Colombian Peso, the Richest Kind

Certain European nations, particularly France and Italy, have a long tradition of businesspeople keeping three sets of books, one for themselves, one for their partner and one for the tax authorities. This culture of off-the-books accounting for tax purposes led to the now-forgotten "mattress trade" in the euro between 2000 and 2002. The common currency came into existence at just over 1.17 dollars per euro and slid down toward 0.82 by October 2000; it did not embark on a multi-year bull market until May 2002.

The reason for the euro's early weakness was attributed by many to the selling of legacy currencies held as cash for dollars prior to those legacy coins and bills being taken out of circulation at the start of 2002. French francs, Italian lira, Spanish pesetas, Portuguese escudos and the rest had to be pulled out from literal and figurative mattresses, converted into some other form of cash, and the dollar was the refuge of choice. Such is the power of an underground economy.

Of course, that trade cuts both ways. Legend has it counterfeit C-notes, $100 bills with the new enlarged portrait of Benjamin Franklin and those other anti-counterfeiting devices were being offered for sale on the streets of Bangkok before they were issued for circulation in the U.S. A second observation in this regard was counterfeit $100 bills were the currency of choice in Russia during the tumultuous 1990s. By Gresham's Law, bad money driving out good, the real $100 notes were hoarded and the counterfeits were passed into circulation. It is indeed all about the Benjamins.

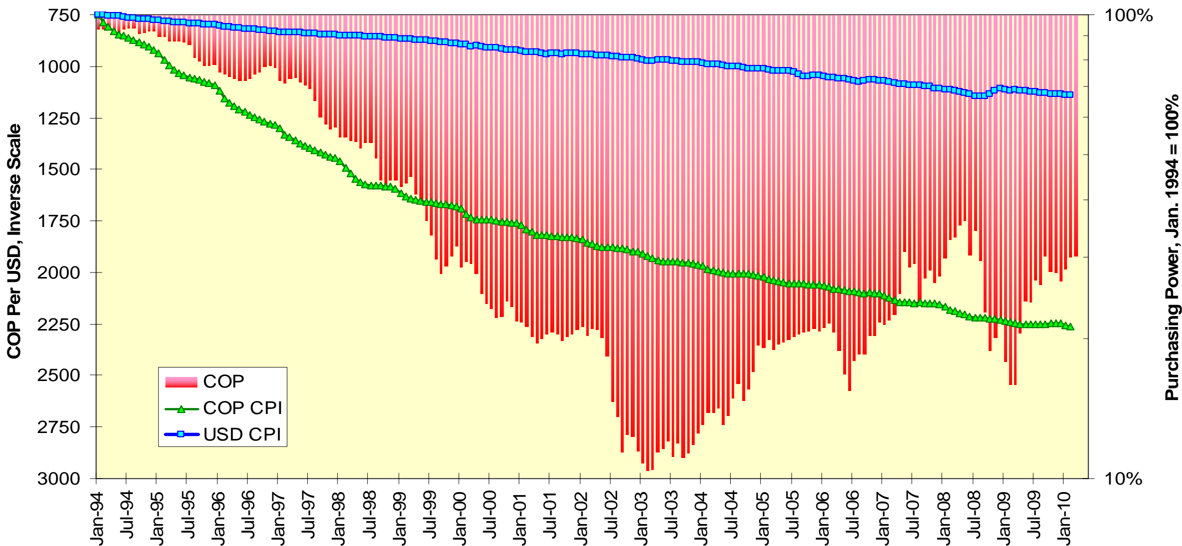
The Velvet Underground
If you play a word association game with "Colombia," you might get more than a few giggles. Ever since the heyday of Pablo Escobar and his Medellin cartel, the country has been associated with a large, um, pharmaceutical precursors and related products sector. The efforts by the Bogota government and the U.S. Drug Enforcement Administration to control this trade have led to an ongoing low-level war with the FARC guerillas who seem to take special joy in blowing up crude oil pipelines from Colombia's Caño Limòn oilfields. The traffic therefore raises the relative size of the illegitimate sectors of the Colombian economy to the legitimate ones by increasing the former and decreasing the latter. The extent to which this is true can be illustrated by the heading for Colombian GDP data on *Bloomberg*: "GDP Excluding Drug Crops."

Truth be told, any economic data from countries such as Afghanistan, now alleged to provide more than 90% of the world's opium poppy, should be taken with a modicum of skepticism. A World Bank official regarded as an expert on Third World debt was asked in 1976 by a graduate student in international economics how he arrived at certain figures. He pointed up to his office ceiling. Puzzled, the student pressed onwards. The reply came, "I was pointing at that light. When no actual data are available, I stare up at that light, think about what information I have and arrive at what the debt level should be." Some early life experiences are more indelible than others.

Scratch The Commodity Connection
We recently explored some currencies such as the South African rand or Chilean peso (see "Cry, The Beloved Currency" and "Chilean Peso Makes Exceptions To Currency Rules," March and May 2010, respectively). Those were easy to do as the gold and copper markets, respectively, are transparent. While Colombia is a large exporter of coffee, cut flowers, emeralds and other gemstones and increasingly crude oil, no one pretends it is the dominant export. We will not be able to establish a commodity link for the Colombian peso (COP) here.

