Insight INVESTMENT

GLOBAL MACRO RESEARCH
CURRENCY DEVALUATION AS A POLICY TOOL

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GLOBAL MACRO RESEARCH

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EXECUTIVE SUMMARY

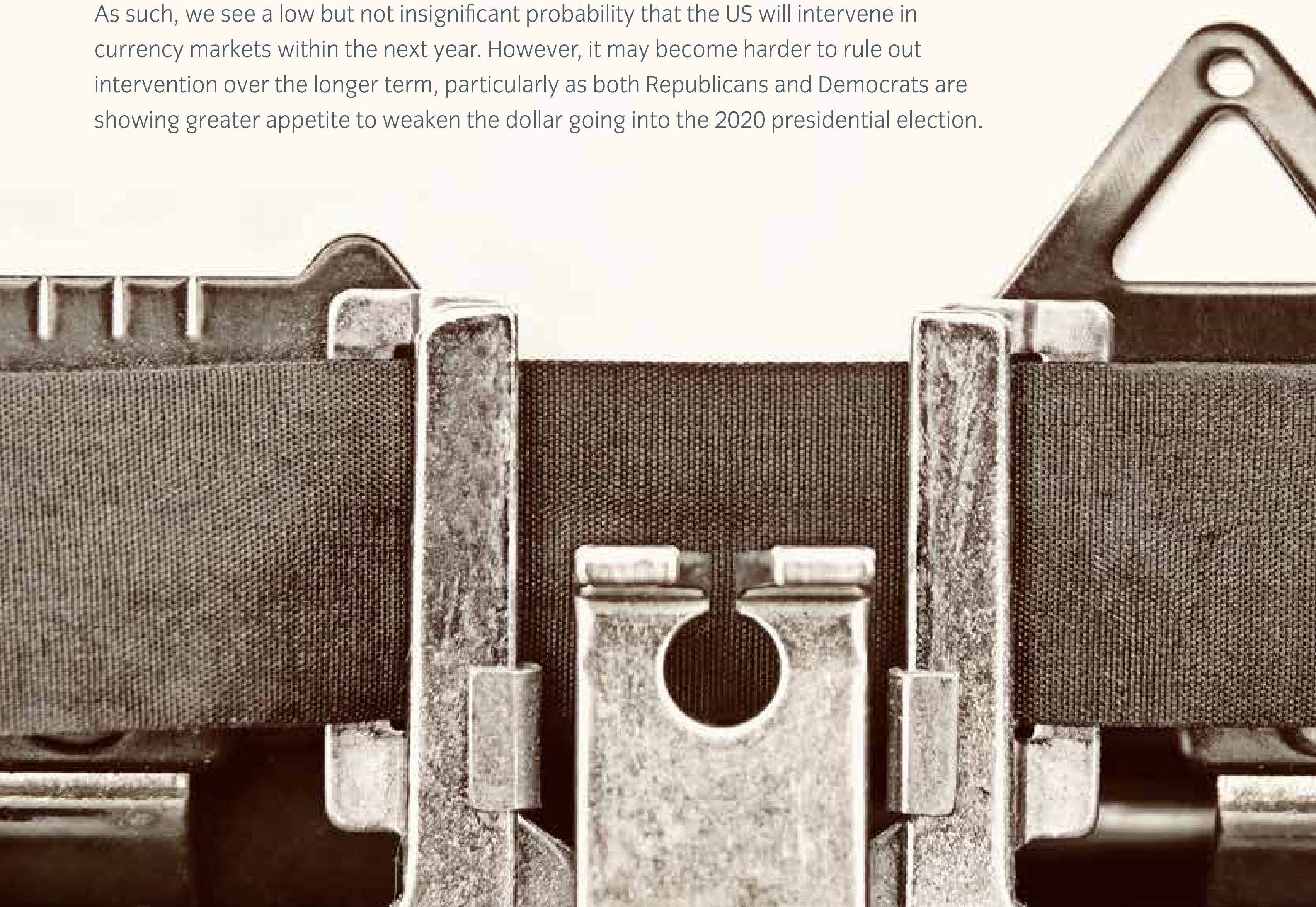
Is currency intervention returning as a tool to help countries stimulate growth?

