Central bank reserve policies with holes like Swiss cheese

By Jan Dehn

In the global section we highlight Switzerland's decision to abandon its FX intervention ahead of QE from the ECB which is an important warning for Emerging Markets (EM) central banks not to invest so much in developed market currencies, just because they happen to be big and liquid. What may be big and liquid may also be volatile and unstable. Ultimately, a volatile, unstable currency does not protect the purchasing power of the assets denominated in that currency – just ask the Swiss. Elsewhere, the World Bank's Global Economic Prospects report predicts that EM real GDP growth will accelerate to 4.8% in 2015, which is almost back to 2013 levels after a dip in 2014 following the 200bps re-pricing of EM yield curves during the Taper Tantrum.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	957	–	0.20%
MSCI EM Small Cap	1,001	–	-0.12%
MSCI FM	593	–	-0.08%
GBI EM GD	6.15%	–	0.30%
EM FX spot	–	–	-0.61%
ELMI+	4.56%	–	-0.22%
EMBI GD	5.68%	385 bps	0.68%
EMBI GD IG	4.38%	251 bps	0.84%
EMBI GD HY	8.51%	680 bps	0.37%
CEMBI BD	5.55%	390 bps	0.16%
CEMBI BD HG	4.33%	267 bps	0.51%
CEMBI BD HY	8.41%	678 bps	-0.63%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	2019	-0.42%
VIX Index	20.95	6.89%
5 year UST	1.30%	-8 bps
7 year UST	1.61%	-7 bps
10 year UST	1.84%	-7 bps
US HY	7.11%	-0.26%
European HY	5.19%	0.24%
EURUSD	1.1608	-1.95%
USDJPY	117.19	-0.99%
Brent	47.61	2.40%
Copper	143.00	4.00%
Gold	1276.26	3.37%

Additional benchmark performance data is provided at the end of this document.

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The World Bank's Global Economic Prospects publication was issued this week. It is upbeat about growth in EM in 2015 and we share that view. The World Bank sees EM growing 4.8% in 2015, up from 4.4% in 2014. This means that EM growth rates will be more than twice those in developed countries, despite expected faster growth in both the US and the Eurozone. It also means that EM has largely completed its recovery from the 200bps Taper Tantrum interest rate shock sustained in 2013.

Fig 1: **World Bank Global Economic Prospects: Forecasts (%)**

	2015 vs 2014	2015	2014	2013
World	UP	3	2.6	2.5
Emerging Markets	UP	4.8	4.5	4.9
East Asia and Pacific	DOWN	6.7	6.9	7.2
Eastern Europe and central Asia	UP	3	2.4	3.6
Latin America and Caribbean	UP	1.7	0.8	2.5
Middle East and North Africa	UP	2.5	2.3	0.9
South Asia	UP	6.1	5.5	4.9
Sub-Saharan Africa	UP	4.6	4.5	4.2

Source: World Bank.

Looking at the World Bank projections in more detail, they expect global growth to increase from 2.6% in 2014 to 3.0% in 2015. Emerging Markets will grow 4.8% in 2015. This means that growth rates will almost be back to 2013 levels after a dip of about 0.5% to 4.4% in 2014 in response to the interest rate shock caused by the Taper Tantrum. This underlines two important points. First, EM countries are generally quite resilient to interest rate shocks, mainly because they have less debt. Second, they tend to bounce back from shocks quickly, mainly due to decisive and rapid policy adjustments as well as flexible economies. Indeed, the World Bank expects the bounce-back to continue for the next three years, taking EM growth rates to 5.3% in 2016 and 5.4% in 2017.

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Within EM, the World Bank sees East Asian economies growing more moderately in 2015 (6.7% compared to 6.9% in 2014). Within this region, China's growth is seen to continue its gradual deceleration in 2015. China is implementing an ambitious reform program, including financial liberalisation, but these reforms will place the country in an extremely strong position to perform over the longer-term. It is also important to bear in mind that growth rates in China should be slowing as the country turns away from a high saving/high investment economy towards a more consumption driven economy. Elsewhere in East Asia, the World Bank sees faster growth in Thailand, Indonesia and the Philippines. South Asia is set to do very well, according to the World Bank. The region will accelerate to 6.1% from 5.5% in 2014 due mainly to India, although all South Asian countries will grow faster except for Afghanistan. In Eastern Europe and Central Asia (ex-Russia), growth will increase to 3.0% from 2.4% in 2014 on the back of faster Turkish and Ukrainian growth. Latin America will expand more than twice as fast in 2015 as in 2014, albeit from a low base; the forecast is for 1.7% average growth in Latin America in 2015. Only Argentina and Venezuela are seen to have negative growth in 2015, while both Mexico and Brazil will grow faster. Finally, the World Bank expects moderate increases in economic growth in the Middle East/North Africa as well as in Sub-Saharan Africa (2.3% and 4.6%, respectively).

