Policymakers today are excited about the U.S. dollar/Chinese renminbi exchange rate. A currency war is looming. In reality, worries in the United States and Europe about the exchange rate of China’s renminbi are misplaced. In fact, worries about exchange rates in general are pointless, and three trade secrets for forecasting currencies help explain why. But before I discuss currencies in particular, I will review and discuss general misconceptions about risk management and financial market forecasting that lead to misconceptions about exchange rates as well as other markets and the forces that drive them.

**Investment Story 1: Risk Capacity vs. Risk Sensitivity**

One of the factors that contributed to the recent financial crisis was the tendency of financial managers to separate the people who manage risk from the people who do the investing. Common sense should tell us that this should not be done. After all, one cannot invest without being a risk manager, and anyone who manages risk must think about the investment returns. Indeed, the most successful investors I know are people who are far more skilled at risk management than they are at forecasting markets. When asked once for the secret of his success in investing, Warren Buffett replied, “I always sold too soon.” Yet, the investment industry continues to separate the risk management function from the investment function.

Good risk management is the key to strong investment returns. It is not just the function through which financial managers can reassure clients that they do not run the risk of losing all of their money if it gets invested badly. Those who have been in the financial markets for a long time, however, know that anyone, clever or not so clever, can lose a lot of money in the markets without trying too hard.

Politicians favor the “bad apple” theory of financial crises. It allows them to point their finger at someone and say, “You did it, so you will be punished.” Thus, their constituents see them responding forcefully to the crisis. Bankers also favor the bad apple theory because it blames the bankers who did not survive. Those who do survive can say, “Look at us. We weathered the storm. We are the good bankers. Punish those other, bad bankers.”

Unfortunately, the bad apple theory is incorrect because it suggests that financial crises are random events, which they are not. Financial crashes always follow financial booms. The only way to stop or mitigate financial crashes is to limit financial booms, yet financial booms occur when investors begin doing things that they think are safe. They believe that they have found a strategy—a new paradigm, a new technology, a new financial innovation—that nullifies risk. So, they leverage up and double their bets, and they convince themselves that what they are doing is safe.

For the past 10 years, the dominant concept behind risk management has been risk sensitivity. If managers can be properly sensitive to risk and measure it accurately, they can protect themselves and their investors. Yet, the past 100 years should convince us that investors are good neither at identifying nor at measuring risk, partly because risk is changeable. Strategies that once were safe become risky. Furthermore, the behavior of investors can change things from safe to risky. Risk can certainly be managed, but not through risk sensitivity. During the next few years, I believe the philosophy of risk management will migrate away from the notion of risk sensitivity and toward the notion of risk capacity.
During the recent boom, investment managers were lulled into a belief that liquidity is not a serious issue and that they could identify any risk, analyze its characteristics, measure its probability of occurrence, and neutralize its danger. But many different kinds of risk exist, and each kind of risk has specific characteristics. Liquidity risk is different from credit risk, which is different from market risk, which is different from operational risk, which is different from reputational risk. Because they have different characteristics, they must be hedged differently. For example, liquidity risk is the danger that investors may suddenly need funding, which may force them to sell assets at lower than optimal prices. To hedge liquidity risk, therefore, investors should ensure that they have sufficient long-term funding. Having long-term funding, however, does nothing to hedge credit risk because the longer an investor holds on to a risky credit, the more likely it is that it will turn bad. Credit risk, therefore, is hedged by having access to a diversity of credits.

Risk capacity assumes that even if investors measure risk incorrectly, they still retain an ability to offset the risks they are likely to face. Therefore, the key to successful investing is understanding one’s capacity for different kinds of risk and then maximizing the amount of risk taken according to the capacity to take it. Investors who do not maximize such risks are underleveraging their assets. But if investors identify risks that they have no capacity to take, they must manage such risks as well as possible. Investors cannot count on being able to actually measure risk and successfully hedge it; they must identify their capacity for different risks and maximize those risks up to their capacity.

