BNY MELLON
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MACRO MORNING BRIEFING

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Pharma Haven Currencies

Local pharmaceutical industries underpin much of DKK and CHF

- Pharma plays disproportionately large role in Danish, Swiss economies
- Pharma-related fiscal, trade and capital flows material for currencies
- US BAT would materially damage terms of trade for pharma producers

Success brings monetary and political headaches

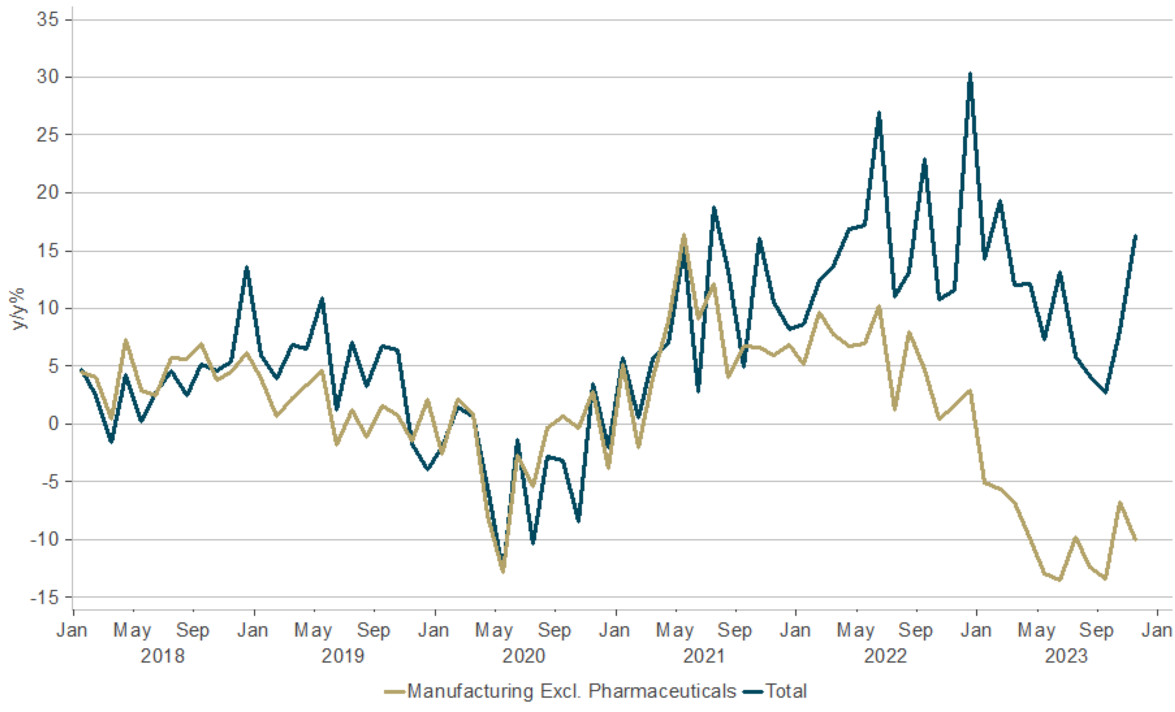
Currency pegs, currency boards or exchange-rate targets rarely set pulses racing in FX markets – unless there is a chance of abandonment. Most emerging markets have scrapped such mechanisms. Over the last 15 years, incidents of note have largely been in developed markets, with central banks of surplus nations trying to prevent currency appreciation. The Swiss franc and Czech koruna have been the best examples of such forms of extraordinary monetary policy, but we doubt they will be revisited barring extreme circumstances.

Over the past two years, however, the Danish krone has been attracting particular attention due to esoteric developments. The success of one pharmaceutical company and demand for its products has led to severe distortions in the local economy, with ramifications for monetary and fiscal policy. It has been well documented that the market capitalisation of the company itself is larger than the country's GDP – though this is a secondary matter as it is comparing a 'stock' (market capitalisation) concept to a flow (GDP) concept. However, the Danish government has acknowledged that the pharmaceutical industry is now so large in the country that it is necessary to separate the sector from the rest of the economy. This is not unlike how Norway needs to separate its onshore and offshore economies to account for the outsized impact of its energy industry, the export revenues of which also play a pivotal role in the formation of monetary, exchange-rate and fiscal policy in the country.

