

MATRIX

The Case for the Secular Appreciation of EM Currencies

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Twenty-five years ago, the world of academia and of policy-making was abuzz with words like “debt overhang”, “debt repudiation”, “fiscal adjustment” when referring to the dire economic situation of many middle-income developing countries. The World Bank and the IMF were heavily involved in financing structural adjustment or “adjustment with growth” programs. Already in 1981, one year before the first Mexican debt crisis, Mark Gersowitz and Jonathan Eaton published their seminal article “Debt with Potential Repudiation: Theoretical and Empirical Analysis” in the Review of Economic Studies.

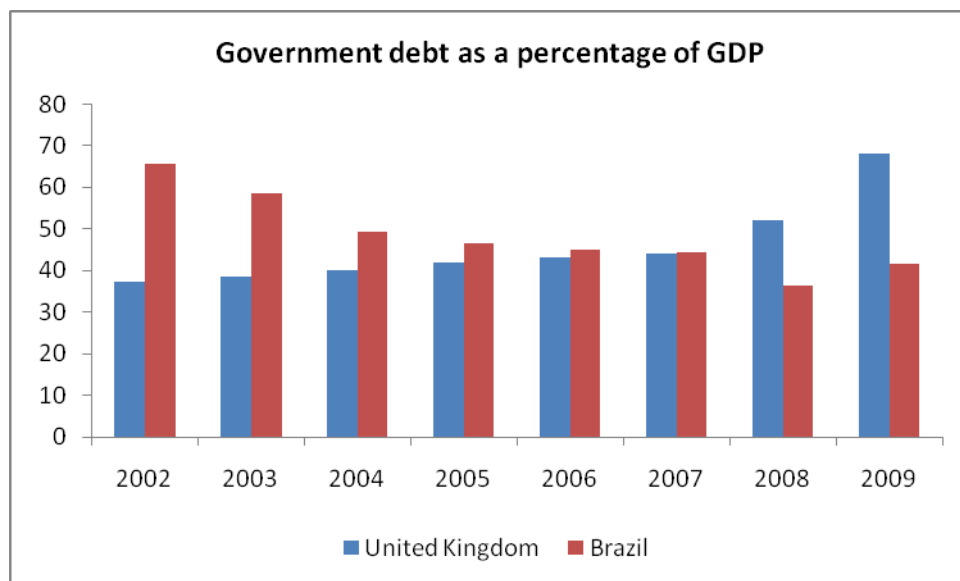
It is ironic that, a generation later, the same issues are re-surfacing but this time they are referred to developed countries: will Greece, Portugal, Spain be able to service their public debt? Will Japan be able to get out of its debt trap? And what about the solvency of the UK? Not to mention the ultimate doomsayers who are thinking of a solvency problem for the US. The adoption of a Brady-like Plan and the issuance of Brady-like bonds to solve the debt problem of highly-indebted developed countries have been suggested, given its success in easing the debt-burden of developing countries. Interestingly, no major developing country is facing debt problems. Very few of them are living through the same fiscal nightmare as G7 countries and most banks in emerging markets are sound. The point is that most developing countries of the 1970s have become “emerging markets”, taking full advantage of the drive towards globalisation and following very appropriate domestic policies. The consequent more positive growth outlook for EMs will manifest itself through a long-term, or secular, appreciation of the nominal exchange rate, as we are about to show.

From Less Developing Countries to Emerging Markets

Imagine being a modern-day equivalent of the lonely Japanese soldier left behind on a desert island and now getting back to Tokyo, or imagine being the Soviet astronaut coming back from Mars after a 20 year space mission: you would be in for a major shock. How on earth did it happen that China overtook Japan as the most dynamic economy in Asia? And it is accumulating trillions of US dollars in reserves thanks to its export success? And how about India, which has become a major world player in the technology sector? Or, a capitalist Russia? And how about Brazil, which is now a net international creditor, are you joking?...

