CURRENCYMONITOR

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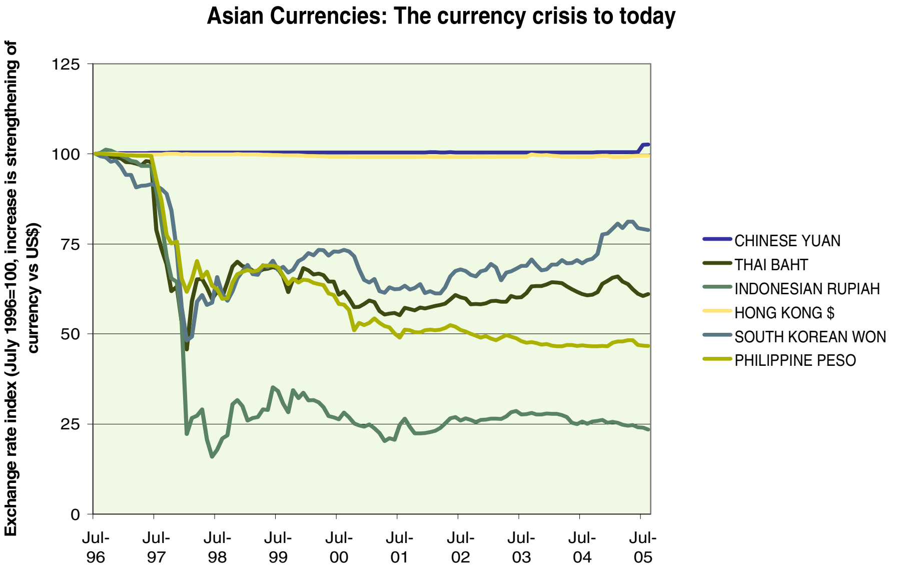
They've Got You Pegged

by Ghene Faulcon

With all of the talk about China and its shift away from a US Dollar based peg, we felt that it was time once again to look at emerging markets and their associated currencies . This month we will focus on how their currency regimes have changed since the last time they got so much press almost a decade ago. Recall that in the mid to late 1990's there was the Asian tiger phenomenon, which became the Asian currency crisis and then Asian contagion. We'd hope that by studying the situation yesterday and today, we might gain insight about tomorrow.

Why were these countries pegging their currencies the first time around?

We'd like to avoid a long treatise on macroeconomics here (for which the IMF and World Bank are far better suited), and instead attempt to summarize the reasons. Briefly, these countries were tied (i.e. "pegged") to the US dollar, which was relatively weak in the early part of the 1990's. This meant that these countries were competitive in world trade, both as their weak currency made their goods cheap to the rest of the world and the apparent stability (via the "peg") guaranteed that they would remain cheap.



Source: Datastream and First Quadrant, L.P.

What caused them to break?

The US dollar strengthened from 84 yen/dollar in April 1995, to 127 yen/dollar just 2 years later – a 50% increase. As the Asian tigers held their pegs to the US dollar, their currencies similarly strengthened and as a result their trade attractiveness deteriorated. The end of the trade boom exposed the hidden problems in their economies, such as the large external deficit (by borrowing in US dollars) used to finance projects that were questionable (at least in hindsight). This was not a tenable situation. Speculators were the "straw that broke the camels back" when they came in to the markets to arbitrage those inefficiencies. The result was the "Asian Flu" of 1997-8.

The important thing to note here is that the initial success for these countries was due to the advantageous trade position resulting from the peg holding the currency cheap and stable relative to their trading partners. The trouble for these countries started when they held their pegs to the US dollar despite the deteriorating trade position resulting from the strengthening of the dollar.

What is the situation now?

If we look at the country that gets the most attention these days, we see that China is in much the same position today as the Asian tigers were in the early 1990's. It has a peg (now no longer directly pegged to the dollar, but not far off), large growth driven by trade resulting from that peg, and "questionable spending" (estimates have China's bad loans at nearly 40% of GDP at the end of 2004[1], but not dollar denominated). However, China is not in *exactly* the same position as the Asian Tigers of the late-1990's.

What are the important differences?

