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Exchange rate regimes and structural realignment of global economies

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Chatham House

Tokyo Club
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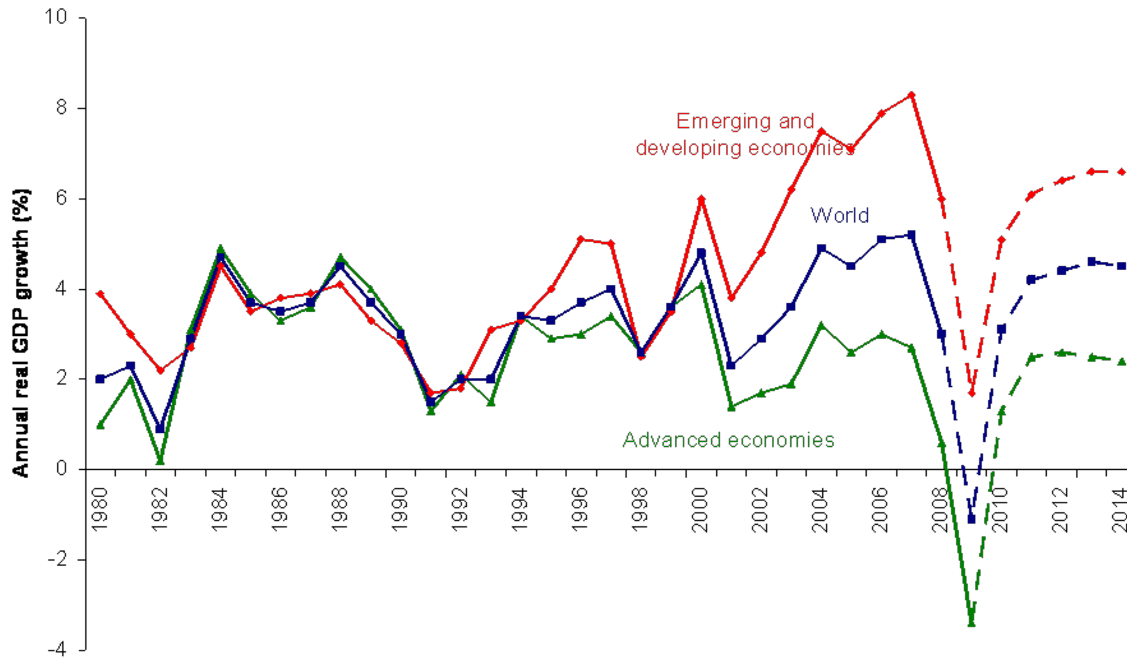
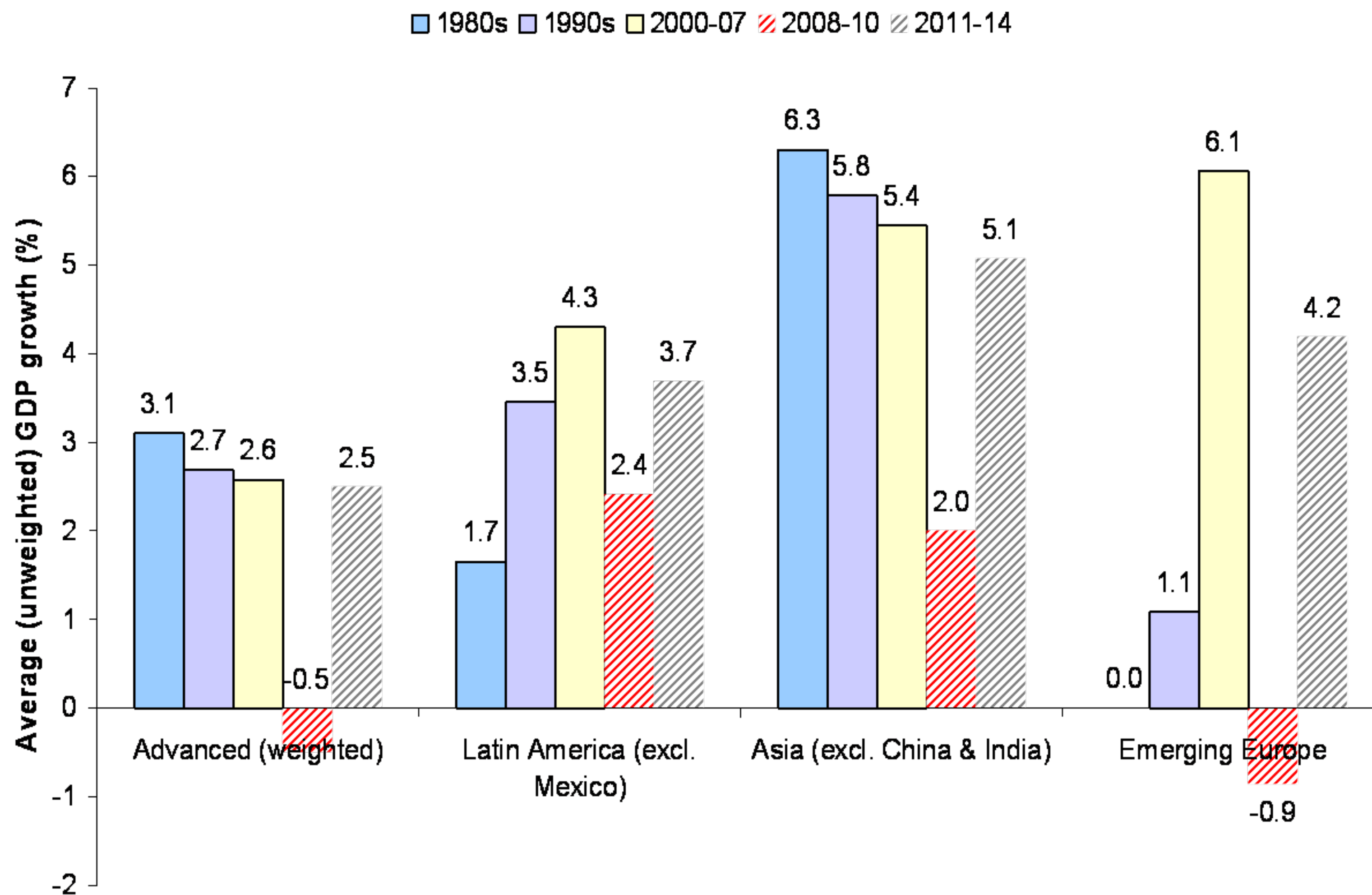
Divergence between old and new world growth rates has developed, set to persist



- The great moderation ends in unexpectedly massive recession
- Turbulence could continue as recovery unlikely to be smooth
- Global cycles have not disappeared and could be larger than before – policy makers need to address this

