A Managed Exchange Rate Regime in 2009

Patrick McNutt of **Manchester Business School** addressing Alumni associations in Singapore and Hong Kong has called for a managed exchange rate regime to be on the agenda for the Summit scheduled in Washington DC on November 15th. It happened before in the 1980s. He argues that in the absence of such a regime, 2009 will continue to experience ***a signalling cycle*** in exchange rate movements as investors expect lower interest rates in the EU, converging to US and Japanese rates, and thus the Euro and the Sterling will persistently devalue against the $ and Yen for 2009. This will only serve to prolong the downturn in the world economy.

Lower interest rates in Euro-zone and in UK will facilitate a speculative strengthening of the US$ in 2009. Price of Euro and Sterling denominated imports falling in the US will impact positively on US main street consumers, but a slowdown in the US could be averted in 2009 with a managed exchange rate regime across a basket of trading currencies. From where does main street import? Are our exports securing jobs at home? Is inflation fuelled by higher import costs? These will become key issues as investors across the world, in the absence of a managed exchange rate regime, will continue to carry trade, selling one currency to finance investment in higher yield currencies.

Introduction

In uncertain times signalling can be an excellent tool for making sense of conflicting information and data – it will not always give the right answer but rather it can provide the right questions to ask. His arguments refer to the period in late October 2008 and are timely given the fact that the US President-elect and world leaders will be attending the international Summit called by President Bush and scheduled for Washington DC on November 15th 2008. The Summit of the largest twenty economies has been arranged in order to advance a common understanding of the financial crisis and to agree a set of principles for international governance of world financial markets. The timing issue in itself is indicative of the changing nature of the financial news. Nonetheless there are some economic fundamentals that should not be overlooked. To understand these we need to observe the signals and locate the economic fundamentals within the context of a signalling game.

What is a Signalling Cycle?

Signals are conduits of information and as we observe the signals as actions by others, we are often forced to act as well. For example, when you observe people selling shares you also begin to sell. The economic fundamentals are best understood as signals: for example, declining GDP growth, inflation levels, interest rates and exchange rates are signals. They convey information and more importantly they offer one possible insight into economic indicators in 2009, an insight that the government leaders at the Summit might find useful in their discussions.

In uncertain times signalling can be an excellent tool for making sense of conflicting information and data – it will not always give the right answer but rather it can provide the right questions to ask. For example, the current financial crisis and consequent financial bailouts announced across the world is about psychology, it is **reassuring** the markets rather than **assuring**. It represents a necessary reaction to a financial system that had debt hidden in complex debt instruments by magical set of accounting rules.

The fear of recession has been ingrained into many analysts' 2009 forecasts, and key patterns in the signalling are beginning to emerge in late 2008 in terms of negative analysts' commentary on corporate earnings. This reporting on earnings targets represents a more rational understanding of the signalling cycle in 2008 than the irrational 'herd instinct' observed during the past year, and thus less complex to understand. It is less complex because exchange rates can be managed in a coordinated mechanism. The real economy impact on growth and unemployment, however, will be sustained by continued volatility in stock markets, loss of confidence and trust and fluctuations in exchange rates. As fluctuations in exchange rates begin to characterize a 2009 signalling cycle analysts will begin to report on 'below target' corporate earnings in terms of exchange rate exposure.

Exchange Rates

Arguably, by the summer of 2009 as the signalling cycle evolves into analysts' predictions on exchange rate movements there will have to be a managed exchange rate regime on the agenda of world leaders, simultaneously addressing fluctuations in Yuan, Yen, pound, Euro and the US$. Exchange rtes will have to be managed to contain downside surprises in the corporate sector.

The Yen is appreciating at Y95-100 to US$ and this will have a direct effect on Japanese exports. Sony and Canon are signalling lower profit forecasts citing exchange rate concerns. Japan has experienced minimal domestic growth over past number of years so an economy depending on exports for growth will either have to devalue its currency to increase its exports or refocus on other economic determinants of growth. China and Japan are ranked second and fourth respectively by total value of US imports in 2008.

