CHATHAM HOUSE

Exchange Rate Regimes and Structural Realignment of Global Economies

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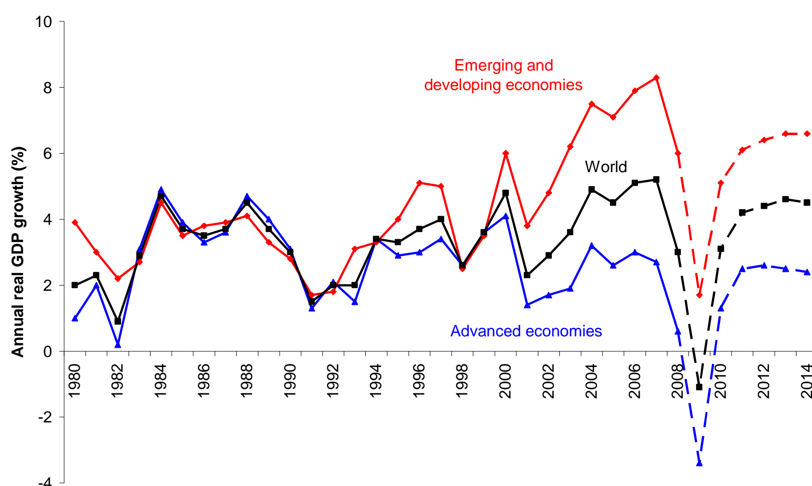
Exchange rate regimes and structural realignment of global economies

To say that the last year has been highly unusual is obviously an understatement. The world economy is only just emerging from shock at the scale of a crisis that has posed a severe test for both natural resilience and policy making skills. Remarkably, given the fears of prolonged depression that were rampant in early 2009, there are now signs of recovery. The pick up in economic activity is chiefly in the developing world and is especially marked in Asia, helped by China and an emerging upturn in the ICT sector, which is important for many Asian exporters. However, in contrast to rising confidence in emerging market prospects, there remains considerable uncertainty about the scope for both short-term and long-run growth in mature developed economies. These conclusions suggest a continuation of the substantial "growth gap" between the developing and developed world and there are signs that this will have an impact on currency developments as well, affecting not only the relative strength of regional units but also the increasing use of developing countries' currencies in the global system. This paper examines the economic impacts of the global crisis and implications for future prospects before concluding with a discussion of how various regions may view currency trends and potential changes in the alignment of exchange rates.

Variable impacts of the crisis on regional economies

No region of the world escaped unscathed given the scale of the shock to the global economy instigated by the collapse of Lehman last September, primarily due to immediate and savage losses in world confidence, capital flows and trade that dwarfed other trends – non-essential spending was slashed by fearful companies and consumers and this spending is returning much more slowly than it went. However, the impacts have not been uniform, with a large drop in activity being seen in advanced economies, where GDP is now estimated to fall by around 3-3.5% in 2009 (Chart 1), down from growth of 2-3% pre-crisis. In contrast, developing economies showed resilience, with aggregate GDP expected to expand by almost 2% in 2009, still a slump versus the 6-8% growth rates seen pre-crisis.

Chart 1: The developing divergence between old and new world growth rates



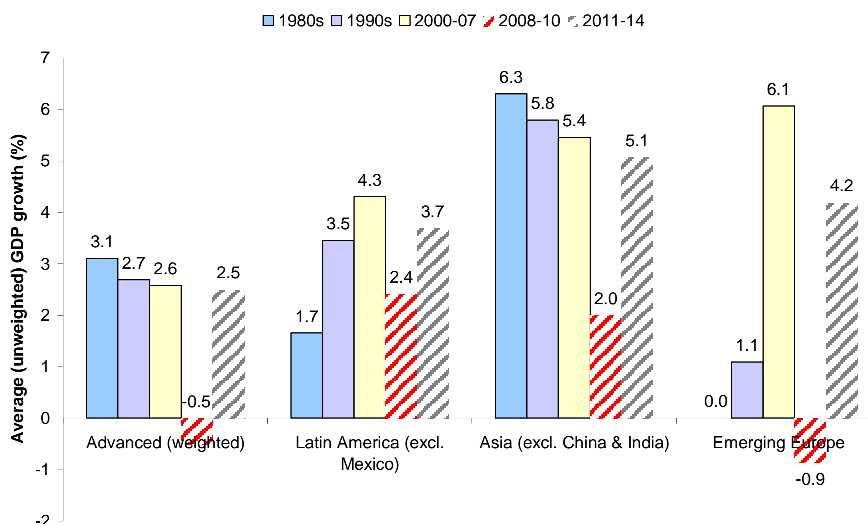
Source: IMF data and forecasts

These figures reflect the varying effects of the crisis as well as initially divergent growth rates. Since the 1990s, emerging economies have been growing significantly faster than advanced economies, with the result that the growth gap has risen to around 4-5%.

However, in spite of the robust performance of the developing world, there were considerable variations across regions with large losses being registered in Emerging Europe, where GDP fell by close to 20% for a number of economies in early 2009. In particular, indebted countries such as the Baltic countries and Ukraine were the worst hit as capital flows and credit dried up along with export markets, creating balance of payments crises. On the other hand, excluding Mexico (affected by its close US ties as well as a one-off impact from swine flu), Latin America suffered surprisingly light losses despite the downturn in commodity markets. Asia was the best performer, maintaining positive growth due to the strong results from China and India, however, excluding these (and Japan), there was a small overall loss in GDP clearly due to the drop in world trade. Asia also had considerable variation in results, from a massive decline of nearly 10% in GDP for Singapore and Taiwan in the first quarter of the year to growth of 5-6% in India and China in the same period (rising in later quarters to 8-9%).

In fact, excluding China and India, because of their dominant effect on Asia, and Mexico due to its specific problems, Asia and Latin America have seen a relatively similar, stable performance through the recession (Chart 2) and Latin America actually shows less variation in results across countries – which contrasts with popular perceptions that Asia was the main bulwark against global recession compared with volatility in other regions.

Chart 2: Real GDP growth by region (unweighted)



Source: IMF data and forecasts

The origin of the financial storm that kicked off the global recession crisis can be traced back to the emergence of the banking and financial crisis in the US - and also Europe - in 2007, itself feeding off escalating property market woes. However, in the early stages, the external impact was muted although ripple effects started to be seen across world equity markets from early 2008. For most emerging markets and developing economies, and some

developed economies that were not at the epicentre of the financial crisis, the recessionary shock only came later once the global downturn was driven by external rather than internal factors. The key transmission mechanism to virtually all of the global economy was trade, which started to weaken in mid-2008 before collapsing dramatically after the Lehman bankruptcy severely impaired the financial system and confidence, instigating immediate panic hoarding of liquidity, a credit crunch and massive cuts in both investment plans and consumer spending on high ticket durables. The savage nature of the late 2008 downturn was as shocking as it was unexpected. Export losses, coupled with vulnerability to the simultaneous collapse in capital flows and credit and to rising risk premia, hit countries in proportion to the relative importance of these factors in each economy. Subsequently, second round effects continued to feed through after the initial shock (e.g. on to raw material and component suppliers and on to jobs).

Emerging Europe was the region hardest hit by the reversal of capital flows given the dependency of many economies on foreign capital and the significant role of West European banks operating subsidiaries in the region. To a lesser extent the involvement of Western banks was also problematic for Latin America, although the share of domestic banks is larger and, among foreign banks, the significant participation of relatively healthy big Spanish banks reduced the adjustment burden. Latin America had also pursued debt reduction, financial restructuring and more prudent policies in the years prior to the 2008, enabling it to be more resilient than in past downturns.