Source: IMF

Average rates of growth by region and period



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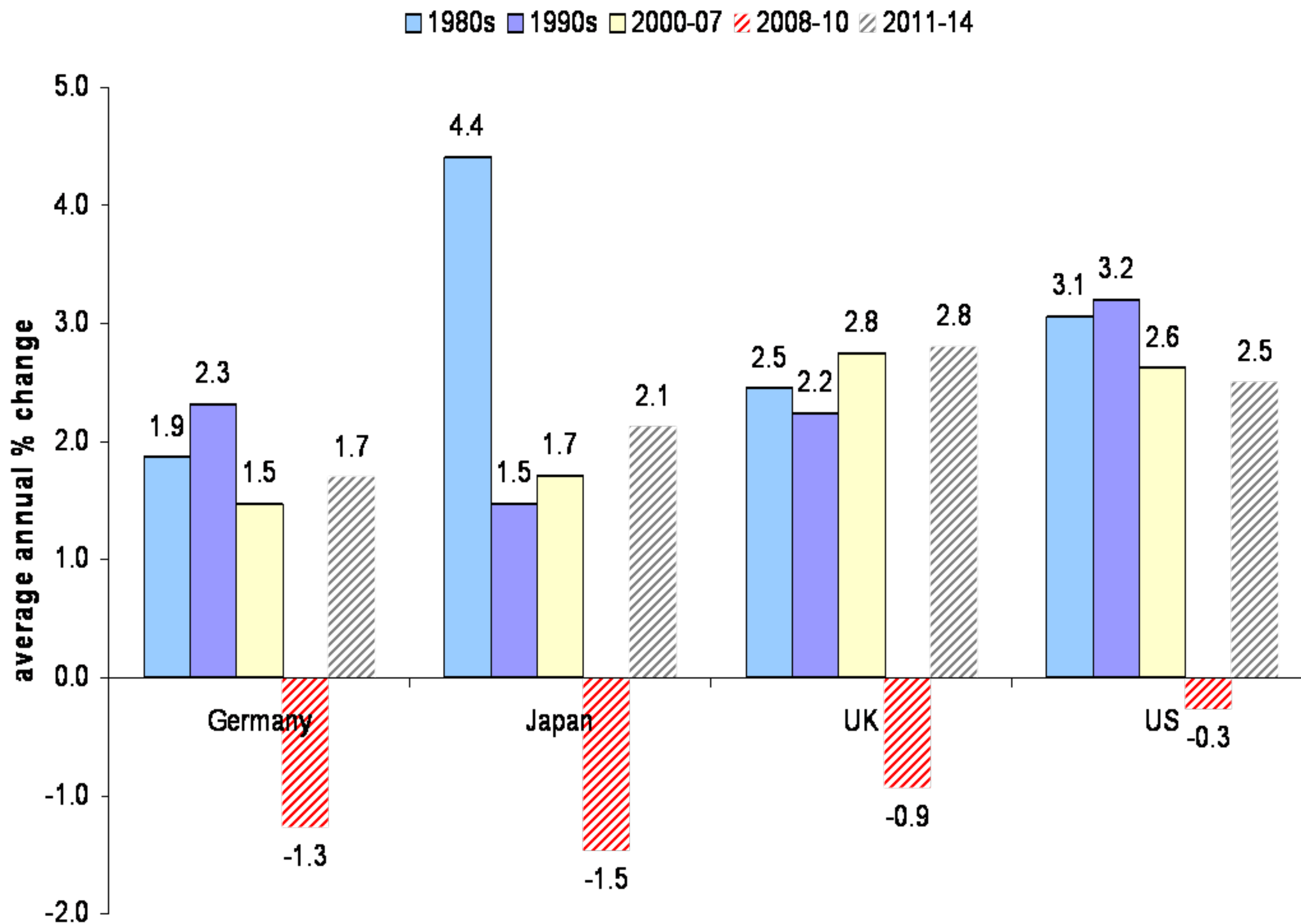
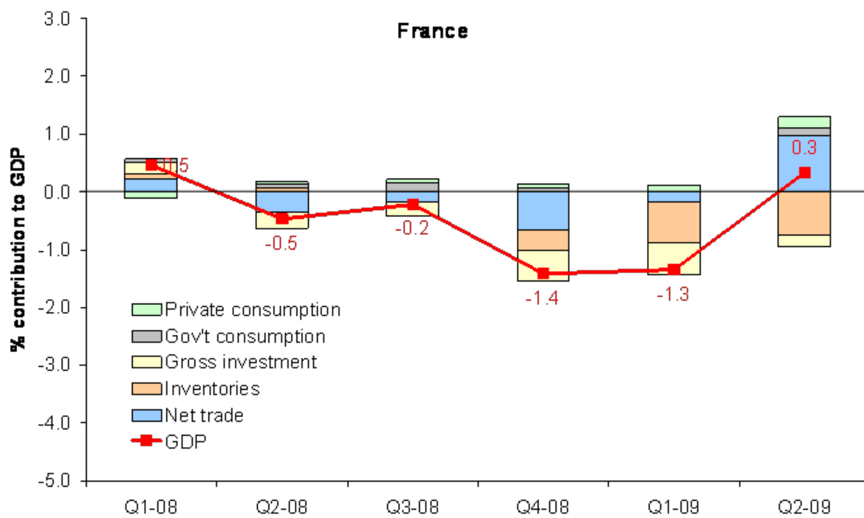
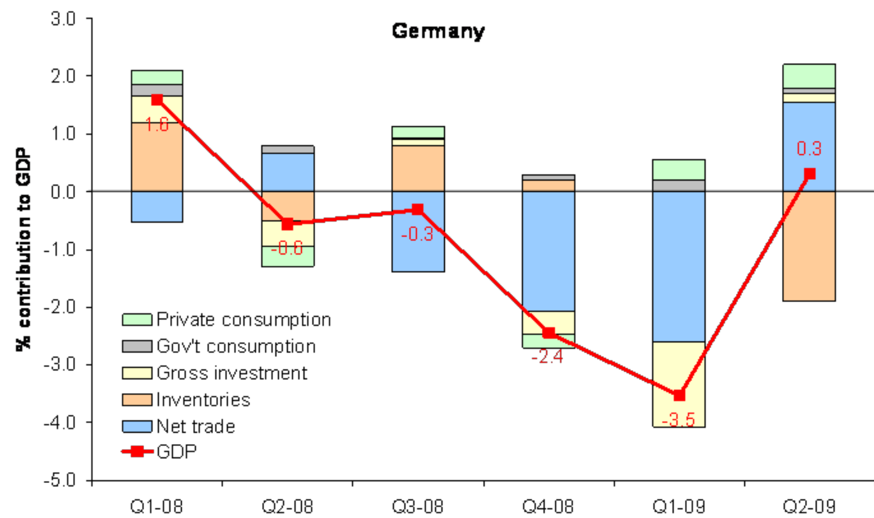
Why bigger losses in some countries than others?