The World Bank cites a long list of potential external shocks that may impact EM in 2015, such as global monetary conditions and commodity prices. On balance, we think both are likely to be supportive for most EM countries in 2015. In general, however, the importance of external shocks to EM tends to be vastly overstated, probably because factors exogenous to EM, such as US policy rates or commodity prices tend to be far more easily observable than what goes on within EM countries. The reality in EM is that domestic economic and political conditions matter far more than external conditions, not least because EM countries have become far more diversified and robust economies over the past couple of decades. When external shocks occur – as they inevitably do – the quality of the policy responses to the shocks matter far more than the shocks themselves, in our view.

- India: India is going through a proper goldilocks period, where better economic activity coincides with declining rates. The wholesale price inflation rate fell to just 0.1% yoy in December versus 0.4% expected. Retail price inflation is also softening. In December CPI inflation was 5% yoy compared to 9.9% in the same month last year. This enabled the Reserve Bank of India to implement an earlier than expected – and unscheduled – rate cut of 25bps. More cuts are likely, though they are likely to be moderate in pace. Rate cuts ultimately have to follow a fiscal lead in order to be sustainable, i.e. the government moderates spending and Governor Rajan can then follow suit with more cuts. Maintaining credibility is absolutely key: the benign constellation of growth and disinflation is in large measure a product of greater policy credibility on the part of policy makers. So far it has allowed 10 year domestic bond yields in India to decline from 8.64% in August to 7.67% at the end of last week.

- Ukraine: Prospects of a peaceful settlement in Donbass deteriorated sharply last week, but the hope remains alive. Tensions declined significantly in December and early January as leaders of the Normandy Quartet – Germany, Russia, France and Ukraine – prepared for peace talks in Astana. A peaceful resolution has become possible after senior Ukrainian politicians indicated that the question of Crimea could be set aside for a later date. Yet, last week a preliminary meeting of Quartet foreign ministers failed to find common ground and the planned meeting of heads of state in Astana on 16 January was cancelled. However, Chancellor Merkel called for renewed talks and Russian officials said that a Kazakhstan meeting of the Normandy Quartet was possible in late January. For now, however, the failure to find common ground unleashed clear signs of escalation. Russia reportedly sent more troops to the border with Ukraine, Ukraine announced mobilisation, Russian-supported rebels in Donbass stepped up attacks and the US re-engaged with Kiev with an offer of loan guarantees. These are all negative signs and the risk is now that Donbass has to be dragged through yet another mini-cycle of conflict until the interested parties are once again incentivised to find a peaceful solution. One accompanying risk is obviously that Western powers consider new measures against Russia, though we think sanctions are increasingly ineffective. In broader perspective, the recent re-escalation merely represents a lost opportunity for peace, not a serious deterioration relative to where we were before. The economic pressures for a resolution remain. The conflict is becoming very costly for all parties. For this reason, we think efforts to find a solution will continue. As for the US gesture to extend USD 2bn in fresh loan guarantees to Ukraine in 2015 this is merely a sticking plaster on a larger wound; the recurrent cost of the conflict is far higher than USD 2bn.

- Venezuela: Moody's, the ratings agency, cut Venezuela's foreign currency debt rating to Caa3 from Caa1 (stable outlook). S&P rates Venezuela at the equivalent CCC+ rating, but with a negative outlook. Fitch rates Venezuela CCC. We estimate that Venezuela will have a financing gap of USD 14bn with the price of Venezuelan crude oil at USD 40 per barrel. We also believe that the government could generate about USD 40bn in FX savings using various measures, although those measures would involve a significant political cost for President Maduro ahead of parliamentary elections later this year. In the end, of course, doing nothing is not an option. Maduro's odds of political survival are best if he avoids a balance of payments crisis and our base case is that he will take the steps required to avoid non-payment of Venezuela's foreign obligations.

