Ashmore

# Disequilibrium and the Dollar

By Jan Dehn

**Yet another cyclical slowdown is a reminder that HIDCs (Heavily Indebted Developed Countries) have deep structural problems and that the world economy is in state of deep disequilibrium.**

The combination of structural problems and disequilibria produce temporary stagnation in the macro fundamentals – low growth, low inflation, and low policy rates. This combination has also changed the behaviour of FX markets. Trends have given way to volatility, and the potential for more currency volatility is continuously increasing. Currency markets are being fuelled by QE and policy makers in the HIDCs are gradually shifting towards outright currency manipulation. Yet so far the moves in the currency markets have been broadly mean-reverting. We are in a phoney currency war. But the lack of trend in currency markets is not going to persist – the structural drags eventually fade. Of the numerous drags holding back HIDC growth, US household deleveraging is likely to be the first to release its frosty grip. This brings back growth, and with growth comes inflation and rates are then brought into play. And when rates come into play the long-ignored issue of HIDC debt is shunted to the fore. For the first time since the crisis, the world will then be brought face to face with the question at the heart of every single debt crisis the world has ever seen, namely: who is going to pay? It seems unlikely that fiscal policy will provide the answer, because HIDC governments seem unwilling or unable to tax people.

Enter monetary policy. The direction taken by the Fed when inflation returns will therefore not only be very political, but it will also matter hugely to currencies – a hawkish Fed will be Dollar positive, while a dovish Fed is Dollar negative. We believe the next Fed Chairman is likely to be a dove. The Fed will allow inflation expectations to rise above nominal yields, thereby reducing real yields and pushing down the Dollar. The combination of a weaker Dollar and rising inflation heals the US debt problem and savers and foreigners pay. After the adjustment, the Dollar can strengthen again.

It is popular to be bullish the Dollar. The argument appears solid: the US will grow faster and it will have higher rates. So the Dollar should be stronger. But the simple intuitive appeal of this argument ignores the reality that the US economy first has to exit its current state of deep disequilibrium and its heavy debt load before it arrives at its eventual (more Dollar positive) long-term equilibrium.

The transition to long-term equilibrium is likely to involve a major downwards realignment of HIDC currencies, but particularly the Dollar, against the currencies of the world's major surplus economies. Indeed, it is this realignment which helps bring about the Dollar's resurrection as a credible global reserve currency, albeit it will have a smaller role alongside a more diverse set of reserve currencies in the future.

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## Frozen fundamentals

Dollar bulls base their positive view of the currency on the view that the United States will grow faster and have higher real interest rates than other countries, especially other HIDCs. This is a powerful and intuitively appealing argument, because relatively stronger growth and higher interest rates are important sources of currency strength.

But these conditions are not in evidence today. While the United States is growing faster than Europe this is in large part due to a higher rate of population growth. Besides, the ECB partly offsets America's growth advantage by maintaining higher policy rates. The Fed also obeys a two-sided mandate and clearly cares more about employment than inflation. Indeed, it wants to see inflation higher, not lower. And the Fed does not sterilise QE. The ECB, on the other hand, sterilises QE. It has a one-sided mandate to fight inflation, and inflation only. Net net, taking all these factors into account the case for owning Dollars versus other HIDC currencies is not hugely compelling.

Indeed, it is the similarities rather than the differences between the Dollar and the other HIDC currencies which explain why HIDC currencies have been relatively range-bound against one another since the outbreak of the subprime mortgage crisis in 2008/2009. The fundamental drivers of currencies - real growth rates and real interest rates – have been low and stable, indeed almost frozen, right across the HIDCs. Against this backdrop, the elevated levels of risk aversion and heavy buying of Dollars by Emerging Markets central banks largely explains why HIDC currencies have held up well against Emerging Markets currencies.