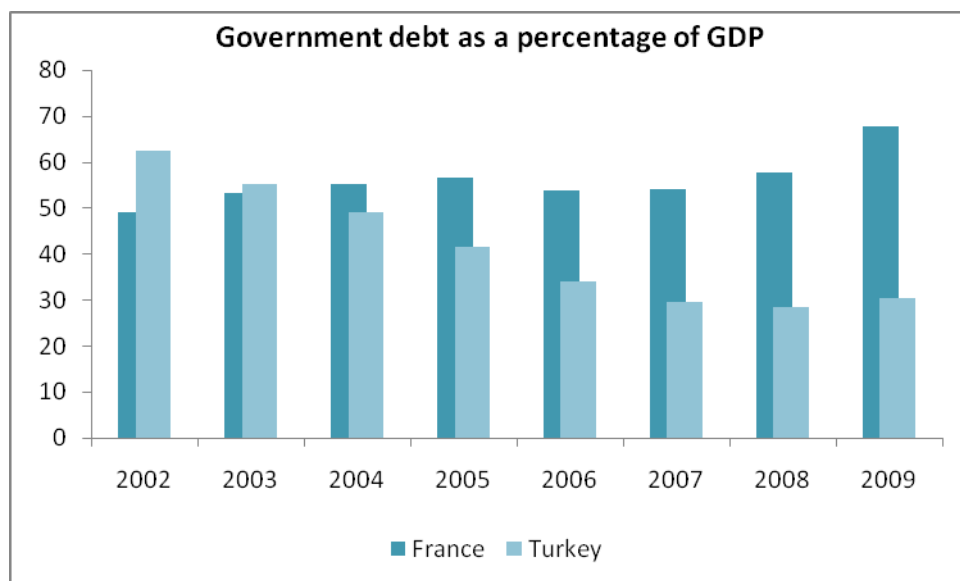
The point is that LDCs (Less Developed Countries) have become Emerging Markets (EMs) thanks to a combination of factors.

First, domestic policies have changed or, to put it more bluntly, politicians and policy-makers in these countries have learned the lessons of the past and did not repeat past mistakes. Nobody better than Lula da Silva, Brazil's current president, shows how this attitude has changed. Lula spent his entire adult life as a trade unionist and very left wing politician. He used to openly call for the repudiation of external debt, for the nationalization of foreign investments and for all the trite communist policy measures. Once elected president in 2002, with the Brazilian EMBI spread at 2200 bps, he somehow saw the light (although it was clear before the elections that he would not deliver on all his socialist promises): fiscal prudence was the main plank of the new government's economic policy, forget any protectionism, rather: encourage foreign direct investment and push for more trade, and allow the central bank to act independently and focus on containing inflation. The outcome has been a spectacular success in rebalancing the economy, in making it more efficient and competitive and making it grow, thus sowing the seeds for a more widespread economic growth and improvement in the standards of life.



Source: IMF

Turkey has gone through a similar experience, emerging from a major currency crisis in 2001 to become the country with one of the most prudent fiscal policies on earth and keeping inflation in check thanks, again, to a very independent and determined central bank. Structural changes domestically and a strong pro-FDI bias contributed to achieving very impressive rates of growth.



Sources: IMF, Central Bank of Turkey

Together with fiscal and monetary policies, trade policies played a major role in making EMs grow and become major international players. Long gone, fortunately!, are the days of the “infant industry argument” and of the “secular decline of the terms of trade (for LDCs)”. EMs embraced globalisation enthusiastically, seizing the opportunities created by opening up to foreign trade and investment. India and China are the prime examples of the impact that abandoning protectionist measures has on an economy, even in the case of countries with a very large population. A consequence of this generalised opening up to foreign trade and investment has not only been the classic more efficient allocation of resources and more balanced growth but also the adoption of market-friendly structural and institutional changes, like anti-monopolistic laws, independent central banks, more transparency... A lot remains to be done and not every country has gone through the same positive steps that the most successful ones have experienced, look at Chavez’s Venezuela for example, a country that has recorded very large swings in GDP growth rates and is mired in high inflation and a populist fiscal policy. Or Argentina: after the bounce-back following the debt repudiation, the country appears to be back to its old self, with politicians showing little respect for independent institutions, be it the statistical office or the central bank, and following populist policies. Overall, though, more and more countries are taking cue from the more successful ones and being more and more integrated into the world economy.

Part of the adoption of sounder domestic policies and more open trade and investment policies was a refocusing away from maintaining a fixed exchange rate towards meeting an inflation target. The exchange rate-based adjustment programs of the early 1990s did not

work for the simple reason that fiscal policy was not supportive of such an arrangement (i.e., it was too expansionary) and ultimately led to the build up of devaluation pressures that proved impossible to stop. The ensuing balance sheet adjustment of both public and private entities in the country caused large shifts in wealth and in the allocation of resources, mostly resulting in the widening of income inequality. A different approach started being championed towards the mid/late 1990s. The new focus of domestic policy was the control of inflation and the abandonment of any exchange rate management, i.e., the exchange rate could fluctuate freely. A free floating exchange rate can, at the same time, provide signals of how world financial markets are assessing the country's outlook as well as providing a buffer against exogenous shocks. Of course, the exchange rate is a country's "supreme price" and depends on the market assessment of the country's outlook. It should, thus, come as no surprise that EMs exchange rates have appreciated over the past decade, given the adoption of more prudent and more open policies, as mentioned above. Next, we will take a closer look at this trend.

