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Currency Wars: The Fed Strikes Back

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Currency Wars:
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By Jason M. Thomas

Neither the Federal Reserve nor the European Central Bank (ECB) officially targets the exchange rate when setting monetary policy. But there's little doubt that exchange rate fluctuations have significantly influenced recent decisions and market communications. If this is a "currency war" – a sequence of events where two (or more) economies simultaneously compete to weaken their exchange rate – the Fed is likely to "lose" because domestic conditions will force the Fed to tighten policy well in advance of the ECB.

Nontraditional Currency Wars

An important distinction must be made between direct intervention in foreign exchange markets and policies that influence the exchange rate *indirectly* through reductions in domestic interest rates. When a central bank prints domestic currency to buy foreign assets, it is using monetary policy in pursuit of an exchange rate target. With the notable exception of the Swiss National Bank (SNB),[1] central banks in advanced economies have not taken this approach. To the extent the Federal Reserve, European Central Bank (ECB), Bank of England (BOE), and Bank of Japan (BOJ) have influenced exchange rates since the Global Financial Crisis, it has only been indirectly, through balance sheet policies aimed at easing domestic financial conditions and stimulating demand.[2]

The ECB Easing Conundrum

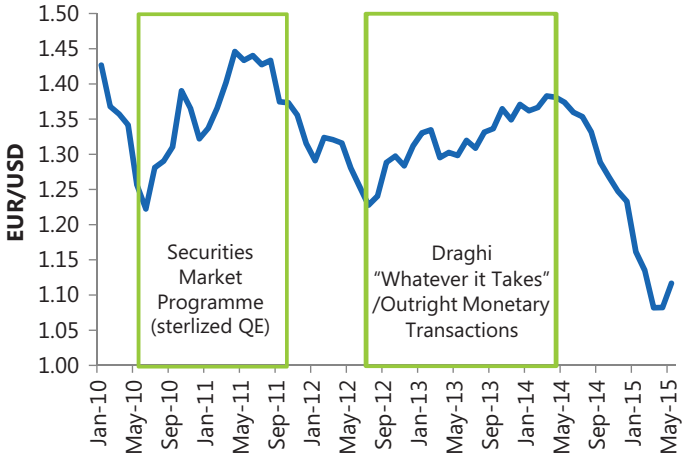
Of course, it is hardly obvious when exchange rate movements are the natural consequence of domestic monetary policy and when these movements are the *object* of such policy.[3] The ECB's QE program is a case in point. The "Public Sector Purchase Program," launched officially in January 2015, is justified entirely by sluggish domestic conditions, but also seems consciously designed to engineer a lower exchange rate. While ECB officials deny any official exchange rate target, ECB President Draghi labeled last year's strengthening of the exchange rate as a "serious concern"[4] and hinted that "exchange rate developments" would be a key criterion by which to judge the QE program's success.[5]

It is difficult to fault the ECB for incorporating the exchange rate into decision-making. Since the onset of the euro crisis in 2010, the euro has tended to *strengthen* in response to ECB easing (Figure 1).[6] By allaying concerns over currency fragmentation and sovereign default, ECB easing caused market sentiment to improve, which attracted inward capital flows that placed upward pressure on the exchange rate. As a result, the ECB was deprived of one of the normal benefits of policy easing, as repeated euro appreciation choked off a normal, self-sustaining recovery.

To ensure the added "supply" of euros from the latest round of monetary easing was not overwhelmed by greater "demand" for euro-denominated assets, the ECB coupled €60 billion monthly QE with a negative deposit rate. A negative deposit rate discourages corporates and households from holding euro-denominated cash balances and increases the price the Euro System national banks can pay for sovereign securities. In conjunction, this policy forces investors in search of positive yields on safe assets to diversify internationally, which places downward pressure on the exchange rate.