Other notable consequences from the Lehman collapse were the steep falls in equity markets (at peak, a loss of some 50%, around $35 trillion, in global market capitalisation), substantial currency volatility (initially favouring the dollar as a safe-haven but then swinging back again as dollar sentiment deteriorated during the course of 2009) and difficulties in the corporate bond market and debt issuance (although this improved markedly by mid-2009). However, stock market volatility is less relevant for emerging economies as they do not rely heavily on equity as a source of corporate finance and impacts on household wealth are largely confined to small numbers of high net worth individuals. Balance of payments and currency impacts have also been mitigated as many countries had accumulated a buffer stock of foreign exchange reserves in the pre-crisis boom years. Nevertheless, currency swaps were an important means of preventing a global credit crunch impacting on trade. Both stock markets and currencies have since regained much of their lost value. Bond markets were also paralyzed post-Lehman but there has been a partial recovery of issuance in 2009 in spite of most countries having to deal with higher credit risks (the EMBI/CDS spread surged but then eased off). Some countries have exceptionally high risk premia (in Latin America, for example: Ecuador, Venezuela and Argentina) but this is more due to underlying local political factors rather than the global crisis. Overall, it is clear that currency effects and stock market turbulence were not critical in determining the scale of the economic downturn in emerging markets - and they probably played little role in developed countries outside of the US and Europe. Trade was the dominant factor and, for those countries with exposure to external deficits and debt, the loss of capital flows.

Focus on trade as main channel of contagion

The most widespread effects of the crisis have been due to the unprecedented slump in world trade, especially in cyclical manufactures and related services. Signs of weakness were already evident in the decline of the Baltic Dry Index from mid-2008 onwards but it was only after the Lehman collapse that exports around the world really began to tumble sharply,

with sales typically dropping by 20-30% in late 2008. The collapse in demand in the major advanced economies had particularly dramatic impacts on open developing countries. The shortfall in sales together with falling commodity prices resulted in a steep contraction in the value of exports of manufactures, services and commodities. In total, the value of world trade will probably fall by a massive $3-4 trillion in 2009.

Adding to the disruption, there was an abrupt reversal in capital flows and a shortage of trade finance in the early stages of the crisis (and the cost of credit also rose sharply). However, these problems caused less widespread distress compared to export losses and they subsequently eased in part due to the speedy provision of currency swaps and expansion of IMF funding.

The rapid decline in commodity trade – especially shocking after the record prices seen in early 2008 – immediately affected the fiscal balances of commodity exporters, halting investment projects which had been launched when prices were high and damaging investment in commodity industries in general. Indeed widespread and heavy cutbacks in investment expenditure around the world, which have decimated investment goods production and exports, will be a key reason for the recession having a longer run impact on global growth potential even after trade recovers.

Trade surpluses in export-oriented developing countries have generally narrowed and exports have only partially recovered since the initial slump. The slight revival in overall world exports since the low point in early 2009 has been due largely to two factors, the pick up in commodity prices and the Asian recovery, with China the main impetus for this. The ICT sector is also beginning to look stronger and there should be a modest improvement in trade across the board in late 2009.

Table 1: Countries ranked by % of exports of goods and services in GDP

Low (10-20%)	Medium (20-40%)	High (40-60%)	Very High (+60%)
Japan*	Italy, UK	Germany, Sweden	Netherlands, Ireland
Australia	France, Spain	Finland, Denmark	Hungary, Baltic States
Brazil, India	Portugal	Romania	Slovenia, Slovakia
United States	Mexico**	Austria, Poland	Czech Rep, Belgium
	Canada, South Africa	India	Russia
	China	Eurozone average (40-45% of GDP)	Taiwan, Korea
			Hong Kong, Singapore

Source: Own calculations from nominal national accounts (Countries with the most severe GDP losses during the crisis are marked in red, ** Mexico had exceptional economic problems unrelated to the global recession)*

The consequence of the fall in trade has been a corresponding collapse in industrial production in those countries most exposed, particularly those geared towards the production of cyclical manufactures for the US and European markets (e.g. Korea, Taiwan, Mexico). Diversity in trade definitely helped limit the shock, and has been the reason why some emergers have withstood the crisis better than others. For example, Brazil's exports include a high proportion of staples such as food commodities that are less volatile than

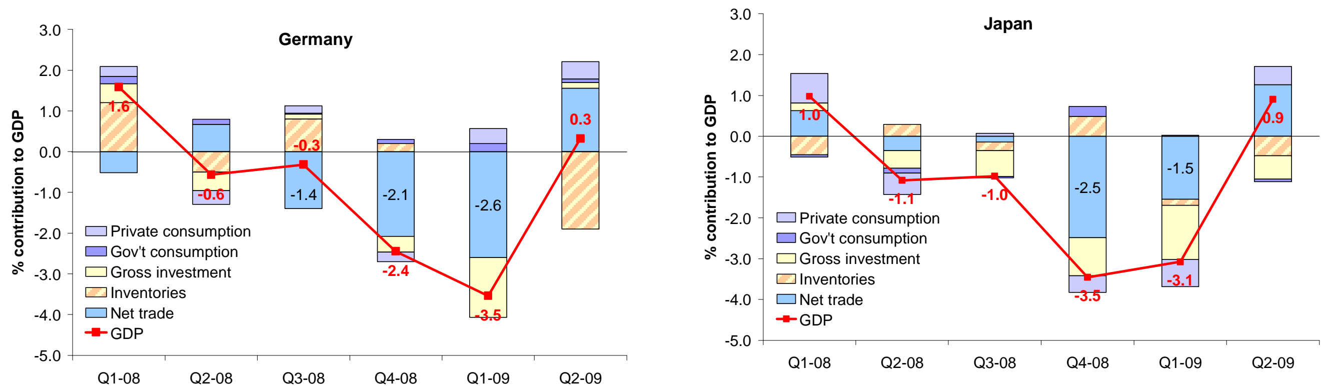
manufactures. In general, it can be seen that countries which were most open to trade, especially in global cyclical goods industries such as machinery and cars but also in related services such as logistics, trade finance and tourism, fared the worst in this recession, especially if they could not rapidly stimulate domestic demand to take up the slack.

Looking back at the final quarter of 2008 – i.e. the period immediately after the collapse of Lehman Brothers – we can summarise the key features, both structural and cyclical, that most determined the scale of the initial impact of the crisis, with trade topping the list:

- *The exposure to trade in goods and services* Global demand cycles have particularly large impacts on trading hubs (e.g. Hong Kong and Singapore) and small, open economies that typically have high export/GDP ratios (e.g. in Asia but also in most of the smaller European countries). However, even large economies can suffer from substantial losses if exports are a high share of GDP, as in Germany (Chart 3) where the global downturn has provoked a steeper recession than in other major economies with significant implications for the government deficit and debt/GDP ratio.

- *Trade in durables and investment goods* These sectors were particularly badly hit by this recession, impacting most severely on those economies that specialise in these goods (primarily Germany and Japan).

Chart 3: Impact of trade on GDP, Germany and Japan



Source: OECD

- *Excessive dependence on capital flows* Although this was not such a widespread problem as the impact of trade losses, countries dependent on capital inflows suffered from balance of payments crises as soon as global finance dried up, forcing them into steep recessions and emergency support programmes (e.g. Eastern Europe).

- *Excessive leverage both at the corporate and household level* High levels of debt encouraged consumers to cut back harder on spending (e.g. in the US) while foreign currency denominated external debt was particularly punitive, with costs ballooning when exchange rates moved adversely and/or the risk premium rose (e.g. the Baltics).

- *Falling asset prices and related wealth losses* In some countries – notably the US – the strong correlation between falling asset prices/related wealth losses and consumer confidence/spending had a strong impact on GDP growth. In the US, wealth losses

from peak to trough were probably greater than annual GDP. However, in other economies, especially developing countries, these impacts were negligible.

Mitigating the crisis

As the crisis has subsided, a year later it is possible to single out some structural factors, as well as policy responses, that contributed to mitigating its impact. It is important to view these as interlinked as policy lessons may be draw from the relative resilience of some economies.

