TD Economics

Special Report

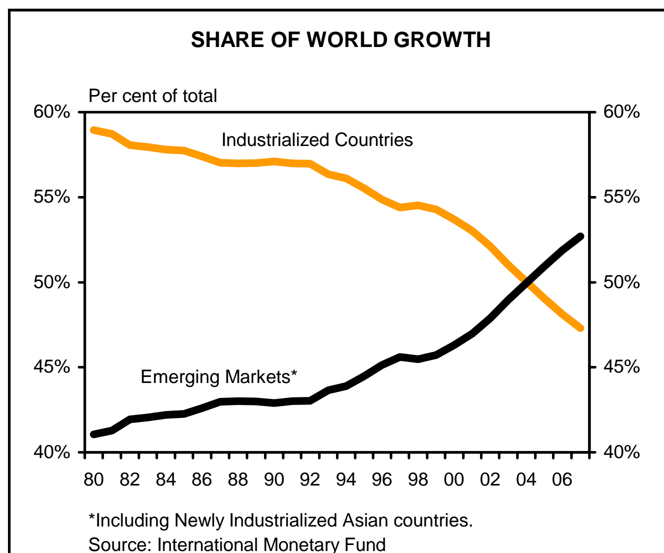
November 8, 2006

TARNISHING THE IMAGE OF THE EMERGING MARKET GILDED AGE

There's no denying that emerging market economies have been on a roll. Since 2002, these fast-growing economies have expanded by 7.1% a year and blown past the 4.1% average annual growth rate they achieved over the last 25 years. This performance is in sharp contrast to G-7 economies, whose average growth rate of 2.6% over the last four years is unchanged from their historical experience. Inflation targeting and credible monetary policy have led to more stable prices in emerging markets. As a result, inflation has averaged just 5.6% in emerging markets over the last four years, compared with the 28% average annual inflation rate seen in the decade prior. Since 2000, emerging markets have bulked up their foreign reserve holdings by 3.5% of their collective GDP each year, a rate expected to almost double in 2006 and 2007. This has helped to lower exchange rate volatility, reduced fears of a financial crisis, and raised credit ratings which in turn have lowered borrowing costs. Also breaking with past bad habits, authorities have used the present windfall to pay down existing debts, ensuring a more sound footing.

HIGHLIGHTS

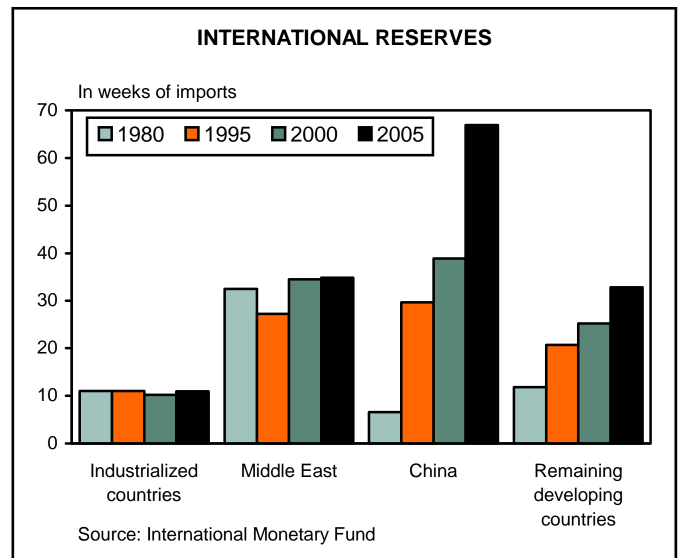
- **Improved policies have provided greater economic stability in many emerging markets, yet vulnerabilities remain, largely related to the fixed exchange regimes.**
- **In the past, these regimes cracked under the pressure of growing current account deficits.**
- **Now, current account surpluses are leading to well-documented build-ups in international reserves, but less-well-documented increases in lending, inflation, and asset appreciation.**
- **Ultimately, emerging markets' self-interests are best served by allowing their exchange rates to strengthen in order to reduce these domestic economic risks.**



*Including Newly Industrialized Asian countries.
Source: International Monetary Fund