In the case of the US, some policymakers are considering currency devaluation as an economic stimulus tool for the first time this century.

The US administration is concerned about its widening trade deficit, and the arguable overvaluation of the US dollar is a barrier to closing it.

However, we believe it is **highly unlikely an intervention would succeed** in significantly lowering the value of the US dollar in the medium term. Even if successful, it would **likely fail to narrow the trade balance**. Instead, we believe it would materially risk sparking a 'currency war' between the US and its peers.

As such, we see a low but not insignificant probability that the US will intervene in currency markets within the next year. However, it may become harder to rule out intervention over the longer term, particularly as both Republicans and Democrats are showing greater appetite to weaken the dollar going into the 2020 presidential election.



WHY MIGHT THE US PURSUE A WEAKER DOLLAR?

FOR THE FIRST TIME IN THE 21ST CENTURY, US POLICYMAKERS ARE SERIOUSLY CONSIDERING MEANINGFULLY INTERVENING IN THE CURRENCY MARKETS.

WHY HAVE COUNTRIES BACKED AWAY FROM CURRENCY INTERVENTION?

The US developed an increasingly 'laissez faire' attitude to currency markets in recent decades – very much in line with the emergence of globalisation and the increasingly liberalised economic world order that emerged from the 1970s (when currencies first became free floating).

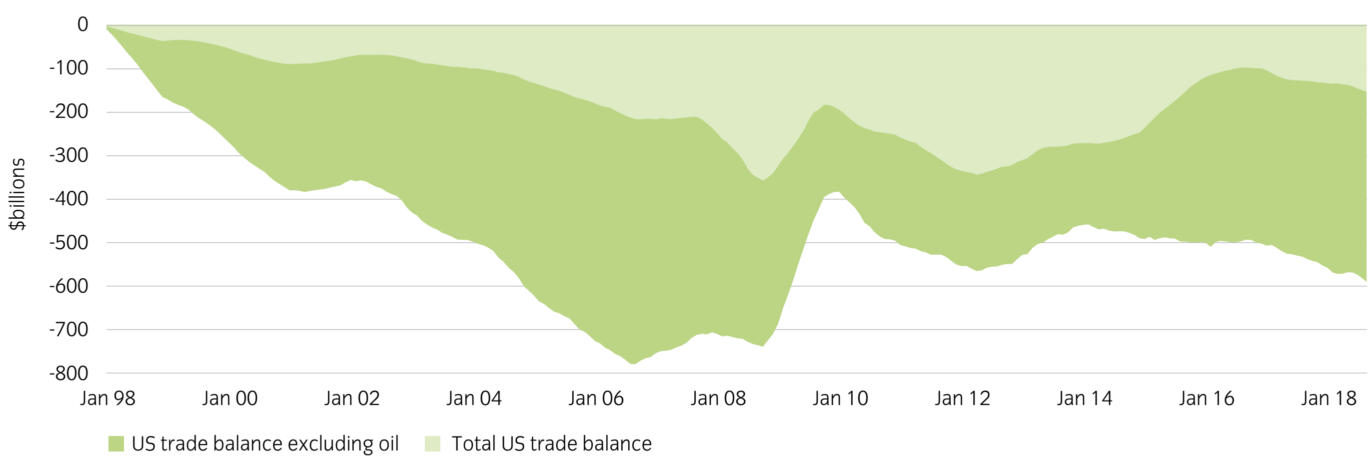
The rise of complex global supply chains and international portfolio flows had left policymakers increasingly concerned with the ineffectiveness of currency intervention.

ATTITUDES TO INTERVENTION ARE REACHING AN INFLECTION POINT

However, globalisation and trade liberalisation are now facing a domestic political backlash given factors such as inequality, a perception of Chinese theft of US intellectual property and a widening US trade deficit (Figure 1).

Narrowing the US trade imbalance (by encouraging the growth of exports relative to imports) has become a clear goal of the administration. Political trends are now therefore increasingly focused on protectionism. However, a major hurdle remains – an arguably overvalued US dollar. As such, currency devaluation is once again being eyed as a potential policy tool.

Figure 1: The widening US trade balance has become a political issue[1]



[1] Source: Bloomberg, September 2019.