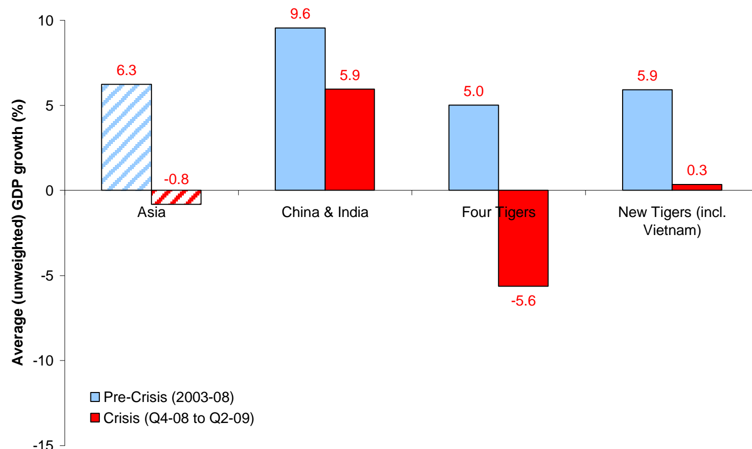
For example, a high weight in an economy of stable, job-retaining sectors such as local service industries, utilities and state-operated industries helped shelter it from the cyclical downturn, curbing the increase in unemployment and thus limiting the impact on households. This was especially the case for France but to some extent the US and UK have also benefited from the stabilising effect of a large domestic service sector. In contrast, automatic stabilisers such as public sector employment, temporary job protection schemes and social security reduced the effect of the crisis on employment and consumer spending in Germany (but at considerable cost to the government), in spite of its vulnerable export industry base and steep loss in GDP. In addition, high levels of household savings coupled with low public or external debt boosted both the feasible scale and impact of expansionary fiscal policy measures in some countries, primarily China. Thus the ability of each country to absorb and mitigate the shock varied substantially and was a function of the combination of structural and policy features.

The scale of fiscal stimulus was clearly important in determining the short-term performance of economies (the long-term results will not be known for some time of course). There were relatively large packages passed in the US and UK compared with smaller scale support in, say, the Euro area. But the potential to combat recession was perhaps most dramatically illustrated by China, which was able to expand both fiscal policy and bank credit sufficiently to pump GDP growth back to nearly 8% in Q2 and 8.9% in Q3 after a dip to 6% in Q1. Asian trade partners have benefited from this boost, with Korea markedly increasing trade with China and even Japan enjoying a small improvement in exports.

India, on the other hand, benefited not so much through fiscal mitigation as from being less open and thus less exposed to the drop in global trade – in spite of burgeoning service exports, these are still a small share of GDP and they have also been relatively resistant to the crisis. The service sector as a whole in fact performed surprisingly well in early 2009. In addition, the sharp drop in inflation eased previous concern over rising prices and overheating, which encouraged easier monetary policy. Indonesia has also been highlighted as relatively robust and, notably, it too is less dependent on the hardest hit sectors of trade.

As illustrated in Chart 4, China and India have maintained strong growth, reassuring other emerging market economies – especially the "old" Tigers that were hit hard through the collapse in cyclical trade – that they could overcome the shock and growth would rebound. While doubts remain about the strength of recovery in the developed world, there is remarkable confidence in the view that the developing world is once more powering ahead at a robust rate and will continue to do so over the coming years. So-called "decoupling" is back in fashion after a short period of uncertainty in the midst of the storm.

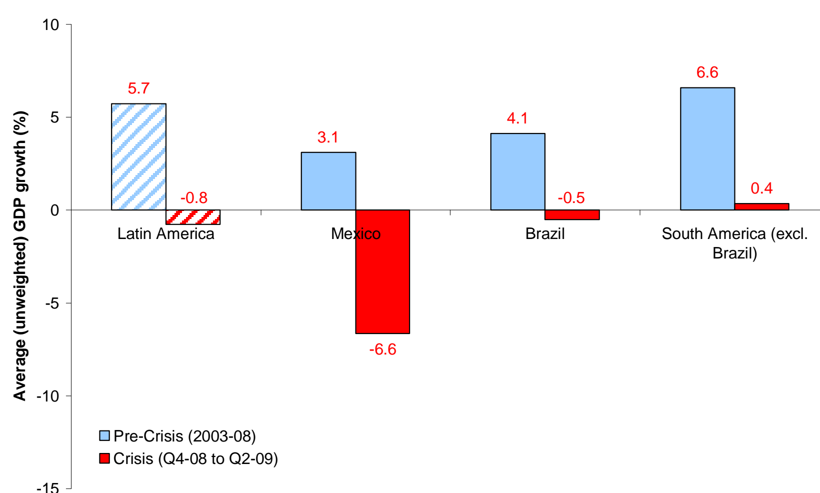
Chart 4: Asia crisis vs. pre-crisis



Source: IMF, EIU, national statistical offices

Latin America also weathered the crisis relatively well, the exception being Mexico due to a concurrent problem with the swine flu outbreak as well as its dependence on the US market. To some extent, the region's resilience is similar to India's and Indonesia's – less dependency on manufacturing trade and offsetting benefits from falling inflation and easier global monetary policy. Improvements in the structure of debt and the build up of foreign exchange reserves buffers also reduced risks and enabled countries to resurface quickly from the initial, and largely unexpected, shock with less recourse to fiscal pump priming..

Chart 5: Latin America crisis vs. pre-crisis



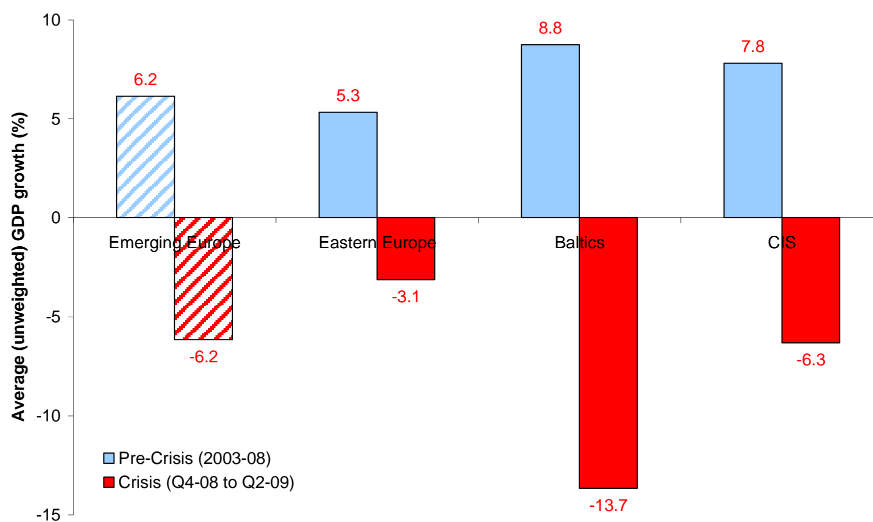
Source: IMF, EIU, national statistical offices

However, a significant exception to the emergers' resilient picture is Emerging Europe, which turned out to be the most vulnerable area of the world due to its high external debt level and dependency on capital inflows and bank lending – which dried up as the crisis hit

last year (Chart 5). Only Poland has continued to grow, with GDP up by a reported 1.5-2% in the first and second quarters of 2009, while the Baltic States – the worst performers in the EU – are suffering from double-digit contractions. The CIS falls somewhere in between but it too presents a quite diverse picture, with the Ukraine's economy collapsing, Russia initially doing poorly but then starting to pick up and Belarus experiencing only a mild recession. Recession is even expected to continue into 2010 in the most badly affected states.

In general, the situation in Eastern Europe has been compared with that facing Latin America in the debt crisis of the 1980s - and many of these economies will struggle to regenerate robust growth against stiff headwinds caused by costly external debt and tough export conditions.

