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No Resolution Trust, but trust a resolution?

Financial reform foot-dragging in Japan may be coming to an end by default. Or will it?

By the end of March of this year, the government is expected to remove the blanket guarantee on deposits in excess of ¥10 million. The blanket guarantee was legislated in August 1996 and overrode the ¥10 million deposit protection ceiling in effect since 1986. It was due to expire five years later, in March 2001, but was delayed until this year under the pretense that small financial institutions had not had enough time to strengthen their balance sheets.

While key ruling-party politicians again called for a new delay as late as last November, the Koizumi administration seems bent on moving ahead. Our reading is that the reform-minded administration feels frustrated and perhaps impotent to carry out the single most important reform of the system – closing down the insolvent banking institutions – and has chosen to act by default. But that is only part of the story.

Let us first digress a bit. We have maintained for a long time that an insolvent banking system presents the single greatest impediment to economic recovery. The reason is simple: poor-performing assets, held and not liquidated by the banks as collateral to their bad loans, block the achievement of equilibrium in the asset markets. It is as if all the manufacturers of autos (in the absence of imports) held out for prices three times higher than market levels – consumers would not buy autos and manufacturers would not sell them. Commerce would come to a standstill, at least for a respectable portion of GDP. This is true for all misguided price-support schemes, and it is true for labor, goods, services, and assets. Idle assets, so named by W.H. Hutt, a little-known pre-war economist, can have devastating impact on economic activity, especially so given the size of the real estate market in Japan. Bank forbearance, by stalling the inevitable rendezvous with reality, has ground the Japanese economy to a halt.

Banks continue to chase their own tails. Writeoffs mount, always above previous estimates. Recently, Japan's top banks announced plans to take full-year loan loss charges totaling US$52 billion, exceeding both bank analysts' estimates and forecasts that banks themselves made in the middle of last year. The losses are taken in spoon-sizes, just large enough to be offset against puny operating profits.

A study released last week by the American Enterprise Institute for Public Policy Research concluded that Japanese banks have *negative net worth of US$1 trillion*. In a continuing effort to shore up a hopeless cause, public funds were injected twice into the Japanese banks: an aggregate of ¥1.8 trillion in March 1998 and an aggregate ¥7.4 trillion in March 1999. Public funds represent 34%, 27%, and 29% of the capital of three of the four largest banks in Japan.

Had the government foreclosed the overwhelming majority of the banks and forced the liquidation of assets, collateral prices would have reached clearing levels. The sizeable and once-and-for-all deflation of asset prices would have a) allowed domestic and foreign investors to buy and put to better use these overpriced

In this issue

Contributions by Albert D. Friedberg, Steve H. Hanke, Neil Rackoff, and Vincent de Caën.

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assets, b) augmented significantly the real purchasing power of the consumer, and c) ended the agonizing, never-ending and thus confidence shattering experience of drip-drab deflation.

With the re-start of economic activity, accompanied by a healthy deflation, the Japanese investment outlook would brighten considerably. Stock prices would recover from their long 12-year bear market, JGBs, even at yields of 1.4%, would provide attractive total returns, and the yen would once again take its place among the world's hardest currencies.

Herein, then, lie our hopes. A run on banks, triggered by the removal of blanket deposit insurance, that will do what the succeeding Japanese administrations did not do for the past 12 years: close the insolvent banks. In the ideal world, of course, all depositors (above the ¥10 trillion) would share in the proceeds of asset liquidations. Depending on the particular bank, market conditions, and the orderliness and breadth of the disposals, recoveries could range anywhere between 0% and 100%.

In the real, not-so-ideal world, the government is likely to "save" the largest city banks and perhaps a handful of prominent regional ones. A haircut may or may not be applied to depositors in these banks. In fact, it is being reported that the Financial Services Agency has ready plans to supply public funds, up to ¥15 trillion, to rescue major banks and large regional banks whose collapse could spark a systemic run. The funds are to be provided out of the crisis-management account of the Deposit Insurance Corporation.

It should be noted that temporarily, the government will nationalize a bank by purchasing its shares in such cases where funds fall short of rescuing it. The government plans to shed the failed bank's failed assets before selling its operation to the private sector. Because we must believe that ¥15 trillion is far too small a figure to shore up the failing banks (or at least those called important enough), we assume that widespread nationalization is a given. If nationalization and the shedding of assets, however, is handled expeditiously and decisively (a big if), equilibrium in the asset markets will be restored in short order.

As we mentioned earlier, however, this is only part of the story. Even if we grant the removal of blanket guarantees on deposits, there are still a number of problems.

For one thing, there is strong evidence that depositors are shifting their funds from time deposits to current accounts. The latter enjoy deposit insurance for one more year. Since interest rates on time deposits are practically zero, there is little or no opportunity cost in shifting out to a non-interest bearing account. The crunch may effectively be postponed for another year!

For another, the recent bank-led bailout of the retailing giant Daiei Inc., lauded by Japanese Prime Minister Koizumi, portends ominously with respect to the government's courage and determination in putting this problem behind. Does the government not understand that asset misallocation can only worsen economic problems? Or is it simply too afraid to bite the bullet? Will they be able to stomach the privately-induced Bank foreclosure? Will they resort to the unlimited nominal resources of the Bank of Japan should the going get too tough? These questions loom ever larger as we approach D-day.

The upshot of an ill executed, or even abandoned, resolution scenario outlined earlier could be as devastating for Japan as the reneging on the Convertibility Board was for Argentina. An interminably long run on banks, monetization of the losses on a grandiose scale, depression coupled with or followed by hyperinflation, banking stresses/failures around the globe via the transmission of counter-party risk, soaring precious metals prices, and an infinite number of other and as yet unforeseen consequences. The spillover effects on the rest of the world would be at least as material as the South East Asian and Russian crises combined and possibly many times worse. Conversely, as we outlined earlier, the investment implications of a market-friendly resolution could be highly favorable. Either way, we ought to be prepared.

Even investors not concerned with Japanese markets should not overlook the overall economic relevance of this matter. In our opinion, the final resolution of the Japanese banking problem is the single most pressing economic issue of our time. If poorly handled, it could literally explode in our face.