## A convenient assumption

Dollar bulls clearly look beyond the current frozen state of macro fundamentals across the HIDCs. Their vision – to be realised sometime in the not too distant future – is one where the United States decisively outperforms Europe and Japan in the recovery stakes. This thesis rests on the assumption that the US economy somehow transitions seamlessly from its current state of severe disequilibrium and high debt to a long-term equilibrium with pre-crisis rates of growth and higher real rates. Economists are probably to blame for this optimistic vision: They tend to think in terms of discrete states of the world; the current disequilibrium will magically give way to a future equilibrium. Economists rarely give thought to the journey between two states.[1]

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We think it is heroic to believe that the transition happens smoothly. The journey from moderately negative real rates, high levels of debt, and sub-trend growth to positive real rates and normal trend growth is more likely to difficult and to raise important distributional questions. Specifically, the transition will bring to the fore the question at the heart of every debt crisis, namely who pays? Those who borrowed too much or those who lend them the money?

## Disequilibrium

The global economy is in a state of extreme disequilibrium. The United States and other HIDCs are experiencing weak growth and sustaining negative real interest rates. Public debt levels have risen sharply in recent years and continue to rise, while in the Emerging Markets central banks continue to accumulate foreign exchange reserves, even though their reserves are already excessive. These are the well-known global stock imbalances (see *'Convergence in the time of imbalances'*, Emerging View, November 2012).

Perhaps the most compelling manifestation of disequilibrium is the lack of inflation despite unprecedented money printing and record low policy rates in the HIDCs. This absence of inflation appears to fly in the face of some of the most fundamental of economic laws, such as the Quantitative Theory of Money (QTM), which specifically links money supply to inflation. But in our view there is nothing wrong with the QTM. The critical link between money supply and inflation is transactions demand for money, which is unusually depressed on account of a plethora of structural drags on final demand and uncertainties about the future. These structural drags are critical to understanding the business cycle. They are the true manifestation of disequilibrium – and it is their resolution which holds the key to a restoration of normal business cycle dynamics.

## The return of inflation

Of all the structural drags holding back demand across the HIDCs, the one which is likely to ease first is US household deleveraging.[2] We expect the ratio of household debt to income to return to its pre-crisis level of 90% by sometime around the middle of 2016. At this point it is likely that the consumer will begin to spend. And, in response to higher consumer spending, it is likely that company CEOs will begin to invest some of the cash on their companies' balance sheets. As GDP picks up so will inflation expectations, particularly given the starting point of negative real interest rates and a bloated Fed balance sheet.

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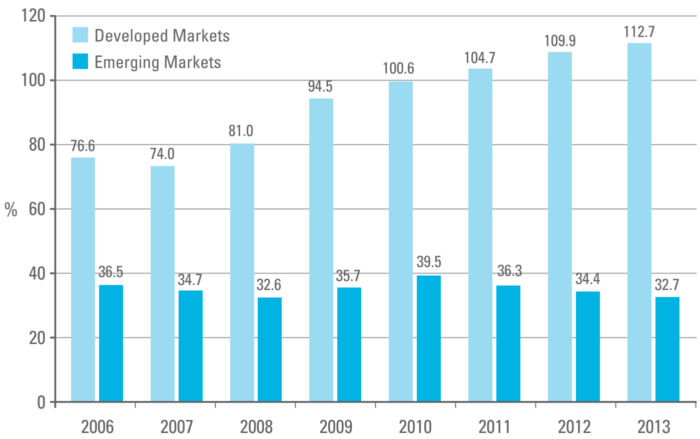
Rising inflation expectations will bring policy rates into play. And rising rates in turn bring the long-ignored question of HIDC debt into focus, because debt levels, public and private, will still be very large. And through this route policy makers and markets will finally be brought face to face with the single most important question in any debt crisis, namely: Who is going to pay?

A comprehensive fiscal solution to the debt problem is unlikely under a lame duck Obama Administration and a divided Congress. The problem of how to manage the debt is therefore de facto a Fed problem. This makes the Fed's action intensely political. And the Fed's action also becomes critical for the fate of the Dollar.

## How do you prefer your poison?

To illustrate why the Fed's chosen path will be both political and critical to the Dollar consider two scenarios, one with a dovish Fed, another with a hawkish Fed.

Fig 1: **Gross government debt (%GDP)**




Source: IMF, JP Morgan.

[1] This is one of the reasons why politicians are loath to follow the recommendations of economists. Economists often ignore or play down the significant distress caused in correcting severe structural problems. Politicians, of course, are extremely sensitive to such distress, especially in the HIDCs where very large parts of the population depend on benefits in some form or other.