First, the currency is being held artificially low rather than artificially high as was the case in the mid 1990's. In the early 1990's, the Asian Tigers did use their pegs to hold their currencies low, but the dollar appreciation resulted in the appreciation of their own currencies. Holding the currency artificially low means that any break would strengthen the currency, making them richer and yet less attractive for trade. Defending against pressure to strengthen the currency is also less detrimental to the economy in the short run. This would be in the form of lowering interest rates, selling local currency and buying foreign currency. The supply of local currency is not limited in the same way as the supply of foreign reserves (the Central Bank can just print more, for example). This means that an active attack by speculators is less likely to succeed and therefore less likely to occur at all.

This time around, though there may be other issues and forces at play, there is little evidence to suggest that a currency crisis is in the making. A possible banking crisis may be on the horizon, though, especially after December 2006 when the Chinese banks will have to compete with foreign banks[2].

Returns and Expectations

During August, only the US and the UK made changes to their official rates – the US increased rates by 25bp while the UK decreased rates by 25bp. Though other central banks met during the month, none chose to change current monetary policy.

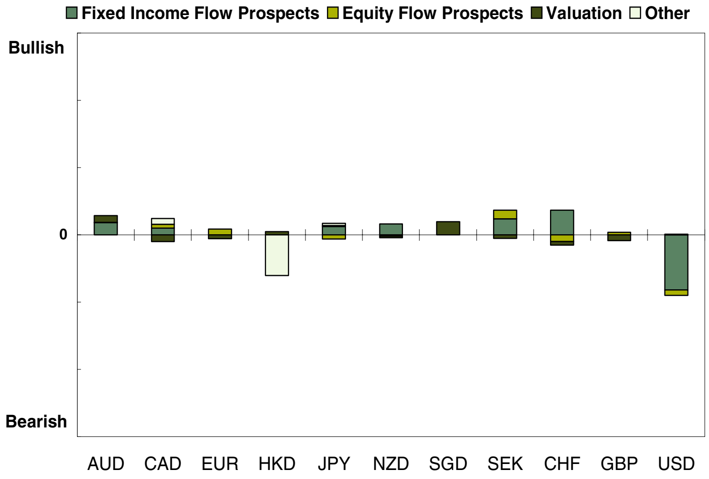
The US Fed increased short term rates again resulting in a 14bp increase in US cash yields. Hong Kong's 23bp increase lead all countries in short rate movement. Canada's 13bp and Singapore's 5bp increases and the UK's 6bp decrease were the only other notable short rate changes. Despite the rising cash yield, US bond yields continued their trend by dropping another 20bp during the month, leading a nearly worldwide decrease in bond yields averaging 9bp. The notable exception to this is Japan, which had a 6bp increase in yields.

Equities were a good investment for Japan (up 6.03%) and Canada (up 2.61%) but were mostly negative, with Singapore (down 3.78%) leading the way followed by Sweden (down 1.48%).

The currency markets were a bit livelier this month than they were last month, with the best performing currency outperforming the worst performing currency by 4.6% and the average currency moving by 1%.

As was the case last month, interest rate changes had the most impact on the model. This resulted in the significant pull back in the US Dollar bull positioning and a more positive positioning for all of the other floating currencies.

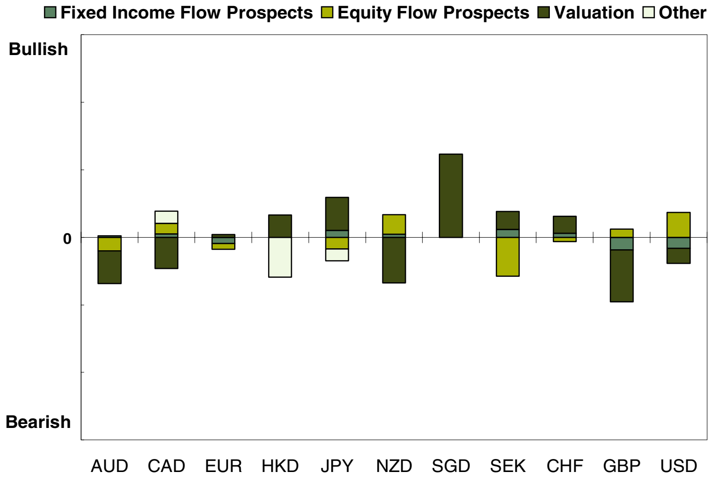
Change in Factor Contributions to Forecast
31-July-2005 to 31-August-2005