Subtracting the pharmaceutical industry, Denmark's industrial production would have been in annualised contraction throughout 2023 (exhibit #1). The country’s economic barometers are solid, and under any criteria the DKK would be considered a minor safe-haven currency, even taking into account potential valuation losses from its currency board with the euro. While healthy fundamentals were in play well before the dominance of one industry or even one company, the potential restructuring of the country and its balance of payments requires recharacterization of the category. If the FX market now views pharmaceutical sales as a sustainable source of current account amplification – associated receipts into household and fiscal channels can also generate productivity gains – then we think the currency deserves to be re-rated, in effect to a higher real effective exchange rate (REER).

To be clear, we are not questioning the currency board itself. Neither are we questioning the continuity of Danmarks Nationalbank's (DNB) FX policy, a policy that remains strongly in Denmark’s national interest, which the Chair of the Danish Economic Councils in 2015 said the country would defend "to the last drop of blood". However, with a fixed nominal effective exchange rate limiting their operational freedom, the DNB and Danish government will likely need very strong policies to prevent the economy from overheating.

Exhibit #1: Denmark Industrial Production Breakdown



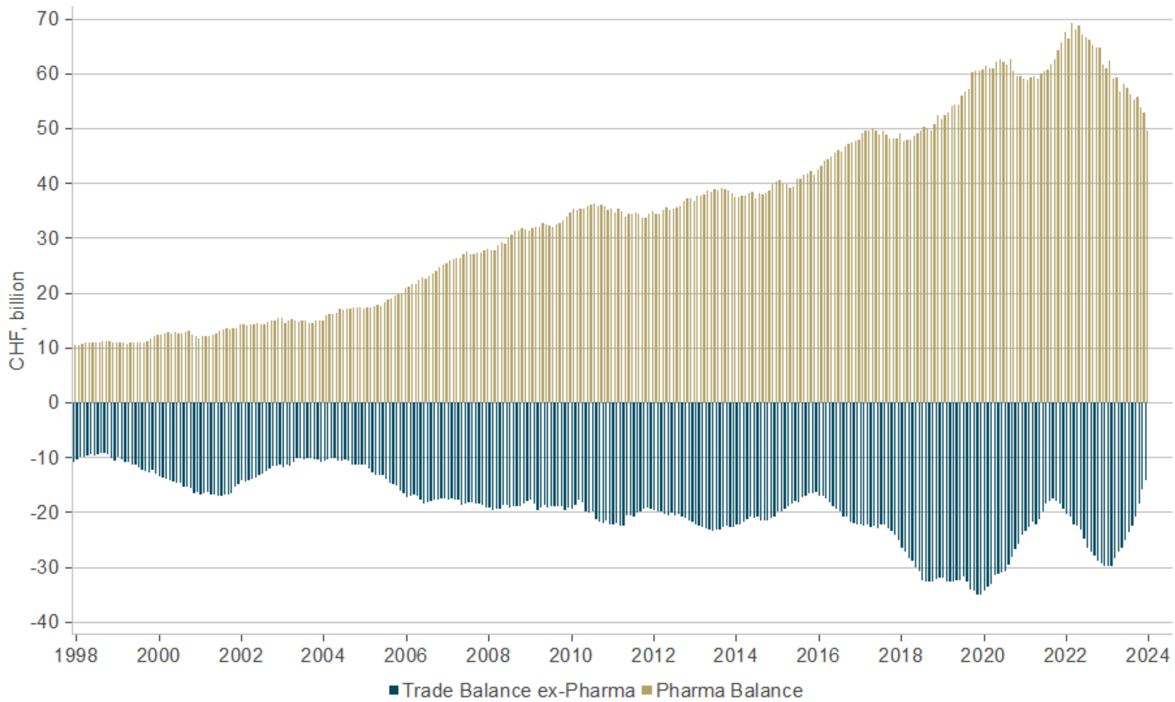
Source: Macrobond, BNY Mellon

Copenhagen can look to Bern for some guidance. While not as high-profile as Denmark’s case, the Swiss franc for all intents and purposes is also partially a pharmaceutical currency. Switzerland's balance of payments is equally as strong and, due to the strength of its financial services industry, the country's financial account is unique and anchors currency strength. According to the Swiss Federal Council, the pharma sector employs only 75,000 people (out of a labour force of over five million) but accounts for 7% of Swiss Gross

Domestic Product and 50% of total exports. As exhibit 2 shows, without the pharmaceutical industry the country would be running a rather large trade deficit.

Compared to Denmark, the Swiss pharmaceutical industry's support for the franc is far more through the current account side, and with a flexible exchange rate these earnings can be directly or indirectly recycled overseas to capture higher yields. Under normal circumstances, the Swiss reaction function is not dissimilar to that of savings-heavy Asian exporters, though discretion and execution is largely driven by the private sector, rather than reliant on state-related actors such as reserve managers or sovereign wealth funds.