Investment Story 2: Forecasting Less for Better Forecasting

The art of financial forecasting lies in the decision not to forecast, which is less banal than it sounds. The mistake that most investment managers make is trying to forecast forecasts. For example, many managers base their asset allocations on an investment return forecast that is based, in turn, on an economic growth forecast that is itself based on an interest rate forecast that is based on an inflation forecast that may well be based on a currency forecast. The more factors that managers try to forecast, the more likely it is that they will get it wrong.

Therefore, one of the most important steps that anyone can take in developing a financial forecast is to write down what he or she knows with some certainty. The world is filled with the unexpected—uprisings and calls for change in the Middle East, earthquakes and tsunamis in Japan. Despite these unanticipated events, some things can be known with a fair degree of certainty, such as demographics.

The age of a population, the number of people working and spending money, the number of people retired and saving money—such demographic patterns are not the most immediate drivers of markets, but they are important and can be known with a degree of certainty. Demographics, in fact, is one of the few factors that economists can actually forecast, and demographics has a significant impact on current account positions, inflation rates, and GDP growth. As I will discuss later, the ability to understand and make simple forecasts based directly on demographics can lead to a better understanding of the drivers of currencies and exchange rates.

Investment Story 3: How to Value Currencies

I spent the first part of my career at J.P. Morgan and UBS working in currency markets. Many of my clients thought that currencies are like equities. Interest rates are analogous to dividends, and GDP growth is analogous to an earnings forecast: the higher the interest rate, the better the currency; the higher the growth rate, the better the currency. This analogy is incorrect. Currencies are bonds, not equities. In the bond world, a high coupon is a measure of risk, not a measure of attractiveness. For example, the strongest currency in the world during the past 50 years is arguably the Swiss franc. But Switzerland has neither high interest rates nor an economy growing at China’s pace. Indeed, Switzerland has had, for the past 50 years, one of the lowest interest rates in the world and one of the strongest currencies, and this status is not random.

The major factor that drives bond values in the long run is inflation. Over the last 20 years, both the growth rate and inflation rate in Japan have been very low to negative. As a result, bond yields are about as close to zero as they can get because in a no-growth, deflationary environment, the best asset to hold is cash. Not surprisingly, the Japanese yen has become a very strong currency, and this year, the G7 has had to intervene to quell the yen’s rise despite worries about the sluggish economy.

Inflation Drives Currencies. The first rule for currencies is that they are driven by inflation. Inflation itself is driven by numerous factors. Economists emphasize such factors as the economic cycle and the competence and credibility of a nation’s central bank. But inflation is also deeply political because inflation transfers wealth from creditors to debtors, from savers to consumers. Countries typically end
up with the inflation rates their populations want, and that reality returns us to the influence of demographics. For example, during the past 20 years, Western economists have been advising Japan to print more money in order to weaken the yen and devalue the currency. They are amazed that Japan, a nation with many fine financial and economic thinkers, does not realize that it needs monetary expansion. It needs inflation, not deflation. But Japan is a country with an old population living on fixed coupons. Citizens who rely on income from fixed coupons do not vote for policymakers who promote inflation.

The United States, however, has a relatively young and indebted population. Citizens in the United States (and in the United Kingdom, to some extent) will thus end up “voting” for inflation. Consider the stance of the Bank of England. In 2011, it will certainly raise interest rates because its credibility will be damaged if it does not. The rise in interest rates, however, will be behind the curve, not because the central bankers are incompetent but because, at a time when its citizens are relatively young and indebted, a nation does not want its central bankers to be too aggressive in fighting inflation.

The monetary and fiscal policy choices nations make can vary radically depending on their demographics. China, for example, has a unique demographic for an emerging market. Because of its one-child policy, China’s population is rapidly aging. Therefore, inflation is a much greater challenge for China than for India, which has the more typical emerging market demographic of a young population.

If currencies are bonds and bonds are driven by inflation and inflation relates to demographics, the U.S. dollar will continue its downward trend. The Japanese yen and the euro will defy those investors who think of currencies as equities and will outperform despite economic growth that is steady and not stellar. But currencies are not about growth; they are about a store of value.