Chart 1 – Topix Bank Index

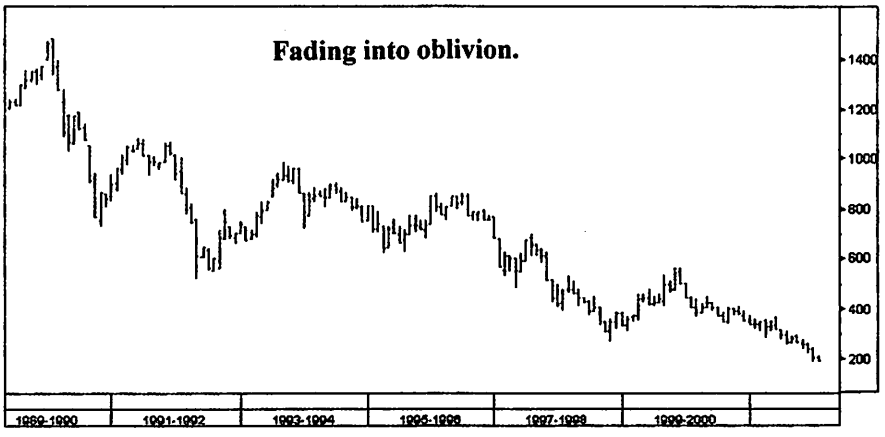


Chart 2

TOPIX BANKS INDEX Relative to TOPIX INDEX
(TOPIX:TOKYO PRICE INDEX)

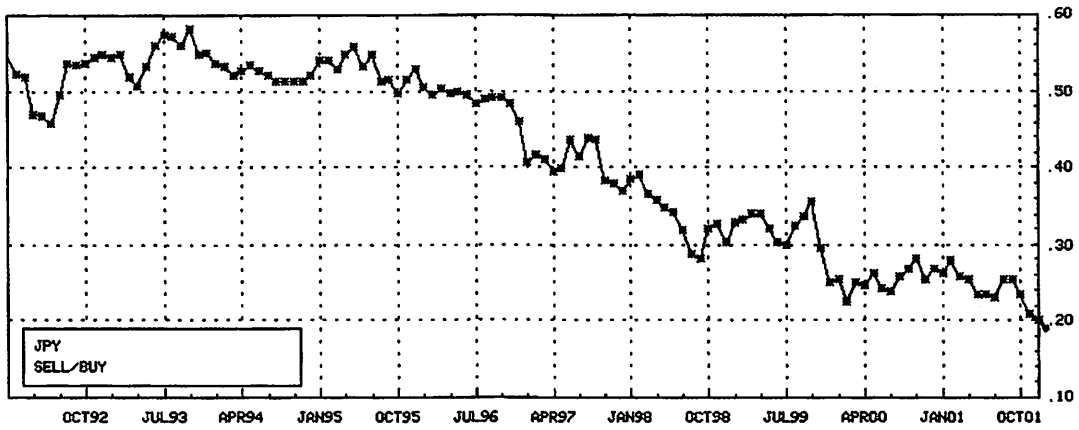


Chart 3 – 10-Year Japanese Government Bond (JGB)

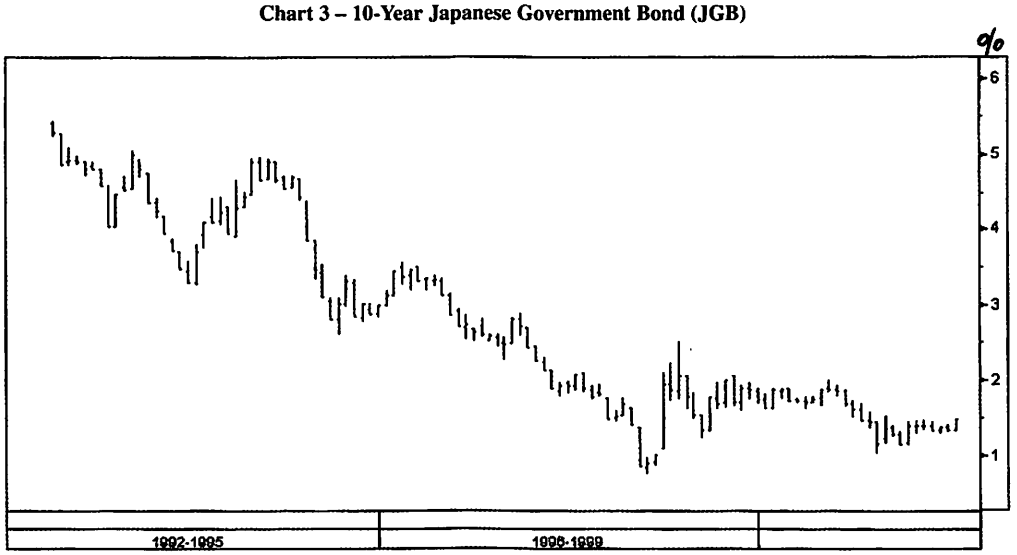
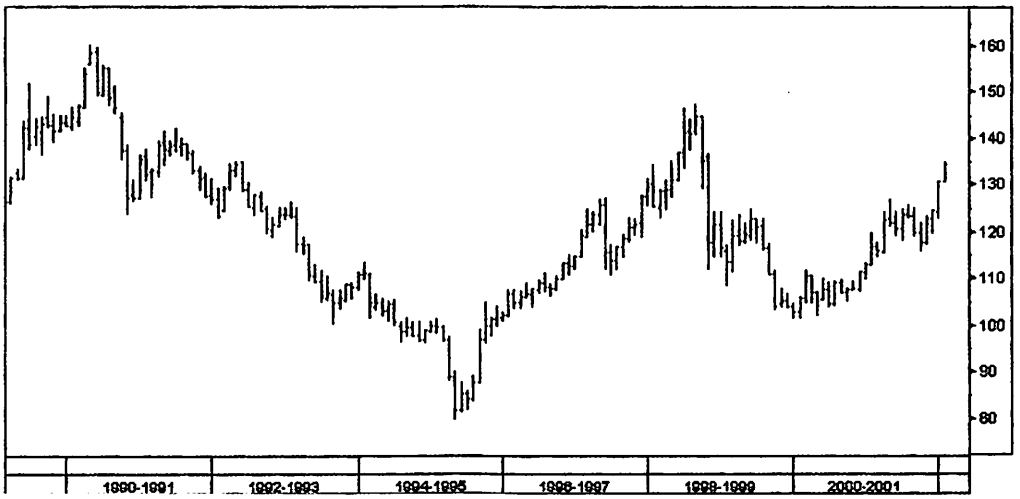


Chart 4 – Japanese Yen



ARGENTINA

Argentine plunder

By Steve H. Hanke

Currency devaluations, particularly in emerging market countries, have been a common occurrence during the past decade. Since 1995, the currencies in, among other places, Mexico, Thailand, South Korea, Indonesia, Russia, Brazil, Turkey, and most recently, Argentina have been devalued. The devaluation of the Argentine peso was, however, like no other. It was in a class by itself.