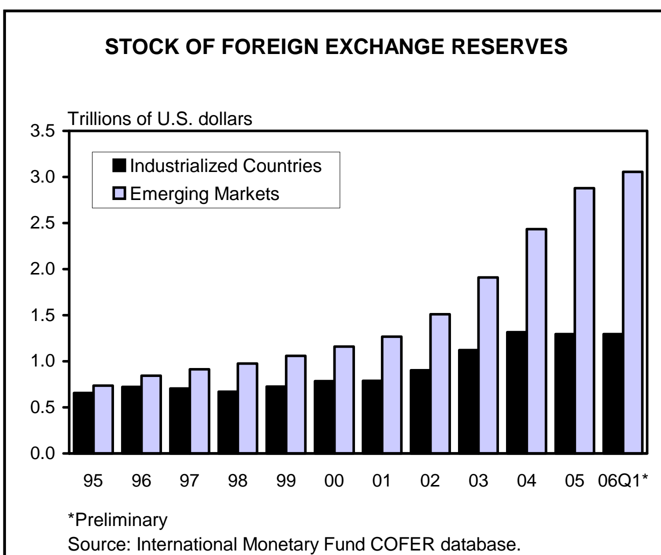
These recent developments have unequivocally lessened the chance of the financial crises we saw in the late nineties. But those that suggest instability is a thing of the past may be getting ahead of themselves. Some nations such as Hungary have failed to make much progress in improving their fiscal and debt situations. More importantly, risks evolve and the seeds of every slowdown are sown in the preceding expansion. As a result of strong gains in commodity prices and industrialization in Asia, emerging markets now have an average current account

surplus in excess of 3% of GDP rather than a deficit of nearly 1%. Many of these same countries maintain a fixed exchange rate, which necessitates a rapid accumulation of foreign reserves to keep their exchange rate constant. Rapid accumulation of reserves necessitates rapid lending, inflation, and asset appreciation in these same economies. This heightens the risk of economic overheating and slows the development of the domestic financial system and consumer base. While fixed exchange rates are nothing new for many emerging markets, the transition from current account deficits to surpluses exposes emerging markets to increased domestic vulnerabilities that could be addressed by allowing their exchange rates to strengthen in the future.



Why it's different this time

In the past, there were common themes to emerging market performance. They commonly ran current account deficits, importing more than they exported. At the first sign of trouble, foreign investors were quick to pull the plug on their investments and channel their cash out of the emerging market. Lower demand for domestically-produced goods and investments caused emerging market currencies to lose value. The governments responded by raising interest rates to increase the return on investments and selling foreign reserves (i.e. buying their own currency) to artificially prop up the demand for their money and keep the exchange rate constant. This was generally an untenable situation. Eventually, high interest rates choked off economic growth, the country ran out of reserves, and they had no choice but to let the currency depreciate. The government lost credibility. Worse yet, a weakened exchange rate meant anything denominated in a foreign currency was now more expensive. This included dollar-denominated debts which made up a large share of emerging market debt. So the depreciation increased the risk of national bankruptcies.



The opposite situation exists now, leading some to speculate the good times can just keep on rolling. Globalization has increasingly extended production lines into emerging markets like China. The rapid appreciation of commodity prices has also been a windfall to the numerous emerging markets which depend on these products for their exports. These developments have led to current account surpluses. Emerging markets have found serving as a base of production a much more enduring position than relying on the vagaries of investor sentiment. This will make the economies more resilient through the ups and downs of the business cycle. When nations like Canada run a current account surplus, this relative strength is usually met with a stronger Canadian dollar, which tempers exports and promotes imports. Emerging markets, on the other hand, generally prefer to maintain fixed exchange rates. (See the accompanying box, "The Holy Trinity.") This turns out to be a crucial caveat in understanding why the details have changed, but risks remain.

How an old dog's gained new risks

Current account surpluses are pressuring emerging market exchange rates to strengthen. In order to prevent this, they are accumulating additional foreign reserves and lowering interest rates in order to make their currencies

less attractive and diminish the pressure for currency appreciation. This exposes emerging markets to a new set of risks. First, undervalued exchange rates are fueling growing exports and limiting imports. Like adding fuel to the fire, this increases the need for the government to intervene to keep the exchange rate fixed in the future. Second, the more reserves you accumulate, the less benefit they add. The ability to defend your currency for two or three months is helpful. China's ability to support their exchange rate for over a year assuming all trade flows stopped tomorrow is excessive. Third, accumulating and holding these reserves have real costs.