Chart 6: Emerging Europe crisis vs. pre-crisis



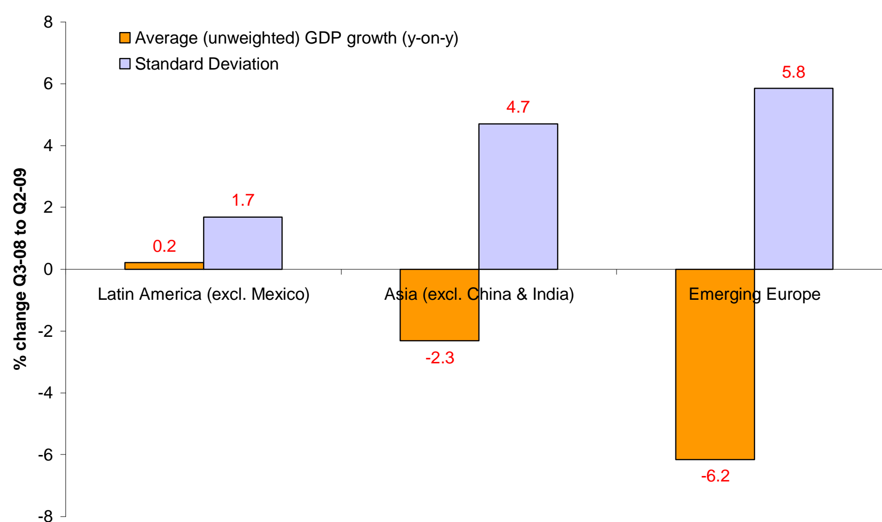
Source: IMF, EIU, national statistical offices

Developing countries dominate future pattern of growth, mature economies floundering?

While there is considerable uncertainty surrounding the outlook for the major economies – as debate continues over alternative shapes for their recovery – there is far greater assurance that the developing world is already staging a fairly rapid and sustainable V shaped rebound, as described above. The consensus view is that most emerging economies will continue to perform strongly for years to come.

Nevertheless, there is a marked divide in fortunes between those which went into this recession with the strength and ability to absorb and mitigate the impact of the crisis and those which were structurally vulnerable and at risk of being further weakened by the crisis. The first group of countries are rapidly returning to growth while those which were caught out are not only suffering steep recessions but probably face a long recuperation period as well. As highlighted above, Emerging Europe is the most impaired region and may need considerable nurturing to get back on its feet.

Chart 7: Performance since Q3-2008 in terms of average growth and variation in growth within each region

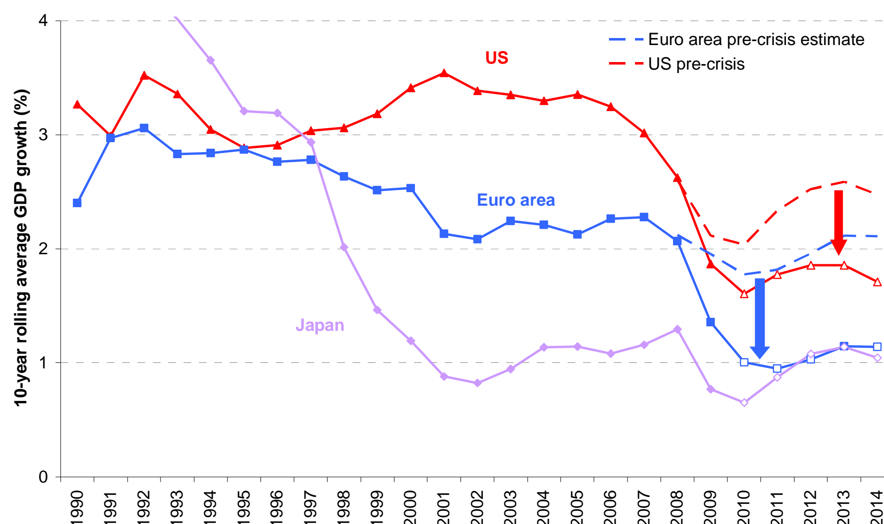


Source: EIU, national statistical offices

Setting aside the particular problems of Emerging Europe, as long as the developing world keeps its finances and external balances in good shape, it is plausible to assume that catch up growth and a competitive cost base can keep its GDP growing at an average rate of 5-6% per annum for at least the next decade and probably longer. Statistically, this implies that world growth could be 2-3% per annum, even if there were to be no growth at all in the OECD economies, because the developing world now accounts for almost 50% of world GDP at PPP rates (the measure typically quoted by the IMF, at market exchange rates it is about a third of world GDP).

In contrast to this rosy picture for the developing world, and also compared to their own historic performance, consensus scenarios for growth in the leading developed economies range from mediocre to poor. Mainstream forecasters do not expect a return to pre-crisis trend growth rates (3%+ for the US and 2%+ for the EU) over the next five years (Chart 8). In Europe output growth is predicted to drop to around 1%, which would set Europe about on a par with the historically weak performance of Japan. Within Europe, there are also important changes underway. Spain, for instance, has seen growth drop substantially and looks set to suffer long-lasting effects from the crisis given its domestic problems such as overbuilding in the property sector and the subsequent collapse in construction and jobs. It is no longer the fastest growing among major European economies although the other economies are also seeing growth projections fall as analysts reassess long-run as well as short-term prospects.

Chart 8: GDP 10-year rolling averages: US, Euro area, Japan



Source: IMF data and forecasts

Overall, OECD growth is widely expected to recover to an average of 1-1.5% in 2010, picking up to around 2% by 2011 and beyond. Although such a pick up looks steep when depicted following the drop in GDP this year (looking more V shaped than it deserves), this actually represents a relatively shallow recovery compared with those which followed previous steep recessions – in the early 1980s, for example, US growth rebounded to around 8% for a while before easing back to a more normal 3-3.5%. Not only is the present recovery expected to be lacklustre but it is also likely to be rocky, with quarterly (annualised) growth rates possibly varying from zero to as much as 5-6% during the next couple of years – and there may even be a temporary dip into negative growth at some point over the coming year, quite probably in early 2010.

There are good reasons for an uneven and hesitant outlook:

- The US consumer is far less certain to be a driver of growth than in the past, certainly until debt levels have been reduced (they are already coming down) and employment prospects improve (unlikely before mid-2010). EU and Japanese consumers have never provided much dynamism even in better times and are therefore unlikely to step up spending now.

- Many businesses will still be operating well below capacity in 2010, damping scope for an investment recovery and raising the risk of further restructuring and plant closures in the hardest hit industries. The long-term impact of cuts in investment will also impose a toll on productivity gains and GDP growth – this is one of the main reasons for analysts to cut estimates of sustainable long-run trend growth.

- Governments will start to come under pressure to cut back emergency stimulus programmes and other spending in order to prevent debt/GDP rising yet higher while central banks will become increasingly eager to raise rates, especially once

economies move out of deflation – which could happen by the end of 2009. Exit strategies are therefore a major threat to a sustained recovery.

Effectively, the forecast scenario for the mature economies (roughly the OECD block) appears to be a choice between

- an IMF style mediocre but steady recovery (actually less V shaped than it looks and is more shallow than previous recoveries from recession), in which the current pick up in consumer demand slowly gains traction, driving gains in trade and also business investment;

- a double dip, in which growth sags in early 2010 because the stimulus effects that are currently boosting demand fade away, to be replaced by the first signs of policy retrenchment. Nevertheless, a dip early in 2010 could be followed by a stronger rebound as the year progresses, especially in the US, which would be reaping the benefits of a weaker dollar, rising productivity and improving business confidence.

Few forecasters envisage a return to past trend growth rates. How much of this change in medium to long-term view is due to the impact of the global recession and its aftermath is unclear – it may partly reflect a reassessment of long-term growth potential that was coincidental with the crisis and perhaps emboldened by the recession experience. It is possible that the US could buck this downgrade but Europe appears relatively resigned to such downward revisions, which will become further entrenched into policy setting. Certainly if the more downbeat predictions prove accurate then the financial crisis will have cast a very long shadow. This will also impact on currency trends, as highlighted below.