Investors’ Risk Appetite Drives Currencies in the Short Run. In the short term, currencies (and other asset classes) are driven by the cycle of investors’ appetite for risk. That view is common today, but it was quite unusual in 1997, when I developed the risk appetite index.

When I was at J.P. Morgan, we had a wonderful economics department. Whenever there was a crisis, the traders would ask the economists to advise them about what they should do. Invariably, the economists would say that the countries with the best fundamentals would do the best in the crisis and the countries with the worst fundamentals would do the worst in the crisis. They then would recommend that the traders own the countries with good fundamentals. They gave this advice every time, and every time they got the markets wrong. And they did so because they were considering the situation statically. In a crisis, investors do not analyze the situation to determine where the value is. They simply want to get out of trouble as quickly as possible and bring their money home. That is the paradigm of short-term valuation in a crisis.

The currencies that do well in crises, the currencies that hold their value, are often those of countries previously thought to have poor fundamentals; because they have poor fundamentals, no one is holding them, and so they are immune from the universal selling. The currencies that prove most vulnerable to crises are those of countries that investors had previously considered to be the tigers with great fundamentals, countries with money flowing in and an excess of international borrowing.

So, the second rule for currencies is that positions and flows dominate when investors suddenly become risk averse. Valuations, fundamentals, and inflation are all important in the long run, but in a crisis, investors will repatriate their funds.

Some in the industry make this observation an absolute and assert that flows always drive currencies. I caution against such thinking. When I left J.P. Morgan for State Street, I believed that flows mattered most in currencies. But in those days, State Street had one of the world’s largest custodial databases and knew the flows. My examination of State Street’s flow database reminded me of something we are all taught in school: For every buyer there is a seller. Thus, looking only at flows reveals little during normal times. Indeed, most price action in the marketplace has no flow behind it.

Sometimes a new piece of good economic news comes out, and the traders will move the currency up to where they think it ought to be according to the new fundamentals. The traders are, in effect, repricing the currency, and they stop pricing it upward only when they get selling pressure. If I were to examine flows on the days when a currency rises the most based on a news item, I would likely find that investors were net selling that day to the traders.

Flows and positions matter most during periods of crisis, when all that matters to investors is that they get out of positions they are in. Comprehending the flows of those investors who can get out helps in understanding currency movements.

Currencies Are a Distraction. Spending a large part of my career studying currencies helped me learn my third rule for currencies, which is one of the most important lessons I have learned:
Currencies are a distraction, especially for emerging market economies. Unfortunately, emerging markets’ central banks tend to spend too much time debating where the currency should be when they should be debating education policy, tax policy, health policy, and investment policy. These are the important things that determine whether an emerging market grows sustainably.

Exchange rates are nominal prices that make no difference in the long run. One of the key reasons that Italy, Spain, and Greece are having such difficulty today is that they are too accustomed to devaluing their way out of problems rather than concentrating on how to reform the structure of their economies with the real ingredients of education, training, and the development of good institutions. Worrying about currency valuations and exchange rates distracts politicians away from dealing with the more serious choices they face. The notion held by U.S. policymakers that a revaluation of the Chinese renminbi will somehow save the U.S. economy is completely false. In monetary terms, the Chinese economy is only one-quarter the size of the U.S. economy. Nothing China does with its exchange rate will save the U.S. economy. And why should it do anything? The United States has gone through a period of excess borrowing, loose regulatory policy, easy monetary policy, and easy fiscal policy. The United States has created its own unsustainable position. Why would the United States conclude that the way to correct the situation is for other nations to raise their exchange rates? That approach will only accommodate and will not wean the United States off its debt addiction.

The only solution is to manage and reduce the excessive consumption in a way that does not hit the most vulnerable in U.S. society and does not lead to excessively high rates of unemployment. A sustainable savings rate for the economy needs to be determined while doing the least possible damage to our social fabric. Dithering over exchange rates is an utter distraction.

**Conclusion**

Managers need to concentrate more on their risk capacity than their risk appetite because it is very hard to correctly measure the changing price of risk. Managers can forecast better by forecasting less and by thinking about the things that are fairly certain. Investors need to remember that currencies behave like bonds, not equities.

