THE CHANGING FACE OF “CURRENCY WARS”

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THE POST 2002 ENVIRONMENT

• Since start of 2002 the average level of headline inflation has been 2.37% while the average Fed Funds target rate has been 1.79% (a 58 bp lag).

• By way of comparison the average headline inflation rate between January 1971 and the election of Ronald Regan as President in November 1980 was 7.78% y/y while the average Fed Funds rate was 7.44% (a 34bp lag).

• In contrast, between the start of 1980 and the start of 2002 the average Fed Funds target rate was 7.22%. The average level of headline inflation has been 4.17%

• During the era of “strong USD” policy (1995 to 2002) the average Fed Funds rate was 5.28% while the average headline inflation rate was 2.57%.

• US was not the only nation pursuing an aggressively easy monetary policy over the past eleven and a half years. In March 2001 Japan introduced policy of quantitative easing.

• US, Japan and China also involved in extended battle over currency policy.

Investors often behaved in a rational manner and bought:

- Currencies supported by central banks with a strong, anti-inflationary stance.
- Precious metals such as gold
- Equities in markets with currencies linked to the USD that were likely to benefit from export fuelled growth
- Commodities (such as oil) that were likely to be in demand as export booms in China (and elsewhere) continued on.
DEFINING THE “CURRENCY WARS”

As inflows from the US and Japan have risen over the past eleven years, many central banks have intervened aggressively in an attempt to prevent their currencies appreciating. As a result FX reserves have ballooned across both the emerging and developed world.

- According to the IMF, at the end of 2001 total FX reserves globally stood at just over USD 2 Trn.
- By the end of Q1 2013 total FX reserves had jumped to just over USD 11 Trn.
- Within this, the reserves of emerging and developing economies rose from around USD 800 Bn to USD 7.415 Trn.

Reserve managers looked to keep the composition of their FX reserves suitably diversified

- For those emerging and developing economies that report the make up of their reserves, the USD went from representing 74% of these reserves at start of 2002 to 61% at end of Q1 2013 (up from 57.7% in Q3 2011)
- The EUR went from representing 19% of reserves at start of 2002 to 23.5% at end of Q1 2013 (down from 28% in Q3 2011)
- “Other currencies” have become an increasingly important part of the mix in recent years. CAD now represents 2.2% of reserves while the AUD stands at 1.8%.
- All the available evidence indicates that the phenomenal growth in FX reserves was a significant factor in driving markets over the past decade or so.
AUGUST/SEPTEMBER 2011: A TURNING POINT?

• The price of gold peaked in early September of 2011.
• The gap between Fed Funds and inflation began to narrow from its multi decade peak.

Source: Reuters
THE CHANGING FACE OF THE US

• Industrial production in the US is up 13.5% since the start of 2010.

• Between 1988 and 2008 US oil production fell by 30%. Since then, however, it has been rising steadily, hitting a 17-year high in 2012 (according to the DoE) with output up 20% in the previous four years.

• The IEA expects North American crude output to grow by 3.9m b/d by 2018, with US “tight oil”, which includes production from shale, accounting for 2.3m b/d, and Canada’s oil sands for 1.3m b/d.

• North America accounts for almost half of the 8.4m b/d increase the IEA anticipates in global liquids production, which includes biofuels and processing gains at refineries, over the next five years.

• This is feeding through into an improvement in the competitiveness of US manufacturing industry.
USD OUTFLOWS DRIED UP…

USD FOREX Cumulative Flow vs DXY

All Investors

Cumulative Flow

FX Rate

3 Jul 07
13 Sep 07
26 Sep 07
8 Feb 08
22 Apr 08
3 Jul 08
15 Sep 08
26 Nov 08
10 Apr 09
24 Apr 09
7 Jul 09
17 Sep 09
30 Nov 09
12 Feb 10
27 Apr 10
8 Jul 10
1 Dec 10
11 Feb 11
26 Apr 11
7 Jul 11
19 Sep 11
30 Nov 11
14 Feb 12
9 Jul 12
19 Sep 12
30 Nov 12
14 Feb 13
29 Apr 13
10 Jul 13
30 Aug 13

Cumulative Flow

DXY

BNY Mellon iFlow™
…AND THE FLOWS INTO EM BEGAN TO SLOW

Quarterly change in emerging and developing market FX reserves (USD Bn) (source IMF)

Source: Reuters
THE SLOWDOWN IN FLOWS INTO EM INTENSIFIED

• Given that flows out of the USD were already slowing, it was understandable that Mr Bernanke’s comment to Congress on May 22 2013 that the Fed could begin to taper its bond purchases “in the next few meetings” would have a significant impact on emerging markets.