Source: IMF

France and Germany also show varying impacts of crisis





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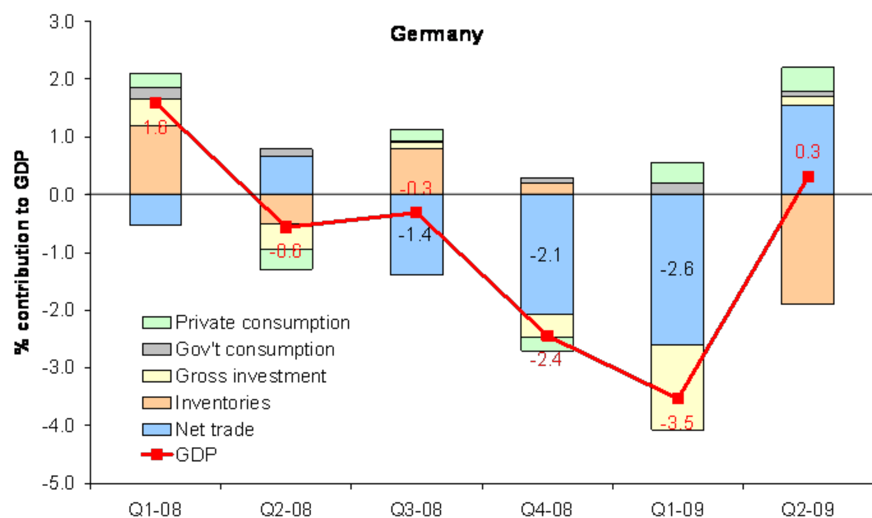
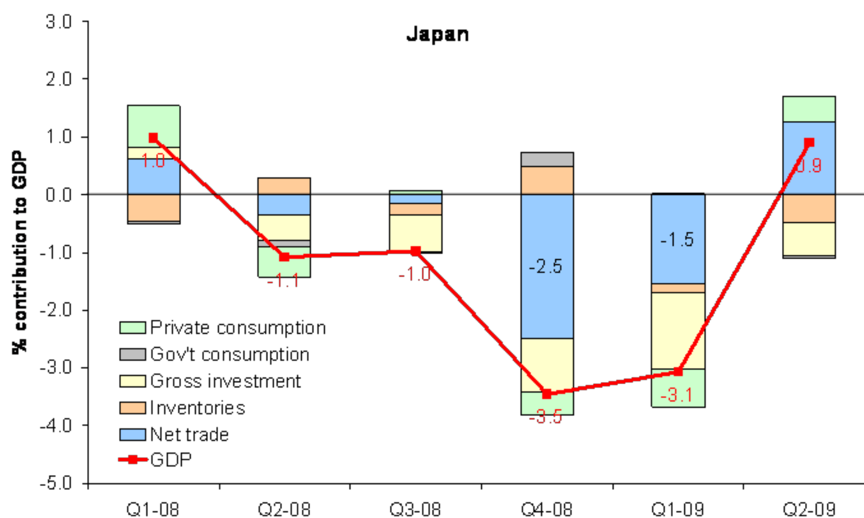
Effect of cyclical trade in Germany and Japan





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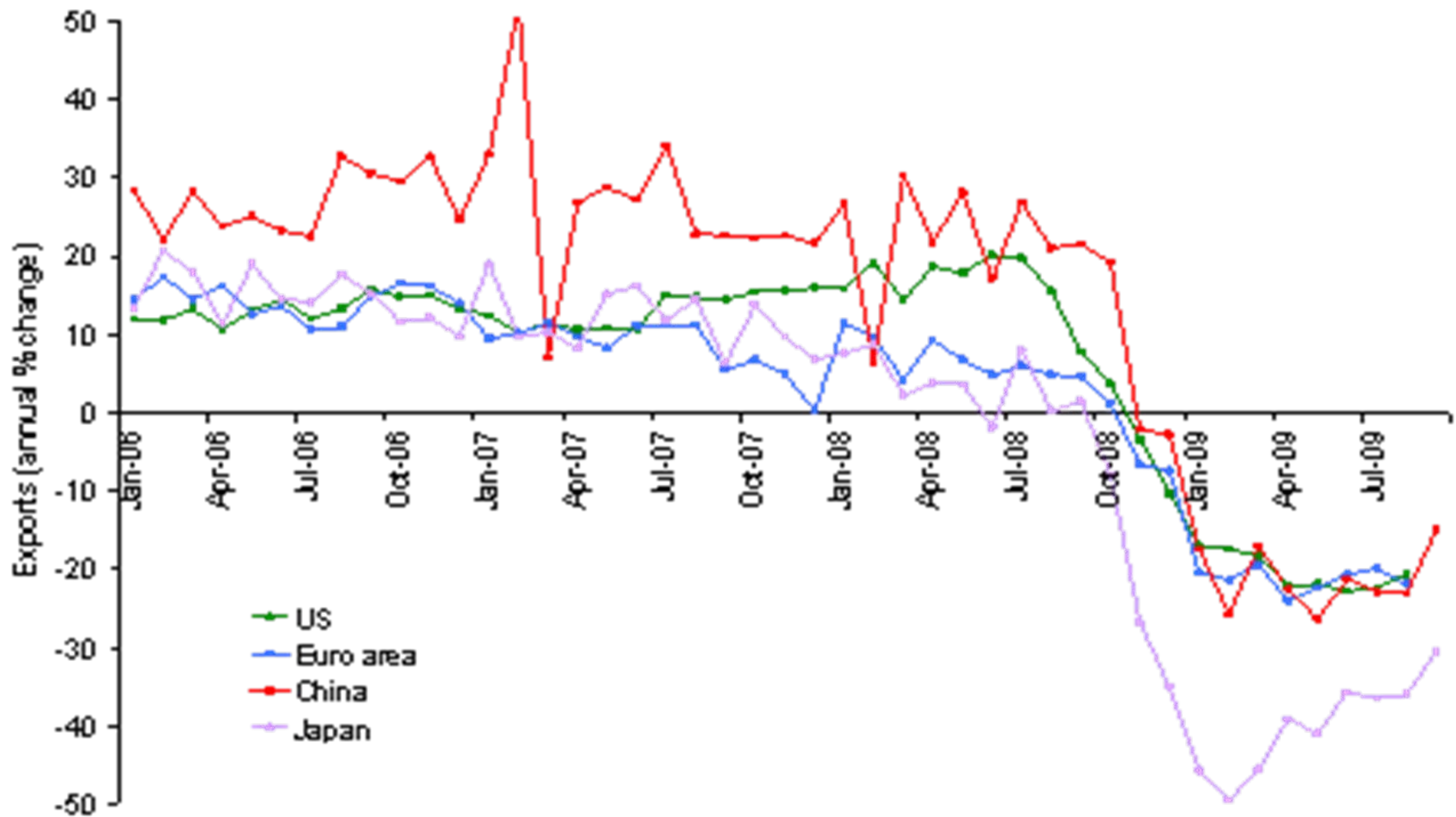
World trade loss worth $3-4 trillion in 2009