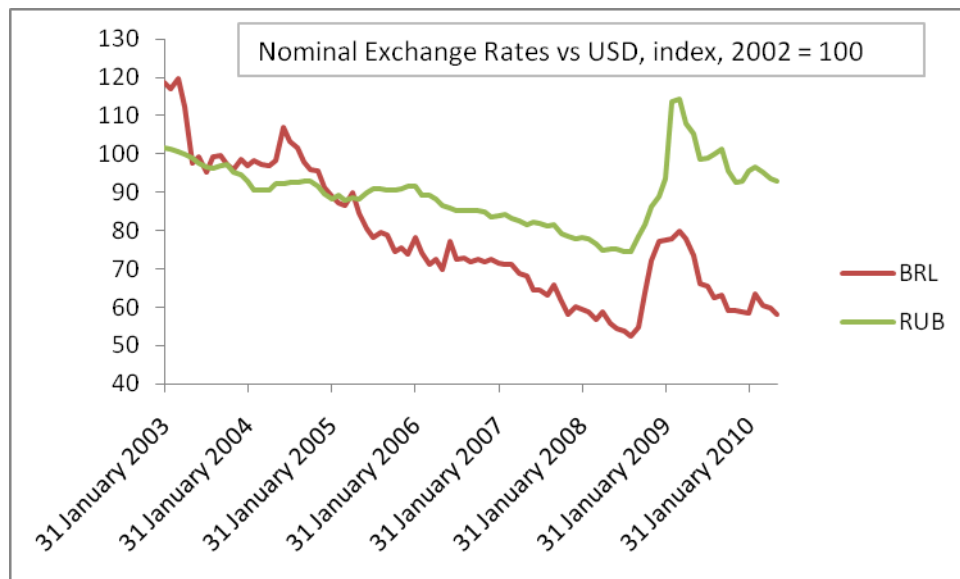
Why the secular appreciation of EMs' nominal exchange rates?

To make the case for the long-term, or secular, appreciation of the EMs' nominal exchange rates, one has to start with the Balassa-Samuelson theorem (or hypothesis, as some like to call it), which provides the theoretical underpinning for the EMs' appreciation of the real exchange rate (i.e., the nominal exchange rate adjusted for the inflation/labour cost differential). This theorem states that the increase in productivity in the tradable sector due to a more efficient allocation of resources leads to an increase in wages in that sector. Due to inter-sectoral labour mobility, wages (=costs) are going to rise in the non-tradable sector as well, thus leading to a generalized increase in the price level (since it is a weighted average of tradable and non-tradable prices) which is faster than the increase in the trade partners. As a consequence, the country's real exchange rate appreciates.

This, however, provides no support whatsoever to our claim of a secular appreciation of the nominal exchange rate. It could well be the case that an appreciation of the real exchange rate is accompanied by a depreciation of the nominal exchange rate (this happens when the depreciation of the nominal exchange rate is lower than the inflation differential).

To make our point, we have to go back to the new paradigm of domestic policies many EMs are following, i.e., the adoption of an inflation targeting paradigm for conducting monetary policy. Inflation targeting is adopted by most EMs that have floating exchange rates and this

implies that the central bank's actions are focussed on meeting this target only. There is no exchange rate or money supply target, the focus is on meeting the inflation target. This implies that, in the Balassa-Samuelson framework, the appreciation of the real exchange rate takes place primarily and mostly via an appreciation of the nominal exchange rate. Notice that the recent financial market crisis and the associated increase in risk-aversion has caused a spike in the EMs' nominal exchange rates but it was not the blow-out of the seventies and the overshooting appears to have run its course.



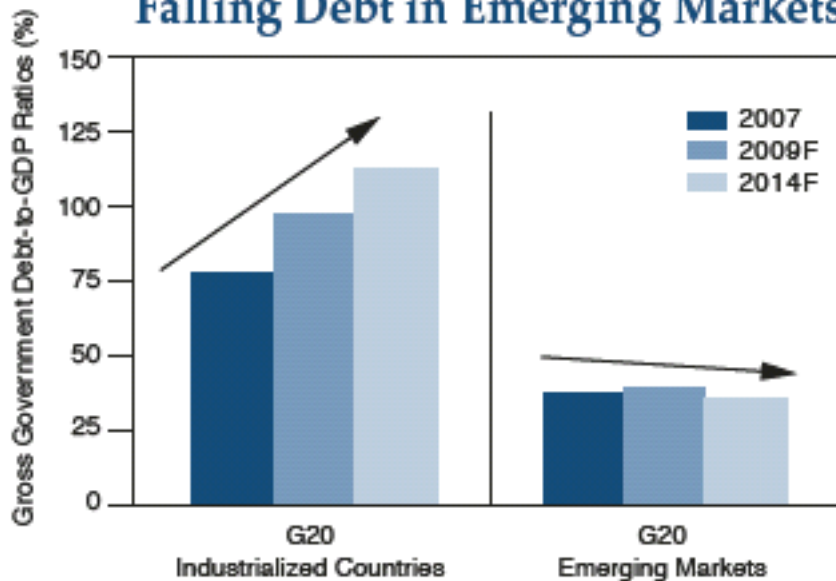
Source: Bloomberg

Other factors supporting the secular nominal appreciation of EMs' currencies

The Balassa-Samuelson theorem provides support to our thesis of a secular appreciation of nominal exchange rates based on developments in the real economy together in an anti-inflationary policy setting. But other factors are contributing to the nominal appreciation of EMs' currencies.