Impacts on currencies and exchange rate policies across emerging markets

The crisis ripped through the world economy and devastated trade and financial flows thus, inevitably, impacting on currencies in the process. However, it is important to note that neither currencies nor bond markets were at the root of this crisis although there had been suggestions for some years that global imbalances could lead to a major economic disaster via a collapsing dollar and rising US bond yields. This is important as it already points to some lessons regarding the currency outlook.

In the first stages of the crisis, the rapid sucking back of capital to both the US and Japan immediately strengthened the dollar and yen but weakened the euro and other units, with the exception of pegged currencies. As an inflection point arrived in early 2009, sentiment and markets began to turn around and emergency financing arrangements (from currency swaps to IMF aid) also got underway. At least some of the previous flows returned to partly reverse the first-round crisis effects on exchange rates. However, as with other reactions, the impact around the world has not been uniform and future prospects remain divergent. The varied reactions across the major regions of the developing world depend on fundamentals and the steps taken to limit currency risk. While Asia is relatively secure and Latin America has shown considerable resilience, Eastern Europe remains prey to the risk of volatility and further currency depreciation.

Asia

Excluding Korean and Indonesia, the impacts of the crisis on Asian currencies have been more muted than in Latin America or Eastern Europe. And Asian units have firmed up quite quickly. In part this is due to the region including the most important dollar pegs: China and Hong Kong maintained this anchor as they did through the Asian crisis in 1997-98. Otherwise, all of the flexible exchange rates devalued to some extent against the dollar just after the Lehman crisis, even if many countries used foreign exchange reserves in smoothing operations to limit currency volatility.

Although the US dollar is the key anchor currency for the region, the rising importance of the Chinese renminbi (in both regional trade and currency politics) cannot be overlooked. Malaysia, for example, de-pegged its currency from the US dollar immediately after China did the same in 2005. China's central bank (the PBC) has also been active in establishing currency swap lines with regional partners as well as with countries outside Asia (notably Argentina but also some in Eastern Europe).

Asia clearly benefits from strong fundamentals: exposure to swings in capital flows and foreign currency risk were offset by the size of international reserves and, since the Asian crisis, foreign debt has been limited. Government measures also came into play, such as central bank support to local banks. But ultimately, it was confidence in a swift recovery that made capital inflows return after the crisis had reached its trough during the first quarter of 2009. Figures showing depletion in foreign exchange reserves during the early stages of the crisis also reveal how much these reserves were utilised as a buffer during the early stages of panic, allowing the shock wave in financial markets to pass without more severe disruption to exchange rates. However, over the last six months, reserves have been built up again, helping limit the speed of currency appreciation and completing the cycle of smoothing operations. While the latter operations have come in for criticism, this tends to overlook the previous part of the cycle – in effect, both exchange rates and FX reserves are simply returning to more or less where they were pre-crisis and recent intervention has not represented an aggressive move to weaken Asian currencies.

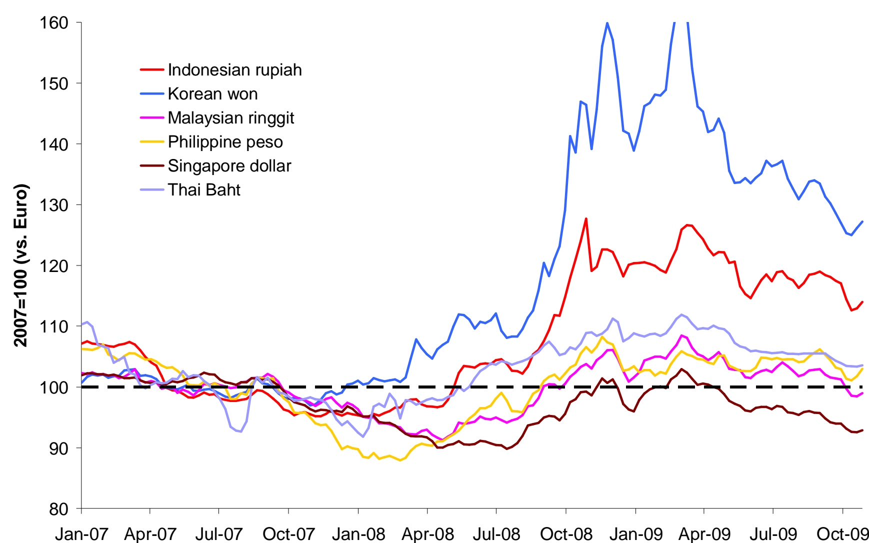
Overall, the realised currency shocks have probably been marginal to the performance of the Asian region since the crisis struck, the main channel of contagion being trade, hit by the collapse in global demand for consumer durables, ICT and investment goods.

Table 2: Asian currencies and reserves

	Regime	Anchor	Peak	Trough	Reserves ($ bn) Loss	Latest
Chinese Reminbi	Crawling peg	US Dollar			**None**	**2,223.9**
Hong Kong Dollar	Currency board	US Dollar			**None**	**223.2**
Indian Rupee	Managed float		**305.4** (May-08)	**239.5** (Nov-08)	**65.9** (21.6%)	**267.3**
Indonesian Rupiah	Managed float		**58.5** (Jul-08)	**48.3** (Nov-08)	**10.2** (17.4%)	**58.1**
Korean Won	Independent float		**264.2** (Mar-08)	**200.4** (Nov-08)	**63.8** (24.1%)	**245.4**
Malaysian Ringgit	Managed float		**125.5** (Jun-08)	**87.3** (Apr-09)	**38.2** (30.4%)	**94.8**
Philippine Peso	Independent float				**None**	**36.7**
Singapore Dollar	Managed float		**176.7** (Jun-08)	**163.5** (Feb-09)	**13.2** (7.5%)	**176.3**
Thailand Baht	Managed float				**None**	**129.1**
Vietnam Dong	Fixed peg	US Dollar	**23.9** (Dec-08)	**19.1** (Jul-09)	**4.8** (20.1%)	**19.1**
Total						**3,473.9**

Source: IMF

Chart 9: Asian currencies



Note: Higher figures denote devaluation

Source: Oanda

Latin America

Despite strong trade links to Europe, particularly in the Southern Cone countries, Latin America generally operates within the dollar's sphere of influence. Many countries have historically operated dollar pegs although the majority now have some sort of floating regime, with a couple of exceptions. Argentina famously used a currency board as a response to severe inflation in the late 1980s and early 1990s, managing a fixed exchange rate to the

dollar until the system imploded during the 2001 crisis when the peso was forced to devalue. Since then the peso has been kept within a narrow but "crawling peg" band that has encouraged gradual devaluation. The other country with a fixed rate is Venezuela, also pegged to the dollar since 2005 but with a black market rate significantly weaker than the official rate. And two of the smaller countries, Ecuador and Panama, are entirely dollarized.

The existence of flexible exchange rate regimes undoubtedly served as a safety valve in the face of the massive post-Lehman external shock although some countries (Brazil, Mexico and especially Venezuela) did temporarily tap into foreign exchange reserves to prevent their currencies from sliding precipitously in the midst of the storm. Brazil and Mexico were additionally aided by currency swaps with the US Fed amounting to $30 billion (Argentina is notable for establishing a $10 billion swap with China). Since then, the Mexican peso has largely stabilized at around 20% below its pre-crisis level (boosting competitiveness and the local currency value of worker remittances from the US), while the Brazilian real (like most Asian units) has picked up again and now trades close to its previous highs.

Why did currency movements in Latin America have so little effect on economic performance during the crisis? Certainly the region found itself in a more resilient situation compared with previous periods of volatility. Two of the previous currency shocks - Mexico in 1994 and Argentina in 2001 - had been preceded by exchange rate inflexibility which then caused massive and sudden devaluations when the rate was allowed to float under pressure. In addition, the consequences of devaluation have been less severe as foreign debt levels are more manageable than they were in the 80s and 90s and, just as importantly, the composition of loans is mostly in local currency, meaning that both governments and corporates do not suffer from ballooning debt when the local exchange rate falls. With the added safeguard of substantial international reserves and more stable fiscal balances and public debt, the region has performed well.

