Exchange rate regimes and structural realignment of global economies

Vanessa Rossi and Paola Subacchi
Chatham House

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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
Why bigger losses in some countries than others?

Source: IMF
France and Germany also show varying impacts of crisis.
Effect of cyclical trade in Germany and Japan
World trade loss worth $3-4 trillion in 2009
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%)
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: CHATHAM HOUSE
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:
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.
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: CHATHAM HOUSE
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
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
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
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