[2] The nine most important structural drags in the HIDCs are: (a) public debt and entrenched deflations expectations in Japan; (b) institutional constraints, public debt, and 'zombie' banks in Europe; and (c) excessive household debt, low corporate investment rates, the medium-term fiscal outlook, and how to unwind QE in the United States.

A dovish Fed would allow inflation expectations to rise higher with time, faster than the rise in nominal yields. It would do so by 'leaning against' the treasury market with sustained interventions in the bond market, even after growth picks up. As a result real yields will actually fall, even as nominal yields go up. The fall in real yields weakens the Dollar. The weaker Dollar in turn improves the external competitiveness of the United States, stimulating growth via exports. But the United States also enters an era of gradually higher domestic inflation, which erodes the real value of debt, thus inflicting losses on future consumers through inflation's deleterious effect on the purchasing power of savings. Foreign creditors also pay through the erosion of the value of the Dollar. But importantly from a political point of view, current consumers – who are also current voters – get off relatively lightly.

By contrast, a hawkish Fed would allow the bond market freely and fully to price the hiking cycle, perhaps even aiding the increase in real rates by aggressively unwinding QE via active sales of securities and even hiking rates. The Dollar gains due to lower growth and the higher interest on offer for those with money in Dollar accounts. The cost to current consumers – voters – is high on account of rising cost of borrowing and the slowing economy. Dollar appreciation partly compensates foreign holders of US treasuries. Savers gain as inflation declines and real rates rise.

Which of these scenarios is most likely?

In our view, a dovish Fed scenario is more likely. The US economy is emerging from a condition of low growth, high debt, and deflation fears. There is currently no inflation problem. More importantly, the distribution of risks from a policy mistake appears very asymmetrical. Excessive dovishness may push inflation higher, but that mainly affects foreigners and future generations. Excessive hawkishness, on the other hand, has the capacity to inflict major economic damage on the US economy today. After 30 years of declining yields a rapid return to average long-term yields could wipe out as much as 35% of fixed income in the HIDCs.[3]

Moreover, the US debt to GDP ratio will be well north of 100% of GDP by 2016, so debt service costs for the US government would also be sharply higher. In Europe, bond yields would also rise sharply due to the high correlation between US treasury yields and German Bund yields. The likelihood of a second sovereign debt crisis would therefore rise significantly. For example, Spain's borrowing costs could rise to 10% or more if US treasury yields returned to their long-term average. With a 100% debt to GDP ratio, Spain would have to find 10% of GDP each year for debt service alone.

This underlines the point that the size of the debt burden in the HIDCs and the political obstacles to addressing the structural impediments to growth cannot be ignored once inflation returns and rates come into play. The principal reason why the Fed and other HIDC central banks are likely to opt for inflation and currency devaluation over higher real rates and strong currencies is precisely that the debt problems are so large that it is too painful to fix them by other means.[4]

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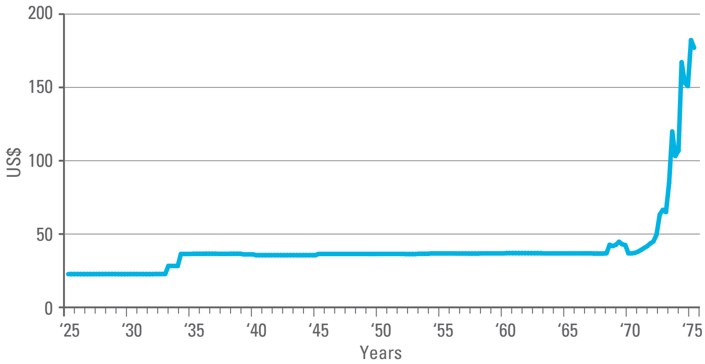
### How, who, and how fast?

It is difficult to say how far the Dollar and other HIDC currencies have to fall. The last time the US was in a similar situation was in 1971 when, following heavy fiscal spending in the 1960s and during the Vietnam War, the Dollar devalued from $35 per ounce of gold to $185 per ounce over the course of just four years. This time around the fiscal imbalances are larger and the surplus countries are mainly in Emerging Markets. This suggests that the Dollar move could be larger.