In fact, the main concern at present is how to control the Brazilian real's burgeoning strength. On a short-term basis, an uncontrolled surge could damage economic prospects and provoke bubbles in local markets. Clearly the central bank has already eased interest rates to relieve some of the pressure on the high yielding favourite of the global carry trade – but ever lower rates to discourage capital inflows are also not sustainable. In response to this dilemma, a new (2%) tax on short-term capital inflows was recently announced (in November) but it remains to be seen how successful this will be in preventing further appreciation.

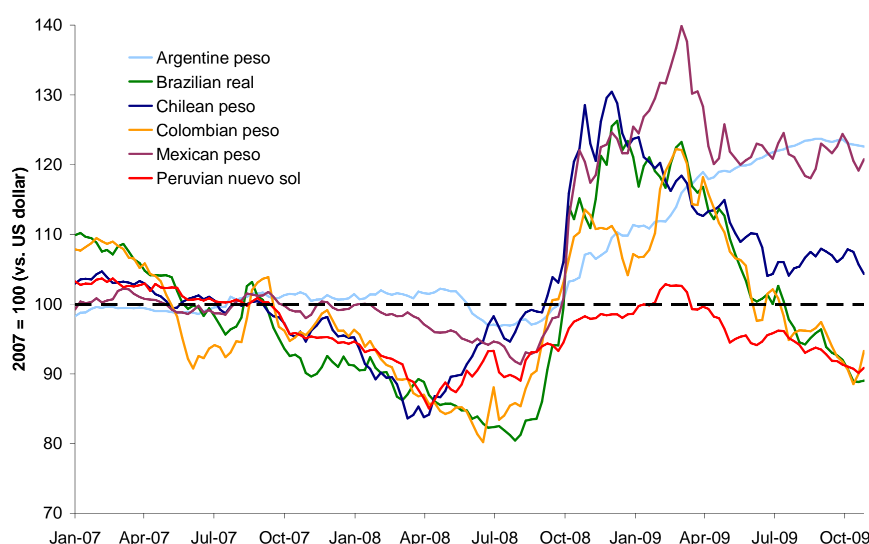
This dilemma a relatively new problem for a Latin American currency but certainly raises concerns about the potential for both short-term and long-run overvaluation should the Brazilian real maintain its attraction for investors - or start to be used as a reserve currency. Brazil is not yet ready for this and would cope better with a more gradual appreciation and move on to the world stage.

Table 3: Latin American currencies and reserves

	Regime	Anchor	Reserves ($ bn) Peak	Trough	Loss	Latest
Argentine Peso	Fixed peg	USD / Monet. target	**48.8** (Mar-08)	**43.5** (Oct-08)	**5.3** (10.9%)	**46.3**
Brazilian Real	Independent float		**205.5** (Sep-08)	**185.8** (Feb-09)	**19.7** (9.6%)	**221.2**
Chilean Peso	Independent float		**24.2** (Sep-08)	**21.8** (Nov-08)	**2.4** (9.9%)	**25.0**
Colombian Peso	Managed float		**23.5** (Sep-08)	**22.7** (Feb-09)	**0.8** (3.4%)	**24.5**
Ecuador (US Dollar)	Dollarized	US Dollar	**5.8** (Sep-08)	**1.8** (May-09)	**4.0** (69.0%)	**3.8**
Mexican Peso	Independent float		**98.7** (Sep-08)	**81.2** (Jun-09)	**17.5** (17.7%)	**87.5**
Panama (US Dollar)	Dollarized	US Dollar	N.A.	N.A.	N.A.	**N.A.**
Peruvian Nuevo sol	Managed float		**34.6** (Jun-08)	**28.4** (Feb-09)	**6.2** (17.9%)	**31.1**
Venezuelan Bolivar	Fixed Peg	US Dollar	**33.1** (Dec-08)	**17.5** (Mar-09)	**15.6** (47.1%)	**22.2**
Total						**457.8**

Source: IMF

Chart 10: Latin American currencies



Note: Higher figures denote devaluation

Source: Oanda

Emerging Europe

In contrast to other emerging market regions, currency impacts were partly at the root of Emerging Europe's difficulties in coping with the crisis, This was partly due to the variety of currency regimes in place and the significant implications of exchange rate swings for large external debt positions. Broadly, the region's currency arrangements can be categorized as:

- new EU member states already in the Eurozone, such as Slovakia and Slovenia;

- the Baltics and Bulgaria, all (so far) pegged to the Euro but not yet euro members;
- other non-Euro EU member states and non-EU states with floating exchange rates, which allowed countries to devalue heavily against the euro during the crisis;
- Russia roughly operates a fixed peg based on a more or less equal weighting on the Euro and the US dollar.

Both flexible and fixed regimes proved vulnerable in one way or another on account of the region's weak or uncertain fundamentals, in some cases exacerbated by recent EU entry and the impact this had on the capital account, credit and debt. In terms of vulnerability, the existence of significant currency mismatches in local debt markets (including household debt and mortgages) made the consequences of devaluation (or the threat of breaking pegs) extremely harsh. During the boom years, most of these economies had become highly leveraged, with the majority of loans denominated in Euros or Swiss francs due to lower financing costs - banks found it more profitable to borrow cheaply abroad, passing the currency risk to local households and corporates (many of these banks were in fact subsidiaries of Western banks looking for growth opportunities in new markets). Furthermore, EU membership - and expected euro entry – provided a false sense of security, encouraging willingness to assume currency risk.

For Euro members and countries linked to the Euro, while external debt problems may have been attenuated by currency stability, there was no possibility to use exchange rate flexibility as an external shock absorber or as a means of boosting export competitiveness. As a result, when neighbouring non-euro currencies devalued, the euro-linked countries suffered larger contractions in net trade and GDP. Capital outflows were also driven by the risk of pegs being abandoned, creating further pressure on pegged currencies.

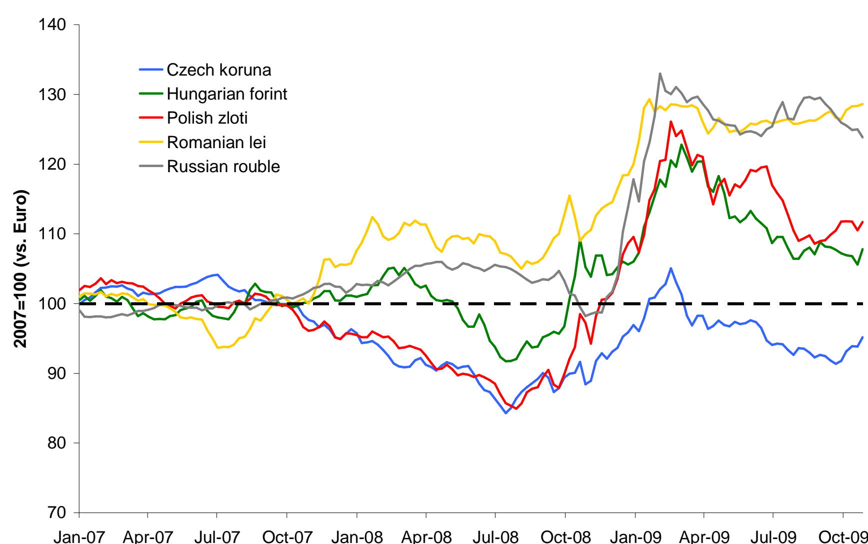
Ultimately Emerging Europe bore the brunt of the crisis, with help coming only in the form of IMF, EBRD and EU rescue packages. Many were provided with some sort of currency support (for two CIS countries, Belarus and the Ukraine, rescue packages also included revaluation to a currency basket in the former and a move towards a floating regime in the latter). In fact, around 80% of the IMF's bailout money has been allocated to Emerging European economies and even the region's best performer, Poland, required assistance in the form of a Flexible Credit Line to bolster confidence, being the second country after Mexico to be granted access to this new credit facility.

