

Global Economy and Exchange Rates

The state of some of the major economies like the U.S., Europe and Japan, is as intriguing as I recall for a long time. Are these countries heading for deflation; inflation thanks to extremely loose monetary and fiscal policies; or neither? Even the extremely shrewd managers of “macro” hedge funds, who customarily earn huge returns for their investors by correctly reading the direction of the macro-economy, seem to be puzzled: most of them have earned very poor returns in the current year. On the other hand, Mark Mobius of Templeton Asset Management believes that global recovery is ‘well in place and may accelerate now’, thanks to growth in the BRIC countries (Brazil, Russia, India, China) and in Turkey and South Africa.

Coming to the West and Japan, by the first quarter of 2010, the U.S. had recovered about 2/3rds of the output lost in the recession, Japan 45%, the euro zone 13% and the U.K. just 11%. Since then, central bank after central bank in these countries, have expressed concerns about slower growth in the remaining part of the year. Subsequent economic data confirm the gloomy outlook. In the U.S., jobless claims are at a 9 month high. Japan grew barely 0.1% in Q2; growth prospects have also been dampened by the appreciation of the Japanese currency in the current year. One major exception is Germany, which registered growth of 9% p.a. in the second quarter thanks to a sharply fallen euro against both the dollar and the yen, and booming exports to emerging markets. The Bundesbank has last week increased its growth forecast for 2010 from 1.9% to 3% -- obviously, the Q2 rate is not sustainable. The rest of the euro zone remains weak with Greece, in particular, facing social unrest and a sharp fall in tourism, which contributes as much as a fifth to the GDP. Question marks are once again being raised about Greece's ability to meet the fiscal targets to which assistance from the EU and IMF is linked. Europe has also been forced to cut needed investments in sectors like renewable energy because of fiscal compulsions. It may be recalled that many economists including our Prime Minister Dr. Manmohan Singh (at the last G20 Summit) had cautioned that fiscal stimulus is still needed, and it would be risky to go for

premature fiscal tightening: many major European economies obviously have different views.

Looking at the financial markets, in recent weeks, bond yields in the U.S. have fallen, with the 30-year bond yielding marginally above 3.5%; a 10-year U.S. treasury is yielding barely 2.55% p.a. It is obvious that investors are not worried about inflation. It is equally obvious that investors are moving away from risky assets to the traditional safe haven of U.S. treasuries. (It is therefore difficult to agree with Mr. Mobius who is predicting buoyancy of capital flows to the emerging markets.) In fact, the dividend yield on the 10 largest dividend payers, at 4%, is more than on even the 30-year bond! The price earnings ratio for the Dow Jones Index is a little over 11 while the S&P 500 stocks are priced at a slightly higher multiple. Clearly, stocks seem to be undervalued as compared to the bonds but, even at current levels, equity investors are showing signs of nervousness. Even China seems to be slowing down, partly as a result of the monetary tightening undertaken to cool the property and stock markets. No wonder Stephen Roach of Morgan Stanley has reduced his forecast for global growth to 3.25% p.a. over the next 5 years compared to 4.7% p.a. over the 5 years to 2007.

There are several other interesting factors in relation to Chinese policies. It may be recalled that China has announced a few months back a change in the exchange rate policy making it more “flexible”. Most analysts had interpreted this as gradual appreciation of the yuan in dollar terms. However, China seems to be serious in terms of flexibility: the yuan has dropped in dollar terms on a few days in recent weeks, in the wake of the euro’s bounce from below \$ 1.20 to \$ 1.32 at one stage (latest \$ 1.28). China’s policy to diversify the reserves gradually, away from the dollar and towards the euro and the yen, continues. Recently, it has added South Korean treasuries in the won to its investment portfolio. To no one’s surprise, Chinese GDP has already crossed Japan’s at the current nominal, as distinct from PPP, exchange rates, thus becoming the second largest economy in the world. It is worth recalling that Chinese GDP was barely 50% of Japan’s as recently as 2005!

What can we say about the future prospects for the western economies and Japan? Martin Wolf of the Financial Times recently argued that “A Japanese-style “lost decade” threatens the developed world. That is particularly likely if everybody starts to tighten

together.” While there are no signs of this, one worry is that, too often, the reaction to domestic problems has often been isolationism, and strengthening of anti-immigration and protectionist sentiment.

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