- Turkey: The external balances continue to gain dramatically from lower commodity prices. As of November, the year-to-date current account deficit in Turkey had declined to USD 38.7bn compared to USD 56.7bn at the same point last year. About USD 11bn of the improvement is in the non-energy balance, which suggests that the improvement is not just due to lower oil prices.

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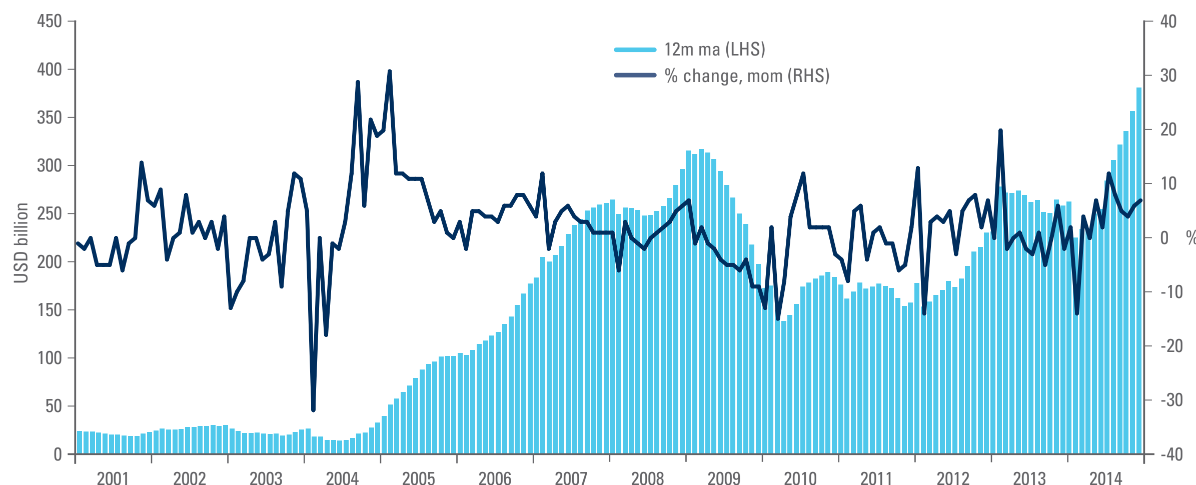
• China: Trade activity was substantially stronger in December than expected. Exports rose 9.7% yoy in December compared to 4.7% yoy in November, while imports contracted by less than anticipated (-2.4% yoy vs -6.7 yoy in November). China's trade balance was USD 49.6bn in December. This takes the trade surplus to USD 382bn for the year as a whole, which is a staggering 47% larger (USD 122bn) than in 2013. Even so, China's FX reserves ended the year at USD 3.84trn, marginally higher than at the end of 2013, but below the June peak of USD 3.99trn. The slowing of reserve accumulation in 2014 despite the strong trade surplus reflects both valuation changes and outflows via the capital account. As China continues to liberalise its capital account we expect flows across the capital account to go in both directions. Chinese savers want global exposure, but global investors will also want exposure to China's USD 4.4trn bond market and its USD 5.25trn A-share market (their combined size is equivalent to 57% of US GDP). Total new loan financing in China declined in December following instructions from the PBOC to slow loan growth. The fall in loan growth was mainly in the interbank market, while household and business lending increased.

Fig 2: **China: Trade balance**



Source: Ashmore, Bloomberg.

• Eastern Europe: In the not so distant past, the stronger CHF would have spelled trouble for Hungary given its large number of households with CHF mortgages. This is no longer the case. A final conversion of mortgages to HUF is planned for 1st February 2015, but the central bank (MNB) took EURHUF cross-currency swap and spot exposures out of the market with massive auctions in Q4 2014. Banks had already been cleaning their EURCHF positions since the confirmation of mortgage conversions last year. OTP Bank Group, one of the largest in Eastern Europe, announced that it has covered all CHF exposure on outstanding FX mortgages after the central bank provided EUR liquidity last year. PKO, the largest bank in Poland, says a further 20% appreciation of CHF versus PLZ would pose trouble, if sustained for a protracted period. This is because CHF denominated loans account for about 24% of household loans in Poland, or 8% of GDP. The main effect of a strong CHF is to reduce households' disposable income net of interest payments, thus lowering consumption and GDP growth.

• Argentina: The central bank is due to receive another USD 400m as part of its USD 11bn swap arrangement with China. Argentina's FX reserves have risen by 14% to USD 31.3bn since October last year. The improvement in Argentina's reserve balances makes the chance of a balance of payments crisis in 2015 increasingly unlikely. Markets are likely instead to focus on prospects that Argentina's next government will prioritise a normalisation of relations with holdout investors, starting in early 2016.