In contrast to these problems, Russia was able to make significant use of its large foreign exchange reserves to absorb some of the initial shock hit last autumn. Nevertheless, it had to abandon attempts to fix the rate as reserves dropped quickly – the authorities chose to let the rouble devalue instead. However, as global conditions and oil prices have improved, the rouble and Russian economy have strengthened again and Russia still has considerable financial resources due to savings made in the pre-crisis boom. The accumulation of reserves took Russia's reserves to the third largest in the world after China and Japan, although from a peak of almost $600 billion, reserves dropped to as low as $370 billion in early 2009.

Table 4: Emerging Europe currencies and reserves

	Regime	Anchor	Peak	Trough	Reserves ($ bn) Loss	Latest
Bulgarian Lev	Currency board	Euro	**20.1** (Jul-08)	**14.0** (Feb-09)	**6.1** (30.3%)	**16.9**
Czech Koruna	Independent float		**37.9** (Apr-08)	**33.6** (Oct-08)	**4.3** (11.3%)	**40.6**
Estonian Kroon	Currency board	Euro	**4.2** (Jul-08)	**3.3** (Feb-09)	**0.9** (21.4%)	**3.6**
Hungarian Forint	Indep. Float		**27.3** (Jun-08)	**22.6** (Oct-08)	**4.7** (17.2%)	**44.7**
Latvian Lats	Fixed peg	Euro	**6.3** (Jun-08)	**4.2** (Mar-09)	**2.1** (33.3%)	**6.5**
Lithuanian Litas	Currency board	Euro	**7.2** (Jun-08)	**5.2** (Feb-09)	**2.0** (27.8%)	**6.5**
Polish Zloti	Independent float		**81.9** (Jul-08)	**56.2** (Jan-09)	**25.7** (31.4%)	**74.8**
Romanian Lei	Managed float		**39.4** (Jul-08)	**32.9** (Feb-09)	**6.5** (16.5%)	**43.0**
Russian Rouble	Fixed peg	US Dollar / Euro	**582.7** (Jul-08)	**368.1** (Feb-09)	**214.6** (36.8%)	**394.6**
					Total	**631.2**

Chart 11: Eastern European currencies



Note: Higher figures denote devaluation

Source: Oanda

Currency trends: deciphering the plausible from the implausible?

The impact of the crisis and shifts in the pattern of global growth have had marked effects on currencies over the last year and will continue to influence the outlook. Indeed, there have been sizeable swings in all the major currencies and leading regional units in emerging markets. For example, after the dash back into the dollar in the midst of the crisis, negative sentiment has resurfaced, with the euro simply reflecting this gyration in the dollar. There is renewed talk of the need for further dollar devaluation to address trade imbalances as well as concern that a weak US economy and dollar might prompt a move away from use of the dollar as the world's reserve currency.

However, there have to be counterpart currencies to a falling dollar and this is where arguments for a dollar collapse begin to break down as they require implausible changes in bilateral exchange rates and/or implausible roles for other currencies, at least in the short to medium term.

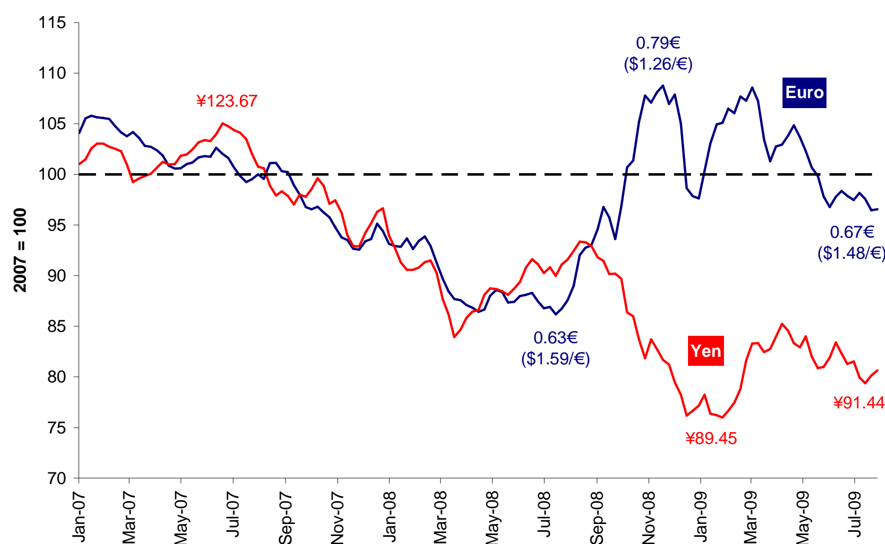
The Yen already strengthened markedly against the US dollar through the crisis and has so far maintained these gains to trade mostly in the range of 80-90 yen/dollar compared to 110-120 pre-crisis. But the Japanese economy probably could not cope with much further strengthening in the yen. Asset prices and investment opportunities are also insufficiently attractive to prevent capital from flowing out, limiting yen strength. It may even provoke instability, rather than a gain for US trade, should the yen appreciate too far.

Similarly, the euro is also looking strained after an even more turbulent year than the yen. The dollar/euro rate has seen a substantial cycle from a peak of around 1.60 in mid-2008 to 1.25 in early 2009 (as the dollar benefited from safe haven status and repatriation of liquidity to support US companies) and is now back to near 1.50. With the economy struggling to recover and exports, the usual driver of Euro area growth, still weak, a strong euro is hardly welcome to European industries already facing a high cost base and low sales revenues.

Dollar weakness has been encouraged by carry trade, which is now operating out of the US rather than its previous epicentre, Japan. At the other end of this carry trade – which feeds off access to very low interest rate funds supplied through the banking system – are the popular high yielding currencies (funds are believed to be leaking into equity and commodity market speculation as well). This is most obviously impacting on Brazil but other countries include Turkey and South Africa, among developing countries, as well as Australia and New Zealand.

Perhaps most indicative of the persistent swing in sentiment regarding the emerging markets and currency prospects, and of the power of carry trade, the Brazilian real is now back to its pre-crisis peak against the dollar after a sharp drop last autumn (along with most other currencies except the yen). However, Brazil is wary of the impact of further appreciation as well as the risks of imprudently cutting interest rates in order to stem capital inflows, as these trends may stoke other economic problems and local bubbles. In response to concern, the authorities have just moved to impose a tax (set at 2%) on short-term capital inflows. Similar concerns can be found in other countries facing currency appreciation and more measures could be forthcoming to curb what is seen as excessive short-term speculative pressure. US, Japanese and European central banks may also face demands to limit access to low rate funds and/or raise official rates in order to curb carry trade.

Chart 12: Euro and Yen against the US Dollar



Source: Oanda

Nevertheless, in spite of short-term concerns and the desire for limits on the speed of change in exchange rates, it is clear that there is growing market interest in the leading emerging market currencies that will persist in the long run. This has rapidly raised the status of these units and implies that some will soon become important players within the global foreign exchange system. While talk of a substantial shift away from the dollar as the world's reserve currency may be premature, the role of the new currencies will develop and reduce the importance of the dollar over time.

The obvious and important exception to the currency volatility seen during the crisis has been the renminbi, which has hardly moved against the dollar in 2008-2009 as China re-imposed the dollar peg in the midst of the crisis – perhaps conscious of the role stability played during the Asian crisis of 1997-98. This followed a steady appreciation since the freeing up of China's currency regime in mid-2005.

