an earnings yield of 100/18 or 5.6%, would buying that stock stop to make sense. In other words, low bond yields drive up stock prices and p/e ratios – frequently beyond sustainable levels.

38. If markets are analyzed this way it becomes clear that there must be an upper limit to where they can move before the air becomes too thin. This was the situation: stock markets were simply too expensive. **Corporate profits were rising at a much slower pace than stock prices.** News about problems in China and expectations that the Fed was close to start a new rate-raising cycle were the triggers which finally brought stocks down. Their fundamentals were not in synch with market valuations.

39. I can only speculate where stock prices will go from here. Monetary policies in the euro area and most emerging economies will remain very accommodating and thus continue to support stock markets. In **Western Europe** the improvement of the economy in the wake of a weak exchange rate and the large purchasing power gains from falling commodity prices suggest that markets will be relatively resilient. **China's stock markets** are artificially propped up the state and are bound to fall once this strategy is given up. **In the US**, the negatives are the coming change in Fed policies, the overvalued currency and high valuations; the main positives are the relatively strong economy and the decline of unit labor costs, the most important cost component.

40. Overall, I sense a feeling among investors that **the emerging market party is over** for the moment. They prefer less risky safe-haven assets.