Mounting inflationary costs

The first cost of such high reserve accumulation is a rapid expansion of lending by domestic banks. Foreign money has flown into the emerging market banking system and increased the pot of money available to be lent to domestic borrowers. In South Korea, bank loans to support residential property investment have grown from one-tenth of total bank lending to one-third in just five years. Banks in other emerging markets accumulating large reserves have had similar experiences. This raises a concern as to how the maturing financial systems in these countries will cope during a cyclical downturn. When credit is extended at such a brisk pace, it is difficult to ensure its quality. This explains why these episodes are commonly followed by an increase in bankruptcies and defaults. It's also why Chinese authorities – where one out of every two new dollars of reserves rests – have been struggling to slow lending growth.

This leads to the second cost which is a broader inflationary trend. Just as investors want to buy stocks that are rising, it is only natural they want to invest in countries

The Holy Trinity

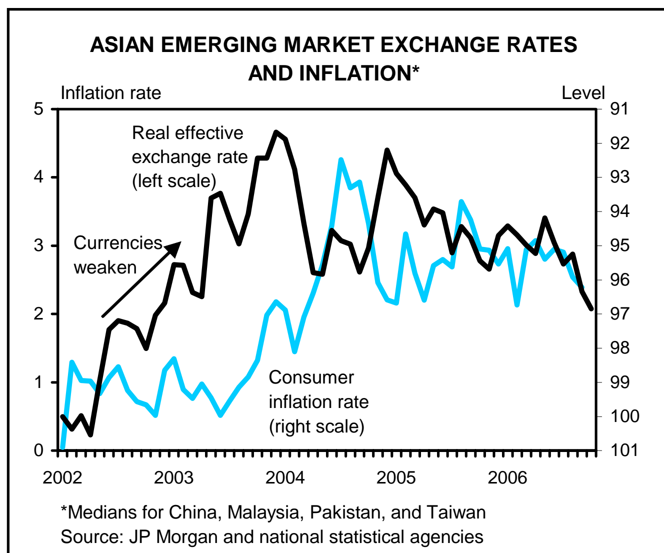
Every country faces what has been dubbed "the trilemma" or "holy trinity." This is derived from the fact that no country can simultaneously enjoy a fixed exchange rate, an independent national monetary policy, and a free flow of financial assets across their borders. Short of a detailed explanation, suffice it to say that the physical act of a nation meeting two of these objectives negates the possibility of achieving the third. Most industrialized countries allow their exchange rates to fluctuate (float) to reflect the flow of cash in and out of their economy. A fixed exchange rate, on the other hand, means the government promises that converting their money to some foreign currency will always be done at exactly the same exchange rate. Their hope is that this stability can overcome their reputation for volatility and promote trade and investment flows. It is also useful for developing countries whose fledgling financial systems do not yet offer tools to hedge the risks resulting from exchange rate fluctuations. Under a fixed regime, as the demand for the nation's currency ebbs and flows, the value of the exchange rate should change, but the government buys and sells foreign currency in order to balance the opposing forces and keep their promise of a stable exchange rate.

A number of emerging markets fix their exchange rate to the U.S. dollar and allow at least some international mobility of financial assets. With two of the three members of the trinity accounted for, these emerging markets have little ability to control their own monetary policy. Rather, it is entirely determined by the Federal Reserve, the monetary authority for the country to which they have fixed their exchange rate. Holding all else constant, the rate of economic growth in an economy with a fixed exchange rate slows by one percentage point when the country they have fixed their exchange rate to raises interest rates by five percentage points. This means the unusually low interest rates which helped the U.S. recover from the 2001 recession also fueled some of the uncommonly strong growth seen in many developing countries. With the Federal Reserve returning U.S. interest rates to a neutral level after increases totaling 4.25 percentage points, much of this stimulus is gone.