Exhibit #2: Swiss Trade Balance Breakdown

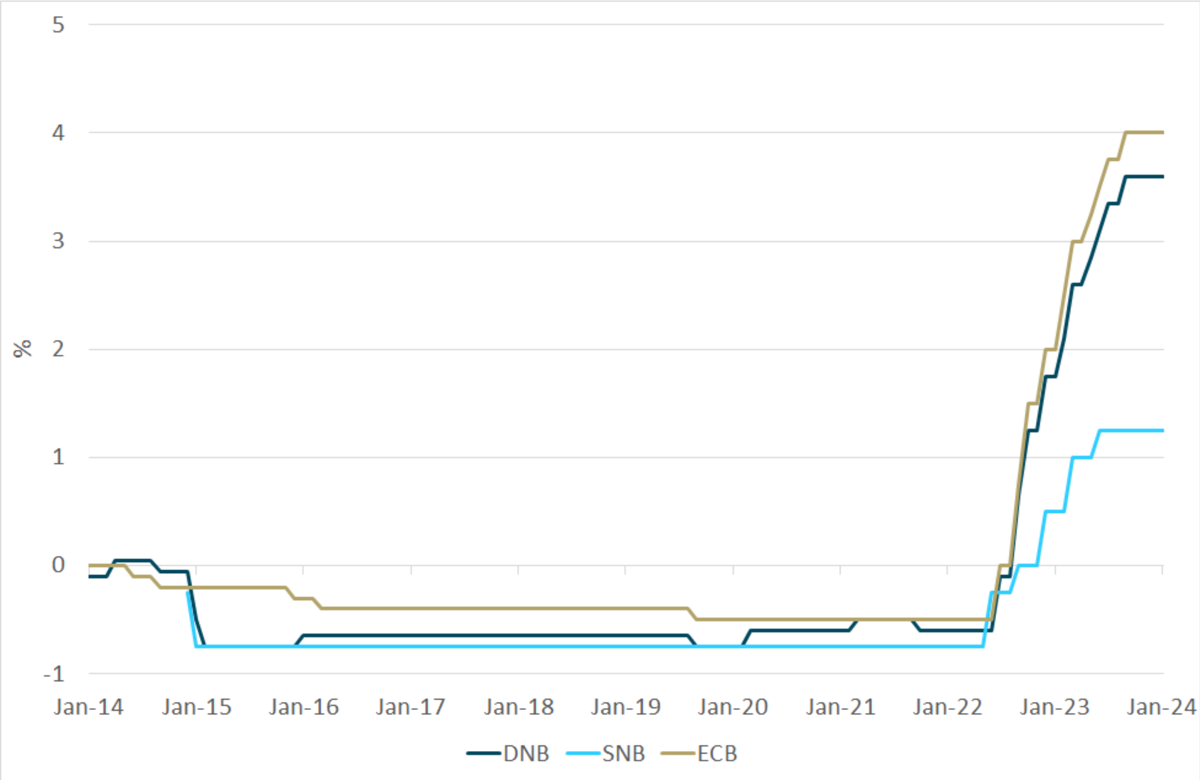


Source: Macrobond, BNY Mellon

Problems usually arise when the external yield and risk environment is no longer conducive to outflows and these savings stay onshore. The best example was during the Eurozone sovereign debt crisis, when the very existence of the euro was called into question. While the SNB's actions attracted significant attention, there have been periods of stress for DKK, as well. The DNB was forced into negative deposit rates for much of the zero-rate era, along with the SNB. Exhibit 3 illustrates that even during the most recent round of inflation-target and positive rates, both the DNB and SNB have been forced to keep their respective deposit rates below the ECB's benchmark. In the DNB's case, the sudden surge in pharmaceutical-related flows has resulted in a wider corridor between it and the ECB. The need to maintain respective currency arrangements have forced the Swiss and Danish central banks into what is probably a far more dovish interest-rate position than might be preferred.

The SNB has the option of allowing strong franc appreciation to tighten financial conditions, whereas in Denmark's case strong macroprudential management – led by its unique mortgage market – and fiscal restraint will likely be the conventional levers to prevent over-heating driven by low real rates and the lack of a currency offset. When manufacturing or even general export receipts are strong and competitiveness through the wage channel is a risk, self-imposed restraint is the only way to limit REER gains and competitiveness losses. This is especially true for pharmaceutical-related currencies, as patent protections mean that revenue streams can be maintained for an extended period.