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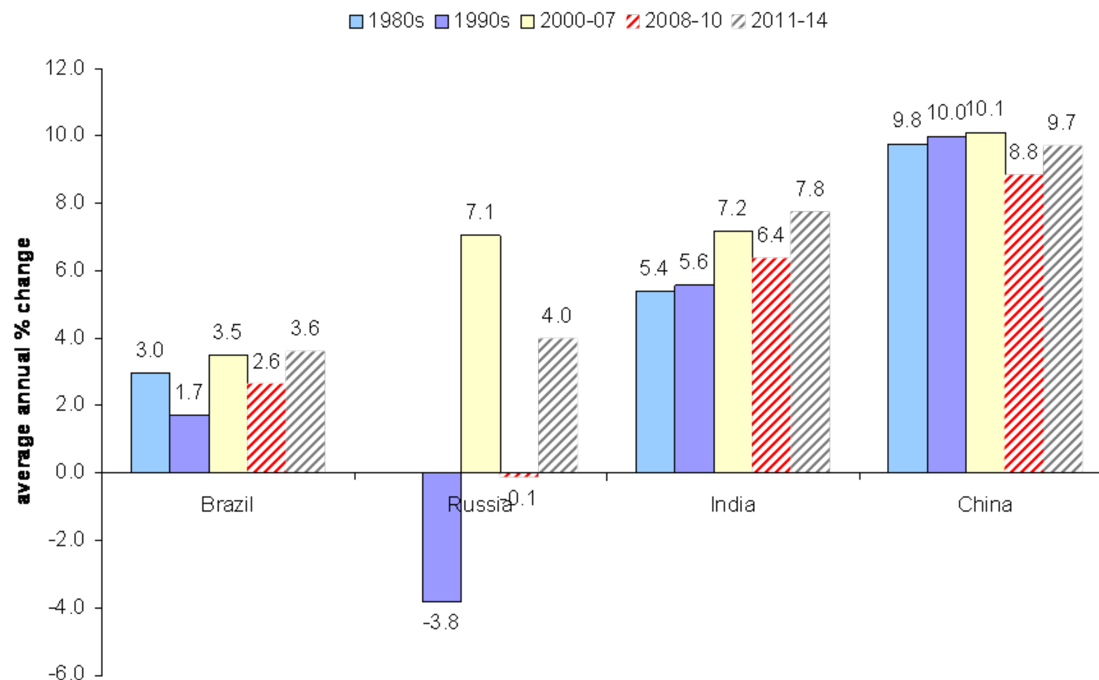
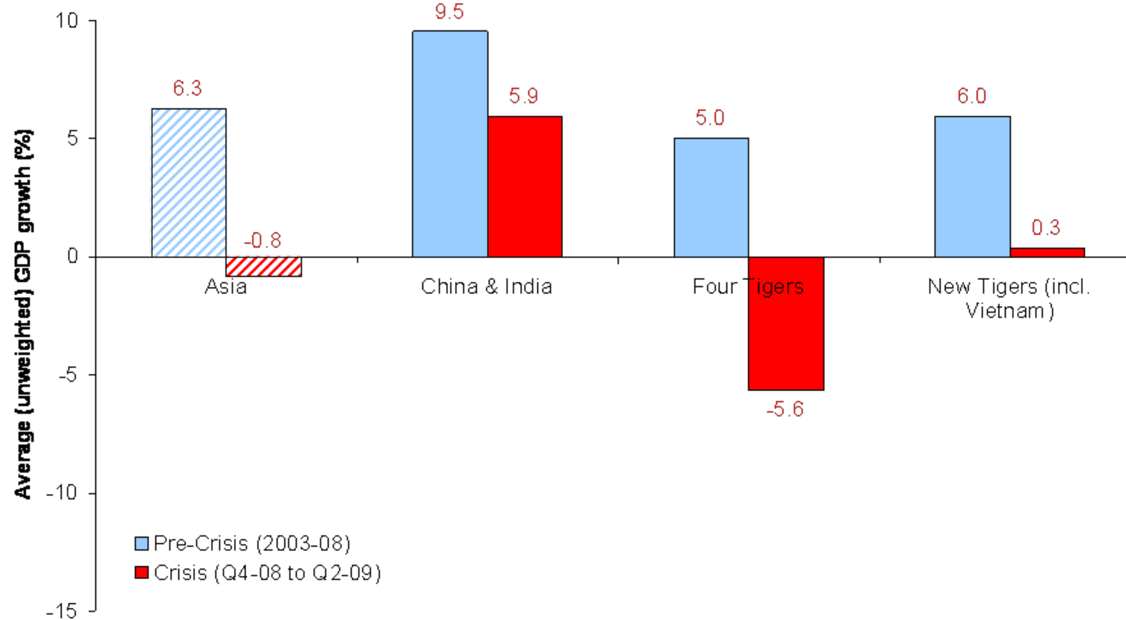
Average growth rates in BRICs



- Emergers' growth largely on the back of China
- Brazil growth steady (above 80s and 90s rates) but not spectacular
- Russia hardest hit country among BRICs

Source: IMF

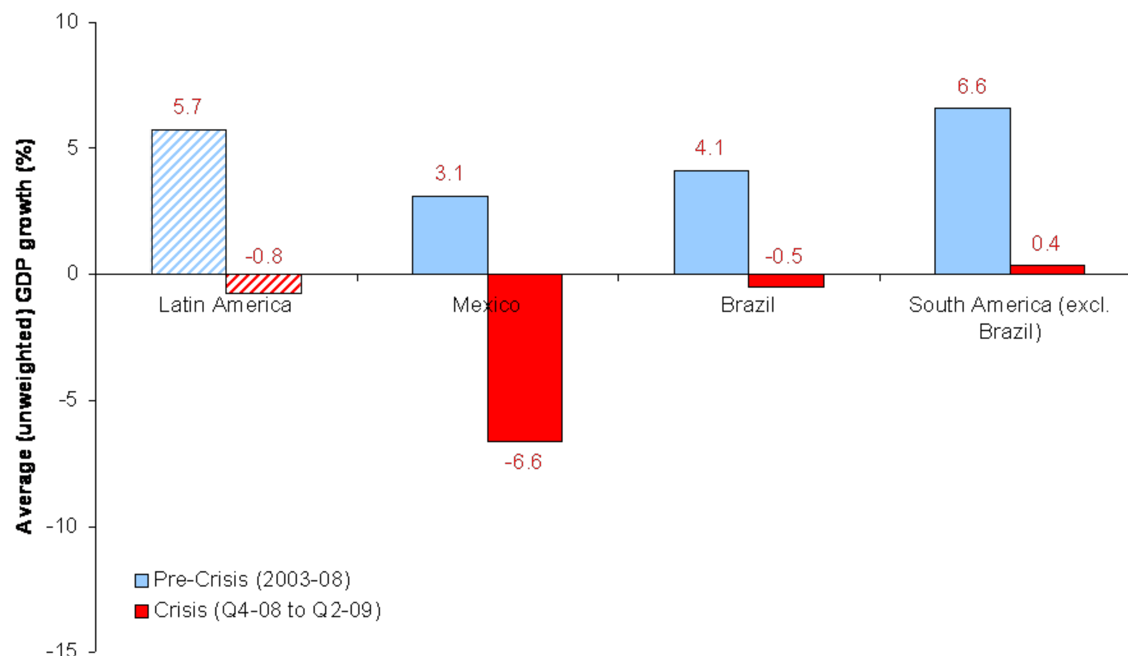
Asia crisis vs. pre-crisis



- China and India have maintained strong growth
- "Old" Tigers hit hard by slump in cyclical manufactures trade
- New Tigers doing relatively well particularly Indonesia and Vietnam (both over 4% growth on average during last 3 quarters)

Source:

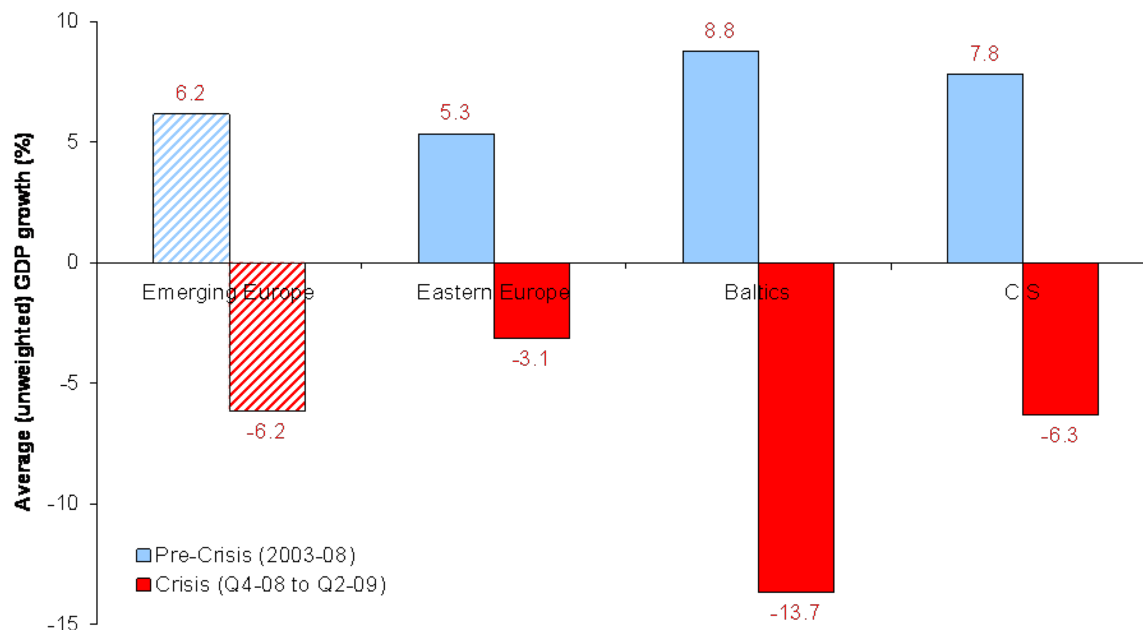
Latin America crisis vs. pre-crisis



- Relatively good performance apart from Mexico, divergence in performance during crisis roughly 4% (-2% to 2%)