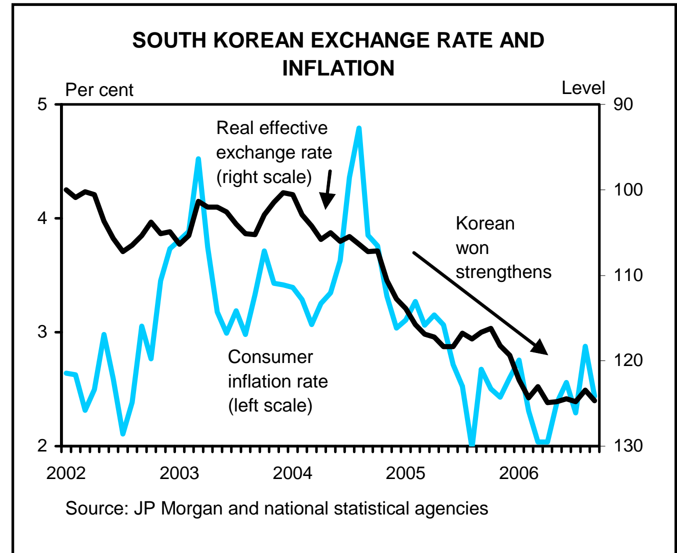
For those developing countries which have independent central banks, interest rate increases have been limited. The same factors driving dampened inflation in Canada and the U.S. such as international production chains, limited pricing power, and little pass-through from high oil prices to core inflation have also been present in developing countries. These conditions have made the job of all central bankers easier over the last several years. As wages in developing countries rise and the substantial overcapacity in such markets as China diminishes, renewed vigilance will be needed to contain inflation. Any umbrella can keep out the rain when the sun's shining. The real test for emerging market central bankers is yet to come.

that are growing. A strengthening currency – or in the case of many emerging markets the pressure on the currency to strengthen – is a sign of cash flowing into the country. In general, more cash equals more inflation. The more reserves a country accumulates, the more they fight this, but the inflationary pressures still mount.

This has been especially pronounced in Asian emerging markets which have accounted for the largest share of global reserve accumulation. Consumer price inflation trended upwards since 2002 in those East Asian countries which accumulated the most reserves, while South Korea saw inflation halve since 2004 when they became one of the few emerging markets to stop intervening and let their currency appreciate that year. The trends can be seen elsewhere in the world, as well. In Latin America, Brazil has seen the most exchange rate appreciation and decelerating inflation. Venezuela, on the other hand, has kept its exchange rate virtually unchanged over the last four years in spite of elevated oil prices. As a result, inflation in Venezuela is running five times higher than in Brazil. To an extent, the competitive global manufacturing environment has limited inflation in the goods market to date. But price increases are broad based, and the faster the pace of reserve accumulation in emerging markets, the faster they have seen equity and home prices also appreciate. This opens the economy up to irrational exuberance and the possibility of asset bubbles when prices are driven more by the amount of money flowing in looking for a home and less by the economic fundamentals underpinning the market.



*Medians for China, Malaysia, Pakistan, and Taiwan
Source: JP Morgan and national statistical agencies



Source: JP Morgan and national statistical agencies

The pitfalls of sterilization

Governments can try to limit this inflation to some extent in a process called sterilization. The central bank issues new bonds to the domestic market, effectively taking cash out of the economy and replacing it with IOU's, in an attempt to mop up as much liquidity as possible. However, the government has to pay interest on these bonds, and in an emerging market, interest rates are generally higher than those in advanced nations. As a result, these costs often exceed the interest income reserve authorities earn on their holdings of foreign currency government bonds (the physical shape that foreign reserves tend to take). When the Bank of Korea became concerned at how fast their currency was rising in 2004, they began once again to intervene in 2005 and 2006. Over this period, these sterilization bonds led to losses in interest costs amounting to approximately 1% a year of total reserves. Over the last couple of years, this interest rate spread has narrowed in favour of emerging markets and lowered these carrying costs. As the spread widens and returns to a more normal level, however, the cost to emerging markets to sterilize money supply growth will rise. These costs will be further inflated as the level of reserves swells.

