The Emerging View
Phoney Currency Wars

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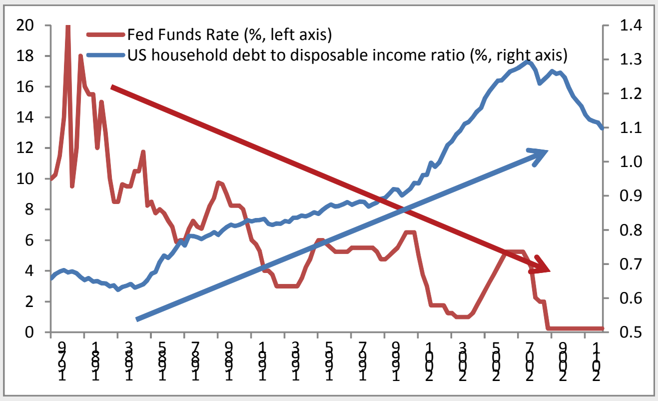
Phoney currency wars

In August 2010, the US Federal Reserve launched QE2. The following month Brazilian Finance Minister Guido Mantega coined the phrase ‘currency wars’ to characterise the damage inflicted on Emerging Markets by over-easy monetary policies in the HIDCs (Heavily Indebted Developed Countries). Quantitative easing, he argued, weakens HIDC currencies, undermines Emerging Market exports, saps their growth and in the final analysis transfers the cost of adjustment from HIDCs to Emerging Markets through currency weakness.

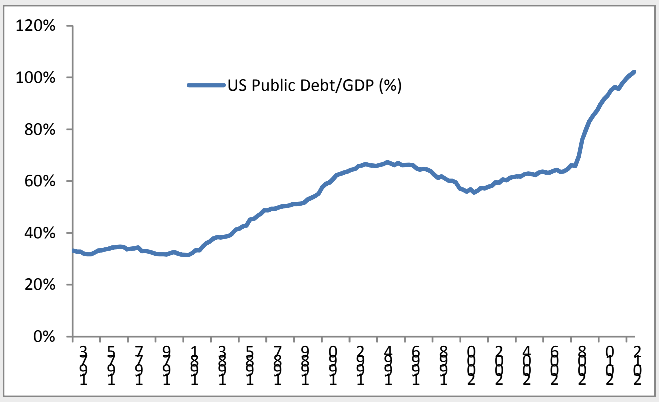
Mantega’s currency war has not gone away; it is merely on hold, in much the same way that phoney wars presage the outbreak of real hostilities. The real currency war kicks off when economic fundamentals – interest rates, growth rates, and inflation – begin to move. For all the recent stasis in currency markets, currency realignment is still the main vehicle, whereby the global imbalances will be unwound, particularly the excessive debts in the HIDCs and their counterparts in the shape of excessive foreign exchange reserves in Emerging Markets.



Global stock imbalances….

Temporary economic conditions and policy choices keep currencies locked in relatively stable ranges, but these conditions are not immutable. Deleveraging will unfreeze credit markets, resulting in higher spending, stronger growth, and eventually rising inflation risks. The Fed will be forced to raise rates and to reverse its unorthodox easing measures.

We hope the process of unwinding the global imbalances will happen slowly, because the alternative is a mighty dollar crash. Accommodative Fed policy fuelled an ever growing debt bubble for 30 years (chart above). Financial innovation and deregulation also helped to lever up the U.S. economy. Average U.S. household debt to income rose from 70% in the early 1980s to 130% by 2008. Public debt doubled over the same period to 60% of GDP, and has increased by a further two thirds to reach 100% of GDP (chart middle right).