• Ecuador: Finance Minister Fausto Herrera announced that Ecuador has secured its required USD 10.5bn of financing needs for 2015, despite oil prices at USD 40 per barrel. This follows some spending cuts and agreements with China for additional financing. The government also announced that it no longer plans to issue debt in 2015 on account of market conditions. In other words, the government will repay rather than roll the maturing 2015 bond.

Snippets:

• South Africa: December PMI disappointed relative to expectations, but remained above the 50 level. December PMI was 50.2 versus 52.2 expected. Analysts misgauged the impact of rolling power cuts in early December.

• Brazil: Retail sales rose 0.9% mom in November. Markets had expected only a 0.2% mom improvement. The government is embarking on a major fiscal correction in 2015 and expectations are for weaker growth in Brazil as a result. However, Brazil's fiscal expansion was associated with declining domestic demand as

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consumers and businesses began to fear the consequences of bad government policies. One of the risks for 2015 relative to consensus is that the private sector responds more positively to fiscal retrenchment than expected. Whether this happens depends almost exclusively on the credibility of the measures to be taken.

- Mexico: Investment was stronger than expected in October, rising 6.8% yoy vs 5.1% yoy expected. Machinery and equipment investment in particular was very strong. Investment rates are likely to improve going forward due to oil sector investments and the recovery in the housing sector.
- South Korea: Bank of Korea left rates unchanged at 2.0%.
- Indonesia: Bank Indonesia left policy rates unchanged at 7.75%.
- Peru: The central bank cut the reference rate by 25bps to 3.25%. This follows a soft growth print for the month of November.
- Romania: Inflation in December was just 0.8% yoy, taking the 2014 inflation average to 1.1%, which is the lowest ever in Romania. Inflation in 2013 was 4%.
- Russia: Moody's downgraded Russia's sovereign debt to Baa3, one into the investment grade spectrum of ratings. We think the risk to sovereign debt is a great deal less than Moody's, whose action appears to be motivated, belatedly, by the price action. This is usually the case with ratings agencies, in our view. Indeed, despite the fall in oil since June 2014 Russia's current account surplus increased to 3.3% of GDP in Q4 from 3.0% in Q3. We expect further growth in the current account surplus in 2015 due to the weaker RUB and the contraction in domestic demand caused by higher real rates and other adjustment policies being put in place by the Russian authorities.

Global backdrop

Central bank policies to concentrate huge volumes of FX reserves in a very narrow set of QE currencies were shot full of holes – much like a Swiss cheese – following last week's decision by the Swiss National Bank (SNB) to ditch its 1.20 EURCHF cap ahead of ECB QE later this week). The decision to abandon the cap sent the CHF wildly higher despite the SNB's decision to cut interest rates by 0.5% to -0.75% and further intervention. The global currency backdrop is now extremely unsettled; other European countries pegged to the EUR may now also consider cutting rates.

More than half a decade after the Subprime Crisis the developed economies are still turning to monetary policies to try to address the economic problems and these monetary policies are now slowly producing a greater footprint in the global currency markets. Of course, this is unfortunate, because the economic problems are not primarily monetary in nature to begin with. In other words, we are creating a brand new set of problems in the shape of global currency instability.

Monetary policies, instead of effective economic medicine only lift financial asset prices, particularly in developed countries on account of the biases built into the global regulatory system and the financial system's many incentive problems.

Many developed markets have now reached valuations that are far in excess of what can be justified in terms of fundamentals.

Hence, either central banks must either continue to feed the beast, or if they withhold sustenance, risk major financial market unrest.

In the longer-term, hyper-easy monetary policies will also generate inflation. This problem still lies ahead of us, perhaps now a step closer as currency volatility will undoubtedly have some effect on expectations.

The SNB's predicament has direct parallels with that of many EM central banks. Like the SNB the large EM central banks have ploughed the vast bulk of their reserves into a very narrow selection of developed market currencies and bonds.

The risks should now be clear for all to see. The so-called 'risk free' EUR just had a 20 standard deviation event. From the perspective of Switzerland, the dramatic appreciation of CHF has wiped out a large chunk of Switzerland's FX reserves. Many EM central banks with large EUR positions will have suffered similar, albeit smaller losses. The even bigger shock still lies ahead when inflation returns to the US and the Dollar too must be employed to help America out of its debt and reforms crises.