Source:

Emerging Europe crisis vs. pre-crisis



- Worst performing region in the world: only Poland growing (1.5)
- Baltics suffering from double-digit contraction
- CIS: Ukraine collapsed, Russia doing poorly, Belarus only mild recession

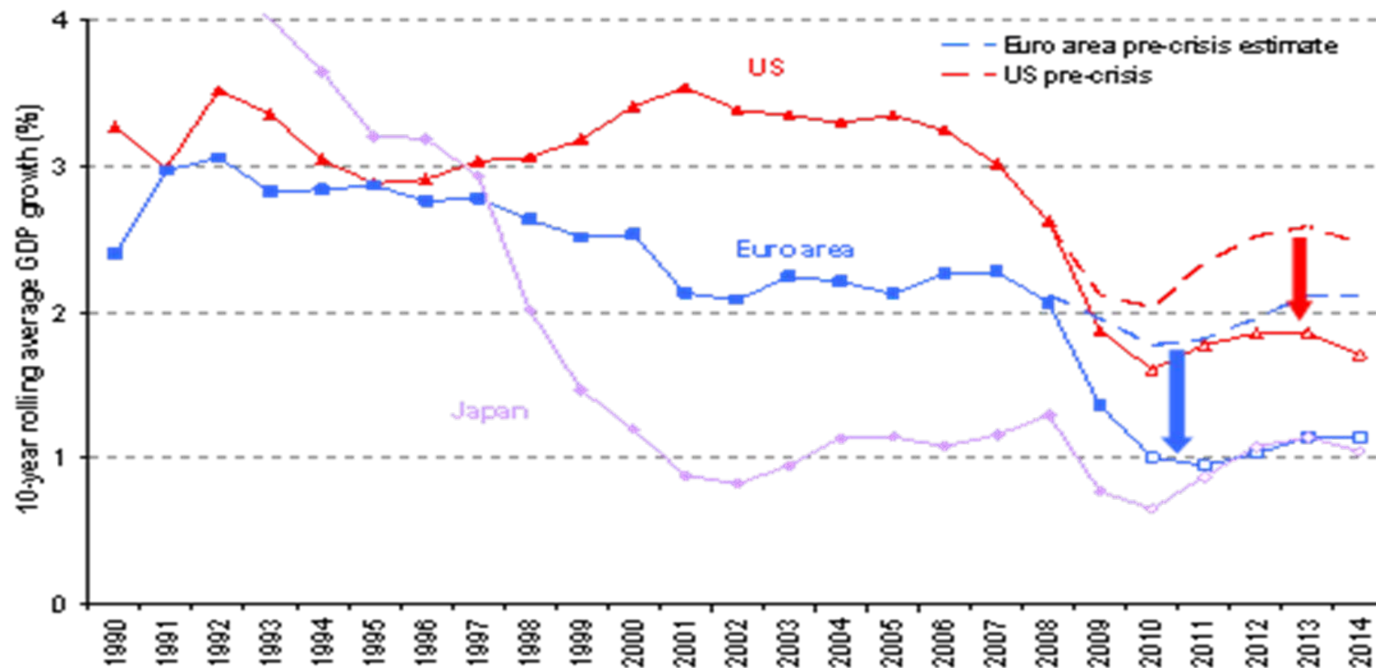
Source:

Performance since Q3-2008

- Latin America low impact despite commodity downturn
- Asia, small open manufacturing exporters (4 Tigers) hit hardest
- Emerging Europe worst affected region in the world: indebted, credit dependent countries (Baltics, Ukraine) now struggling to export their way out of crisis

Source:

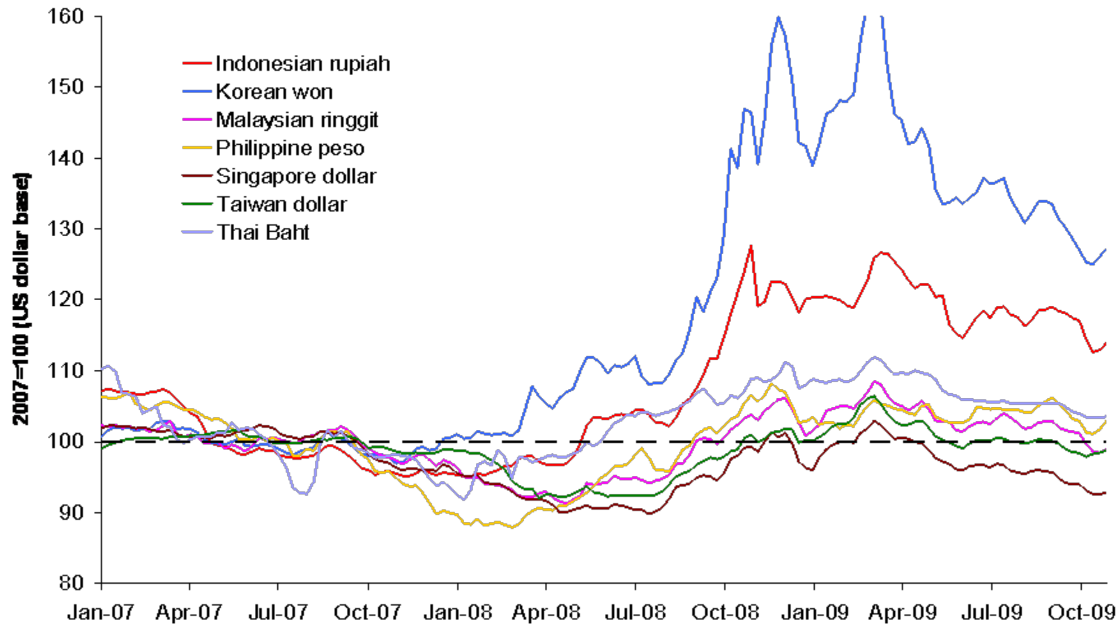
GDP 10-year rolling averages: US, Euro area, Japan



- Rolling averages roughly corresponding with long-run potential output growth: pre-crisis roughly 3% for US, 2% for Europe
- Post-crisis drop to around 1% in Europe, Japanese level, and 2% for US