On January 6, the Duhalde government repealed the Convertibility Law of 1991, which had established a parallel currency system in which the peso and dollar legally circulated at a peso-dollar rate of 1-to-1. To replace that setup, a dual exchange rate was established: a temporarily pegged rate of 1.40 pesos per dollar for certain transactions and a floating rate for all other transactions.

Just what sets Argentina's devaluation apart? For one thing, the foreign exchange markets were closed from December 21, 2001, until January 11, 2002, an unusually long period. In addition, at the time of the devaluation, the central bank held a very large stock of foreign reserves relative to its peso monetary liabilities. But what made the devaluation truly unique and unprecedented in the contemporary setting was the fact that it involved legal plunder, something that has gone unnoticed and unreported.

To get a handle on all this, we must go back to basics. And there is no better place than in Frédéric Bastiat's (1801-50) classic pamphlet *The Law*, which was published in June 1850. Bastiat was not a legal positivist. Accordingly, he did not use the word "law" to denote any decree or statute approved by a legislative assembly. For him, the word "law," when used correctly, had to meet certain moral criteria. And the main features of that morality included liberty, justice, and property.

Bastiat referred to two types of plunder: illegal and legal. The illegal type, such as theft and swindling, is dealt with by a penal code. Bastiat didn't dwell on this type of plunder. Instead, he focused on the more complex issues surrounding legal plunder. That type of plunder occurs when a law is passed that takes from some persons what belongs to them and gives it to others to whom it does not belong.

This brings us to the uniqueness of the Argentine devaluation. The Convertibility Law gave a peso holder the right to freely convert a peso into a US dollar. That redemption pledge was made credible because the central bank was required by law to hold foreign reserves to fully cover its peso liabilities. It was this redemption pledge that made the convertibility set up unique and distinguished it from the typical fiat money system.

With the repeal of the Convertibility Law on January 6, the redemption pledge was thrown to the winds, and the peso-holders' claims on foreign reserves held at the central bank were revoked. Argentina's devaluation, then, represented more – much more – than a garden-variety devaluation. It was a great bank robbery. Foreign reserves equal to US$17.8 billion that were the property of peso holders were confiscated by the government.

That was just the beginning. In addition to stealing the foreign reserves from people who held pesos, the Duhalde government has passed other laws and issued regulations that trample on property rights and make a mockery of the rule of law. This legal plunder was authorized by the Argentine Congress on January 6, when it approved the Law of Public Emergency and Reform of the Exchange Rate Regime. This law transfers extraordinary powers to the President of the Republic and allows him, in effect, to rule by decree for two years. In consequence, the government has introduced one measure after another that has taken property without compensation.

For example:

- Contracts denominated in dollars will be redenominated in pesos.
- Bank loans denominated in dollars below $100,000 will be redenominated in pesos at the old 1-to-1 rate. These include mortgages, home improvement loans, personal loans, auto financing, small and medium sized business loans, and credit card balances.
- Public utilities will be required to bill in pesos, not dollars, and will no longer be allowed to index their prices to changes in US inflation. This will alter the terms of many recent privatization agreements.
- Rents formerly paid in dollars must be payable in pesos for 180 days and then be renegotiated in pesos.
- Any "unjustified" layoffs during the next 90 days will require indemnification at a rate double that required under the previous law.
- Oil exports will be taxed at a rate up to 40%, and in principle, these tax revenues will be used to subsidize the banking system.
- Argentine companies will not be allowed to buy dollars to pay foreign creditors, unless they first negotiate a three-year

extension of maturities on their loans. This will result in a forced default on a great many corporate loans.

- Farmers will receive special treatment (as yet, not specified) when they renegotiate their dollar-denominated debt.
- Contrary to an earlier pledge by the government to retain individuals' deposits in the currency in which they were denominated, the government will redenominate all deposits into pesos.
- Any proceeds received by private pension funds from term deposits at banks will be required to be invested in government bills. Consequently, private pension plans will be required to purchase paper from an issuer that is in default.
- A bankruptcy code has been proposed that will be prejudicial to foreign creditors and companies. If enacted, this will flaunt a basic tenet of the rule of law: equality before the law.

In addition to not trusting the peso, Argentines don't trust their banks. And for good reason. In August and November of last year, Domingo Cavallo, the former economic czar, engineered "voluntary" debt swaps in which local banks swapped liquid, relatively high yielding government bonds and bills for lower-yielding illiquid notes guaranteed by earmarked tax revenue. This maneuver was designed to save the government money. However, it put a big dent into the banks' balance sheets and rendered many banks illiquid. Because of the imposition of recent measures, the banking system has been pushed into insolvency, according to a Moody's report of January 18.

And given the current sorry state of affairs, a recapitalization of the banking system is probably not in the cards. What prudent banker would pour more money into what has become a legal black hole? And forget the Argentine government. It's broke. That leaves the IMF and other multi-national outfits. Will they turn a blind eye to legal plunder and cough up the big bucks needed to recapitalize the banking system? If they do, they will be accomplices in a crime. If they don't, the banking system will remain insolvent.

Argentines' savings are trapped in an insolvent banking system. And if that isn't bad enough, their dollar savings are rapidly being redenominated into a sinking peso. It is not surprising that about 80% of the population yearns for the convertibility system, and that the street violence in Argentina refuses to subside. Even though few Argentines have ever heard of Bastiat, they know legal plunder when it hits them in the face.

What makes Argentina's devaluation so amazing is the fact that most independent economists, most of the press corps, the International Monetary Fund, the Bush administration – and you name it – thought, and still think, it was necessary. Apparently, legal plunder is acceptable, if not necessary, in Argentina, but not in Zimbabwe.

Why was Argentina's devaluation necessary? The story goes like this and has been repeated *ad nauseam*. Under the Convertibility Law, the peso was linked to the strong dollar and became overvalued. This rendered Argentina uncompetitive, caused the economy to slump, and forced Argentina to default on its debt.

Does this story hold water? The claims about Argentina's lack of competitiveness are nonsense. A classic sign of uncompetitiveness caused by an overvalued currency is declining exports. But Argentina's exports increased every year in the past decade except 1999, when Brazil, its largest trading partner, suffered a currency crisis.

Exports during the first 11 months of 2001 were about 3.2% ahead of exports during the same period in 2000. Considering that the real growth in world trade was only 0.9% (estimate) last year, Argentina's export performance was relatively strong. Indeed, the export sector has been one of the few bright spots in the Argentine economy. If the rest of the economy had been growing as fast as the export sector during the last two years, Argentina would not be in a recession, and the government would not be bankrupt.