FIGURE 1

EUR/USD Exchange Rate in Response to Prior ECB Easing



QE's Success and the Fed Reaction

One could argue that ECB policy worked only too well. In the seven months after the ECB cut the deposit rate to -0.2% and hinted at QE, the euro depreciated by nearly 22% against the dollar.[7] The magnitude of the move elicited a swift response from the Fed. In a December 2014 speech, Federal Reserve Bank of New York (FRBNY) President Bill Dudley explicitly stated that the Fed would monitor the foreign exchange value of the dollar when

1 Between 2009 and January 2015, the SNB acquired the equivalent of $450 billion in foreign assets with the expressed intend of preventing the euro from rising above 1.2 per Swiss franc.

2 Rogers, J. et al. (2014), "Evaluating Asset-Market Effects of Unconventional Monetary Policy: A Cross-Country Comparison," Fed IFDS Number 1101.

3 C.f. Taylor, J. (2007), "Globalization and Monetary Policy: Missions Impossible," in Gali. J. and Gertler, M. (2010), International Dimensions of Monetary Policy, University of Chicago Press.

4 ECB Statement, May 8, 2014.

5 ECB Statement, January 22, 2015.

6 Bini-Smaghi, L. (2014),

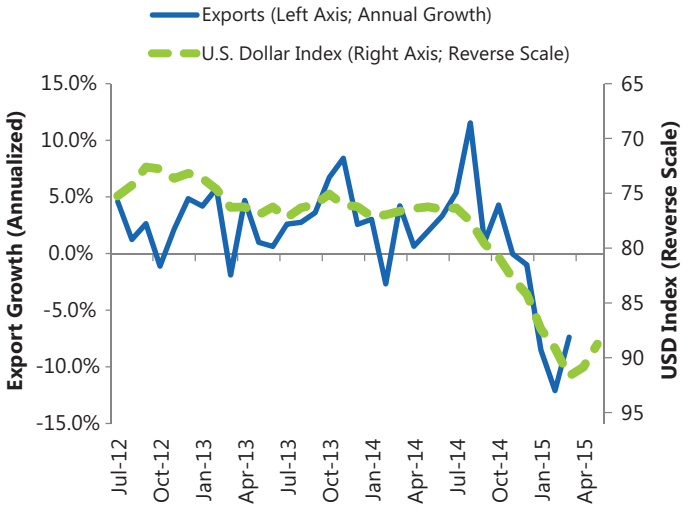
7 Draghi pledged to increase the ECB balance sheet by €1 trillion in September following the 10 bp cut in the deposit rate to -0.2%. "Draghi Sees ECB Becoming More Active in Fight for Euro," Bloomberg, September 22, 2014.

deciding how soon to normalize interest rates.[8] Although unappreciated at the time, Dudley's speech was the first formal announcement that the Fed would target the exchange rate when setting policy. This shift was confirmed by the March 2015 Federal Open Market Committee (FOMC) minutes, released April 8, 2015, which cited "a leveling out of the foreign exchange value of the dollar" as one of several preconditions for rate increases.[9] The resulting decline in the probability of a June 2015 rate hike led the euro to rise by nearly 8% against the dollar over the next five weeks.

As with the ECB, it is difficult to fault the Fed for consciously targeting the exchange rate. A sharp decline in global oil prices spurred more than twenty foreign central banks to slash rates since September 2014.[10] In the six months ending March 2015, the U.S. dollar appreciated by 21% on a trade-weighted basis,[11] which led to a 13% real decline in exports that subtracted 1.9% from GDP in Q1-2015 (Figure 2).[12] The Fed worried that tightening in the face of such massive external easing could push the exchange rate to dangerously high levels. The IMF and World Bank support the Fed on this score, warning that the dollar is "moderately overvalued" and that rate hikes should not start before 2016.[13]

FIGURE 2

USD Index and Annualized Export Growth



Of course, the ECB did not appreciate the euro's surge and responded, in turn, by announcing its intention to "front-load" three months of asset purchases into May and June 2015.[14] Ostensibly designed to confront liquidity shortages in the summer holiday, this announcement was interpreted as subtle policy easing. The euro quickly declined by 5% against the dollar, erasing about half of its gains since the release of the FOMC minutes.[15] Further easing could be forthcoming if the stand-off in Greece causes euro area financial conditions to tighten.