It is both naïve and short sighted to believe that some currencies are more suitable as reserve currencies than others regardless of what policies are being pursued in those countries. Money printing and excessive debt will ultimately extract their tolls on the values of developed market currencies. The risk most EM countries face is that their central bankers will not accept this fact until the rout begins. By then it will be too late, because everyone will be running for the exit at the same time.

Another lesson is that instead of naïvely believing in the 'risk free' status of some currencies and trying to fight currency appreciation with recurrent interventions central banks should accept that the global currency environment as exogenous (to the vast majority). When currencies then come under appreciation pressure the right policy is to reform the domestic economy so that it can compete despite currency appreciation.

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Global backdrop

Otherwise, other countries, many in EM, will soon find themselves in a currency shock that poses major competitive challenges for their exporters.

Indeed, it is already abundantly obvious that one of the great differentiators across the EM universe will be between those EM countries that are actively preparing for the consequences of hyper-easing and reform-neglect in developed economies, and those that are not. China will be among the best prepared; the country is constantly reforming, precisely because China knows that the same will happen to their currency as just happened to CHF.

While developed economies are increasingly going to pursue 'beggar thy neighbour policies' as substitutes for proper domestic adjustment and reform and pass the cost on to other countries it is unlikely that these predatory policies will work. They don't address any of the underlying structural problems. One thing is clear, however, they make investments in the countries that pursue such policies less attractive for global investors, because every investment denominated in their currencies will be eroded in terms of global purchasing power.

This is just the beginning: currencies will become more and more important drivers of global sentiment as countries increasingly turn to currency debasement in lieu of fundamental reforms. Indeed, the fireworks look set to re-start as early as this week, when the ECB goes ahead with QE. The Advocate General of the European Court of Justice (ECJ) opined last week that the ECB's Outright Monetary Transactions (OMT) programme is a legal instrument. The ECJ traditionally follows the opinion of the Advocate General. So QE can now go ahead, legally speaking. The ECB can target purchases at any country it wishes, including single countries if needed. It can also buy bonds with low ratings and even own restructured bonds. There are no hard limits on the size of its purchases. The remaining question relates to the German constitutional court, whose prior statements suggest that it does not agree in full with QE. However, this risk is not likely to stand in the way of launching ECB QE, in our view.

And ECB QE will be just in time, because on 25 January Greece goes to the polls and may elect a government that could send the whole Eurozone back into a debt crisis. This – and more importantly the need to have a sovereign defence against eventual US Fed hikes – is the main reason why the ECB is now pushing QE. A single month of negative headline inflation, while convenient is usually not enough to sway central bankers, particularly since it is caused by an obvious one-off exogenous effect, namely falling oil prices.

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	0.1%	0.1%	0.8%	3.0%	1.7%
MSCI EM Small Cap	0.5%	0.5%	1.3%	6.9%	2.3%
MSCI FM	-3.1%	-3.1%	0.8%	12.8%	6.8%
S&P 500	-1.85%	-1.85%	11.65%	18.57%	14.56%
GBI EM GD	0.62%	0.62%	-4.06%	-0.22%	2.22%
ELMI+	-1.33%	-1.33%	-7.64%	-1.26%	-1.00%
EM spot FX	-1.37%	-1.37%	-12.72%	NA	NA
EMBI GD	0.10%	0.10%	6.56%	6.33%	7.36%
EMBI GD IG	0.66%	0.66%	9.41%	5.63%	6.80%
EMBI GD HY	-0.93%	-0.93%	1.64%	7.38%	8.15%
5 year UST	1.76%	1.76%	4.59%	1.45%	3.76%
7 year UST	2.42%	2.42%	8.25%	2.37%	5.62%
10 year UST	3.10%	3.10%	13.53%	3.84%	7.21%
CEMBI BD	0.10%	0.10%	4.23%	5.99%	6.34%
CEMBI BD HG	1.02%	1.02%	7.37%	6.22%	6.66%
CEMBI BD HY	-1.89%	-1.89%	-2.17%	5.82%	5.89%
US HY	-0.13%	-0.13%	1.03%	8.00%	8.87%
European HY	0.46%	0.46%	5.02%	14.31%	11.46%
Barclays Agg	0.02%	0.02%	0.26%	0.80%	2.35%

Source: Bloomberg, total returns. Figures for more than one year are annualised.

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