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Top Takeaways from the 2018 Annual International Monetary Fund (IMF) Meetings

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We have just returned from the annual IMF meetings in Bali. (Yes, Bali. Some did see symbolism in line with the AOL/Time-Warner merger and the Japanese purchase of Pebble Beach!) While there, we met with central banks, finance ministries, economists, politicians, and market participants (traders, bankers, investors, etc.). Speaking of symbolism, and tectonics, we experienced a non-trivial – 6.4 – earthquake right before the start of meetings. Here is a summary of our top takeaways.

To Start … Three Tectonic Shifts

1. **A new era in China relations: participants came away putting China at the top of their list of concerns**

- It's about more than trade. Investment regimes, intellectual property, election interference, and the military are all part of the new, tense, relationship. This seemed to be a surprise to the Chinese, who came to meetings thinking that the U.S. administration was isolated, and that they (the Chinese) could wait it out. There was also an expectation of support from multinational corporations, that hasn't materialized either.
- China's hand may be weak. We asked a question that got a good deal of attention. Essentially, it was: "Isn't the U.S. in a very strong position given China's relationship with its population (high trust countries don't need controls), the large claims (M2) the population has on its central bank reserves, and the tough options these give the Chinese government – adjust the currency and risk a self-reinforcing selloff, peg the currency and lose reserves (and then risk a self-reinforcing selloff), or be successful in this last and witness lower investment and growth (and *then* risk a self-reinforcing selloff)?" The Chinese answer was not really there, in our opinion. In fact, an *end* to the de-levering process was hinted at, and some aggressive scenarios of a re-leveraging policy for China (it was said it might not have *enough* leverage, as the savings rate was high) were considered. We are astounded that this is even a remote possibility from a country with a fiscal deficit of 11% of gross domestic product (GDP), among other constraints. One of the U.S. participants (private, not government) said that the check on U.S. policy would be global economic and asset price weakness that would eventually (in a few quarters) bring the U.S. around to a summit. We are not so sure that a stock market selloff will turn U.S. policy around when the tension points have broadened so quickly beyond trade.
- Chinese "debt diplomacy" getting challenged? African and frontier economies saw recurring discussions on the problems of Chinese "debt diplomacy" (i.e., we'll lend you too much, and seize assets when you default, as with Sri Lanka's famous port[1]). European leaders have called on its executive arms to thrash out new guidelines on Chinese investment, especially as it relates to Silk Road maritime routes. The U.S. used the meetings to announce the creation of the International Development Finance Corporation (IDFC) to challenge China's Belt and Road Initiative. You get the picture?
- Chinese officials seemed taken off-guard. For the first time in our experience, we saw Chinese officials behind the curve, almost floundering. This is important, in our opinion, as the heretofore high-quality of Chinese policy had been a mantra of ours. So what that good policy is based on the communist party's fear of its population, it meant that the massive leverage machine could keep going as there was legitimate hope of a "growthy" future.

Now, we're not so sure. Their personalization of attacks struck us as a sign of weakness. The lack of support from their audience told us they (wrongly) expected support from the IMF crowd. China seems to be surprised at the bipartisan support for Trump's trade policies, growing international concern about China on intellectual property and security issues, as well as a lack of multinational support for China.

- There are, nonetheless, a number of positive scenarios, and many participants made cases for these. On December 18, we will see the 40th anniversary of China's opening up to market reforms, and there could be an announcement of new positive reforms. A rapprochement at G20 was also considered possible. We should add that most participants already expect some currency weakness and a lower growth path. Markets have obviously reacted, to a large extent, so many participants thought there was an excellent buying opportunity.

2. Tighter financial conditions and market structure: it is dawning that if quantitative easing (QE) helped, quantitative tightening (QT) might hurt

- After almost a decade of loose monetary policy, and a market that saw the U.S. Federal Reserve (Fed) move to the market's more dovish view, we may be in for a change. The market is now moving to the *Fed's* more hawkish view (as represented by the Fed "dots" that imply about 50bps more of tightening than the market). Inflation is just beginning to be discussed as a risk for the first time since the global financial crisis, and represents a key potential catalyst for higher interest rates.
- Market structure is increasingly viewed as a risk. The global re-leveraging from 2008 had two underpinnings. First, easy G4 plus China policy, including low interest rates, experiments in monetary policy (QE), and huge fiscal stimulus, particularly in China. Second, China was able to participate in this re-leveraging while keeping its currency stable. Recall that the currency (the yuan) has been below (i.e., stronger than) 7.0 to the U.S. dollar since the Lehman crisis. Also recall that the San Francisco Fed has attributed the Asian financial crisis to China's devaluation in 1995. But we'll stop there since we're overloading on China. Nonetheless, the point is that China was very risk-supportive for emerging economies until recently.
- Further on market structure, regulatory pressures have meant that this growth in debt was not matched by growth in market-making activity. As a result, the stock of bonds divided by turnover has declined.
- Lastly on market structure, witness the growth of passive investing in global bond markets. This has created new behavior, which we have described thus: "In the old days, when you hated something, you didn't own it. Now, when you hate something, you are 'underweight'". We all know, too, that bond indices perversely encourage allocations to increase as leverage increases. As a result, there are stocks of investment in countries that do not reflect a high likelihood of being maintained if policy doesn't step up to the tougher financing environment.