In an attempt to bolster their overvaluation claims, many asserted, on the basis of taxi rides from the airport or other casual impressions, that prices were high in Buenos Aires, and that high prices were evidence the peso was significantly overvalued against the dollar. A recent Union Bank of Switzerland survey of prices in 58 of the world's largest cities found that for a basket of 111 goods and services, weighted by typical consumer habits—including three categories of house rent—Buenos Aires ranked 22nd, about midway between the most expensive city, Tokyo, and the least expensive, Bombay. The survey also found those taxi rides that were allegedly so expensive cost about 8% less than in Rio de Janeiro.

And there are plenty of other indicators that contradict the overvaluation story. For example, *The Economist* magazine's Big Mac Index indicates that the peso, before its devaluation, was 2% undervalued. This didn't stop *The Economist* from repeatedly editorializing about an overvalued peso. Even though the Big Mac Index, as well as more sophisticated estimates of equilibrium exchange rates, should be treated with skepticism, a recent careful study of the matter using data from 1993 to 1999 indicates that the peso was always within 6% of its so-called fundamental equilibrium real exchange rate.

The overvaluation story is a lie, one that created nothing but cover for the peso devaluation. Never mind. Will the devaluation get the economy going again? Let's go through the arithmetic on the restrictive and unrealistic assumption that the devaluation is the only thing that has happened in Argentina. To stimulate Argentina's exports by 1%, the real

value of the peso (adjusted for inflation) would have to depreciate by 10%. Exports in Argentina accounted for only 9% of GDP last year. This implies that if the current devaluation of 50% (the floating peso is trading at two to the dollar) doesn't pass through to any domestic inflation – in short, if the nominal devaluation is a real devaluation – exports will increase by about 5%. Even under these unrealistic assumptions, a 50% devaluation would add only less than a half percent to GDP. Consequently, in the best of all possible worlds, the devaluation will add very little to a GDP that has, thanks to the devaluation and the new exchange-rate regime, collapsed.

Any way you cut it, there was no factual justification for Argentina's devaluation. And given the property rights enshrined in the Convertibility Law, there was no moral basis, either. The same can be said about all the other measures in which the Duhalde government has flaunted the rule of law.

All this was apparently more than the finance ministers from the member states of the European Union could bear. On January 22, they issued a joint "Statement on Argentina" in which they called the Duhalde government on the carpet for not abiding by the rule of law and the principles of a market-based economy. This is encouraging, particularly given that most of these ministers are members of socialist parties. Unfortunately, the same can't be said of the Bush Administration and its Trojan horse, the International Monetary Fund. Unless they reverse course, they will be accomplices in Argentina's crime.

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THE EURO

On the temporary weakness of the euro: another explanation

By Vincent DeCaen

This article is the third in a series devoted to the exploration of recent theorizing on the determinants of the exchange rate, with special attention to the euro. In the first (Oct. 1, 2001), we examined Sinn and Westermann's modified portfolio-balance approach to the exchange rate and their identification of the velocity of the deutschemark and the Eastern European black market as the source of euro weakness. In the second (Dec. 3, 2001), we then considered the strength of the US dollar in terms of productivity and capital flows. Several recent papers had suggested that the Balassa-Samuelson approach to labor productivity as a determinant of the exchange rate might explain an apparently overvalued US dollar.

In this, the third, we turn to an IMF working paper by Guy Meredith (WP/01/155) that revisits the many explanations for dollar strength and/or euro weakness, confirming our negative evaluations of those previous attempts. Meredith proposes another *temporary* source of weakness stemming from the 1999 conversion to the euro: an oversupply of euro-denominated assets induced by constraints on portfolio allocation. It is estimated that this effect would be 10 times that of Sinn and Westermann's "multiplying deutschemarks" – sufficient to explain the 25% undervaluation of the euro. It would follow, therefore, that the euro should soon begin to *re-appreciate*, following this *transitional* portfolio reallocation.

1. Euro movements

The magnitude and speed of the euro's decline confounded consensus predictions of euro appreciation – "another inglorious chapter in attempts to forecast exchange rates." Rationalizations *ex post* have only extended this "inglorious chapter."

It is important to remember, however, that the euro's weakness continues an underlying trend beginning as far back as 1995. Since 1995, the synthetic value of European currency has depreciated 35%. This depreciation translates into a loss of 20% in terms of *real effective* value (the percentage is smaller in these terms because of US strength against *all* currencies). Crucially, as Meredith points out, the loss of real effective value becomes significant only with the introduction of the euro in 1999.

Roughly half of this loss (10%), Meredith estimates, can be attributed to the US dollar effect, associated with the surge in equity market capitalization. The other half (10%) is euro-specific and, according to Meredith, reflects changing conditions in European capital markets and the issuance of euro-denominated debt. Both foreign and domestic borrowers created a supply of euro-denominated issues while European lenders were diversifying into non-euro assets.

In stark contrast, the estimated *equilibrium* level of the euro is roughly $1.15-$1.20 – coincidentally, the level at which the euro was initially introduced. The broad consensus is that an 85¢ euro is undervalued by 25% to 30%; IMF staff estimates are consistent at a 25% undervaluation.

2. A modified monetary framework

In our first piece (Oct. 1, 2001), we reviewed two approaches to explaining a two-region exchange rate: the older

"monetary" approach and the newer "portfolio-balance" approach. We concluded there that the fundamental disagreement is over "uncovered interest parity" (UIP). UIP is the hallmark of the older monetary approach whereas UIP is rejected *ex ante* in the portfolio-balance approach.

Meredith adopts the older monetary approach in which domestic and foreign assets are assumed to be *perfect* substitutions. On this view, the *expected change* in the exchange rate (i.e., the forward rate minus the spot) is equal to the difference in domestic vs. foreign interest rates (both CIP and UIP are assumed to hold). The exchange rate is thus a function of *interest rate differentials.*

The crucial modification of the standard textbook equation is the introduction of a variable for the "expected excess returns" on domestic assets, which is combined with the interest rate differential. In effect, this variable introduces the "portfolio-balance effect" through the back door (assets are *imperfect* substitutes), attributable to the usual suspects: some combination of imperfect asset substitutability and risk aversion of investors.

These variables are then related to economy-wide outputs. Domestic output depends negatively on both domestic exchange and interest rates. Output that increases beyond potential levels must boost long-term interest rates. The exchange rate, then, is related to trade through the relative domestic and foreign prices of outputs, and is related to capital flows via interest rates (reflecting in part the expected real exchange rate).