Finally, managers need to remember the three trade secrets about currencies. First, inflation drives currencies in the long run. Second, risk appetite drives currencies in the short run. And at an extreme, in a crisis, most investors’ first instinct is to sell and bring their money home, not to find out where value is or what should be shorted. Third, currency valuation is a distraction and takes attention away from more fundamental policy issues.

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Question and Answer Session
Avinash D. Persaud

Question: How do you compare operational risk with liquidity risk?

Persaud: First, consider how to hedge each type of risk. Risks have different names, but if they are hedged in the same way, then they are not different risks. What differentiates one risk from another is the way in which it is hedged. For example, having sufficient long-term funding is the proper hedge for liquidity risk. With enough long-term funding, investors are never in a position to sell an asset at an unnecessary loss.

Long-term funding is not, however, the optimal hedge for operational risk. Such funding may help a company survive an operational problem for a little while, but managing operational risk has less to do with the maturity of the funding than it does with improving efficiency and transparency by stress testing what is going on internally.

Question: How do you quantify risk and measure the capacity to deal with it?

Persaud: Consider the United Kingdom’s Treasury. It is taking more than one type of risk these days. For the liquidity risk it is taking, it has enormous capacity. Because the Treasury is part of the government and because the government is, in essence, immortal—although some people would say regrettably so—it has almost unlimited long-term funding and capacity for liquidity risks.

Conversely, the Treasury has no capacity for reputational risk. Once a fiscal authority loses the trust of its constituents, it finds it hard to continue such normal functions as collecting taxes and managing the economy.

Investment managers do not need a computational analysis to determine the areas in which they have or do not have capacity for risk. Indeed, the cult of numbers has blinded managers to the obvious on more than one occasion, and I say that as a student of the mathematical and statistical aspects of economics and finance.

In my time as a director of the Global Association of Risk Professionals, we used to meet new risk professionals and tell them, “We are going to spend an hour talking about risk management without numbers.” Perhaps 80 percent of good risk management can be done without numbers. Indeed, the numbers have tended to lull managers into a false sense of security. It has encouraged them to focus on what they can enumerate and to ignore, or almost ignore, what they cannot enumerate. Yet, the biggest risks are often the things that cannot be easily quantified.

It is not the things you think are dangerous that are actually most dangerous. Financial managers have elaborate models of risk management that provide a systematic series of red, amber, and green traffic lights. When we see the red light, we know not to go there. When we see green, we think we are safe. But the areas marked green are the ones that hide the greatest potential danger.

Question: Why has the Japanese yen risen since the earthquake in March 2011?

Persaud: One of the wonderful things about currency markets is that they are very responsive to expectations. I think that in the case of the yen in 2011, people were looking back at the Kobe earthquake in 1995 as well as previous Japanese equity crashes and observing that, when faced with a crisis, the Japanese bring their money home.

Japan has had a long period of current account surpluses, which means that it has been exporting its capital abroad. So, when the Japanese bring their money home, the yen rises sharply. It all comes back to my rule on risk aversion. Japanese investors are not buying the yen because they are making some value judgment about insurance losses in Japan or about the scale of the potential nuclear disaster. They are faced with a condition of deep uncertainty and risk, and when faced with those conditions, they bring their money home.

I think that is why the yen rose after the earthquake, and as things settle down, it may weaken again, at least against some European currencies, such as the Swiss franc.

Question: Do you foresee the Chinese renminbi and the U.S. dollar ever reaching parity in terms of currency status?

Persaud: I got into trouble in 2002 for arguing that the renminbi would be the next world reserve currency. I did not mean that it would assume that role in the next year but, rather, over a long period of time. China is a big trader, and it is going to be a very big economy, perhaps the biggest economy in 20–30 years.

Because it will be a big trader with a big economy, a lot of people will have to hold renminbi; thus, the renminbi will become an international currency. And because of China’s demographics and its aging population, the renminbi will be a low-inflation international currency with an easy metamorphosis to a reserve currency.
Although it is true that China has capital controls and a relatively young financial system, that situation will change. Imagine how an Englishman in 1910 might have reacted to the suggestion that the U.S. dollar would one day be the world’s reserve currency. I can imagine the indignation accompanied by an exclamation: “But they don’t even have a central bank!”