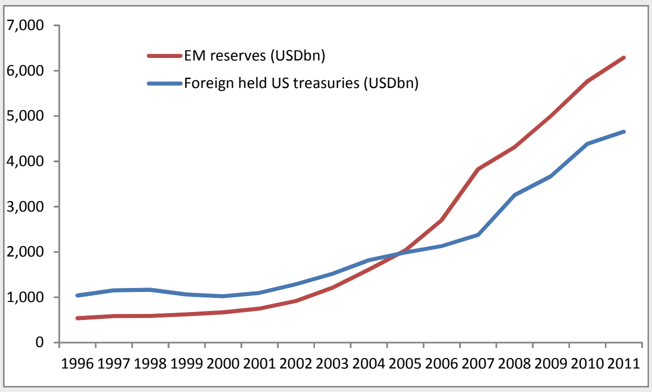
Emerging Market central banks contributed to the global imbalances by investing their foreign exchange reserves in government securities from the biggest borrowers (see chart below right). The close relationship between Emerging Market central bank reserves and growth in US treasury issuance illustrates a key insight about the global imbalances: they are a stock problem, not a flow problem. The stock of debt in the HIDCs is too large and the stock of reserves in Emerging Markets is too large.

This implication is that HIDCs must sustain surpluses (positive flows) for many, many years before the debt problem (stock) is resolved. The same argument, but in reverse, holds for central banks in Emerging Markets. A year or two of current account deficits cannot unwind imbalances of this magnitude.

Where the symmetry ends, of course, is that the HIDC debt and Emerging Market reserves are denominated nearly exclusively in HIDC currencies, particularly the dollar. Emerging Markets are living with a ticking time bomb buried at the heart of their most formidable sovereign defences, their FX reserves.

...with insufficient flow remedies...

Some adjustment of the debt/reserve imbalances has begun on the flow side. Emerging Market current account surpluses declined from 5.6% of GDP in 2006 to 2.1% at the end of 2011, though due to weak external demand rather than stronger domestic demand. So far only China has deliberately begun to rotate growth from exports to domestic demand.



But the flow measures to date have not even been enough to stop the growth in reserve accumulation. Emerging Markets’ exposure to HIDC debt continues to increase. According to US treasury data as of 17 July 2012, foreign official entities increased their holdings of U.S. treasuries by 17% from an already very high base in the past 12 months to May.

HIDCs have similarly made marginal progress in slowing debt accumulation. The U.S. current account deficit declined from 6% of GDP in 2006 to 2.7% of GDP at the end of Q1 2009, but has since widened again. Household debt to disposable income has fallen the equivalent of 15% of GDP. But the decline in household debt has been dwarfed by the rise of U.S government debt of 40% of GDP since the crisis began. The U.S. economy is therefore more indebted in aggregate today than before the crisis began. A similar picture applies in Europe though many European countries have reluctantly begun to adjust their fiscal balances and to reform. Europe’s deleveraging experience will therefore differ in detail, but not in broader macroeconomic terms — it’s problem is also about too much debt.

...is unsustainable and it will stop

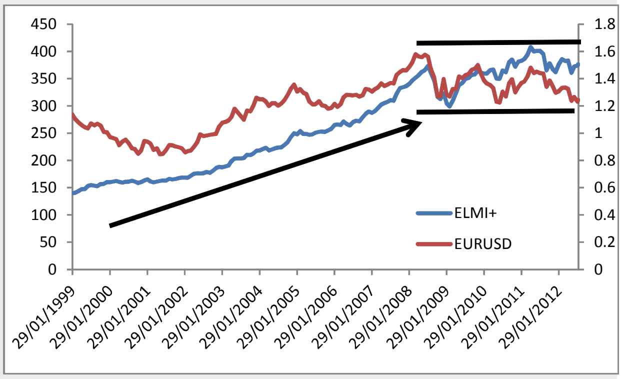
It is unsustainable for public debt levels in HIDCs and foreign exchange reserves in Emerging Markets to continue to increase indefinitely. Rising debt service costs stifle private sector growth and eventually lead to crises, such as the one we see in Europe. Similarly, continuing reserve accumulation has ever growing opportunity costs in terms of forgone investment and consumption opportunities in the domestic economy. Investment risk also rises with reserve accumulation, especially since diversification is so poor in central bank reserves. Finally, there are ever growing sterilisation costs and distributional issues.