We mentioned above the different fiscal record of EMs and developed economies. This divergence is going to continue for some time, putting developed countries' currencies further under strain. The IMF forecasts that the debt/GDP ratio for the industrialized countries will keep rising in the coming years while it will remain stable for the more advanced EMs. The fiscal position of developed countries relative to that of the EMs, therefore, is likely to deteriorate. Also, one should not forget that the population in EMs is generally younger than in developed countries, i.e., it is more productive and will require less welfare expenditure in the coming years.

Rising Debt in Industrial Countries vs. Falling Debt in Emerging Markets



Source: International Monetary Fund

Chart 6

The current doubts and tensions in the markets with regards to the solvency of some developed countries and, more generally, to the increase in public debt burdens in the developed countries are not going to wane any time soon, thus making investors look at alternative investments, thus further channelling money towards EMs, even more than it is already taking place.

The EMs' strong economic performance and improved economic outlook, in fact, have brought about an increase in capital flows into the EMs. In the past, the vast majority of these inflows were FDIs and predominantly in the mining or resource-rich sectors of the economy. Nowadays, thanks to the adoption of more market-friendly domestic policies, FDIs cover a wide range of activities, from mining to banking to manufacturing, either because of the privatisation effort underway in many EMs or in the form of greenfield investment. Most FDIs contribute to further economic growth, thus providing further ammunition to the Balassa-Samuelson theorem. Going forward, it is likely that capital flows to EMs will cover a vast array of assets, as their domestic financial markets deepen.

As the EMs' economies grow faster than the G7, their share in global GDP grows and asset allocators will have to include EMs markets in their portfolios. Also, benchmarks are going to be re-adjusted to reflect the increasing importance of EMs. All this will result in higher

allocations to EMs, thus exerting appreciating pressure on their nominal exchange rates. Notice that this diversification is going to be implemented by both private and official (i.e., central banks and sovereign wealth funds) investors.

Are policy-makers in EMs welcoming this appreciation?

First of all, productivity gains are generally so strong and cost levels so low that it will take a long time for EMs to lose their competitive advantage over the G7. Robust export performance on the part of the EMs is here to stay for a while, as structural change keeps being implemented and markets remain open.

Second, an appreciation of the nominal exchange rate contributes to keeping inflation under control and is, therefore, welcome. What is not welcome is a fast appreciation, which could easily result in an abrupt depreciation if sentiment changes. Most policy-makers in EMs rather welcome a steady nominal appreciation and some countries have adopted measures (mostly, taxes on short-term capital inflows) to avoid large and sudden nominal appreciations. These measures, though, are intended to slow-down nominal appreciation and make it a smoother, more predictable process. Policy makers know that they cannot fight it and cannot stop it without imposing unwelcome consequences on the economy.

Third, policy-makers in EMs have realized by now that a nominal appreciation of their currencies is the “cost” to pay for achieving full integration in the world economy and, therefore, raising the standards of living of the population.

Still, there are some countries, India and China above all, that prefer to control, or manage, their exchange rates in order to foster export growth. In our view, this is a short-sighted policy that will be abandoned at some point in the future as appreciating pressures mount. Also, pressures from trade partners, as well as pressure from the population, will ultimately lead the authorities to readjust (i.e., appreciate) their nominal exchange rates. The point is that the longer one manipulates/represses the appreciation of the currency, the stronger the appreciation will be and the ensuing overshooting could create unwelcome consequences in the economy.

In conclusion...

The case for the long-term, or secular, appreciation of the nominal exchange rate in EMs seems to be very strong. This does not mean that it will be a smooth appreciating trend and periods of high volatility are likely.

However, the adoption of flexible exchange rates, by definition, rules out speculative attacks on a given currency thus eliminating the risk of abrupt adjustments in the nominal exchange rates, as in Turkey in February 2001, when the Lira exchange rate depreciated by 40% overnight. More importantly, it is the combination of sound fiscal policies, independent central banks, openness to foreign trade and investments, full integration into the world economy that underpins the appreciation of the EMs' nominal exchange rates.