Ashmore

The Emerging View
Bernanke Signals Dollar Weakness Ahead

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September 2012 Issue No. 96

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Imbalance

At the Bretton Woods Conference in 1944 stability in exchange rates was desired after the negative experiences of inter-war deflation (and then inflation). There was not enough gold in the world to go back to the gold standard without a politically unacceptable rise in the gold price. Keynes argued for a new international monetary system focused on an International Clearing Union (ICU) and a new currency 'Bancor'. He proposed international balances would all be held at the ICU in Bancor. This was at a time when all foreign exchange transactions went through central banks. The potential build in global imbalances was uppermost in Keynes's mind. Deficit countries can be cut off from access to capital but with no such constraint on surplus countries, and bearing in mind that for every deficit there is a surplus, surpluses can create deficits elsewhere until crisis strikes. To dis-incentivise such a build-up Keynes recommended negative interest rates on large surpluses. The US, as the largest creditor at the time, vetoed the proposal.

Instead, it was agreed the Dollar would be convertible to gold at $35 an ounce and other currencies pegged to the Dollar. After current account liberalisation in 1958 and then the election of President Kennedy (seen by European markets as likely to be fiscally profligate) the system started to come under pressure from the London gold market exerting downward pressure on the Dollar. Intervention was required to counter this, and came in the form of the 'Gold Pool' whereby the surplus central banks in Europe agreed to sell gold to support the Dollar.

The Dollar was (and is) in effect the global currency, and the Federal Reserve was (and is) central bank to both the US and global economies. There is a potential conflict between these two functions known as the 'Triffin Dilemma'. This is normally expressed in terms of short-term internal and long-term external balance. If the world is growing then the central bank has to provide liquidity - not to do so would cause stagnation. But whereas a truly global central bank would provide liquidity globally the US Fed. mainly provides this liquidity into the US economy. How does this then make its way into the global economy? If one is not careful, via a build up of US debts threatening Dollar credibility.

In 1971 the last straw was US Treasury Secretary John Connally's blunt quote on a trip to Europe that the dollar was 'our currency, but your problem'. European central banks consequently asked for their gold back and Nixon suspended convertibility. The Dollar fell, peaking at almost $195 an ounce in 1974. Other currencies remained pegged until 1973 but there followed a decade of inflation - inflation which eroded debts and got rid of global imbalances.

Today's imbalances built after the Asian crisis. After that experience many emerging markets chose to self-insure themselves by building their central bank reserves to what have become excessive levels, so exporting their savings to the US and Europe. They pushed the US yield curve down in the process. This, together with North Atlantic regulatory failure, led to the super-bubble which started to erupt in 2007 and 2008.

Make me Chaste, but not yet

Fed. Chairman Bernanke, facing this crisis in the banking sector in 2008, wanted to avoid a catastrophic loss of confidence leading to depression. His method was to help rebuild bank balance sheets, for which he wanted time and stability elsewhere. Yes, he knew there was a housing sector problem that had to be dealt with, but not yet. Yes he knew that excessive central bank holdings of Dollars were unsustainable and had to be reduced, and that consequently the Dollar had to fall in real terms against surplus country currencies, but not yet. He did not want large shifts in mortgage markets or in global currencies until the banks were fixed. He was addicted to the myopic - focussed on crisis management.

Forbearing Neighbours

Emerging market central banks have obliged by being patient before re-balancing. Although the insurance they had bought through their build-up in reserves worked adequately in 2008, they have continued buying Dollars since, resulting in a stable Dollar and delaying the inevitable global rebalancing. However, the costs of holding these large reserves are high. The money so hoarded is not consumed or invested locally. There is a fiscal cost of sterilization. There are substantial duration and currency risks associated with holding the reserves in low yielding bonds from the US and other deficit Heavily Indebted Developed Countries (HIDCs). At some point these reserves will need to be diversified and reduced.

The main reason for holding most reserves in Dollars has been perceived liquidity, but the key question is: How much liquidity would there be in a crisis? In 1971 central banks herded for the exit from the Dollar. There is a similar 'Prisoner's Dilemma' now: whilst gradual diversification of reserves is preferred by all, the incentive to cheat and sell first is high. Central banks are realising that their collective investments in US Treasuries are too large to guarantee liquidity when most needed in a crisis.

