Policy blunders and currencies

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In December 2015, I wrote a commentary entitled "The Illusion of Policy Divergence" which expressed my skepticism on the longevity of the so-called "reflation trade" that was in fashion at the time. The consensus opinion was that US monetary and fiscal policies were poised to diverge from those of the rest of the world because the Federal Reserve had embarked on a pre-programed exodus from quantitative easing and zero interest rates, while President Trump was promising to undertake a major fiscal stimulus with a massive infrastructure program.

That policy mix – tighter monetary conditions and loose fiscal policy – tends to be a classic prescription for currency appreciation, at least as long as it generates a domestic economic cycle that is asynchronous with what is happening elsewhere.

And therein lay the illusion - large parts of the world, notably Europe and China, were already recovering from the lull of 2013 without the need of fiscal assistance. Moreover, other members of the QE Club were destined to follow in the Fed's footsteps, unwinding their unsustainable asset purchases and negative real interest rates. That scenario meant the global economy as well as national economic policies were gravitating toward convergence rather than divergence, thereby undermining the flimsy rationale for the US dollar rally.

Now that scenario is playing, but under much different initial conditions than those of 2015. Indeed, every major economy is expanding, monetary policies of developed countries are slowly but surely reverting toward a new normal, and most developed countries have turned on the fiscal spigots. Those synchronous policies and economic cycles should promote tranquil exchange rates.

Yet, something sinister is lurking in the policy climate – namely, the prospect of trade wars and other retaliatory acts, unsustainable debt and deficits, and random acts of nationalism - that could have lasting and damaging consequences. Currencies and asset prices in general will be among the casualties of these policy blunders, and the US dollar in particular may not arise from the wreckage.

AN AUGMENTED MODEL OF INTEREST RATE PARITY

A simplified way of thinking about a directional (unhedged) carry trade is to presume interest rate parity will hold over an intermediate period with some extra bells and whistles for inflation and expectations. The objective of the carry trader is to find a currency with a higher yield than elsewhere AND with a good chance of remaining that way for long enough to earn a significant arbitrage. In short, the arbitrageur is looking for an interest rate differential that is likely to persist. Although interest rate parity argues that the rewards of a significant interest differential soon will arbitraged away by an adjustment in the currency, in practice, differentials do persist, sometimes for long periods, because a country is pursuing domestic policies that diverge from those elsewhere for whatever reason. Often this occurs because its economic cycle is out of sync and hence calls for different policy settings. In simplified terms, this framework might be expressed as:

$fx_{10} = (r_1 - r_0) + Exp\ (r_1^t - r_0^t)$

where:

fx_{10} = nominal exchange rate between currencies of countries 1 and 0

$r_{1,0}$ = real short-term interest rates in countries 1 and 0, at current and some future period, t

Exp( ) = expectations of factors affecting future real interest rates

The time horizon is critical in determining what matters in this framework. Over a short horizon of three to six months, interest rates matter in attracting capital flows that supplement financing for current account balances. Deficit countries depend on these flows, which can be flighty, and hence must maintain higher real interest rates. Surplus countries only need to offer sufficient yield to keep these fluid capital flows at home. Other short-term influences include surprising economic data or political events that may portend changes in monetary or government policies, large international transactions, and tax changes affecting offshore cash holdings of multinational companies. Often these factors create more noise than trends, unless the interest rates differential is expected to persist due to asynchronous policies and economic cycles.

As the time horizon lengthens, the policy mix takes on greater importance, as symbolised by inclusion of the second term on expectations of future interest rate differentials. For example, in recent years, the Japanese yen was used as the funding currency for many carry trades because there were no signs of renewed growth or inflation that might persuade the BOJ to exit its super aggressive monetary stance and hence little chance of narrowing the differentials with higher yield currencies abroad. A host of other factors come into play. After 12 to 18 months, for example, inflation differentials plus whatever affects expectations of those differentials begin to make a difference.

A longer time horizon translates into a longer list of influences on expectations and future real rates as well as other cross border flows. At some point, the cumulative difference between domestic economic fundamentals and those aboard begin to take a toll on the exchange rate, for better or worse. Given enough time, changes in prices of key commodities, in competitiveness and current account balances, technology transfer, and the relative strength of domestic demand at home and abroad tend to outweigh the monetary conditions that encourage fleeting "hot" money flows.

