Ashmore

The Emerging View

Liabilities & Purchasing Power

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The Problem

Money illusion is the illusion that a currency is fixed rather than a moving price like any other. It prevents us from distinguishing between purchasing power and nominal values. On retirement pensioners want purchasing power, which is not the same as a fixed number of Dollars, Pounds or Euros, or for that matter Reals or RMB. One only has to consider the impact of a decade of inflation, as happened for example in many countries in the 1970s, to appreciate the difference. The same argument holds for other pools of savings with long term liabilities.

Inflation Linkers

Taking domestic inflation into account helps stem the gap between nominal values and purchasing power, which an investor can do by buying inflation-linked bonds. But (a) such bonds may not track the basket of consumption goods that a retiree wants; (b) whilst inflation linkers can protect against short-term spikes in yields they, like other bonds, do not protect against sustained higher real yields, including those associated with high inflation periods; (c) the market for these bonds remains small relative to other government bonds; and (d) were the market much larger then the government's ability to manage its debt service would be reduced creating a credit deterioration and higher yields. This fourth argument is a macroeconomic one - governments use inflation to erode their debts but cannot do so if the debt is all linked to inflation. The objective of creating a larger inflation-linked market to protect savers may come into conflict with the ability of a country to afford paying for the standard of living its retirees want.

In periods of deflation an additional problem is that financial repression and irrational perceptions of risk may result in artificially low yields (including on inflation linkers). This reduces returns on these investments. Additionally, if the net present value of future liabilities is calculated using government bonds (mandated by regulators) there is an additional negative impact on pension funds.

Second-Best Solutions

Because of the problem of widespread rise in yields in high inflation environments (point b above) it is common to hedge against inflation risk by buying other assets likely to go up with inflation. This includes equities and real estate. The comfort of being able to match liabilities accurately is exposed as impossible. It is also in practice impossible for other reasons, including that life expectancy is constantly changing . Once we are committed to investing in credit risk, we are drifting towards what we might describe as the first law of asset liability management: have some assets to manage. This takes priority over the planning of detailed value and duration to match liabilities with assets. We are in the land of second-best.

Since we cannot foresee the future perfectly this inevitably means thinking through major future potential losses due to a broad set of circumstances. We may wish to employ scenario planning and diversify across different asset classes and macro-economic risks. Taking a view on global inflation is required, but how to weight inflation in different countries? Depending on where you are and what you want to buy in the future, inflation rates in foreign countries may have large or small impact on your purchasing power. A simple uniform weighting of inflation is not the answer. Also, this still does not deal with something related to point (d) above - inflation and credit risk are linked, so one cannot always manage inflation and credit risk separately.

Relative Price Changes

The impact of relative price changes on a consumer are captured in a Consumer Price Index (CPI) or Retail Price Index (RPI), provided that the goods consumed are those in the index, and in the same proportions. Thus perhaps because of the theoretic capture of relative price movements in inflation linkers, the thinking on this issue sometimes goes no further. However, as discussed, inflation linkers are not likely to offer long-term savers more than a partial solution to matching liabilities. And relative prices can change a lot over a period of a couple of decades. In a globalising world, economies are becoming more open and relative prices are changing fast. In particular, emerging countries are taking more market share of production and consumption in ever more goods markets. Faster than average productivity growth in emerging countries should arguably increase their competitiveness and hence trade shares and pricing power; but perhaps more clearly, greater numbers of consumers in emerging markets will determine the relative prices of the items they purchase in international markets. Over 85% of the world's population live in Emerging Markets, and disposable incomes there are growing rapidly.

Two major trends are affecting purchasing power. Firstly there is a rapid expansion of consumption in emerging markets driven by the growth of large middle classes and their changing tastes. Secondly, the financial crisis in the HIDCs (Heavily Indebted Developed Countries) is leading to increases in savings and changing consumption patterns there, including less demand for luxury items and less essential goods and services.

It is not possible to be accurate in any assessment of future purchasing power. One needs to take into account: trends in demographics and income distributions and hence consumption patterns; factor cost and production trends; shifts in technology; the rate of institutional developments in the emerging world enabling more stable governance and greater capital formation and competition; and uniformity of global market prices for related goods. On this last point, significant quality and reliability and brand differences will be retained by developed countries in some areas, but will be eroded by competition and outsourcing in others. The post-2008 reality in the developed world changes the relative power of governments to maintain competitive advantages for their companies - it levels the playing field. Emerging market companies are in many instances going to face fewer disadvantages compared to the past in terms of quantitative restrictions, quality standards, trade taxes, subsidies and the impact of tax and other policies on factor costs. If the deleveraging HIDCs employ protectionist policies in the face of greater foreign competition, the emerging world is likely to retaliate and trade more with each other. Either way their consumers will determine global prices. For all these reasons, whilst accurate measurement is difficult, the trend towards greater Emerging Market purchasing power is clear.

Liabilities are Global

A pensioner's liabilities is the future cost of consumption. This is increasingly going to be largely determined in Emerging Markets. Even if someone retiring buys domestically produced goods, these goods may be priced in a global market and the bulk of competing production AND consumption may be in Emerging Markets. Already oil and various commodities are priced in Emerging Markets. This will extend to many more goods (though probably few high-end technology goods). Domestic protectionism is no answer either - the saver will simply have to pay for more expensively produced goods than available on global markets.

Why is purchasing power not more explicitly factored into liability calculations already? The recent low inflation environment in developed countries, the West's strong geopolitical bargaining power affecting preferential trade access, their dominant consumers, and their agricultural and textile protection have all resulted in the problem not having been of major proportions in the last three decades. And arguably prejudice, momentum, and agency problems have allowed the issue to be ignored for the purposes of future planning (so far).

Rebalancing and Inflating Away Debt

Whereas HIDCs face currency depreciation and inflation to erode debts, Emerging Markets face currency appreciation and less inflation risk. As we have argued before, the huge Emerging Market Central Bank surpluses are unsustainable. Global rebalancing is likely to mean 30% upward moves in emerging currencies versus HIDC currencies as these reserves are reduced and re-allocated more to other surplus countries. Following the current deflationary period we may also then experience a period of high inflation in HIDCs - as in the 1970s - to erode indebtedness. But Emerging Markets need not have inflation to erode debts which they don't have. In many instances they also have electorates aware of the pain of inflation (in some case experienced within living memories). These electorates are not deluded about economics in their voting habits, and vote for low inflation.

A Convenient Fiction

What passes for meeting liabilities today is a fiction - a convenient one for governments wanting to engage in financial repression. Fiduciaries may claim to be meeting liabilities by focussing on nominal future pay-outs, but arguably are not looking after the best interests of the owners of the capital they are responsible for if they are not taking into account global purchasing power trends. The focus on contractual nominal liabilities is engrained in regulatory structure also, but is likewise not looking after the best interests of future pensioners and other savers. The government's goal of wanting to capture savings pools to finance itself is potentially in conflict with the objectives of savers, but over the long term the government's interests are also not served if the population is needlessly impoverished in old age through an absence of national investment in the Emerging Markets. Having pensioners not being able to live off their pension may of course also rebound onto dependence on the public purse.

Legislation may and should change this - mandating pension funds to take account of purchasing power may only be a question of time. Fiduciaries may even care to get ahead of such a possible change.

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