Fig 2: **Dollar price of an ounce of gold**



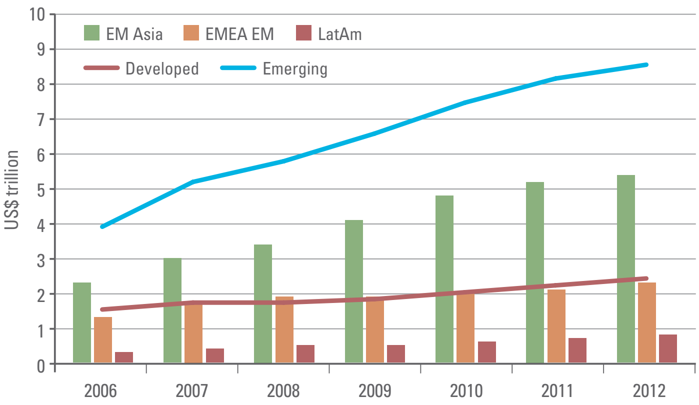

Source: Bloomberg, March 2013.

Emerging Markets central bankers are rarely first movers however, and efforts at currency diversification are still in their relative infancy. Diversification is largely passive. But Emerging Markets central banks will become more active, when their reserve holdings begin to decline due to erosion arising from a falling Dollar and gradually rising nominal yields.[5] Once central bank selling begins, the pace of adjustment of the Dollar and other HIDC currencies against Emerging Markets currencies can be very rapid and potentially disorderly. Much will depend on how well Emerging Markets central banks coordinate their actions.

It is important in our view that the current passivity of Emerging Markets central banks should not be mistaken for impotence. These central banks today control about USD8.7trn of foreign exchange reserves, most of which are in HIDC currencies. It took a mere net short position of USD35bn to push EURUSD to 1.20 at the height of the Euro-zone crisis in 2012.

[3] US 10-year treasury yields rallied from 16% in the early 1980s to just 1.7% today. The 60-year average yield for the 10 year treasury is 6.5%.
[4] The choice of the next Fed governor, likely early next year, will be an important indication of the direction of travel. We expect the appointment of a dovish Fed governor. ECB President Mario Draghi recently appeared to welcome negative rates. The new Bank of England Governor Mark Carney may likewise likely to opt for a weaker currency, and the Bank of Japan has, of course, already made up its mind on this matter.
[5] Some Emerging Markets central banks have up to 80% of their reserves in US treasuries. A return to long-term nominal yields and a 25% decline in the Dollar could wipe out 50% of their reserves.

Fig 3: **FX reserves (US$ trn)**




Source: IMF, JP Morgan.

Larger Emerging Markets central banks are clearly best served by agreeing to appreciate their currencies against the Dollar in such a way that their relative exchange rates remain unchanged. Much of this coordination will have to take place within the G20. The handling of Japan's currency manipulation (so far treated with denial) should be a good indicator of the state of talks.

## Equilibrium at last

When the United States went off gold in the early 1970s, the resulting devaluation of the Dollar went a long way towards restoring health to the United States economy. The same is likely this time around. The real value of debts in the private and public sectors will be much reduced and American exports of capital goods to Emerging Markets will play a key role in driving the US economy. A stronger economy in turn creates political room to undertake longer-term fiscal reform. At the end of the process, the Dollar will remain the world's largest reserve currency, more credible, albeit now with a smaller share of global reserves.[6]

**In our view, Emerging Markets currencies will feature much more prominently alongside the Dollar in the portfolios of the world's central banks. The new global equilibrium will be more balanced and therefore also safer.**

Emerging Markets post-adjustment will rely more on domestic consumption and investment for growth. Domestic demand has been artificially suppressed for decades by currency weakness, excessive trade surpluses, and the resulting accumulation and stockpiling of reserves. The transition to domestic led growth will require significant investment in infrastructure and other productivity enhancing measures to enable exporters to maintain market share in the face of stronger currencies. Access to term capital for corporates in Emerging Markets is critical to this end; hence the much greater role for domestic corporate bond markets in the years ahead. In our view, Emerging Markets currencies will feature much more prominently alongside the Dollar in the portfolios of the world's central banks. The new global equilibrium will be more balanced and therefore also safer.

[6] The Dollar has steadily declined as a share of global currency reserves over the past 10 years. The pace of decline is roughly 1% per year. The Dollar is currently just over 60% of world currency reserves.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