Source: First Quadrant,

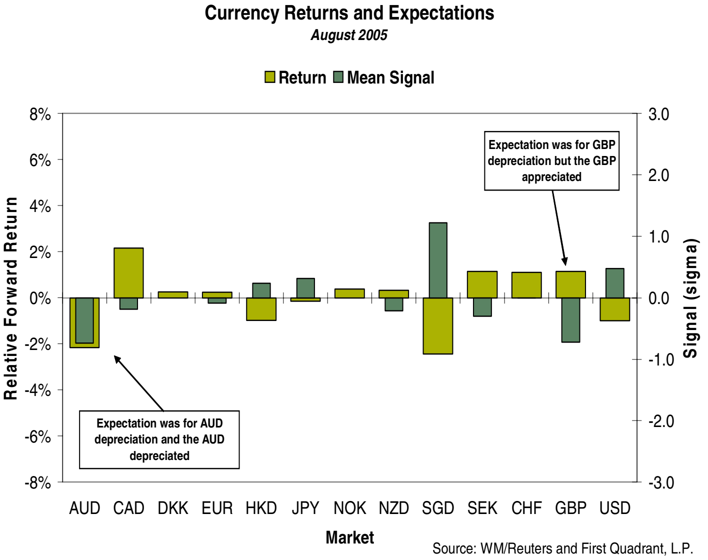
The British Pound continues its reign as the most overvalued currency of our trading basket, followed by the New Zealand, Australian and Canadian Dollars. We have the Japanese Yen as the most undervalued currency with the Swedish Krona and the Swiss Franc close behind. The US, New Zealand and Canada are poised to receive the most equity flow which would likely come from the Swedish, Australian and Japanese equity markets. Prospective bond flows though small, are forecast to land in Japan and Sweden coming from the US and the UK.

Factor Contributions to Forecast
31-August-2005



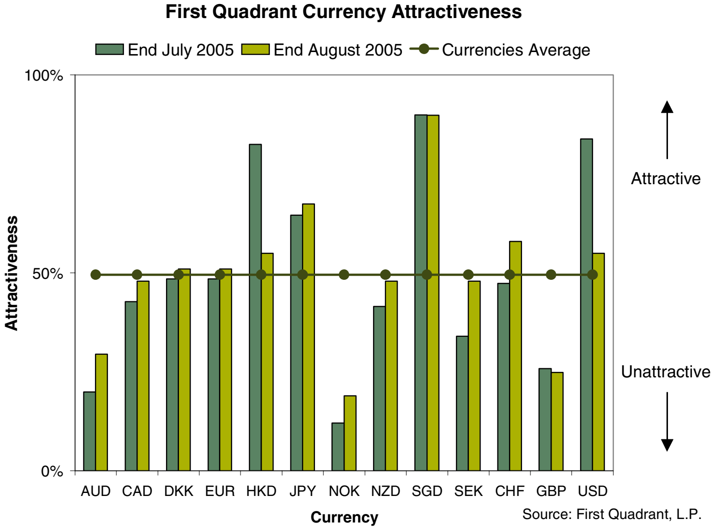
Source: First Quadrant, L.P.

August was a down month overall with two positions (AUD and CAD) working during the month but overwhelmed by the other positions in the portfolio (especially USD, GBP).



Source: WM/Reuters and First Quadrant, L.P.

Relative interest rate movements dominated the changes in the model for the month. The result was a significant pull back from the US Dollar bull position, with most other currencies moving towards neutral from bears or becoming slightly more bullish. We closed out the month with modest British Pound and Australian Dollar bear positions. On the other hand we had a modest Japanese Yen and slight US Dollar and Swiss Franc bull positions with the remainder of the floating currencies neutral.



Source: First Quadrant, L.P.

(Endnotes)

[1] *The Economist, Nov 4 2004. http://www.economist.com/research/backgrounders/displaystory.cfm?story_id=3360451*

[2] *US State Department Website. http://www.state.gov/e/eb/rls/rm/2005/46950.htm*

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