Currency Wars

- FX reserve growth and diversification was a key driver for currency markets between 2002 and 2014
- As pace of reserve growth declined, demand for currencies such as EUR waned
- Harder to see a policy of benign neglect towards USD proving as effective in this environment

It’s hard to avoid the topic of currency war right now, given that President Trump has talked about the actions of central bankers (and, of course, the Fed) quite specifically in these terms over the past week or so (most recently on Tuesday).

However, this is a currency war then it’s very noticeable that the US isn’t faring particularly well (as highlighted by the price action overnight). It’s therefore worth thinking a little more about the dynamics at work.

While no-one ever admitted that the US was deliberately trying to steer the USD lower during much of the past decade, the idea that Washington was following a policy of benign neglect had begun to take hold by late 2004.

In an interview with Dow Jones Newswires at the time, former Japan Vice Finance Minister for International Affairs, Eisuke Sakakibara, noted that during visits to Washington and New York a "surprisingly large" number of both current and former government and central bank officials had seemed to hold the view that "some sort of

Newswatch

1. China/US: China Daily says in an editorial that the US and China are “in the mood for serious dialogue” but notes that one single meeting is unlikely to wrap everything up.

2. Japan: The BOJ keeps monetary policy
foreign exchange adjustment," could be used to address the US twin current account and budget deficits.

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Deliberate or not, what is clear is that the USD came under pressure from 2002 onwards as the Fed began to cut rates aggressively.

This, in turn, saw the FX reserves of energy rich nations or those actively managing their currencies increase sharply. Between the start of 2002 and the end of 2013, global FX reserves increased from USD 2.08trn to USD 11.68trn.

Given the demand to increasingly diversify these reserves away from the USD, this saw holdings in the EUR grow from being worth USD 310bn (19.67% of the total) in 2002 to USD1.506 trn (24.21%) in 2013. Over the same period the EUR rose from around USD 0.86 to around USD 1.36.

It was also noticeable that as the period of aggressive FX reserve growth came to a close (coinciding with China’s announcement at the end of 2013 that it was “no longer in China’s favor to accumulate foreign-exchange reserves”), the EUR managed to stage one of its sharpest falls ever against the USD.

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While there was some evidence of renewed reserve growth globally in 2017, coinciding with the last period of USD weakness, it was noticeable that China’s reserves did not grow during this period (although they did stop shrinking).

This, of course, was entirely consistent with what they had unchanged. The policy statement read, “Downside risks regarding overseas economies are big, so we must carefully watch how they affect Japan’s corporate and household sentiment.”

3. **Australia:** RBA Governor Philip Lowe said that it is "unrealistic" to think that the last 25bp rate cut alone would revive growth.

4. **Middle East:** a US official (speaking on condition of anonymity) tells Reuters that a US military drone has been shot down in international airspace over the Strait of Hormuz by an Iranian surface-to-air missile.

5. **New Zealand:** GDP rose by 0.6% q/q in Q1 as expected (thanks to solid construction activity) to match the Q4 growth rate. Year-on-year, growth came in at 2.5% - the slowest rate since 2013.
said in 2013. Since then, however, global FX reserve growth has largely flat-lined.

This absence in FX reserve growth matters.

If FX reserves aren’t growing then the pressure on reserve managers to aggressively buy the largest alternative reserve currency, the EUR, in order to effectively diversify their exposure diminishes.

Without this artificial boost to the EUR, the currency can behave far more as it should. That might suggest that Mr Draghi’s words may have a greater effect on the currency than those of his predecessors.

This is not to say that the current race to the bottom for monetary policy will have no impact on the FX markets. It seems reasonable to assume that hard assets (such as gold) should perform well in this environment (as it is doing) and that anything with a yield is likely to be snapped up (look at the performance of BTPs overnight). It also makes sense that currencies that have behaved an awful lot like gold in recent years should perform well in this environment. That might explain why USD/JPY is trading so close to its post January 3 lows.

On the Radar

June 20, 2019

• UK May retail sales (0930 BST): Reuters consensus forecast -0.5% m/m; previous flat

• UK BOE policy meeting concludes (1200 BST)

• US Jun Philly Fed survey (1330 BST): Reuters consensus forecast 11.0; previous 16.6

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