The exchange rate is related to economic growth as follows. Real growth that represents a positive demand shock, increasing output past potential levels, necessarily boosts interest rates. The rising interest rate attracts foreign capital inflows, resulting in an appreciating domestic currency. Rising aggregate demand itself also puts upward pressures on the interest and exchange rates.

Meredith makes two important theoretical points. First, explanation of exchange rates tends to be circular, given the relations between variables; further, this explanation is heavily dependent on highly subjective views of the future. It is true that expectations are, to some extent, already implicit in the interest rate differential. But this differential is the only directly observable determinant, while *unobservables vastly exceed* this differential in impact. Ultimately it is the task of the analyst to evaluate the plausibility of the implied expectations at a given exchange rate. Such healthy agnosticism is a welcome antidote to dogmatic claims circulating.

Second, the wildcard of *expected excess returns* (on domestic assets) can give rise to surprising if not perverse relationships between interest and exchange rates (read "portfolio effects"). Crucially, an *increase* in expected excess yields on domestic assets results, given our basic equation, in a rising exchange rate – or alternatively, a *depreciating* currency. A weak currency induces domestic activity, which in turns boosts domestic interest rates.

In other words, it is possible to see rising interest rates at the same time as the currency is heading south, contrary to normal expectations. However, since expectations – and specifically expectations of excess yields – are never known, such "portfolio effects" are not directly observable: The underlying role of expectations can only be *inferred*, and the plausibility of these expectations evaluated.

Crucially, for Meredith, an *oversupply of domestic assets* could boost the expectation of excess yields, causing the currency to depreciate (now assuming assets are *imperfect* substitutes).

3. Review of explanations for euro weakness

Broadly considered, there are three categories of explanation of euro weakness, all three of which we have already treated in previous articles.

3.1. Irrationality

To be *au courant*, Meredith includes non-fundamental dynamics, what we treated under the heading of *behavioral finance* (see "Summary," July 31, 2001). This is logically the fallback explanation for any unexplained residual.

3.2. Structural Factors

The second category, structural or socio-political factors, was effectively eliminated by Sinn and Westermann (see our first article, Oct. 1, 2001). Under this rubric fall American boosterism and all of the ideologically-motivated critiques of the benighted European way (even though European backwardness is longstanding!). Included here are political factors (something is rotten in Denmark), surging oil prices (negligible effect at best), questionable central bank policies (so what else is new?). Meredith correctly, in our opinion, eliminates the various rationalizations, either by pointing out that the timing is *inconsistent* (recall the depreciation began already in 1995) or *accidental* (there is no causal nexus).

3.3. American New Economy (productivity)

The third category, the supposed "New Economy" effect and soaring American productivity, was eliminated in our second piece (Dec. 3, 2001). However, Meredith adds some telling mönetarist arguments against American triumphalism to our previous discussion. Crucially, a US productivity shock (N.B.: It would have to be a *large* shock) should result in high real interest rates via aggregate demand, and so in turn a rising exchange rate (i.e., *a depreciating US dollar*), according to the basic monetarist equation.

In passing, Meredith comments on the Balassa-

Samuelson effect, currently much ballyhooed as we saw (Dec. 3, 2001). As we concluded previously, US labor productivity would have to be many times current levels to inflate the dollar to such a degree. Meredith concurs, emphasizing the *negligible* impact on the exchange rate of the Balassa-Samuelson effect (perhaps 1%).

(Recall, Balassa [1964] and Samuelson [1964] differentiated labor productivity by traded vs. nontraded sectors, and claimed that a positive productivity shock in the *traded sector* could cause an *apparent overvaluation* of the currency. In passing, Meredith cites consensus opinion that the ballooning American greenback is in fact highly overvalued.)

4. Capital markets and portfolio shifts (=10%)

Finally, we come to Meredith's proposal. The advent of the euro triggered widespread changes in regional capital markets. Liquidity in euro-denominated debt resulted from easier cross-border transactions, in turn resulting in a 1999 explosion of corporate bond issuance (both resident and non-resident issuance). It appears that the rise of euro-denominated debt came at the expense of both the yen and the US dollar, beginning in 1999 (see Charts 5 and 6.)

European institutional investors are subject to portfolio-allocation guidelines, distinguishing between domestic and foreign assets to limit exposure to exchange-rate fluctuations. For these institutions, many "foreign" investments automatically became "domestic" with the introduction of the euro, in turn freeing up funds for investment outside Euroland. In addition, some guidelines were relaxed for some European institutions (e.g., French pension funds), boosting such non-euro investments. This flood of euro assets appears to have been met by lukewarm demand.

Conceptually, the explanation works like Sinn and Westermann's DM hot potato: Europeans simply dumped euros for foreign currency. But whereas the currency shift implied by the "multiplying deutschemarks" scenario amounted to about €30 billion, Meredith estimates the increase in euro-denominated debt at €300 billion: *10 times* the magnitude.

In Meredith's monetarist framework, shifts out of euro-denominated assets could affect the exchange rate only via the *expected excess yield* on such assets. The euro would, according to the equation, depreciate if the expected excess yield were to increase (due to increased demand for borrowing in euros, relative to supply of funds available for investment). Evidence for capital market behavior, anecdotal as it is, is in principle consistent with the depreciating euro on a multilateral basis, coinciding with the introduction of the euro in January 1999.

5. US dollar effect (=10%)

The naive prosperous-economy model, with its surging equity prices in the US, cannot explain the strength of the US dollar, as Meredith and many others point out. The simple fact is that "prosperity" was not confined to the US (indeed, Sinn and Westermann had shown that the European equity markets did relatively better in terms of percentage gains).

However, Meredith highlights a very interesting factoid: Equity market capitalization in the US was much larger than overseas, *relative to GDP* (see Chart 7) – surging to "unprecedented levels" (IT mania was also concentrated in American markets). While US capitalization rose from 80% of GDP (1994) to 180% (1999), EU capitalization rose from 30% to 90% in the same period. In other words, while the EU capitalization was proportionally larger, in terms of *percentage of* GDP, it was 40% *smaller* than that of the US.

Such considerations, applied to the theoretical model (Meredith's appendix A), could explain the US dollar effect. "Unprecedented" market capitalization would feed investment and consumption, boosting domestic interest rates and so in turn the value of the dollar.