THE USD IS UNLIKELY TO DEPRECIATE WITHOUT DIRECT INTERVENTION

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A global slowdown would actually likely place upward pressure on the currency as the USD is required to purchase the ultimate global safe-haven assets – US Treasuries.

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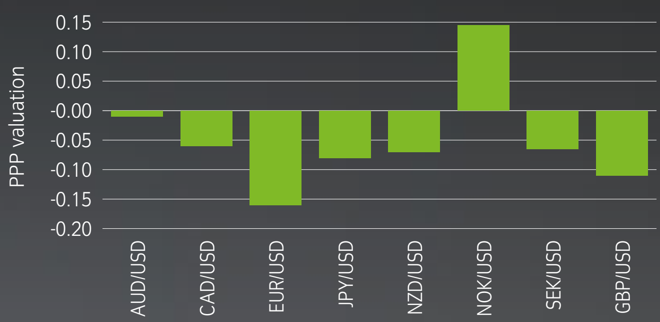
The US dollar (USD) currently looks expensive compared to peers such as the euro and sterling – at least on a purchasing power parity (PPP) basis. In general, if not outright expensive, it at least appears to be the 'least cheap' it has been for 17 years (Figure 2).

Figure 2: the USD looks overvalued against most core currencies on PPP (A negative reading suggests the USD is overvalued)[2]



[2] Macrobond, November 2019.

MEDIUM-TERM CURRENCY DRIVERS

Will the USD weaken without an intervention? It would appear unlikely if we look at the two empirical drivers of medium-term exchange rates[3]:

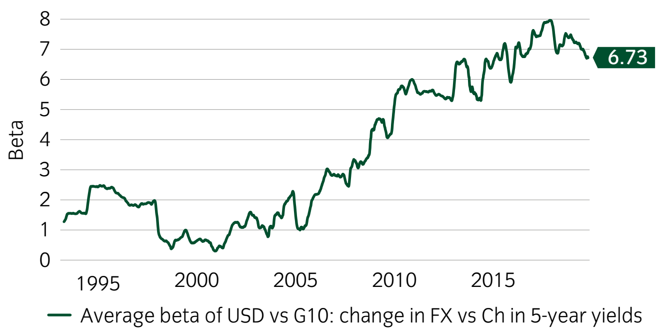
Driver 1 INTEREST RATE DIFFERENTIALS[4]

Unlikely to sufficiently ease

What is the potential for US yields to contract relative to their peers?

If 5-year US yield spreads, relative to other countries, were to tighten by 1%[5] historical data implies USD would likely depreciate by almost 7%[6] (Figure 3).

Figure 3: Average beta of changes in USD (versus major developed market currencies) to changes in relative 5-year yields[7]



As an example, the current difference between US and European 5-year yields is around 2%, so US yields may ideally need to at least converge toward Europe for a material USD depreciation.

Is that realistic? The main factor in the US administration's favour is that rates may be close to their lower limits in core Europe, but the Federal Reserve (Fed) would still likely need to embark on an aggressive rate-cutting cycle.

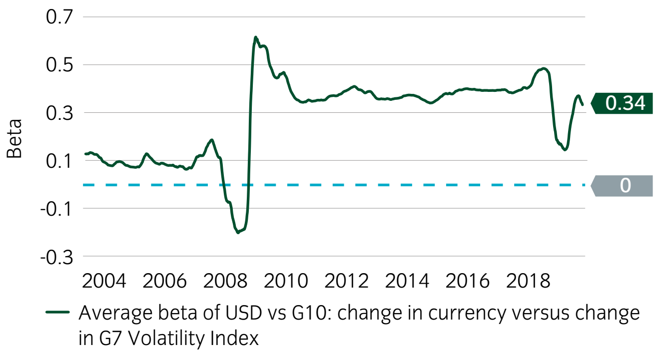
For this to occur amid the normal course of monetary policy, the US economic and inflation outlook would need to materially deteriorate without somehow also inflicting commensurate pain on its global peers (which is unlikely in an increasingly globalised world).

Driver 2 THE USD'S 'SAFE-HAVEN' STATUS

A structural barrier

Even if we were to assume that the Fed were to be forced to cut rates to defend a faltering US economy – the other important empirical driver is the safe-haven status of US dollar (Figure 4).

