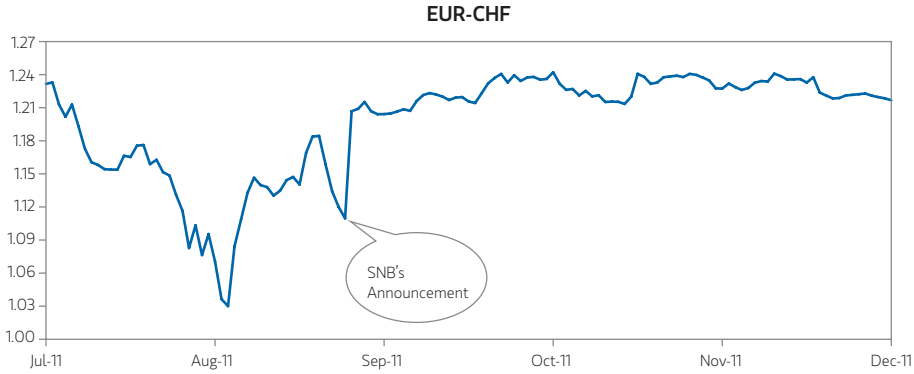
Connecting the Dots

Reflecting on Reflexivity

On September 6, 2011 the Swiss National Bank (SNB)[1] issued a clear, concise and firm communication to put an end to the sharp appreciation of the Swiss Franc. The SNB said in its statement that it is aiming for a substantial and sustained weakening of the currency and will no longer tolerate a Euro-Franc exchange rate below 1.20. The communication elicited an almost instantaneous response from the financial markets with the Franc trading within the desired range (*Display 1*). While the Reserve Bank of India today is facing quite the opposite challenge, with a depreciating rupee, the signaling and action could have been just as focused and single minded.

Display 1: **The SNB Signalling Effect**



Source: Bloomberg, Morgan Stanley Research

[1] The Swiss National Bank. (2011, Sep. 6). Press Release. Retrieved September 2, 2013, from http://www.snb.ch/en/mmr/reference/pre_20110906/source/pre_20110906.en.pdf.

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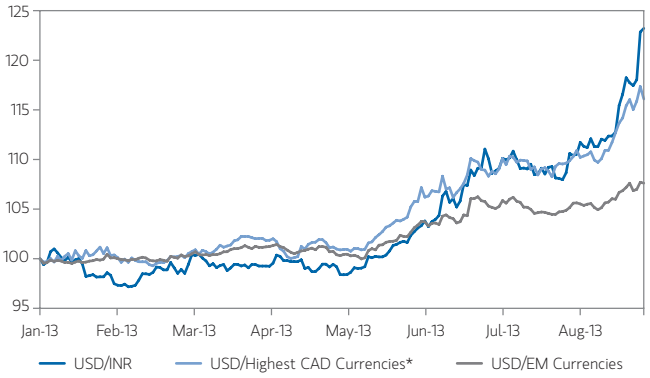
As stock market participants, we have learned from Benjamin Graham[2] that 'in the short term, the stock market behaves like a voting machine, but in the long term it acts like a weighing machine'. This has been the popular perception about markets, even for those who criticize the shortcomings of the Efficient Market Hypothesis. The long-held belief is that while there may be short-term deviations, financial markets eventually tend towards equilibrium, thus reflecting underlying fundamentals. However, what is often underestimated is that in the real world such deviations can become self-reinforcing, and may actually alter the fundamentally driven equilibrium. In other words, like the proverbial tail wagging the dog, the short-term impacts the long term.

This circular relationship between cause and effect is known as reflexivity. Reflexivity plays an important role in markets, which often focus on the effect rather than the cause. If you scroll down the news ticker of a stock that has had a particularly bad day, you will notice that within minutes the news that caused the stock price weakness is quickly forgotten, and the price decline itself becomes the more glaring news headline. As George Soros[3] says, the new paradigm is that instead of being always right, financial markets may always be wrong. Markets have the ability, however, to both correct themselves but also occasionally to make their mistakes come true by a reflexive process of self validation. He suggests that financial markets may not predict economic downturns, but may actually cause them. For example, rising sovereign bond yields may transform a seemingly contained liquidity problem into an outright solvency crisis, as we saw in the Eurozone in the recent past. Media headlines like "Rupee plunges to new lows" lead to a negative feedback loop, where the effect (rupee depreciation) ends up becoming the cause for further depreciation.