6. Conclusion

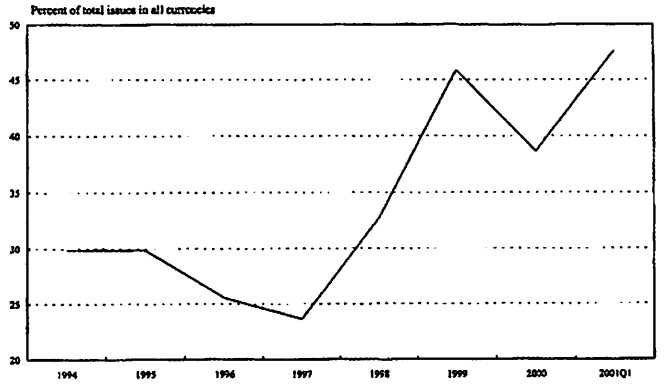
The 20% decline in the euro (synthetic, then real) since 1995 has two equal components, according to Meredith. One half is simply the strength of the US dollar against all currencies. It was explained that the US was disproportionately affected by a positive demand shock (via equity market capitalization) that boosted the greenback.

The other half, the euro-specific half, was attributed to an oversupply of euro-denominated assets, which, via rising expected excess yields, depressed the currency.

The implication, then, for policymakers is clear: no intervention to support the euro is necessary, because these two factors are reasonably expected to fade. Investors might expect to see an appreciating euro in the near term. (However, as Meredith pointed out, the equity market reversal has not yet played out as was expected: The US-EU equity capitalization gap has not closed, as prices remain above 1995 levels – and have fallen by more in Europe vs. America.)

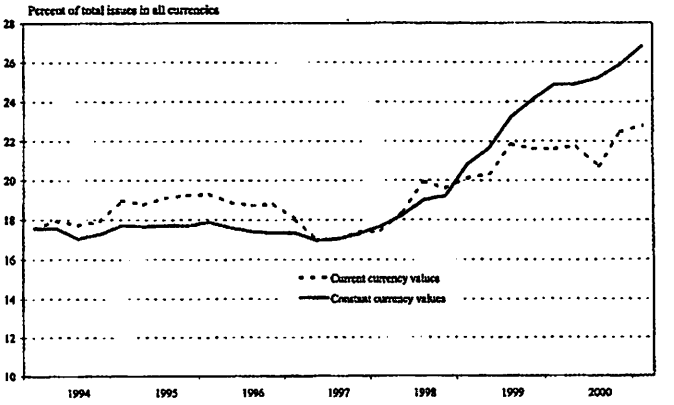
The simulation reported in the paper is consistent with a gradually appreciating euro. Meredith's comments on this simulation deserve further consideration. One notable result, mentioned in passing, was the projected pressures on the American economy. The simulated inflation rates reported in Chart 8 suggest enormous upward pressure on American inflation, beginning shortly and building rapidly, topping out around 2005. Similarly, a 2005 peak is projected in the US trade deficit (Chart 9) and interest rates (real short rate, see Chart 10). These projections suggest a "world turned inside out" (see further, Stephen Roach, in Morgan Stanley's *Global Economic Forum*, Jan. 22, 2002), including a significant depreciation of the US dollar in the next few years.

Chart 5 – New Issues of Euro-denominated Debt Securities



Source: BIS.

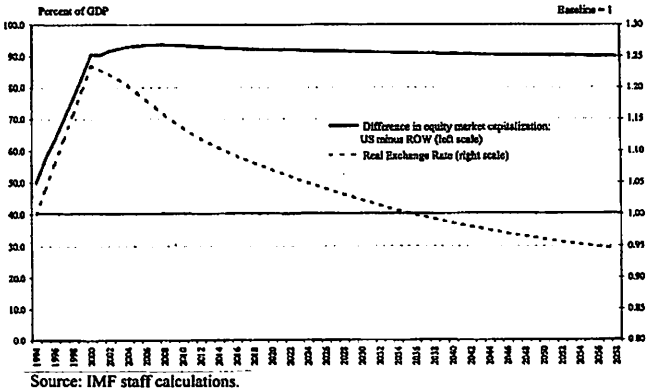
Chart 6 – Euro-denominated Share of International Debt Issues



Source: Updated data from Deiken and Hartmann (2000).

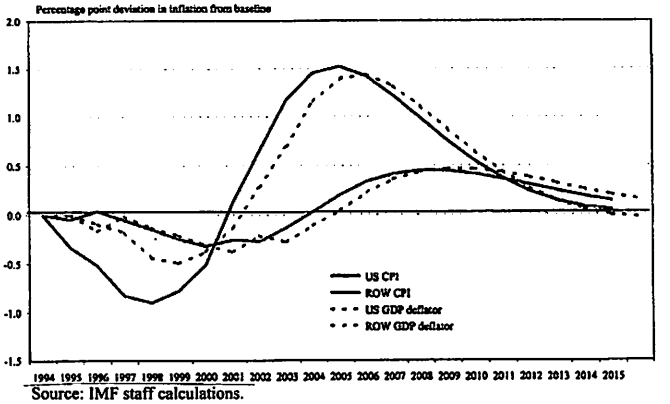
Chart 7

Simulated Market Capitalization and Exchange Rate: Permanent



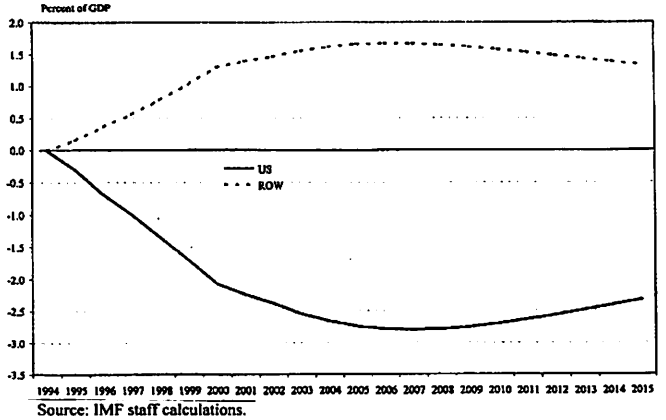
Source: IMF staff calculations.

Chart 8 – Simulated Inflation Rates



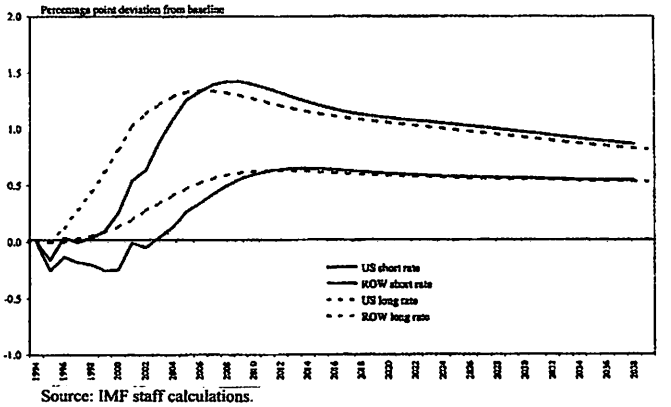
Source: IMF staff calculations.