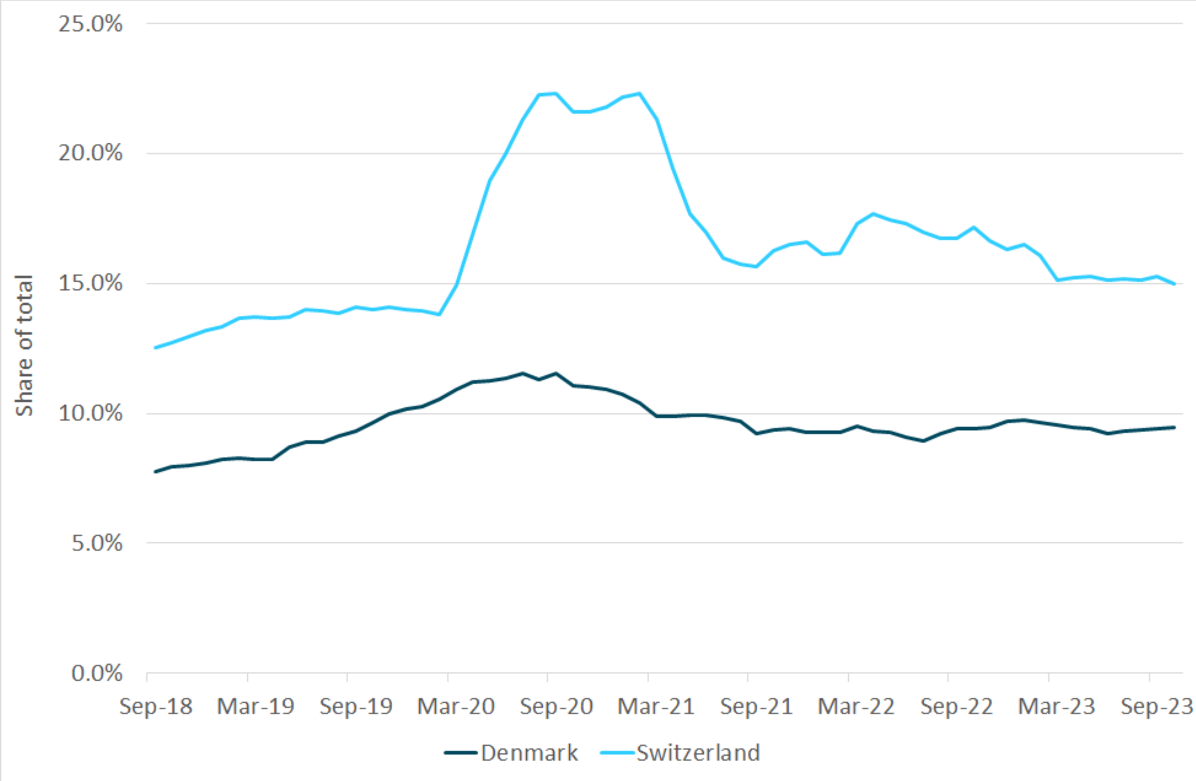
Exhibit #3: Deposit Rate Paths



Source: Bloomberg, BNY Mellon

We do, however, see one significant non-health-related challenge to pharmaceutical havens. For both Denmark and Switzerland, the US is the largest non-European export market (exhibit 4). The Swiss pharmaceutical industry is particularly dependent on sales to the US, and the same will likely materialise for Denmark given that its recent pharmaceutical innovations are particularly in demand across the Atlantic.

Exhibit #4: Exports To US, Share Of Total



Source: Bloomberg, BNY Mellon* based on rolling 12m exports

Burgeoning pharmaceutical-related surpluses seem sure to attract political attention. Switzerland has been mentioned in the US Treasury's Currency Manipulation report in the past. Currency boards or pegs such as Denmark's are also ripe targets, even though there is a very long history of currency links between Denmark and Germany out of economic necessity. Even without placing too much emphasis on the result of the US election later this year (November), trade barriers remain on the advance globally, and it is possible that a border-adjustment tax (BAT) for manufactured goods will be back on the agenda. If tax arrangements for goods produced outside of but destined for the US are subject to preferential tax treatment, a BAT levied on such goods would effectively impose REER appreciation on the exporting country's currency.

The pharmaceutical prowess of Denmark and Switzerland has played an instrumental role in global demand for their currencies and should be celebrated. However, monetary side effects and political complications are never far away in the modern world. Both countries' governments and monetary authorities will continue to have their work cut out to strike the right balance and prevent distortions from generating serious damage to their economies.

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