Figure 4: An increase in the G10 currency volatility index of one has led, on average, to a ~0.3% appreciation in the USD[8]



A global slowdown would likely place upward pressure on the currency as the USD is required to purchase the ultimate global safe-haven assets – US Treasuries.

Even in the case of a hypothetical US-only economic slowdown, depreciation may be limited by the tendency of US investors to 'export' less capital than their peers during bouts of volatility, partly given the size and depth of their domestic market.

[3] The drivers of longer-term exchange rates are different than the medium-term drivers. Long-term exchange rates tend be driven by long-term productivity, as highlighted by the literature around Behavioural Equilibrium Exchange Rate models (BEERs). Here, we are concerned with medium term. [4] The relationship between interest rate differentials and free floating exchange rates is well established (when countries primarily use monetary policy to manage their business cycles. The intuition behind this is that interest rate spread changes can approximate the relative position of each country within its respective economic cycle. [5] Equalling its all-time low set in summer 2012. [6] One of the questions that has been raised recently is: do unconventional monetary policy (UMP) tools like quantitative easing (QE), forward guidance, and yield curve control have a separate impact to interest rates? If so, it would be difficult to empirically disentangle those effects. We do not see this as a concern, however. We believe that UMP influences currencies through interest rate movements. This was underscored when the European Central Bank (ECB) restarted QE on 12 September 2019. It caused 5-year bund yields to sell off relative to 5-year Treasury yields. Subsequently, the EUR/USD also rallied. [7] Source: Bloomberg. [8] Source: Bloomberg, November 2019.

POLITICAL APPETITE FOR USD INTERVENTION IS RISING

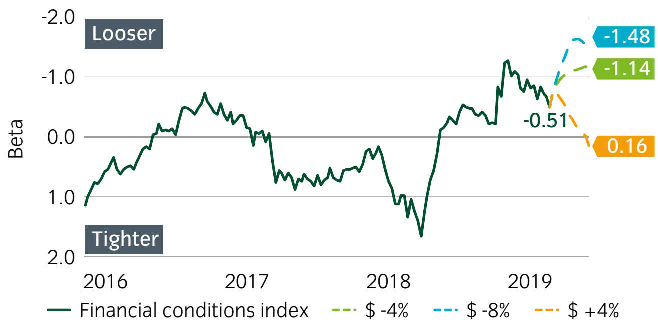
ABSENT A USD DEPRECIATION THROUGH MARKET FORCES OR NORMAL MONETARY POLICY CYCLES, IT IS NOT DIFFICULT TO SEE WHY POLITICAL WILL IS BUILDING FOR MORE DIRECT CURRENCY INTERVENTION.

US FINANCIAL CONDITIONS WOULD LIKELY IMPROVE IF THE CURRENCY WEAKENED

Insight modelled the potential impact of a lower USD on financial conditions, through three currency scenarios (Figure 5), examining USD depreciations of -4% and -8% and a rise of 4%.

The result indicates financial conditions in the US would loosen – which would have positive implications for US financial markets and US GDP.

Figure 5: US Financial Conditions Index[9]



However, when running the impact of these USD scenarios on UK, Eurozone and Japanese financial conditions, we found a material tightening (i.e. negative) impact.

Therefore, a cheaper USD would likely help the US, but materially hurt its peers.

REPUBLICANS AND DEMOCRATS ARE BOTH INTERESTED IN A WEAKER DOLLAR

President Trump has admonished the USD's value on a number of occasions, complaining of a "big disadvantage" against Europe[10] while stating the US should match China's and Europe's "currency manipulation game"[11].

However, the President is not the only policymaker in Washington seeking a lower USD. In late July 2019, a Democrat (Senator Baldwin from Wisconsin) and a Republican (Senator Hawley from Missouri) introduced "The Competitive Dollar for Jobs and Prosperity Act".

The bill would charge the Fed with "achieving and maintaining the current account balance", charging "a variable rate fee" on incoming capital and authorise the Fed to "neutralise exchange rate manipulation by other governments"[12].

We see this bill as unlikely to pass – as taxing capital inflows would likely be substantially negative for global growth and financial markets. However, a weaker USD appears to be emerging as a bipartisan issue heading into the 2020 US presidential election.