Chart 9 – Simulated Trade Balances



Source: IMF staff calculations.

Chart 10 – Simulated Real Interest Rates



Source: IMF staff calculations.

HEDGE FUNDS

Benchmarks III: the final chapter

By Neil Rackoff

In our previous article on benchmarks for hedge funds (December 2001), we discussed Fung and Hsieh's problems with using indices put together from hedge fund databases as meaningful benchmarks for hedge funds. They note that if an investor does use database-generated indices, certainly *sub-indices of specific hedge fund trading styles that are properly constructed* are the most informative in terms of risk rather than using a broad-based index.

They offer a more elegant solution, though, to the problem. This solution is based on the simple idea that if an investor wants to estimate the investment experience of hedge funds, why not look directly at the experience of hedge fund *investors* themselves. Therefore they suggest the use of fund-of-hedge-funds as the best proxy for the hedge fund experience.

As of the February 2001 publishing of Fung and Hsieh's paper, there were 224 fund-of-funds (FoFs) in the HFR database and 322 FoFs in the TASS database. Further, HFR and MAR (Managed Accounts Report) regularly report FoFs' composite performance.

Fung and Hsieh found that returns from fund-of-hedge-funds were less susceptible to the measurement biases that were mentioned in our previous articles. They point out that the track records of FoFs avoid many of the idiosyncratic biases that are embedded in pro forma returns based on individual hedge funds extracted from databases in several ways.

First, the majority of FoFs reported audited performance to their investors where successful investments as well as "mistakes" are recorded. For example, a successful investment in a hedge fund that reached capacity constraints and stopped reporting to database vendors *will nevertheless* remain in the history of the FoF. Similarly, past investments in funds that have closed will also remain in the track record of the FoF. Consequently, there is no survivorship bias in the actual track record of a FoF.

In addition, the question of selection bias does not arise. While an individual hedge fund may choose not to participate in a database, its return would be fully embodied in the performance of any FoF that invests in it. And further, when a FoF adds a hedge fund to its portfolio, the portfolio's history is not affected, so there is no question of instant-history bias. (Instant-history bias is when a data vendor adds a fund into a database and then backfills the fund's historical returns into the database. This distorts the integrity of the data and overall performance of the index created with this new information.)

Fung and Hsieh provide an interesting illustration that highlights the differences in the actual returns of FoFs versus those of a broader based index. They compare the return behavior of the FoF HFR composite verses the broader based HFRI during extreme market conditions to see if the spurious bias generated by the weighting scheme of the HFRI (equal weighted) also exists in the FoF HFR composite.

Chart 11 tells the story of 1998. Before August 1998 both indices moved in tandem. They point our that the "rapid" recovery of the HFRI from the August 1998 debacle can be largely attributed to the artifact of the overall index's equal weighting methodology, where the "losers were bought and winners sold." Such a strategy, when applied to a very diverse hedge fund universe under extreme market conditions, leads to unrealistic return patterns.

The recovery of the FoF HFR composite, on the other hand, was much more gradual, despite the fact that the FoF HFR is *also* an equally-weighted index. They conclude that this implies that few, if any, actual portfolio managers followed the "contrarian" asset allocation strategy implicit in the HFRI broad based index. In addition they also note that it is (and would have been) almost impossible to effect such a quick asset reallocation on over 1,000 funds within the space of a month.

They conclude therefore that using fund-of-funds as building blocks for hedge fund performance benchmark[s] is a better alternative than individual hedge funds and certainly better than broad based hedge fund indices. Fung and Hsieh note that it is important though to make adjustments for portfolio management costs, estimated around 2%, a procedure for approximating which can be found in Fung and Hsieh ("Performance Characteristics of Hedge Funds and Commodity Funds: Natural vs. Spurious Biases." *Journal of Financial and Quantitative Analysis*, Vol. 35, No. 3 (September 2000): 291-307.) However an argument could be made that since the FoF is the true alternative for the neutral position, hence a benchmark, therefore the fees it charges should be part of the performance because that is in fact the experience of investors.

Finally, we understand from Fung and Hsieh's paper (end of section 3) that a second alternative would be to use sub-indices of hedge fund strategies as a measure of performance. However at the very end of the paper Fung and Hsieh lump sub-indices into the same non-informative basket as broad based indices. This is not explained in the conclusion to their paper; however, we think that sub-indices are certainly more useful than broad based indices, especially if one cannot find a fund-of-fund group that is sector or strategy focused.

Neil Rackoff is President of Friedberg Mercantile Inc. in New York.

