



GLOBAL WINDS OF CHANGE

Emerging Asia, global imbalances, and currency realignments.

The global economy is showing signs of increased strength, and conditions in most major international financial markets have improved significantly in the past 12 months. Would-be investors should be wary, however, owing to some important issues including policy challenges posed by emerging Asian economies, the existence of unsustainable international trade imbalances, and the potential for a further realignment of the world's major currencies.

Portfolio allocation and currency hedging strategies which allow investors to anticipate and react to these global forces in a timely manner should prove invaluable in such a volatile environment.

The growing influence of China and India

The impressive growth of China and India since 1990 has elicited both fear and fascination on the part of international investors. While their performance is not unprecedented and mirrors that of many other Asian countries during the last 30 years, there is one notable difference: the two countries together account for roughly 40% of the world's population. In the long run, their remarkable performance should benefit the entire global economy. In the short run, however, many of their trading partners may find it difficult to adjust to the new economic reality.

Unsustainable trade imbalances

The macroeconomic tensions noted above have been exacerbated by a rising U.S. trade deficit and growing U.S. indebtedness. The sharp depreciation of the U.S. dollar through most of the 2002-2003 period reflected growing unease over the size of these global imbalances. Unfortunately, much of the exchange rate movement thus far has been against countries such as Japan and continental Europe, which have relatively low growth rates and a limited ability to cope with large exchange rate appreciations. Other countries, primarily in Asia, have been resisting these exchange rate pressures but will eventually have to give way.

How far will the U.S. dollar fall?

Simulations conducted by the IMF and the OECD suggest that a further sizable depreciation of the U.S. dollar will be required in order to put the U.S. current account on a sustainable track. Even if these predictions prove correct, however, they do not indicate exactly when the adjustment might occur, which currencies are likely to be most affected, or how far they are likely to move.

The magic Bank of Canada equation

Academic literature is filled with failed attempts to model the fundamental determinants of exchange rate movements—with one notable exception. The Bank of Canada developed an equation 12 years ago that seems to track most of the major movements in the Canadian dollar, using four simple variables. More recent research at the Bank of Canada has also shown how a simple Bayesian model might be used to help international investors make conditional portfolio allocation decisions. Although the results are still tentative and require additional testing, three intriguing conclusions emerge from this work. First, it is possible to take a view on the relative attractiveness of domestic and foreign investment and to benefit *ex post* by re-weighting portfolios. Second, selective hedging strategies work—simple rules that imply a constant (or zero) hedging ratio are almost always sub-optimal. Third, portfolio managers need to take an integrated approach to asset allocation and hedging against currency risk (i.e., currency risk should be treated as an integral part of the portfolio allocation problem).

No guarantees

While Canadian investors can realize significant gains from international diversification, they also need to be aware of some important forces changing the world economy. One of the most significant of those is currency risk. Some models have recently been developed that might provide assistance in this regard. Unfortunately, they do not come with any user guarantee. ■

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