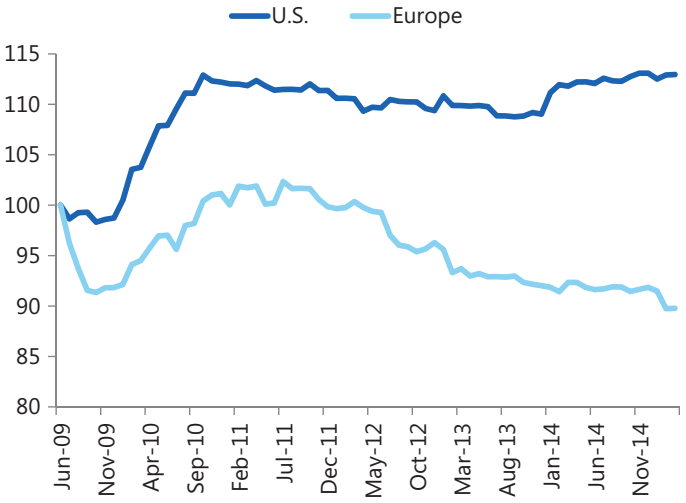
End Game: Domestic Inflation Will Limit Scope of Action

To describe this cycle of monetary policy actions and reactions as a "currency war" is no great stretch. But because this "currency war" involves shifts in domestic monetary policy, as opposed to direct intervention in foreign exchange markets, domestic wage and price trends will ultimately determine central banks' scope of action. Much as the Fed may wish to defer rate hikes, the U.S. economy appears to be much deeper into the business cycle than the euro zone's, which has not yet eclipsed its pre-crisis (2008) peak in real terms.[16] Price pressures already apparent in the U.S. are not likely to be seen in Europe for years. The result is likely to be higher relative U.S. interest rates and a stronger dollar in 2016-2017.

Since the end of the recession in 2009, average operating margins (Ebitda/Sales) in the U.S. have increased by 13% (Figure 3). Much of the margin expansion occurred in 2010, when sales increased by 9% even as payrolls contracted, but stagnant wages and continued efficiency gains combined to push margins modestly higher over the subsequent four years as well. Today, real wages (+2.5%) in the U.S. are growing significantly faster than productivity (+0.2%), which will result in margin compression, an increase in trend inflation, or some combination of the two.[17]

FIGURE 3

Scaled Operating Margins, June 2009=100[18]



8 Dudley, W.C. (2014), "The 2015 Economic Outlook and the Implications for Monetary Policy," Remarks at Baruch College, December 1, 2014.

9 FOMC Minutes, March 2015.

10 Carlyle Analysis of central bank policy statements, March 2015.

11 Federal Reserve, H.10, Major Currencies.

12 Bureau of Economic Analysis, National Income and Product Accounts, Accessed June 8, 2015.

13 IMF, Press Release Accompanying Completion of 2015 Article IV Review for the United States, June 4, 2015. World Bank, Global Economic Prospects, June 10, 2015.

14 Coeure, B. (2015), "How Binding is the Zero Lower Bound," Speech at Imperial College Business School/Brevan Howard Centre for Financial Analysis, May 18, 2015.