Chart 11 – Monthly Returns of HFR's Overall Index & Funds-of-Hedge Fund Index

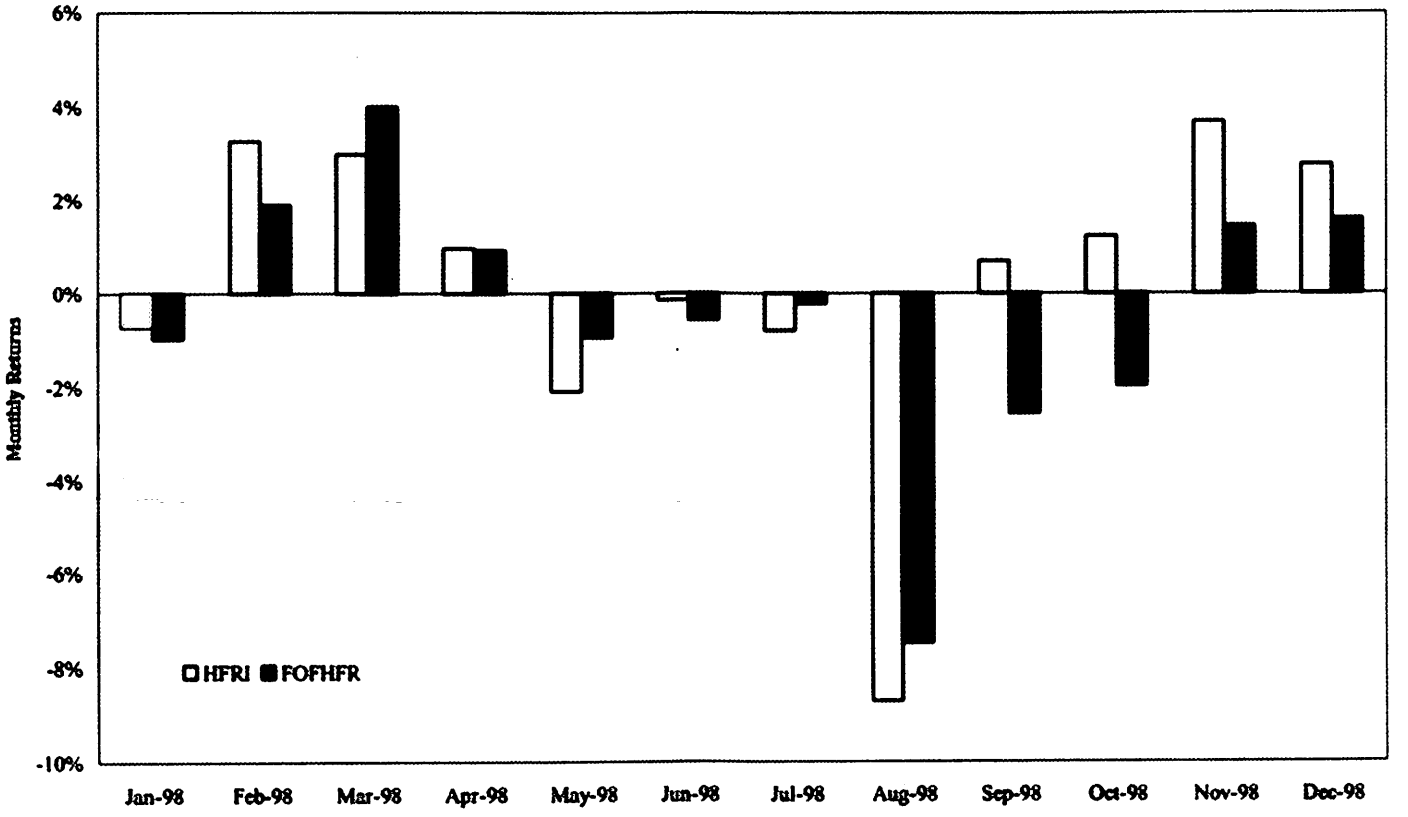


Chart courtesy of William Fung and David A. Hsieh

CHINA

Investing in China: Monitoring A/H valuation convergence

By Vincent DeCaen

In our October 2001 issue, we reported on the stalling of the A/B valuation convergence. Recall that, as part of a broader policy against capital flight, the Chinese government had segregated its stock market: "A" shares for the domestic investors and "B" shares for foreign investors with hard currency (US dollars). Typically foreigners would pay a premium to hold such shares; but in China the "B" shares in fact traded at a discount of 75% to 80% against their domestic "A" pairs.

The restriction on domestic investment in the "B" market was lifted in February of last year, and the "B" shares soared, while the A/B discount plummeted. The A/B discount has predictably narrowed – now around 40%, and apparently stalled in a range of 35% to 45% (see Chart 12). The interesting theoretical question is whether convergence must happen, or whether a persistent discount might remain – analogous to the closed-end fund discount.

A similar discount play is possible if the government similarly liberalized the Hong Kong market in "H" shares. Recently the A/H discount has bounced off a low of 70% (Chart 13). A powerful valuation convergence could be set in motion that would mirror the A/B play, and that could return a hefty profit.

We are currently tracking the nine A/H pairings (Chart 14) with an eye to getting into Hong Kong.

Chart 12 – China A/B Discount (%)

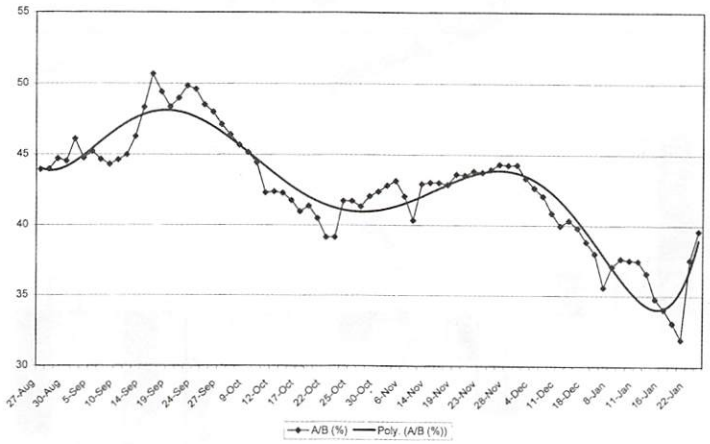


Chart 13 – China A/H Discount (%)

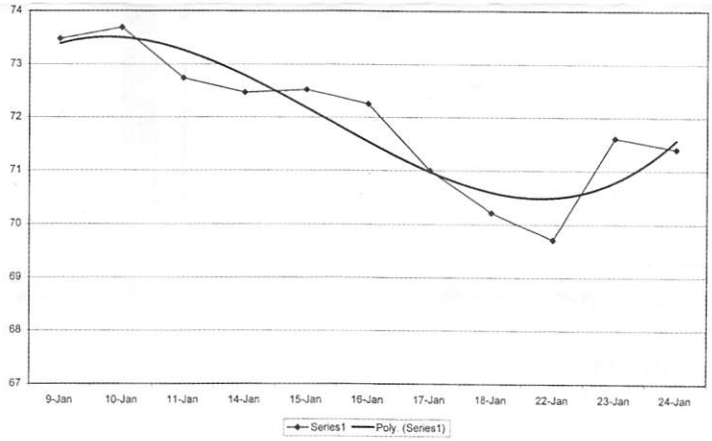


Chart 14 – Nine A/H Pairings

.SS	.HK	NAME	A/H (%)	P/E
600115	0670	China Eastern Airlines Co.	73.99	31.24
600028	0386	China Petroleum & Chemical	64.19	4.57
600896	1138	China Shipping Haisheng Co.	78.24	16.20
600011	0902	Huaneng Power Intr. Inc.	58.29	12.03
600808	0323	Maanshan Iron & Steel	76.73	46.42
600548	0548	Shenzhen Expressway Co. Ltd.	74.29	10.91
600688	0338	Sinopec Shanghai Petrochemical	70.30	8.75
600871	1033	Sinopec Yizheng Chemical	75.07	5.20
600188	1171	Yanshou Coal Mining Co.	71.54	9.61
		average	*71.40*	*16.10*
		median	***73.99***	***10.91***

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