• This slowdown, in turn, helped expose those nations running significant (and expanding) current account deficits to the market sell off that has emerged since May 22nd.

• Most notably the currencies and equity markets of Indonesia, India, Turkey and Brazil were the hardest hit.

• This, in turn, prompted varying degrees of currency market intervention as central banks attempted to cushion the impact of outflows on their currencies.
  – India’s FX reserves fell by USD 19 Bn between the start of May 2013 and the end of August 2013 (6.4%), taking the overall decline since August 2011 to USD 43 Bn
  – Indonesia’s FX reserves fell by USD 14 Bn between the start of May 2013 and the end of July 2013 (14%), taking the overall decline since August 2011 to USD 31Bn
A FEEDBACK LOOP BEGAN TO EMERGE?

• The IMF data implies that emerging and developing nations have likely invested just under USD 4 Trn in US sovereign and quasi-sovereign instruments (along with simple deposits) since 2002.

• While the FOMC can control the pace at which it scales back its own asset purchases, the actions of the emerging market nations remain outside the committee’s domain.

• If nations are consistently intervening to defend their currencies then this should feed through directly into an actual reduction in underlying securities holding by these central banks.

• It is very noticeable that the sharp spike higher in longer dated yields seen since late April 2013 tracked closely on a weekly basis to equally sharp declines in India’s FX reserves (we choose India as an example as it is one of the few banks to publish weekly FX reserve data).

• Also worth noting that the June TICs data revealed that China, oil exporters, Brazil and Taiwan had all reduced their USD security holdings since May.
THE CHANGING RESERVE DYNAMIC

• At the end of December 2009 the allocated holdings in the EUR were valued at USD 653 Bn while at the end of March the number stood at USD 662 Bn (a 1.3% increase).

• The overall size of allocated reserves jumped by over 30% (from USD 2.161 Trn to USD 2.814 Trn) over the same time frame.

• Since the start of the Eurozone crisis the appetite for EUR has collapsed amongst those that report the make-up of their reserves.

• May even go some way to explaining the EUR’s apparent resilience in recent months in the face of FX reserve stagnation/contraction.

• Place at margins seemingly taken up by AUD and CAD

• CAD represented 2.2% of known holdings by end of March (up from 2% in December) while holdings in the AUD amounted to 1.8% (up from 1.7% in December).

• It is therefore interesting to note that it was these two currencies that came under increasing pressure as the EM crisis intensified, rather than the EUR.

Source: Reuters
ANOTHER CHALLENGE

• Premier Li Keqiang pledged in March that China would introduce measures for currency reform and interest rate liberalization.

• Participants at an IMF seminar in April told the WSJ that PBOC officials had made clear they were moving ahead with liberalizing the capital account.

• A paper published in May 2013 (co-written by a senior researcher at the PBOC) stated that the bank aimed to make the CNY fully convertible by the end of 2015.

• May 2013 also saw the State Council say that by the end of this year the government would outline a plan for full convertibility of the CNY.

• PBOC Governor Zhou Xiaochuan told a financial forum in Shanghai in June 2013 that China would speed up the opening up its capital account, though he also noted the process would be flexible enough to re-impose restraints in the event of big speculative capital flows.

• The third plenum of the 18th Central Committee of the Communist Party of China is scheduled for November of this year.
WHY NOW?

Appears to reflect a genuine shift in thinking on currency policy China.

- Yi Gang (the head of SAFE): “People might not know that the People's Bank of China has dramatically reduced the intervention in the market place. For the past more than one year, the official reserves of China have been flat.” (October 12th 2012) (source: Voice of America)

- PBOC Governor Zhou Xiaochuan stated that China's foreign exchange reserves would not rise endlessly and that the current account surplus had peaked as a percentage of GDP and “will continue to decline to a reasonable level in future……People have realized that China has enough foreign exchange reserves and there is no need for further increases.” (October 15th 2012) (source: Xinhua)

- China appears to have more than sufficient reserves (USD 3.44 Trn) to deal with all but the most extreme of circumstances.

- The size of their reserves also makes it extremely difficult for China to actively manage them effectively.
SO WHERE ARE WE NOW?

• The USD index now stands close to 3% lower than it did at the close of business on May 22nd 2013 (the day that Ben Bernanke told Congress the Fed may cut the pace of bond purchases if policy makers saw indications of sustained economic growth).
• This has come despite the fact that other major central banks are sending notably dovish messages.
• There have been good short term reasons for the USDs indifferent performance The EM crisis, Syria). However, it is also noticeable that USD weakness has prevailed even when these factors have waned in importance. We therefore need to look at longer term issues.
THE BIG PICTURE

Source: Reuters
KEEP AN EYE ON USD FLOWS FOR CLUES
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