Source: IMF

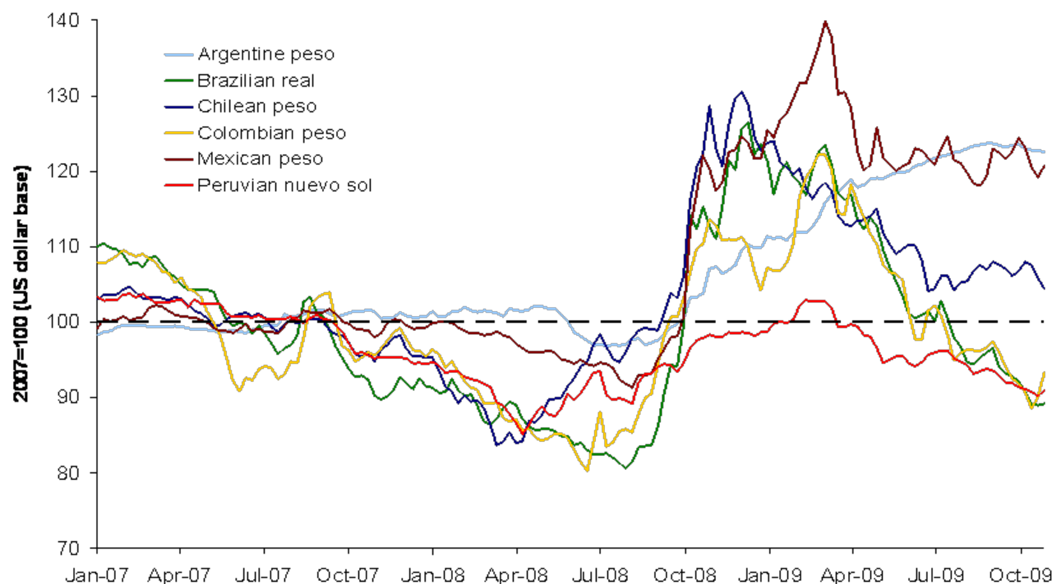
Asian currencies held firm - exceptions Korea, Indonesia



- Strong fundamentals including low levels of debt and high FX reserves damp Asian currency shock although most floating currencies devalued during crisis
- Currency swap lines with major trade partners US and China
- Rebuilding of FX reserves now damping excessive appreciation as crisis eases

Source:

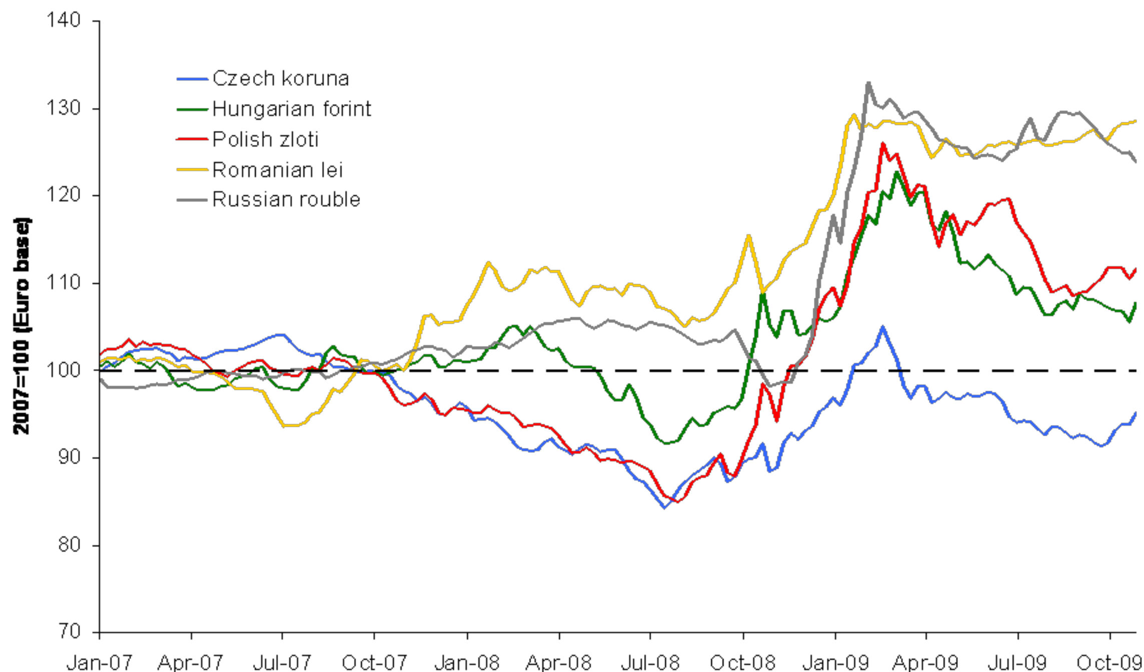
Latin American currencies – mixed outcome



- **Most countries operate floating rates and devalued during peak of crisis – some burning of FX reserves (most significant in Venezuela which has a fixed dollar peg)**
- **Currency swap lines with the US signed by Mexico and Brazil ($30 bn), similar deal with China for Argentina ($10 bn)**
- **Major carry trade currency, the Brazilian real, appreciating substantially from capital inflows**

Source:

Emerging Europe currencies



- **Many countries operate some form of Euro peg (Baltics, Bulgaria, Russia 50/50 peg with USD/Euro). Those unable to devalue had least flexibility in face of shock and therefore saw greatest loss in output**
- **Region has received 80% of IMF bailouts, much of which has been in direct support for currencies or to aid transitions to more flexible regimes (Belarus, Ukraine).**
- **Russia did devalue but initially used a sizeable part of its FX reserves as a buffer against the shock: as much as one-third of its pre-crisis stock (largest in the world after China and Japan) was used up**

Source:

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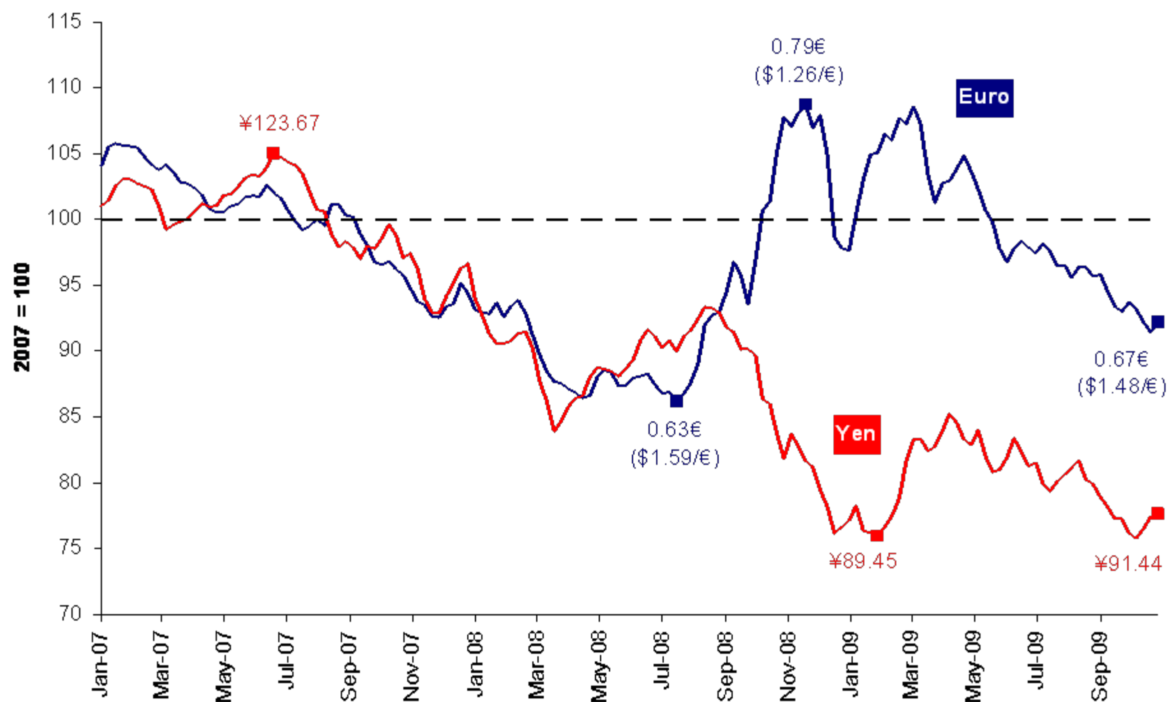
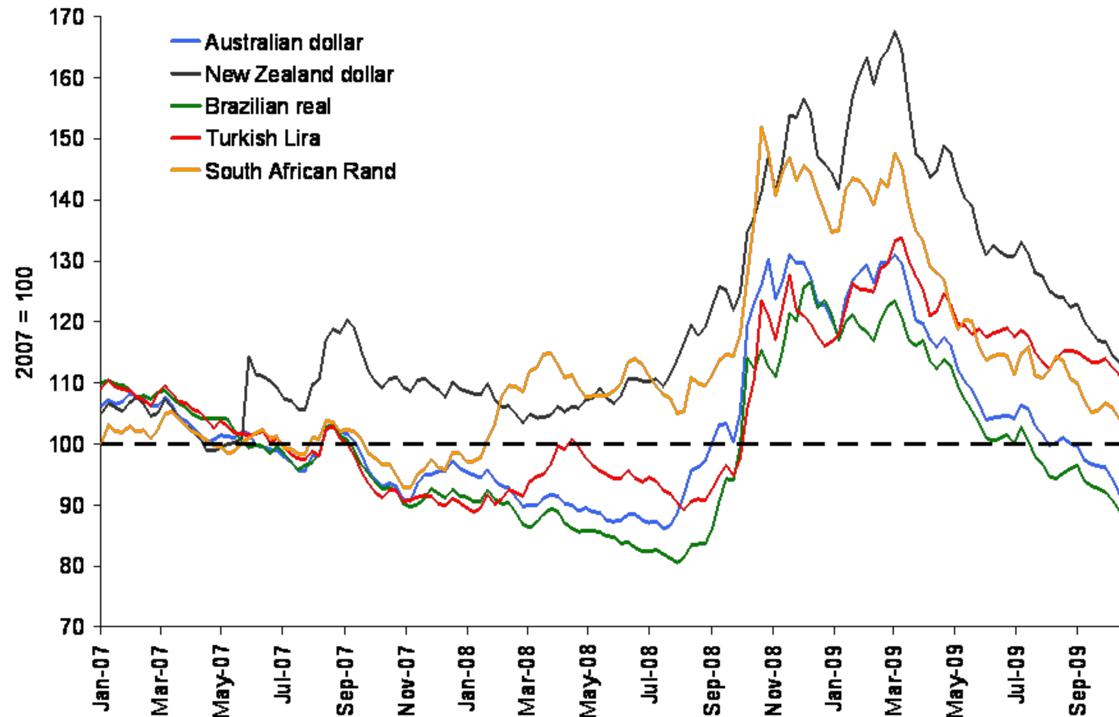
US dollar swings in and out of favour



- **Flight to US dollar in crisis pushed euro weaker as well as other units – Yen was an exception as Japanese carry trade was unwinding and capital stayed at home**
- **US now major source of carry trade, puts downwards pressure on dollar and boosts capital inflows to favoured currencies - also keeps euro strong**

Source:

Traditional carry trade currencies



- With carry trade now operating out of US, most traditional carry trade currencies are showing upwards momentum
- Countries may adopt measures to prevent excessive appreciation. Ex: Brazil has put 2% tax on capital flows

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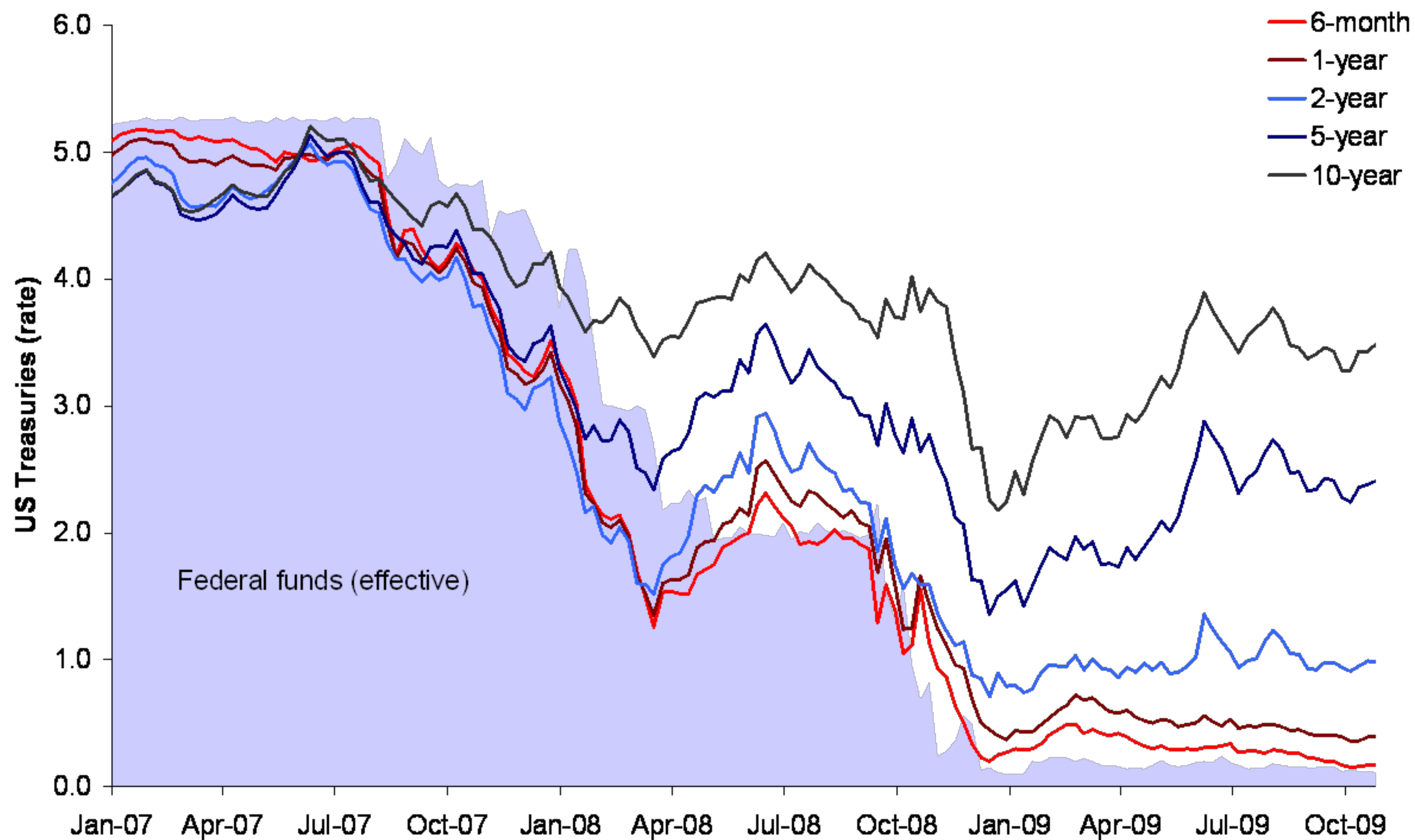
US yield curve – official rates will rise

