Currency Market Update, June 2016

Commentary by SIMON DERRICK

It is a given that monetary policy has played a vital role in driving the currency markets in the post-Nixon shock era, and that its influence has become ever more pervasive over the past two decades or so, as settings globally have become ever more extreme.

THE DOMINANT FORCE

Over the course of the past two years (following the introduction of negative interest rates by the Eastern Central Bank (“ECB”), the evidence points to monetary policy becoming such a dominant force for the foreign exchange markets, that it now largely drowns out all other factors. This is why the concerns that have risen since late spring about the likely pace of tightening by the Federal Reserve, matter.

Any discussion about what the Federal Reserve (the “Fed”) is likely to do this summer must start with the fact that the dot-plot published at the end of the March meeting made it clear that, on average, members of the committee expected the target for the fed funds rate to be raised twice this year. On the assumption that the second hike would likely be scheduled for the December meeting and that the Fed would prefer not to hike rates just days ahead of the Presidential election in November, this left the April, June, July or September meetings as possible dates for the first move.

With no movement in April, this has left three potential dates for a move – each has its own particular set of problems.

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FIRST MOVE TIMING

While the June meeting might seem the easiest choice, given it comes well before the start of the vacation season and the decline in liquidity that typically accompanies it, this also falls less than ten days before the European Union referendum in the United Kingdom ("UK"). A move at the July meeting has the advantage of coming after the referendum, but the disadvantage of coming just days before the start of August. Given the history of market turbulence in August over the past two decades, this would be a bold call by the Fed, particularly ahead of what promises to be a bitterly fought Presidential race. In some ways, September could prove an even worse choice, given that markets would likely spend all of August fretting about the impact of a rate hike. It could therefore be argued that, of the three, June appears to be the least worst option.

While it might be interesting to argue about the best date for the Fed to implement a hike or whether the signals from members of the Federal Open Market Committee ("FOMC") are being misinterpreted, this misses the key strategic question of why the Fed would want to hike rates in the first place. For those that believe the "Fed put" has done more harm than good over the years, signs of a relatively hawkish Fed (certainly when compared to other major central banks) will be welcomed. However, a hawkish Fed brings with it the threat of renewed US dollar strength which, in turn, raises a number of potential issues.

IMPLICATIONS OF RENEWED USD STRENGTH

The most obvious of these is that US dollar strength has proved a significant destabilising force within emerging markets over the past twenty years. Most notably, renewed dollar strength from the summer of 2014 onwards not only forced Russia to adopt a floating exchange rate regime in the latter part of that year (thanks to the collapse in oil prices) but also sparked a sustained decline in the value of China's FX reserves. This latter phenomenon took on particular significance last August when misplaced fears over a yuan devaluation helped lead to heightened levels of volatility in global markets despite a staunch defence of the currency by Chinese authorities.

These fears resurfaced in January in the aftermath of the FOMC's first rate hike in close to a decade, leaving the Chinese authorities to decide whether to continue spending close to $100bn a month to keep the currency stable, or to go with the unappealing alternatives of either allowing the yuan to devalue (bringing with it the threat of fresh unrest in global markets) or rowing back on capital account liberalisation. It is arguable that this is precisely why the Fed decided to send a far softer message at their meeting in January earlier this year. Whether or not this was the case, the US dollar certainly did begin to pull back, while the pressures on the yuan swiftly dissipated. Given this, it is interesting to note that, as dollar strength has returned in recent weeks, the yuan has also quietly been coming under renewed pressure (as have a number of other emerging market currencies). It is therefore worth asking at this stage whether the Chinese authorities would be prepared to mount a fresh defence of the yuan over the summer months, should renewed dollar strength start to take its toll.

There is a second reason, however, why renewed dollar strength might not be particularly welcome this summer. These are the growing signs that, once again, the currency policies of other nations are becoming a political issue within the US. Beyond the continued warnings from the US Treasury that other nations should avoid taking actions to deliberately devalue their currencies and presidential candidates' rhetoric, there are growing signs of it becoming an issue amongst US exporters. Steve Biegun, Ford's Head of International Government Affairs noted recently, "there has to be a clear agreement on what are the rules of the road, and there has to be consequences for those trading partners. Currency manipulation is just the mother of all trade barriers"[1].

CURRENCY CONFLICT

Concerns about "currency wars" are not a modern phenomenon. Indeed, the entire period since 1971 has been littered with accusations from governments (more often than not, driven by the complaints of domestic industry) that other nations were manipulating their currencies to obtain a competitive advantage. Probably the most notable incident to come out of these conflicts prior to 2002, was the signing of the Plaza Accord on September 22, 1985 by the Ministers of Finance and Central Bank Governors of France, Germany, Japan, the United Kingdom and the United States. In it, they agreed that "exchange rates should play a role in adjusting external imbalances. In order to do this, exchange rates should better reflect fundamental economic conditions than has been the case. They believe[d] that agreed policy actions must be implemented and reinforced to improve the fundamentals further, and that in view of the present and prospective changes in fundamentals, some further orderly appreciation of the main non-USD currencies against the USD (was)… desirable".

Although it is debatable whether the weakness of the JPY against the USD in the run up to the accord was really down to a deliberate attempt by Japan to manipulate its currency lower (1980 to 1985 had been the era of the Volker Fed), this had not prevented an increasingly vocal lobby group in the US from beginning to ask for protection against foreign competition. By 1985, the political pressure had grown sufficiently for Congress to begin thinking about trade restrictions. In the face of this, the White House was pressured into negotiating the accord despite its own free-market instincts – presumably seeing it as by far the lesser of two evils.

The net result of these resurgent concerns is that there is mounting international pressure on the Japanese authorities (led by the US) to refrain from either intervening directly in the currency markets or using monetary policy as a tool to weaken the yen. Although there are arguments to be made as to why Japan might be prepared to ignore its G20/G7 partners, the reality is that over the past thirty years or so, Tokyo has typically lost its currency policy battles with Washington.

If the FOMC is ready to hike rates this summer, then it has to hope that it can do so without stimulating fresh USD strength from here, given both the international and domestic political complications this might create.

That will be a tough balance to achieve.

1. http://www.afr.com/markets/currencies/us-seeks-to-check-yen-intervention-in-advance-20160519-gozhmt

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06/2016

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