3. From divergence to contagion: economic cycles diverged, but if this continues, it becomes a contagion

- It is more than just the economic cycle. Narrowly, everyone seemed to "buy" that EM debt's weak performance was triggered by divergent growth starting in the second quarter of this year. In addition, few saw that divergence changing in the near future. However, there was a growing sense that if the above is correct, it will be difficult to reverse, given tapped-out tools, as well as political constraints. This would mean more than cyclical economic divergence.
- Risks spreading? Contagion would be a good framework for thinking about this, but we were struck by how few saw a contagion rolling through either emerging markets or the world, despite the point above. We have a different view, and think a contagion has probably started, with EM economies being the first hit. *If* we are in a contagion, what can stop it? A Fed recognizing the risk and reversing policy? Is this likely? Extremely unlikely, in our view.
- Bond vigilantes back. Here's another big divergence – fiscal policy in developed countries such as the U.S., is getting market attention. For the first time in a decade, the bond vigilantes are back. We heard concerns about the U.S. fiscal deficit and (shudder) interest rate expense. This, too, would mean a steeper curve and higher term premium. This makes sense to us, given that a main result of QE was a lower term premium.
- "Weaponized dollar." This was a popular thing to say.

Many conflated their views on U.S. political developments and many of the issues noted above, with a view on the U.S. dollar (against the Euro mostly). There were a number of comments suggesting that countries should borrow in other countries given the perceived uncertainty in the U.S. This attitude toward the U.S. and the U.S. dollar could mean the Euro benefits most from a "weak USD".

- Europe diverging. Some saw Italy as another divergence, with a showdown with European authorities over the country's new proposed budget for 2019 re-inserting "Europe" as a risk factor. We think the fuse on this one is several quarters long, but a consistent message was to "ignore Italy at your peril." There were also many warnings of a "no deal Brexit", about which we have no opinion.
- Political divergences were recognized, and the crowd seemed much more analytical than emotional, compared to previous meetings. Nonetheless, most see a long-term trend away from multilateralism, which is a big change from the post-World War II phase of international institution-building.
- We'll mention one last divergence – the U.S. as a major oil exporter. There was virtually no attention paid to what this will mean going forward. In our opinion, at a minimum it makes the U.S. economy more divergent. Emerging economy consumer price index (CPI) baskets include a significant amount of oil, which is not the case for the U.S., and the U.S. is now much more insulated from higher oil prices. At a minimum, we think this means a Fed that could hike rates longer than otherwise, increasing divergences between EM and developed markets (DM).

To Finish… Country-Specific Opportunities, or Lack Thereof

India no longer a darling

- Following reforms, particularly the introduction of a national general sales tax (GST), expectations were somewhat high for India. The authorities presented a largely benign macroeconomic outlook. Markets were assured that there'd be no breaking of the 3.3% budget deficit target. But, there did not seem to be a lot of policy space in the event of a challenging global environment. In fact, the authorities downplayed recent global weakness, and said it was transitory. It is hard for us to understand the point of such messaging. Every other country had at least statements, if not policies, about what they'd do in the event of adversity.
- What kind of adversity? One that is particularly relevant going into next year's elections is the need to create jobs. Eight million per year is what is needed to accommodate entrants to the workforce. Agriculture remains a big economic underperformer, accounting for two thirds of employment and only 15% of GDP.
- Oil prices are another risk to India. It was noted that the recent rise in oil prices was due to supply constraints, not demand. As a result, there was not a positive global final demand story that would have benefits for India.
- Other risks include further widening of the current account. A current account deficit over 2% of GDP is when the authorities will start to worry, with rupee weakness the presumed response. Inflation expectations were yet another risk. In our view, it is not clear how anchored they are, and if government policy is to: a) assume things are going to be fine, and b) let the currency go if they aren't. Inflation expectations could come into play.
- In addition, one year after a bank recapitalization plan, we hear the news that Infrastructure Leasing & Financial Services Limited missed debt payments. This is not good. If banks are a problem, you bring it to a head and deal big and immediately. You don't let it fester. This could be a big "oops."