[9] Source: Insight, November 2019. For illustrative purposes only. Based on Insight proprietary model. Where model or simulated results are presented, they have many inherent limitations. Model information does not represent actual trading and may not reflect the impact that material economic and market factors might have had. Information does not reflect actual trading for portfolios managed by Insight. The index consists of assumptions around three components: US policy rate, global corporate bond spreads and global equity market performance. Each of the three US exchange rate scenarios is overlaid. [10] Twitter, 11 June 2019. [11] Twitter, 3 July 2019. [12] According to the lobbyist group "A Coalition for a Prosperous America".

WHAT WOULD THE US NEED TO SUCCESSFULLY WEAKEN THE DOLLAR?

WE SEE THREE FACTORS THAT WOULD BE ESSENTIAL (BUT NOT NECESSARILY SUFFICIENT) FOR INCREASING THE CHANCE OF A SUCCESSFUL CURRENCY INTERVENTION.

1 US TREASURY AND FED NEED TO CO-OPERATE

(Possible)

The Treasury has paltry resources for currency intervention – at about 0.35%[13] of the $6.6trn of global currency that trades daily (88% of which has a USD leg). Undoubtedly, it needs to work with the Fed, which can simply 'print' dollar reserves to buy other currencies.

The Fed would need to extend its easing cycle and jointly intervene in currency markets to uphold its end of the bargain. However, while the Fed has historically tended to join the Treasury, it has no legal obligation to.

2 CURRENCY INTERVENTION IS UNSTERILISED

(Not a given)

By 'printing' USD to buy other currencies, the Fed would increase the money supply. All things being equal, this would put downward pressure on relative USD market interest rates, which would likely depreciate the currency.

However, if it 'sterilises' the intervention through offsetting Open Market Operations (as it has often done) we believe it would likely be a wasted effort outside of the very short term.

3 CO-ORDINATION WITH CORE COUNTRY CENTRAL BANKS

(Close to impossible)

An attempt at devaluation is likely to be ineffective if other central banks simply defended their currencies in response. The US would simply start a 'currency war' (or 'competitive devaluation') in this scenario. To succeed, other core country central banks would therefore need to help the US devalue, as they famously did during the 1985 Plaza Accord[14].

However, today, core country central banks are mostly focused on keeping their currencies competitive to foster domestic growth and inflation. As our analysis shows, financial conditions outside the US would be hurt by a weaker USD; the other nations have little incentive to co-operate.

DOES EVIDENCE INDICATE THAT INTERVENTION CAN EVEN WORK AT ALL?

Even assuming the three conditions are met, the bad news for the US administration is there is still very little evidence that currency intervention can even work in the first place.

Some recent studies have shown a success rate of around 60%, but crucially only examine the impact during the intervention and not in the medium or long term[15]. For this, we are forced to turn to historical anecdotes, but these tend to offer even less comfort.

The Plaza Accord, for example, preceded a 19% depreciation of the USD – but it also coincided with an aggressive US rate-cutting cycle in 1986. Similar can be said of the Reserve Bank of Australia's 2008 intervention, which coincided with US and Chinese fiscal stimulus measures and the passage of the US' troubled asset relief programme (TARP). Causation is therefore hard to prove.

Ultimately – this leaves us highly sceptical that policy action has much hope of pushing the USD meaningfully lower in a sustained fashion.

[13] According to the latest financial statement as of late August 2019. [14] The Plaza Accord was a 1985 agreement between the United States, the United Kingdom, France, Germany, and Japan to manipulate exchange rates by depreciating the US dollar relative to the Japanese yen and the Deutsche mark. [15] Fratzscher, M., Gloede, O., Menkhoff, L., Sarno, L., and Stoehr, T., (2018) "When Is Foreign Exchange Intervention Effective? Evidence from 33 Countries", American Economic Journal: Macroeconomics.

WOULD A WEAKER USD EVEN MAKE A MEANINGFUL IMPACT ON THE TRADE BALANCE?

CORRECTING THE TRADE BALANCE COULD BE A BRIDGE TOO FAR

To achieve the US' goal of achieving a positive trade balance, we believe that weakness in the US dollar would need to be substantial and sustained.