The costs of interference

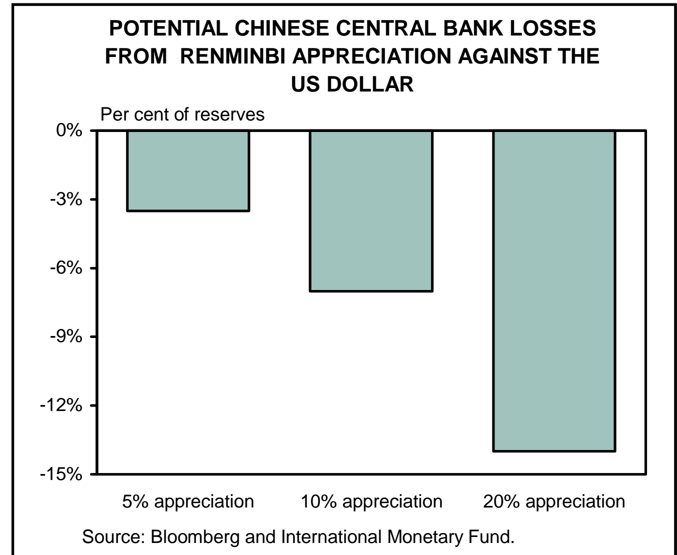
A fourth cost of this is the "overbearing parent syndrome" felt by the budding financial system. Developed financial markets in the U.S. and Canada operate largely without government interference. The government sets laws to ensure individuals' deposits are safe, banks maintain adequate reserves when lending, and stocks and bonds

trade freely and fairly. But, they don't tell banks who to lend to. They don't prevent people from moving their money from one account to another. One reason to maintain a fixed exchange rate is to provide time for the economy to develop a sound financial system. But the present pace of reserve accumulation is driving fierce growth in lending hand over fist. Heavy-handed government dictates such as China has utilized in the past dampen the development of local risk management skills and efficient lending. Moreover, the rapid growth of sterilization bonds has the potential to drown out the domestic bond market, further stunting financial growth. The domestic financial system is not being given the chance to grow up.

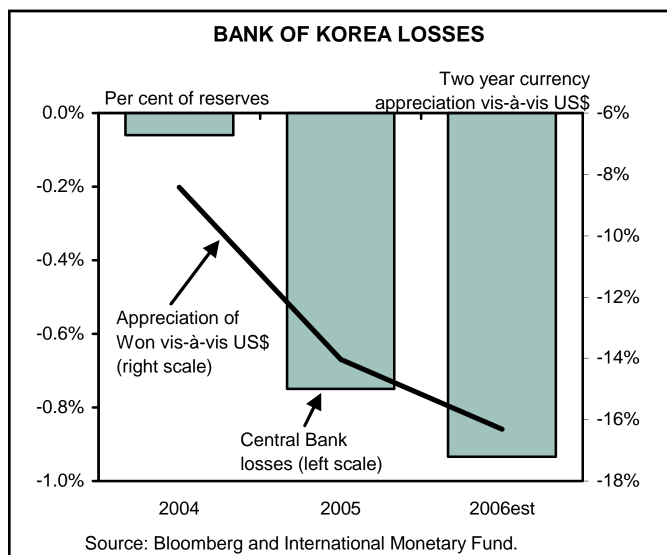
Finally, in spite of increasing inflationary trends, domestic demand and wage growth remain elusive for those nations using reserves to support an undervalued exchange rate. The weak exchange rate directs scarce resources into the export sector and away from domestic consumers. Conversely, the weak exchange rate elevates the price of imports and further dampens consumer spending. In a cost-driven, export-led boom, wage growth becomes a liability for corporate profitability, as there is little reciprocation from higher wages into higher consumer spending. By allowing their currencies to strengthen, emerging markets could lower inflation, improve the allocation of resources, and boost wage growth – all of which would prove mutually reinforcing.