15 Measured between the final trading day before the speech and May 26, 2015. Bloomberg, June 8, 2015.

16 IMF, WEO Database, April 2015.

17 Bureau of Labor Statistics, June 2015 Employment Situation and Productivity and Costs.

18 S&P Capital IQ Database, Value-Weighted Aggregate of Public Companies.

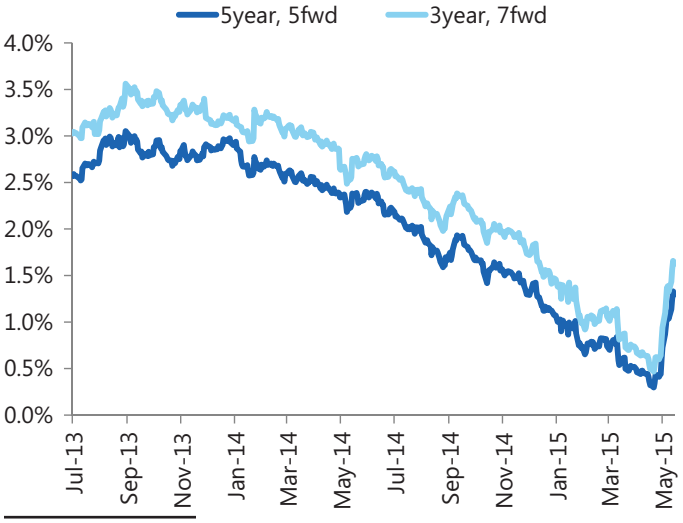
The situation is very different in the euro zone, where cost pressures are absent and margins appear poised to widen significantly over the next few years. Labor market rigidities can make layoffs in Europe difficult, which means that capital income bears more of the downward adjustment in recessions. Operating margins finished Q1-2015 11% below June 2009 levels.[19] Now that sales growth has turned positive, the cycle is likely to reverse. With unemployment above 11% and wage growth slow and decelerating, European capital income is likely to grow faster than GDP over the next two years, pushing operating margins back up towards long-run averages.[20]

While economic conditions will allow the ECB to be significantly more accommodative than the Fed over the next few years, this disparity won't persist indefinitely. Since this "currency war" does not rely on direct intervention, monetary policy can only influence the exchange rate to the extent it eases domestic financial conditions. If successful, such easing should generate an increase in demand that increases imports, domestic wages, and prices in ways that largely offset any temporary advantage from currency depreciation.

The initial response to QE in Europe underscores this point. In the months following the formal announcement of QE, yields on German bunds fell below zero, European stock indexes rose by over 20%,[21] and real household spending growth accelerated to an annual rate of 3.0% (aided by the large decline in energy prices).[22] By successfully reducing the risk of deflation and spurring additional spending, QE made it less likely ECB interest rates would be stuck below 1% indefinitely (Figure 4). The rise in expected future interest rates marked the first signs of stabilization in the euro-dollar exchange rate and an eventual reversion to a 1.19 to 1.25 equilibrium level over the medium term.

FIGURE 4

Implied Terminal ECB Policy Rate



19 S&P Capital IQ.
20 EuroStat. June 8, 2015.
21 Bloomberg, Accessed June 6, 2015.
22 EuroStat Real Retail Sales Index, Accessed June 2015.

Conclusion

A paradox of contemporary monetary economics is that most macro models agree that the exchange rate is crucially important to growth and inflation, but suggest that central banks ignore it for the purposes of monetary policy.[23] Policymakers are told to "look through" exchange rate movements and calibrate policy in response to observed changes in inflation and employment.[24] In these models, the exchange rate adjusts naturally to policies aimed at stabilizing domestic conditions and a central bank can only achieve exchange rate targets at the expense of domestic policy goals.[25]

While it's not much of an exaggeration to describe the series of ECB-Fed actions and reactions as a "currency war," because this "war" is being fought using domestic policy rather than direct foreign exchange intervention, the "winner" is likely to be the ECB given its greater scope for accommodative policy over the next few years. Much as the Fed may wish to defer rate hikes, visible cost pressures are likely to trigger a tightening cycle beginning later this year. This is likely to result in a stronger dollar over the next few years while Europe recovers.

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23 .f. Taylor, J. (2007), "Globalization and Monetary Policy: Missions Impossible," in Gali. J. and Gertler, M. (2010), International Dimensions of Monetary Policy, University of Chicago Press.
24 Clarida, R. et al. (2001), "Optimal Monetary Policy in Closed Versus Open Economies: An Integrated Approach," NBER Working Paper 8604.
25 C.f. Woodford, M. (2007), "Globalization and Monetary Control," NBER Working Paper No. 13329.

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