As we all know, the U.S. financial markets matured quickly, and it did not take long for the U.S. dollar to become the world’s reserve currency. China needs to go through a lot of institutional reform before it can fill that role of a reserve currency, but given the pace of its growth, I expect that to happen.

**Question:** What are your thoughts about Gulf Cooperation Council countries reconsidering their current policy of pegging to the dollar?

**Persaud:** Two elements are essential when choosing a peg: simplicity and links to the actual currency in which the largest proportion of imports and exports are carried out. Pegging against a single currency, such as the U.S. dollar, provides clarity and certainty for investment decisions. A complicated peg, such as a peg against a basket of currencies, can defeat that purpose. Pegging to two currencies is workable, but anything more will start to defeat the objectives of clarity, transparency, and certainty for investments. So, that is the argument for having a single currency peg. But is the United States the right currency to put the peg on? As long as commodities are still priced in dollars, I would say a dollar peg makes sense.

To relate this issue to the previous question about the renminbi as a potential reserve currency, I understand that many observers are asserting that China cannot afford to let the dollar fall. Traders say that a lot. If the dollar falls, they say, the Chinese will impoverish themselves. Traders, of course, assume that everyone else thinks and acts like a trader.

Governments, however, do not think like traders, and they generally do not buy and sell currency positions on public exchanges unless they want to influence their value. So, do not assume that China worries excessively about what a falling dollar might do to the value of its reserves; it can swap dollars for euros with the European Central Bank off the exchange.

**Question:** Do currency controls ever accomplish either short- or long-term goals?

**Persaud:** A dominant narrative today is that the world is growing rapidly because of liberalization and globalization and that Brazil, Russia, India, and China (known as BRIC) are at the forefront of this growth. But BRIC countries are, in fact, reluctant globalizers and reluctant liberalizers. They have opened themselves to trade, but they are much less open to the capital account—to portfolio flows in the case of China, to foreign direct investment (FDI) in the case of India, and to a combination of portfolio flows and FDI in the case of Brazil. On paper, Russia is generally more liberal in those areas.

I would not say that currency controls have no merit. If a country wants to improve asset allocation and use of capital but is short of capital, then a step-by-step opening of capital accounts and removal of restrictions make sense. But such steps should not be taken too quickly. The history of bank liberalizations matches very closely with the history of banking crises. Central bankers have to be cautious. Countries need to think about the structure of their economies. Sovereign wealth funds make perfect sense for emerging markets when they have immature financial markets. Capital controls can play a role in such places. Once financial markets mature—in 20 or 30 years—sovereign wealth funds and capital controls are no longer needed.

I know this is a provocative response. But consider the example of the Netherlands. It was one of the first countries in Europe to find oil and gas, it does not have a major sovereign wealth fund, and it has the largest private sector pension fund relative to GDP in the world. It was able to do that because of the maturity of its financial systems. Other countries cannot do that today. The current structure of capital controls and sovereign funds will not make sense in two or three decades, but it does make sense for young financial markets today.

**Question:** What currencies should investors hold for a three- to five-year period?

**Persaud:** Risk appetite does not come into play because that is a short-term phenomenon. And no one can predict where the economic cycle will be in five years, so that is not an issue either. I would consider countries with the ability to be low-inflation zones on a five-year view, which fits neatly with the framework I presented earlier.

Countries with older, retired populations will be tougher on inflation and will have tougher monetary policies. Western economists will call such behavior bizarre, but that is the choice such countries will make because it reflects the interests of their citizens, who are voters in democratic systems.
Japan and much of Europe will have higher exchange rates than their manufacturers would like, higher than some economists will think makes sense, but they will do it. The United States and the United Kingdom will have weaker exchange rates than the central banks and policymakers say they want, but they will have those rates nonetheless because that is what their voters want. The voters in the United States and the United Kingdom will prefer the risk of inflation to the risk of unemployment or the risk of falling house and equity prices.