We can, however, infer certain factors of economic and financial success for the country. The official consumer price index for Colombia has increased at an average annual rate of 9.58% since January 1994; this compares to an average annual rate of consumer inflation in the U.S. of 2.455% over the same period (please see above anecdote on the credibility of numbers).

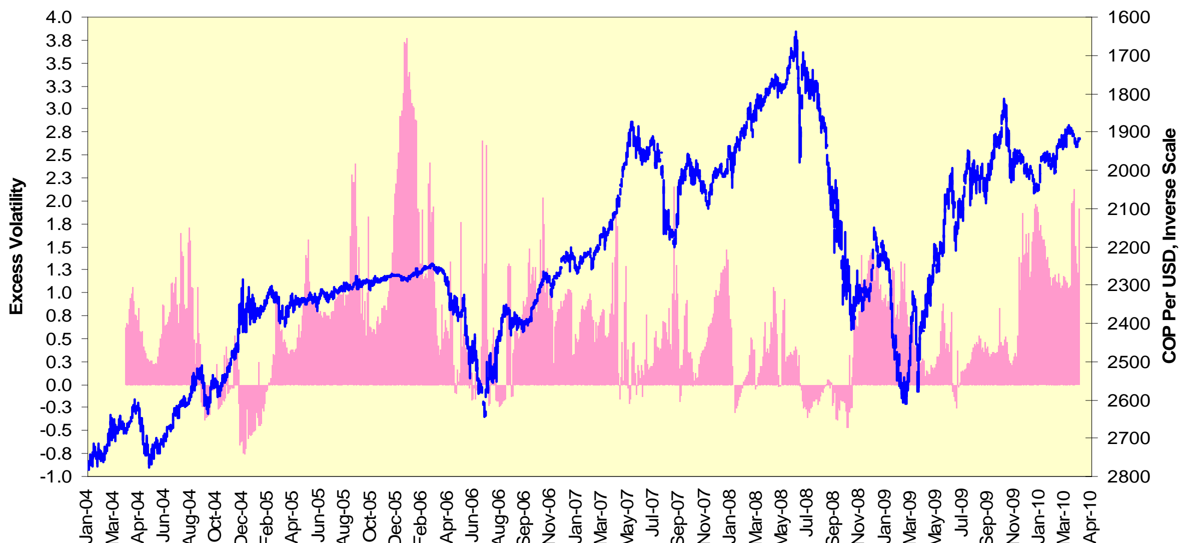
Given the role of relative inflation expectations in the interest rate parity model, we should expect the COP to have weakened against the USD over this period. We would have been wrong. The Federal Reserve's policy of low interest rates easing since 2003 put the COP in an uptrend between April 2003 and May 2008. That trend broke when the financial crisis of 2008 led to massive dollar buying and shedding of risky assets around the world, but it resumed after the Federal Reserve embarked upon quantitative easing in March 2009. Some might consider this picture a damning indictment of the Federal Reserve's money-solves-everything approach, and who are we to disagree?



Pricing The Risk

We have seen across a wide range of currencies how excess volatility, or the ratio of implied volatility on three-month non-deliverable forwards to realized high-low-close volatility, minus 1.00, tends to lead movements in the currency by three months on average. This makes perfect sense as the measure indicates which party in the trade has the higher level of anxiety, and in which direction.

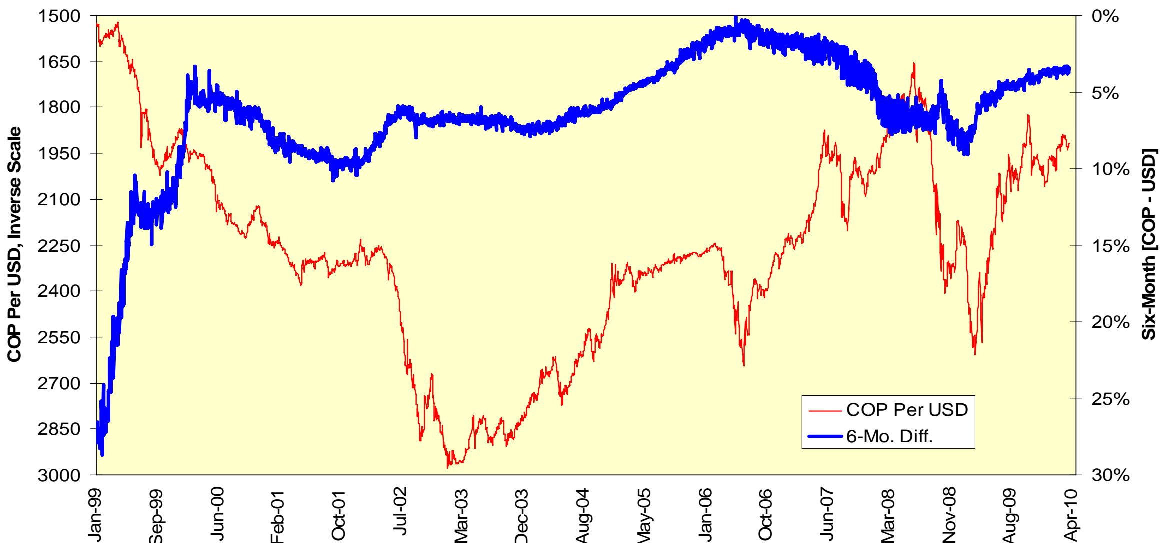
The relationship is rather different for the COP, however. Here the excess volatility on the COP for a USD holder has tended to rise and fall in the general direction of the currency and without the normal lead time. When the COP strengthens, put option buying rises and vice-versa. Even though the COP has put on some prolonged rallies since 2003, the market never embraces COP strength, only COP weakness.