Likewise the Yuan continues to appreciate against the $, but China's growth rate averaging 9% in 2008 cannot simply be explained by reference to exports alone. Consumer expenditure only explains 35% of China's GDP [contrast with 70% in the US] so there could be a focused effort on increasing consumer expenditure. China is already signalling domestic growth by continuing to invest in infrastructural capital projects in 2009 but should expedite tax and price reforms and by reforms to increase consumer expenditure thus avoiding a devaluation of the Yuan to facilitate an export-led growth.

McNutt argues that signalling about the Japanese economy in 2009 will be characterized by the Yen continuing to devalue against the Euro and Sterling thus signalling export-led growth in 2009. The Japanese economy will rely more on exports to Asian economies and secondarily to the US, if in a slowdown, and to Euro-zone and UK, if the Euro and the Sterling persistently devalue against the Yen for 2009

Chinese economy in 2009 will be characterized by the Yuan continuing to appreciate against the US$ facilitating US exporters and signalling consumer-led growth fuelled by relatively cheaper imports from Asian economies. Any downturn in US, UK and Euro-zone in 2009, will encourage a domestic growth stimulus package comparable to China's response during the 1997 Asian crisis.

Conversely, Sterling and the Euro are depreciating against the US$ which will encourage EU export-led growth, but higher import costs fuelling inflation, requiring higher EU interest rates will inevitably frustrate the ECB in reducing interest rates to stimulate EU growth. As investors expect lower interest rates in the EU, converging to US and Japanese rates, the Euro and the Sterling will persistently devalue against the $ and Yen for 2009 helping exporters.

McNutt argues that European signalling in 2009 will be characterized by both the Euro and Sterling continuing to devalue in 2009 against a basket of currencies. The signal that lower interest rates will be required to stimulate economic growth will allow a speculative strengthening of the US $ in 2009. Should foreign capital flows into the UK and US fall in 2009 then imports will have to fall, requiring a devaluation of Sterling, but the buffer for the US $ may be its reserve currency status. Both China and Japan, for example, hold trillion of US$ in reserves. But for how long will the US$ retain its unique reserve currency status?

ASLEEP: Global growth

The 43 nation Asian European meeting [ASEM] which concluded in Beijing on October 25th signals an important shift in economic power to the East. It should be looked at in conjunction with the 25th October meeting of Gulf States in Riyadh; collectively both signal the emergence of a new international economic order for 2009 and beyond.

McNutt had predicted on cnbc.com that ASLEEP (**As**ian, **L**atin American, **E**astern **E**urope and **P**acific Rim) economies will account for 50% of world growth by 2015. He based the forecast on analysing positive (although declining year-on-year) growth numbers for Latin America with 2009 forecast of GDP growth of 5% [5%, 2008], Asia-Pacific 4.5% [5.5%, 2008], Japan 1% [2%, 2008], South Korea and Taiwan 3% [5%, 2008] and China 8% [9%, 2008].

More export-led growth from inter-ASLEEP economy trading in 2009 will increase their foreign reserves and encourage investment in US debt. Savings rich Asia, oil rich SWFs and Asian corporates in particular sit on billions of dollars in cash. ASLEEP economies differ - some have a robust industrial base, for example, South Korea, while others produce commodities like soya bean, palm oil, coffee, oil, sugar, wheat and corn - factors in the determination of core inflation in Europe and the US. If their reserves increase on top of export growth ASLEEP economies may represent a less risky assets than EMs during 2009.

In the absence of managed exchange rates, investors will continue to carry trade whereby one currency will be sold to finance investment in higher yield currencies. This will impact on economy trading and corporate earnings. Currency repatriation by distressed companies and financial institutions can account for the strength in the US$ in late 2008. However, lower interest rates in Euro-zone and in UK will facilitate a speculative strengthening of the US $ in 2009. Price of Euro and Sterling denominated imports falling in the US may impact positively on US main street consumers, but with US GDP 70% explained by consumer expenditure, a slowdown in the US could be averted by mid-2009 if a clear unambiguous signal for a managed exchange rate regime across a basket of trading currencies was issued at the Summit in November. Such a signal might just end this signalling cycle and offer a sustained hope for the future of our global economy.

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