Fortunately competitive factors argue for more gradual collective movement. Most so-called 'currency wars' are arguably South-South. That one's currency will go up against the Dollar may be understood to be more or less inevitable in the medium term, but that one should appreciate first and lose export market share in third markets to other emerging market exporters is not.

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Emerging central banks could also afford to wait. After Lehman Brothers failed in 2008, many had cut interest rates as much (or more) to be prepared for possible further external crises than because of domestic cycle concerns. Hence they expected to have an inflation problem to deal with a couple of years later. Moreover, being staffed by well-educated macro-economists aware of some economic history and the multi-year deleveraging ahead in the HIDCs, they feared the scenario of possible HIDC depression, and so did not want to just use interest rates to cope with inflation when it arrived, but also other policies including exchange rate appreciation.

There was little inflation until the end of 2010, when food prices spiked. There then followed a period of considering whether such external one-off price rises were likely to affect inflation expectations or not. Then in August 2011 the US debt ceiling crisis erupted and this was followed by heightened concerns over 'tail risk' in the Eurozone in September. These had the effect of paralyzing any emerging central bank desire to start changing course on reserve build-up and diversification.

Three Scenarios

Global rebalancing has many facets, one of which is the end to (and then reversal of) the increase of emerging market central bank reserves, and the diversification of those reserves towards emerging market currencies - inevitably leading to Dollar (and other HIDC currency) weakness. Just as in the early 1970s it is intervention or the lack of it from those central banks with surpluses (European central banks then, and emerging ones today) which will determine how and when such adjustment takes place. Although HIDC policy-makers may genuinely believe themselves to be the dominant decision makers - and may have hoodwinked some in emerging markets to think likewise - this is largely a conceit. Emerging central banks hold the key to the large global foreign exchange shifts in the medium term. Those without reserves can persuade and bargain, but - having few reserves - they cannot pull the intervention trigger themselves.

So the fate of HIDC currencies rests with emerging market central banks. There are three scenarios for them. Firstly we might see a continuation of heightened risk aversion and the status quo of emerging currency range trading. Secondly we could yet see a rush for the exit and a Dollar crash (fortunately a low probability scenario). Thirdly, we may see a reduction of risk aversion leading to the start of rebalancing. This seems increasingly to be the new reality.

Let the Rebalancing Commence

The only way to avoid the need for 20 years of HIDC fiscal surpluses is a combination of devaluation and inflation (even, given such large debt loads, if this results in stagflation rather than growth).

ECB President Draghi's commitment to buy unlimited Eurozone sovereign bonds from countries in an ESM (or equivalent) programme if needed has reduced 'tail risks' in the Eurozone. The ECB may end up buying a vast volume of government bonds, and it may even end up doing so in unsterilized fashion and create inflation and devaluation. Draghi has signalled that responsibility for the possible break-up of the Euro will not be his. His messages are: the Euro might devalue if non-sterilized intervention replaces sterilized intervention; and the chance of near-term Euro catastrophe is reduced.

This was followed by Federal Reserve Chairman Bernanke's QE3 - his commitment to continue buying bonds up to and beyond a clear future economic recovery. This signals that he is not only still worried about the parlous state of the de-leveraging US economy, but possibly also that the US banking sector is sufficiently repaired and now robust enough to weather more currency turbulence. He is signalling a weaker Dollar is now acceptable - even desirable.

Emerging currencies have been allowed to drift by their central banks, but this may now be changing. We hear of more and more central bank swap lines between emerging market central banks, and more direct investing in each other's sovereign bonds. This is complementary to the shifts of some of the more export-oriented emerging economies towards domestic demand-led growth and South-South trade.

Once a few central banks see their neighbours' currencies start to move up against the Dollar, Euro and Sterling, it is easier to let theirs rise also. This spares the cost of acquiring and holding large HIDC-currency reserves. And none wants to be the last holding depreciating Dollars.

But could the pace quicken? Barring panic we hope and expect that if the pace becomes a little too rapid for comfort then intervention to buy Dollars will slow it down again. This may confuse some market commentators and be interpreted as a preference for the status quo. What should be more apparent, whether all market participants and policy-makers realise it yet or not, is that the key to foreign exchange dynamics lies with the emerging market central banks today more than ever before.

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