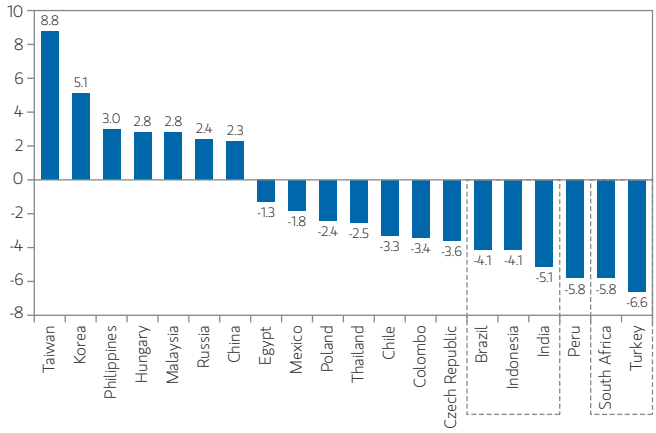
India is not the only Emerging Market to have suffered a rout in the currency market in recent times. The other four markets suffering a similar fate have been Brazil, Indonesia, Turkey and South Africa (*Display 2*). The common underlying thread that made them vulnerable is Current Account Deficit in excess of 4% of GDP in each case (*Display 3*). Central Bankers in each of these countries attempted policy responses that they assumed was most appropriate, but their currencies met with a similar fate. While Brazil announced a $60 billion intervention programme, South Africa preferred not to intervene. Similarly while RBI was criticized for raising short term rates, Bank Indonesia was accused of not raising rates enough. So the conclusion that some may draw is that, apart from fixing the current account problem there is nothing that individual countries can do to fight the global fear of tighter liquidity.

Display 2: **High CAD Emerging Markets have suffered more**



Source: Bloomberg, Morgan Stanley Research. * Highest Current Account Deficit (CAD) Countries are India, Brazil, Indonesia, Turkey and South Africa

Display 3: **Emerging Markets: Current Account Balances**



Source: Morgan Stanley Research

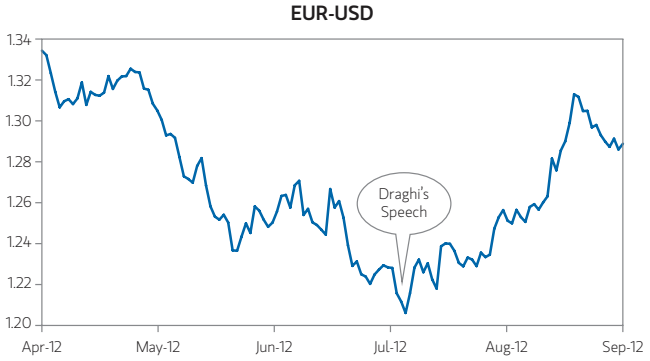
The recipe for a reflexivity spiral, as we have seen, is confusing signals in the short term and continued inaction on long term structural reforms. Knee jerk steps ostensibly meant for crisis management of the Current Account Deficit, such as increasing tariffs, curbs on imports and outward remittances often feed into the negative reflexivity loop. Studies have shown that in most episodes of currency crises, the Current Account Deficits have already peaked out before the event. In India too it appears that the Current Account Deficit this year may be well below last year's level of $90bn or almost 5% of GDP.

The risk is that these negative reflexive loops can alter the fundamental fair value of the rupee, based on Real Effective Exchange Rate models. A weaker rupee could bring back inflation, widen the deficits, slow growth further, raise bond yields and make foreign investors want to exit. Each of these events could again cause further currency deprecation. Hence it is important to address the psychology as much as it is to fix the fundamentals. Failure to influence short-term behavior, as is

[2] Benjamin Graham. (2003). *The Intelligent Investor (Rev. ed.)*. New York: HarperCollins Publishers.
[3] George Soros. (2008). *The New Paradigm for Financial Markets*. New York: PublicAffairs.

observed in a bank run, could alter the fundamentals. History has shown that the word of a Central banker wields immense clout over market participants, as was amply demonstrated by Mario Draghi[4] of the European Central Bank (ECB) in July 2012, when he said "…the ECB is ready to do whatever it takes to preserve the Euro. And believe me, it will be enough." and unlike the earlier SNB example, this assertion did not come from a position of strength, but with the Eurozone having its back against the wall (*Display 4*).

Display 4: **The Draghi Effect**



Source: Bloomberg, Morgan Stanley Research

While we recognise the complexity of the current situation and are loathe to get onto the policy prescription bandwagon, we feel that, in the midst of a carnage, policymakers may consider adopting a barbell strategy. That is, at one end, address the market psychology for the short term through strong worded communication, and at the other end, accelerate structural reforms that will make the economy more robust for the long term.

[4] Speech by Mario Draghi, President of the European Central Bank at the Global Investment Conference in London. (2012, July 26). Retrieved September 2, 2013 from http://www.ecb.europa.eu/press/key/date/2012/html/sp120726.en.html

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