Sooner or later the piper must be paid

The reason governments maintain fixed or quasi-fixed exchange rates, is that the immediate costs of letting the currency strengthen are even larger. Chinese reserves now total over $1 trillion dollars. It is estimated that if they were to let their currency appreciate by 20% – on par with the strengthening seen in the Korean won – they would instantly lose $150 billion U.S. dollars. Central banks are not in the business of making money, though. Given the fact that this will still leave the country with plenty of reserves, the concern is not one of solvency. Rather, the longer this practice continues, the more undervalued these emerging market currencies become. This means these eventual losses grow larger and the needed change to the exchange rate risks being a traumatic shock rather than mild adjustment.



Source: Bloomberg and International Monetary Fund.



Source: Bloomberg and International Monetary Fund.

Moreover, statements by Chinese authorities suggest they are still searching desperately for a way to prevent taking a loss from the falling dollar. There is none. The losses were baked in. The government did not want to dampen growth in the export sector with a stronger currency, so they accumulated reserves to keep the exchange rate fixed. In order to do this, they bought U.S. bonds at the given price, but essentially overpaid since a stronger exchange rate at the time would have allowed them to buy more bonds with less renminbi. This means as soon as their local currency appreciates, they will immediately take a capital loss on this transaction. Emerging market trade surpluses driven by trade flows will be an enduring feature, the pressure to appreciate will not recede, and these losses will have to be taken at some point. These emerging market central banks in effect subsidized exports by keeping the exchange rate low, in exchange for capital losses by the government in the future when they ultimately

let the currency strengthen. But that is not an answer many officials want to hear, making the topic a hot potato in Chinese politics.

Your money's no good here

Reserves are the pillars holding the exchange rate ceiling where it is. Those pillars can be made out of bricks, steel, or even marble if your budget allows, but they can't be used to build the house down the street without your current ceiling caving in. Reserves can be used to purchase any asset in the world priced in that currency. Most of the time these are U.S. government bonds because reserves need to have the ability to be converted into cash quickly. They can't be converted into local currency, however, without immediately being replaced by other U.S. dollars. Otherwise the exchange rate will appreciate.

On this topic, it is commonly mentioned that the Chinese authorities used some of their reserves a few years back to buy all the bad debts from their local banking system and ensure a fresh start for Chinese banking sector balance sheets. This used a very small fraction of these reserves, physically they never even changed hands, and the government guaranteed to provide these banks with additional money in the future to compensate for any lost value as a result of the appreciating currency. In essence, the government took on the exchange rate risk for what amounted to a very small operation relative to the size of their economy and the reserves they had on hand. For this very reason, this exercise is not repeatable on any grand scale in China or elsewhere. Any sizeable appreciation of the local currency would open up the entire domestic economy to severe exchange rate risk, balance sheet mismatches, and the potential for banking sector and government bankruptcies if these contingent obligations prove too large for the government to meet. We have seen no sign of such misuse and see no reason to expect such a systemic problem.

The one-way ticket to appreciation

The only reason not to expect emerging market currencies to rise over time is if you believe multinational corporations will abandon the factories and investments they have made in emerging markets. In this case, exports would dry up, the current account surpluses would go away, and the pressure for emerging market exchange rates to appreciate would disappear. This is highly improbable. Emerging markets have changed their game – and for the better – but there are rules to be followed in every game. It is probably questionable whether increased badgering from industrialized nations will lead emerging markets to change their ways. Ultimately, self-interest is a much stronger motivator.

Those emerging markets which have accumulated large stocks of foreign reserves and reduced their dependence on foreign investment flows have reduced the likelihood of the debt-, confidence-, and liquidity-crises we saw in emerging markets over the last decade. At the same time, their actions are feeding domestic inflation and rapid credit expansion. This poses a risk for the domestic banking sector in these emerging markets. The longer the status quo persists, the more it will be in emerging markets' favour to allow greater currency appreciation to quell domestic pressures. Korea and Brazil were some of the first such nations to allow a sizable appreciation. Singapore and China have since similarly followed suit – although China's exchange rate has appreciated only negligibly on an inflation-adjusted basis. The pace may be questioned but it will continue. The rules demand it.

Richard Kelly, Economist
416-982-2559

The information contained in this report has been prepared for the information of our customers by TD Bank Financial Group. The information has been drawn from sources believed to be reliable, but the accuracy or completeness of the information is not guaranteed, nor in providing it does TD Bank Financial Group assume any responsibility or liability.