Demands for substantial revaluation of the renminbi were less evident at the peak of the crisis (partly because the dollar itself shot up, taking the renminbi with it) but they have resurfaced alongside negative dollar sentiment in recent months. As other key units are now reaching peaks for revaluation against the dollar, attention is returning to the renminbi, boosted by the return of concern over global imbalances. However, revaluations should not be seen as a "cure all" for global trade imbalances, indeed there may be far less impact from currency movements than many seem to think. Competitiveness effects could be quite modest and slow to emerge. In the case of the renminbi, the scale of revaluation that could be contemplated without causing instability in the system (say 20-30% over 1-2 years) would most probably be quite insufficient to make much of a dent on the China-US trade gap (in spite of claims by elasticity optimists such as the IMF). This recalls the persistence of the Japanese surpluses in spite of substantial yen appreciation from the 1980s. And there is a danger that if China were to revalue quickly and substantially it could head into the same resistance as the yen – a higher valued currency might be undermined by capital leaking out

(and this can happen even under China's supposedly closed capital account, as seen in the late 1990s). In fact, this could be a considerable risk for China given its still relatively undeveloped investment instruments and financial market base – which also preclude the renminbi's rapid promotion to an important global currency.

Whatever the post-crisis global imbalances turn out to be - and the emergence from crisis may yet show substantial changes from pre-crisis positions – there seems little scope for further significant dollar depreciation versus currencies such as the yen and euro and increasingly limited potential in the short term against high yielding emerging market currencies like the Brazilian real. China on its own is probably not enough to make a big difference to this picture and substantial revaluation or an early move to achieve reserve currency status could even flop due to lack of follow up support from capital markets.

In spite of talk about a dollar collapse, this analysis implies that dollar stabilization is more likely over the next three to six months. After this, the direction may even shift to dollar recovery if the US economy starts to pull ahead of Europe and Japan by mid-2010, with a robust rebound driven by the emergence of a new wave of business investment in the domestic economy. While the euro and yen might flag, a new wave of change could emerge across global currencies on the back of such a positive break within the mature economies. Units that could track up with a reviving dollar, boosted by increasing confidence in the global economy: this would almost certainly include the renminbi (probably returning to managed appreciation, outperforming the dollar) and also other leading emergers such as the Brazilian real. This scenario, with the dollar acting to push forward a pack of robust emerging market currencies, is plausible – and would help assuage concern about keeping trade imbalances within what might be called "safety margins".

However, the alternative scenario for both the US economy and dollar is further deterioration. If this continues over 2010 and into 2011, putting further pressure on the euro, yen and other currencies, it would severely damage other economies and global prospects of recovery. It could sow the seeds for a speeding up of reforms of the financial system and a reduced the role for the dollar – but only after more painful instability in the world economy.

The choices made by corporate America could play a central role in determining which scenario prevails. The US has come back strongly from the brink before, based on policy support, innovation, investment and confidence in its own future, and it may do so again. In the early 1980s, such a rebound led to such a strong surge in the dollar that it ultimately had to be curbed by the Plaza agreement. There was also a dollar rebound in the optimistic mid to late 1990s after the early 1990s recession and again a small rebound appeared after the dotcom recession. So, in spite of currently negative sentiment regarding the dollar, it should not be written off just yet. As importantly, the arguments presented here suggest that the neither the appreciation of new world currencies nor their status can be changed quickly enough to create a short-term challenge to the dollar.

Appendix

Table 5: Currency swap lines

To	From	Date	$ bn
Indonesia	Japan	Mar 2009	**10.0**
Belarus	China	Mar 2009	**2.9**
Hong Kong	China	Mar 2009	**2.9**
Indonesia	China	Mar 2009	**14.6**
Argentina	China	Mar 2009	**10.2**
Malaysia	China	Feb 2009	**11.7**
Hong Kong	China	Jan 2009	**29.0**
Korea	Japan	Dec 2008	**20.0**
Korea	China	Dec 2008	**28.4**
Brazil	US	Oct 2008	**30.0**
Mexico	US	Oct 2008	**30.0**
Korea	US	Oct 2008	**30.0**
Singapore	US	Oct 2008	**30.0**

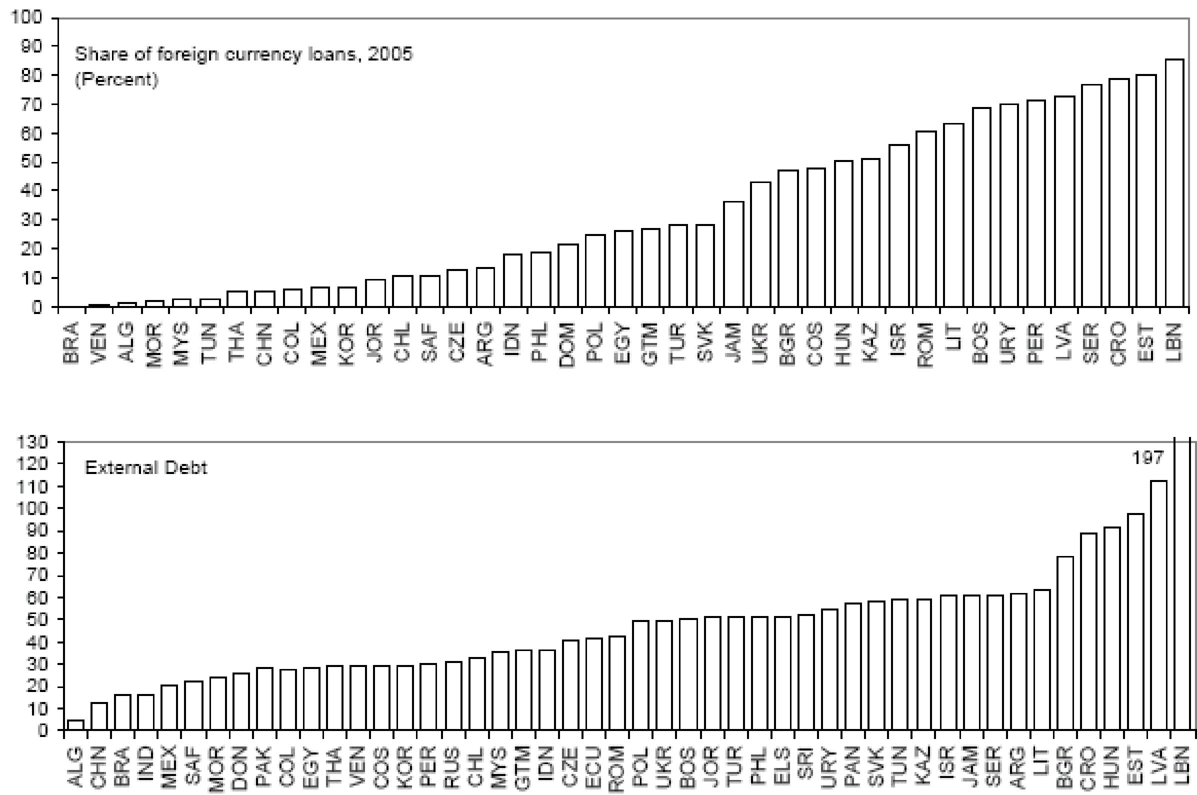
Source: Bloomberg, Reuters

Table 6: Detail of IMF loans and credit lines (over $1 bn)

	Type	Date	$ bn
Sri Lanka	Stand-by Arrangement	Jul 2009	**2.6**
Colombia	Flexible Credit Line	May 2009	**10.5**
Poland	Flexible Credit Line	May 2009	**20.6**
Mexico	Flexible Credit Line	Apr 2009	**47.0**
Romania	Stand-by Arrangement	Mar 2009	**17.1**
Ukraine	Stand-by Arrangement	Mar 2009	**16.4**
Hungary	Stand-by Arrangement	Nov 2008	**15.7**
Pakistan	Stand-by Arrangement	Nov 2008	**7.6**
Belarus	Stand-by Arrangement	Dec 2008	**2.5**
Latvia	Stand-by Arrangement	Dec 2008	**2.4**
Iceland	Stand-by Arrangement	Oct 2008	**2.1**

Source: IMF

Chart 13: External vulnerability



Source: IMF