Indonesia disappoints

- Let's get the good news out of the way. The country's macroeconomic basics are fine. Fiscal policy is excellent, with the finance ministry keeping deficits (2018 is set for 2.1% of GDP) well below the 3% ceiling. The current account deficit has narrowed (though it is still not small, at 3.4% of GDP), graduating the country out of the so-called "fragile five" of 2015's taper-tantrum. Debt is low. Further structural reforms are expected after current President Joko Widodo (Jokowi) is re-elected (which was widely assumed).
- The authorities also said that they understood the cost of using reserves to defend the currency, and promised that interventions were only to smooth movements, not to target

anything. They also recognized the country's profoundly weak domestic financial system, which has meant, among many other things, dependence on foreign investment in their domestic debt market. We kept hearing that the central bank does not want to get behind the curve.

- The problem is the authorities' attitude to foreign investment in the domestic bond market, hardly something trivial to us, given that that's where the rubber hits the road. Unfortunately, our view is that the Indonesians are stuck in heterodox thinking. Heterodox is, actually, too gentle a word. Let's call it contradictory instead. In particular, the country still wants to muck around with its NDF (non-deliverable-forward) market, with the latest example being its push for "domestic NDFs"). We won't bore you with the details, but we will say that the only example of such a policy we've seen in a major EM economy is Russia... the "bad Russia" of before the 1998 crisis. They don't get it. They'll learn the hard way. *Then* we get bullish.
- We were also concerned by the reappearance of "hidden" fuel subsidies, which are now administered through state-owned Pertamina, making them less transparent.
- China is Indonesia's number one trading partner, and this was presented as a "risk", another example of the dominance of China at the meetings.

Argentina impresses... but it will take time to rebuild credibility

- Argentina does not need to borrow until after 2020. The current account is looking set for a small 1% of GDP deficit in 2019. The trade account is going into surplus already. There is optimism on more realistic debt rollover assumptions. Monetary policy is extremely harsh (no change in base money (M0) other than the reserve build), making some think that it is so harsh it risks bringing the government down *along* with inflation. Government support is still at 40%, despite the economic crisis, though. Heterodox political opposition in the form Christina Kirchner is not a serious risk, in our view, as a corruption scandal has undermined her support. We come away slightly more bullish.

Mexico has benefit of the doubt

- In general the incoming government has given a better-than-expected impression. Fiscal has been fine, with revenue collection strong, the budget's dependence on oil declining, and the country's new president inheriting a country with no major vulnerabilities.
- We, too, are impressed, and having spent time with the incoming authorities, believe their fiscal plan is credible. We would also note that incoming President AMLO (Andrés Manuel López Obrador) expressed his support for an independent central bank at the beginning of his post-election victory, so heterodoxy is not a big worry of ours.
- One of the bigger questions, though, is what will happen when the new government inevitably gets tested. Especially since the country has had trouble growing in the past few decades. Whether the central bank can really enact policy counter to Fed policy is another related issue. It is too early for these to be critical questions, though, in our view.
- The topic of Pemex came up and was somewhat messy. On the other hand, it needs money, and resisting foreign participation in projects with Pemex means that Mexico takes on all the risks. Pemex's vertical and horizontal integration remains a big potential problem, as does the somewhat unsympathetic attitude toward foreign participation, on the part of the new government.

Brazil Thrills

- Brazil came out of the meetings looking attractive. It has a strong external stock position, a current account surplus, and is exiting perhaps its greatest depression in a century. Its weakness–fiscal policy–looks likely to be addressed by the incoming president.
- Jair Bolsonaro is likely to be the country's next president. He looks set to implement social security reform, make the central bank "autonomous" (i.e., independent), and privatize assets. (!) This is (and would be) a political and policy revolution. He has also done better than expected in Congressional elections, and has taken his party from nowhere to being the country's second largest. This makes planned and potential reforms much easier.

- If the balance of risks improves as a result of the BRL appreciation we expect on the back of a Bolsonaro victory, then you could see monetary easing. This would benefit the long end of the curve especially, in our opinion. Curve shape is, in our view, mostly a function of fiscal policy, which should see sharp improvements.