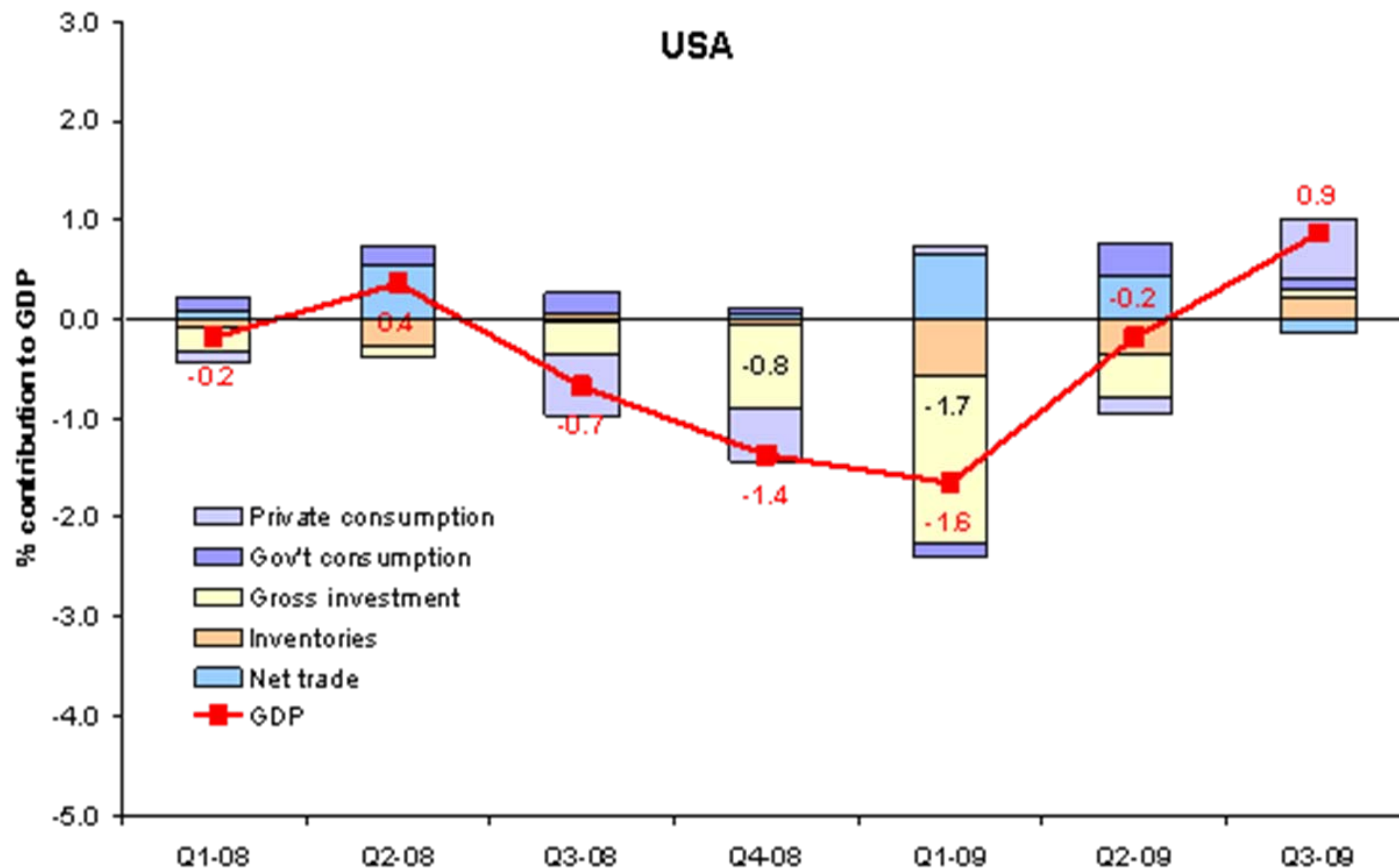


Source: US Federal Reserve

Could dollar revive during 2010?

- Euro strength is hurting the recovery in Europe while a weak dollar improves prospects for US trade and investment
- Corporate America enjoys rising productivity and liquidity – so stalled investment could restart, bring new jobs
- Signs of an economic rebound could reverse dollar against euro by mid-2010
- Such a swing could boost the pack of emerging markets currencies as well

US also exits – more convincingly – in Q3



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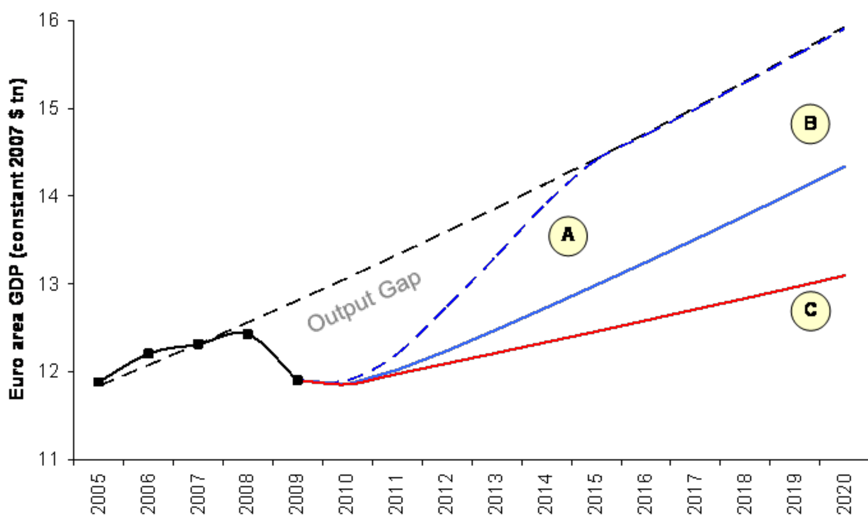
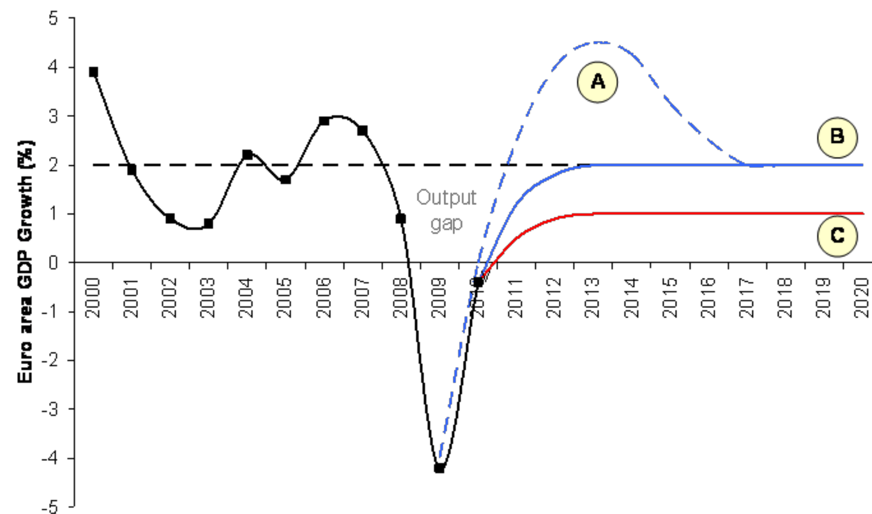
3 Scenarios for potential output





a) **Crisis losses recovered**
b) **Crisis losses not recovered, potential output growth maintained**
c) **Crisis losses not recovered, potential output growth permanently downgraded**

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Two scenarios

- Dollar recovers against the euro as US economy and interest rates pick up
- Improved global outlook and confidence boosts emerging market currencies even more – China restarts appreciation
- So dollar rises but less than emergers
- Alternative: US recovery is feeble with increasing loss of faith in the dollar – so euro continues strong by default, stalls EU recovery and global economy suffers