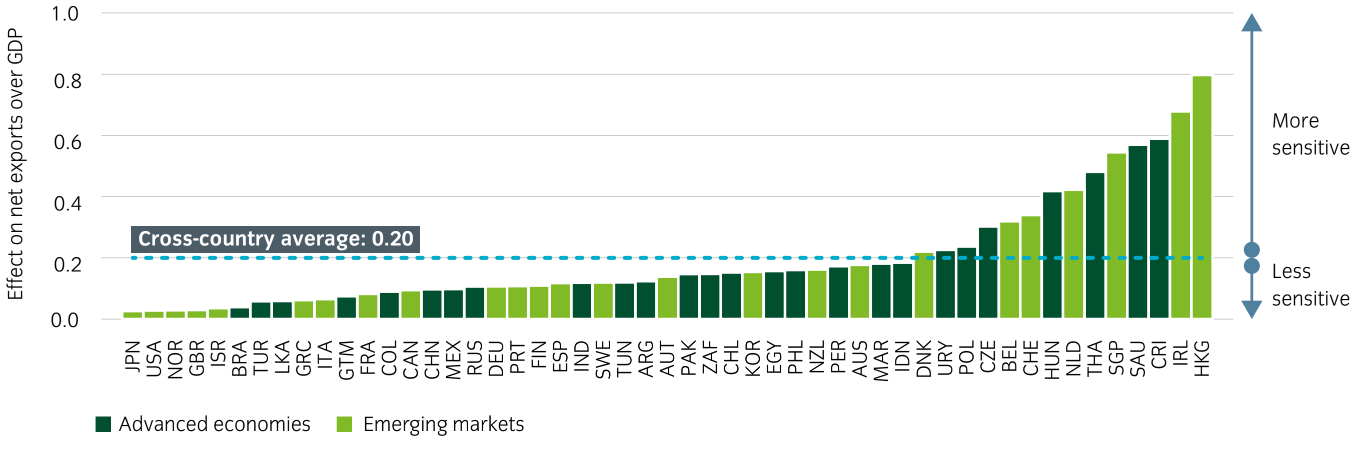
A recent study[16] suggests a 10% USD depreciation would lead to a 0.2% of GDP improvement in the US trade balance (Figure 6).

This is perhaps unsurprising given that US trade is a relatively small proportion of GDP.

Given the current trade balance is in deficit to the tune of 3.2% of GDP, this implies the USD would need to weaken by **more than 100%** to close the trade gap.

> ...the USD would need to weaken by more than 100% to close the trade gap

Figure 6: The estimated impact of 10% USD depreciation on net exports is just 0.2% of GDP[17]



[16] Bussiere, M., Gaulier, G., and Steingress, W., (2017). Global Trade Flows: Revisiting the Exchange Rate Elasticities. Bank of Canada Working Paper 2017-41. [17] Bussiere, M., Gaulier, G., and Steingress, W., (2017). Global Trade Flows: Revisiting the Exchange Rate Elasticities. Bank of Canada Working Paper 2017-4.

CONCLUSION

US INTERVENTION IS UNLIKELY OVER THE NEXT YEAR BUT CANNOT BE RULED OUT FOR THE FUTURE

PROBABILITY OF FAILURE LIKELY TOO HIGH FOR POLICYMAKERS

Overall, we believe that the likelihood of a US currency intervention is low but not insignificant but we believe offers little realistic prospect of success, outside of a modest short-term depreciation.

Furthermore, an intervention would likely be seen as a ratcheting up of trade tensions abroad, and will likely tighten financial conditions outside the US, potentially triggering a 'currency war' and fracturing trading relationships further.

THE ADMINISTRATION WILL LIKELY KEEP TARIFFS GOING AND WILL MAINTAIN PRESSURE ON THE FED

For now, we believe the US administration's path of least resistance will be to continue to pressure the Fed to lower rates while maintaining its current protectionist stance on global trade. Closing the trade balance would realistically likely require a period in which global growth is much stronger than the US, which appears unlikely in the shorter term.

DON'T RULE OUT CURRENCY INTERVENTION AFTER THE ELECTION

Looking ahead, however, intervention cannot be ruled out. We believe the trade war marks a new era in US political and economic strategic priorities, one that likely reflects a secular tipping point. Regardless of the outcome of the 2020 election, we believe policymakers may be all the more likely to view the USD as a potential policy tool in the coming years.

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