South Africa doesn't have a story

- There is little action on the country's budget, despite a supposedly reformist President Ramaphosa. The country has a structural growth problem, with little prospect of resolution from policymakers who have never fully embraced capitalism. Household consumption is declining for the first time in three years. Inflation is surprisingly weak.
- A key problem is labor market reform. It is almost impossible to see any real reforms, as "clientilism"[2] appears entrenched. Public sector wages are supposed to be the benchmark for private sector wages. But public wages have been rising and private wages have been declining. These inefficiencies are most apparent in state-owned companies, and officials once again came to the IMF meeting "armed" not with restructuring plans, but hope for more time. A "loud democracy" with fractious parties was blamed.
- Some stabilizing factors are in place. South Africa looks likely to keep its last investment grade rating, as institutional erosion is viewed as having come to an end, following the ouster of President Zuma, and his replacement by President Ramaphosa. Also, most government debt is in local currency with long maturities, so any fuse is long.

Italy disappoints … but it could simply fester

- The lack of a sharp market reaction to Italy's larger-than-expected planned fiscal deficit was viewed as a positive. The government expected a bigger market reaction from the change in fiscal deficit target to 2.4% from 1.8%. The government is proud of the primary surpluses the country has run for 30 years, as well as current account surpluses, and a healthy net foreign asset position. (Our counter would be that Italy has "borrowed" a low inflation anchor from Eurozone membership which it would not have, left to its own devices).
- Rating agencies may take action at the end of October, though. A 2% fiscal deficit was a line in the sand for many. Also, there is some risk of an accident in the primary market.
- The good news is supposed to be that 70% of Italian debt is owned by Italian banks, at long tenors, so rising interest rates take time to impinge on debt service. It's also called a sovereign-bank "Doom Loop."[3]
- To us, this issue is more likely to fester. Europe-wide elections for the European parliament are next year. The new parliament will choose a new European Commissioner (EC). It's not a convenient time for anyone to have a crisis. (Why would an outgoing EC draw a line that could be moved so soon?)

Most of Africa came off as vulnerable

- There was a lot more optimism on post-Zuma Africa in general ("African Renaissance"), not just South Africa. Many felt that the removal of Zuma's cronies from regional bodies should help to reduce corruption and foster genuine reforms and cooperation. Zuma is one of a few corrupt leaders to have been removed from office, which is hopefully a new phenomenon for the continent.
- However macro issues, and especially that of debt, look concerning. Six African countries are in "debt distress", and another 15 are in the "high risk of debt distress" category. African countries issued a record $7.5bn in debt in 2017, 10 times higher than 2016. And, issuance plans show an increase (if they can get them off).
- Sub-Saharan Africa now has debt levels that existed when the international community launched its HIPC (highly indebted poor countries) initiative to facilitate debt reschedulings.
- In this regard, it is hardly surprising that the issue of Africa's debt to China with its lack of transparency and an apparent crash trajectory with the IMF dominated most discussions.
- One country that emerged as the regional "star" was Angola. The new administration is making rapid progress in purging corruption, while the government and the central bank put together coherent and realistic near-term and medium-term stabilization programs.

Philippines boringly exciting

- Philippines is coming off of 76 consecutive quarters of growth. Inflation is returning to 2-handle; the recent increase is temporary. Debt to GDP is still declining. Structural reform initiatives.

Chile, Peru, and Colombia were boring too (also in a good way)

- This is often the case with these countries. There are no obvious vulnerabilities, other than Colombia worrying that its current account deficit might be too large (at 3.2% of GDP) for the current environment. Colombia also stood out (given the tone of the day) as positive for its lack of exposure to China (it kept coming up throughout the meetings).
- One not boring thing happened related to Colombia. I asked what the country's NATO membership meant. The next thing I know, I'm being told there will be no invasion of Venezuela. I didn't know that was my question, nor that it was something we were supposed to be thinking of. Was this a "tell"?[4] The answer went on to be that the NATO link-up is only about updating internal military standards. We'll see.
- Politics in Chile were viewed as polarizing over time.

Czech, Romania, and Hungary were also boring as usual.

- Each more or less has limited vulnerabilities and overall good economic conditions. All said the ECB didn't have much impact on their decision-making (meaning they aren't going to hike interest rates in lock-step with the ECB).

[1] In early-December 2017, Sri Lanka, struggling to pay its debts, formally handed over the port of Hambantota to China on a 99-year lease.

[2] Clientilism: A social order that depends upon relations of patronage; in particular, a political approach that emphasizes or exploits such relations.

[3] A doom loop is when a bank owns a disproportionate amount of government debt as an asset. I.e., the sovereign and bank are inextricably intertwined.

[4] In poker, a "tell" is a change in a player's behavior or demeanor that is claimed by some to give clues to that player's assessment of their hand. (Wikipedia)

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