So how will HIDCs bring down their debt levels and Emerging Markets central banks reduce the stocks of foreign exchange reserves?

Emerging Markets will increase the pace of domestic demand. But domestic demand can only be increased in a non-inflationary manner if accompanied by supply side reforms, infrastructure investment and the development of corporate bond markets. These are happening across Emerging Market countries, but at a slow pace. Brazil's recent announcement of major infrastructure investment is a sign of things to come right across Emerging Markets.

Emerging Market central banks are likely to continue to diversify away from HIDCs over the coming years, stop building reserves, and eventually reduce reserves at some point. The risk they face is a herd-like exit from HIDC bonds: this would trigger a more violent adjustment, crash the dollar and push up U.S. treasury yields, also threatening U.S. market liquidity (there is no liquidity if everyone takes the same side of a trade). The rapid drawdown of the global imbalances would be disruptive and could force governments to restrain domestic demand severely to preserve domestic and external balance. Constant gradual reserve diversification is the optimal way to reduce this risk.

On the debtor side, HIDCs can increase exports by becoming more productive, lowering costs, or by weakening their currencies (they can also default). Europe is making reluctant progress on reforms under heavy market and German/ECB pressure, but the U.S. has dodged long-term reforms, let alone fiscal reform. The outlook for reform now hinges on upcoming presidential and congressional elections. Cutting labour costs via immigration or higher unemployment, however, faces political opposition and opposition from the Fed, respectively.



Currency depreciation is by far the most likely way to improve HIDC external balances. Debt overhangs, high levels of risk aversion and financial repression have put currencies into a temporary stasis (see chart on the right), but deleveraging will gradually resurrect the fundamental drivers of currencies and more rapid adjustment is of course always possible through additional QE.

Foreigners currently hold 47% of all publicly held U.S. treasuries and 24% of all U.S. public debt. A 25% depreciation of the dollar would wipe out more than 12% of the total stock of U.S. treasuries and 8% of total U.S. public debt.

Currency weakness transfers the cost of adjustment onto foreign central banks, as Finance Minister Mantega pointed out, though in his case it may have been rhetoric, because Brazil's central bank has more exposure to dollars than almost any other central bank on earth. Generally, however, the asset side of Emerging Market central banks —mainly foreign exchange reserves—has been neglected for a long time and remains in serious need of reform, especially diversification. By contrast, the liability side—mainly currency issued by the central bank – is in rude health due to the sound macroeconomic policies in most Emerging Markets.

The Impact on Emerging Markets

The joint erosion of the HIDC debt and Emerging Market central bank reserves via currency re-alignment will have a profound, but nuanced impact on Emerging Markets.

Global growth rates will increase as the burden of debt lifts in HIDCs, raising growth in emerging economies in the process and in turn pushing Emerging Market currencies higher. Currency appreciation in turn encourages much needed economic rebalancing in favour of domestic demand, helping to gradually reduce excessive foreign exchange reserves. Resistance to appreciation will be strong in some quarters, but futile in the face of strong dollar depreciation pressure. At the margin, the combination of currency appreciation, short-term economic rebalancing costs and the need to manage demand as reserves decline will detract somewhat from growth in a broadly better global growth environment. On the other hand, the impact on prices should be mildly deflationary, thus providing a method for controlling inflation and a very supportive environment for local bonds.

The winners will be those Emerging Market countries, which anticipate the coming currency appreciation and improve their competitiveness well in advance. This should involve using foreign capital constructively to drive down domestic costs through infrastructure investment and the development of corporate bonds markets. Competing well in the face of currency strength is all about productivity gains, and long-term foreign flows are particularly effective in helping to modernise and upgrade economies.

Most will succeed in transitioning, spurred on by voters, whose lack of access to social security, unemployment benefit and inflation hedges renders them unrelenting in their demands for growth and price stability. Some will reform late and experience temporary volatility. A few will fail. Credit analysis will become far more important in managing risk across Emerging Markets in the years to come.

(Sources: Bloomberg, U.S. Treasury, Credit Suisse)

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