Rates Not Important

Just like we saw for the Chilean peso two months ago, the relatively illiquid interest rate arbitrage market for Colombian deposits make a normal interest rate analysis for the COP difficult. We cannot compare relative yield curves for the COP and the USD by constructing forward rate ratios for each; the key forward rate ratio for currencies between six and nine months, the rate at which we can lock in borrowing for three months beginning six months from now divided by the nine-month rate itself, is inapplicable.

A simple spread between six-month deposit rates in both countries is revealing for one factor, and that is the huge interest rate gap between the start of 1999 and the middle of 2000. Colombian short-term rates were in excess of 30% at that point. As the interest rate gap narrowed, the COP weakened as those seeking yield went elsewhere. After June 2000, the general course of the COP moved parallel to the interest rate gap for another six years. The connection weakened and broke during the financial crisis, but resumed in force after the bear market low and arrival of quantitative easing in March 2009.

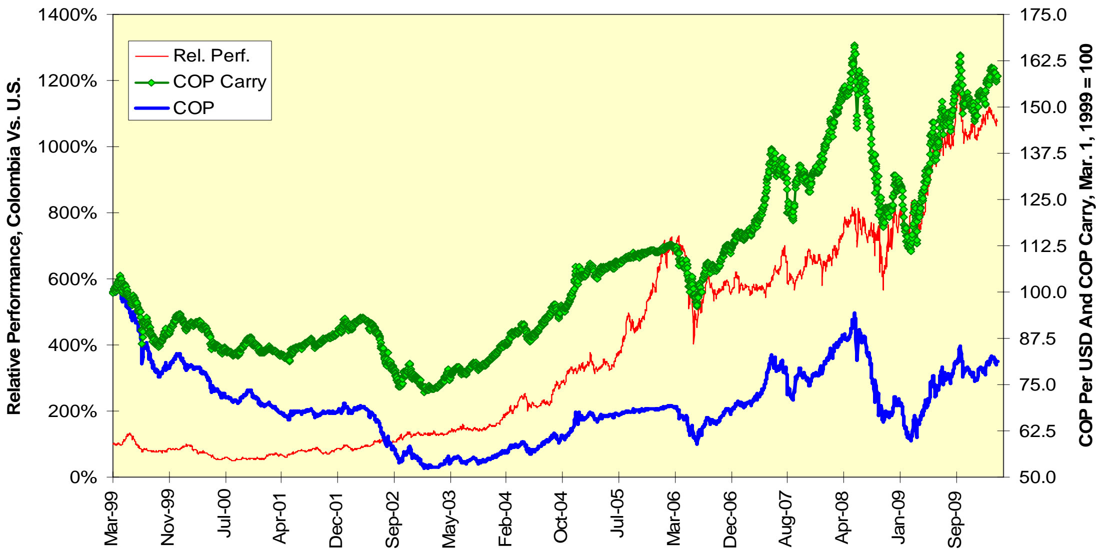


Relative Asset Returns

Those high interest rates should provide a tipoff to which way the USD carry to the COP has been moving over the years. Even if the spot rate for the COP weakens, the interest rate spread should be more than enough to compensate. This has been especially true since U.S. short-term rates were driven toward zero. The rate of return on this carry trade has moved in parallel to the relative performance of Colombian equities to U.S. equities expressed in USD terms.

Here the numbers are a little inspiring. In USD terms, Colombian equities have outperformed their American counterparts at an annualized rate of 26.1% since December 2008. The annualized return on the carry trade has been 15.9%, with the spot rate accounting for 11.1% of that. As it turns out, a brave investor who borrowed the USD and who either lent in the COP or bought Colombian equities at the time the October 2008 low was reached was rewarded handsomely. The action was undertaken without comment at the time and was assigned the label of "brave" or "foolish" only in retrospect.

Colombian Performance Became A Carry Trade After Mid-2006



Can the dual success of the COP and returns on COP-denominated assets continue? The answer will come not from Colombia but rather from Washington, D.C. If the Federal Reserve persists in its manic monetary policies, the success can endure for a long time. Perhaps someone in Bogota or even in Medellin is staring at a picture of Ben Bernanke and wondering, “What’s he smoking?”