Over much longer periods, the cumulative effect of these fundamentals are reflected in a country's foreign assets and liabilities, which tend to dominate the noise embodied in short-term volatility and often even policy disparities that are expected to persist for years. Namely, currencies of countries with large net foreign assets are much less dependent on hot money flows than large debtor countries. Creditors can weather a storm of adversity or price shocks, whereas debtors are dependent on foreign monetary inflows to fill the hole in their financing of their net foreign liabilities. Creditors' currencies tend to appreciate while those of heavy debtors tend to depreciate. In short, a country's initial position in terms of domestic savings and net foreign assets makes a big difference for currency valuations, especially in periods of crisis and when countries make major policy blunders that affect capital flows.

CONVERGENCE AND CURRENCIES

Let's apply this simplified framework to today's circumstances.

A synchronised expansion in which most central banks are normalising monetary conditions toward what they believe to be a neutral policy stance - the first term in our model - no longer dominates.

Even the second term – expected future interest rates differentials – plays a minor role if taken literally. Granted, the BOJ and ECB are lagging behind, but the gradual trajectory of the Federal Reserve coupled with its reduced estimate of the new neutral rate (now less than 3%) have left both current and expected real interest rate differentials relatively small. As a result, lucrative carry trades now require a lot of leverage and have withered in the increasingly uncertain financial landscape.

If carry trades do not dominate financial flows, then intermediate-term fundamentals should play a more noticeable role. Two likely candidates are current account imbalances and inflation differentials. However, neither of these influences has proven to have much predictive power for exchange rates over periods as short as one to two years. Besides, global imbalances have shrunk over the past 10 years, and inflation differentials between emerging and developed countries have narrowed, both of which lend support to a quiescent environment for foreign exchange.

That leaves us with three other general categories of influences on expectations for exchange rates. First, initial conditions, notably full employment in the US, make a huge difference in assessing the expected consequences of policy initiatives, especially fiscal policy. Debt and deficits will begin to matter more. Second, policies detrimental to productivity are red flags, given the widespread decline in potential growth. And ill-advised acts of economic nationalism will take a toll on expectations and ultimately on currency tranquillity.

THE ROLE OF INITIAL CONDITIONS

A consensus of economists and lay persons would agree that the US economy is operating close to or at full employment, whereas much of the rest of the world appears to have more room to accommodate growth. The US unemployment rate of 4.1% is at the lowest level since the late 1990s. Similarly, most empirical research estimates the current gap between real GDP and its inflation-stable potential at zero or even negative.

Full employment demarcates a critical tipping point for assessing both inflation risks and the likely consequences of public policy actions. What might be appropriate at less than full employment can become a serious policy blunder at full employment. Fiscal stimulus serves as the classic example. In simple Keynesian terms, public spending complements private spending at less than full employment, thereby raising aggregate demand and encouraging private investment. By contrast, at full employment, public and private spending increasingly become substitutes as public spending crowds out private demand and investment by raising prices more than output.

We have not quite reached that point yet but will within the next year. In short, whereas growth in excess of the US long-term potential of about 2% would have been welcome when resources were underutilised, it now is a mixed and fleeting blessing that sets the stage for the next recession.

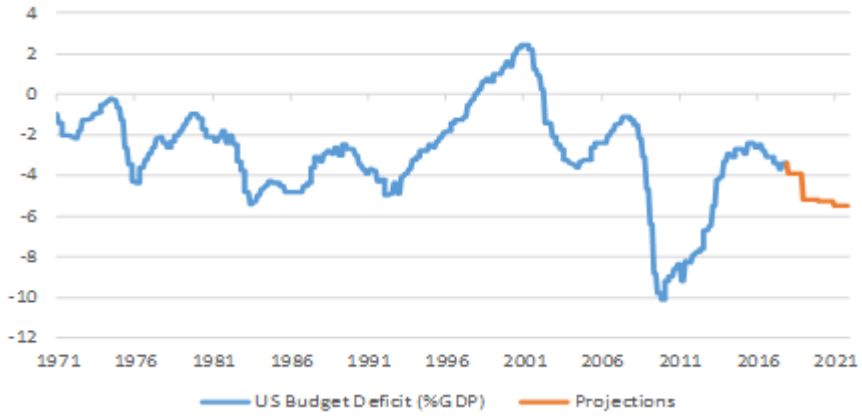
POLICY BLUNDERS AND EXPECTATIONS

In that context, nearly all recent initiatives of the Trump administration will prove to be macroeconomic blunders because the long-term cost will far outweigh any illusive short-term benefits.

Consider the massive tax cut and spending bills passed by Congress. Apart from a host of technical errors that have left companies uncertain about their tax liability, the outsized tax cuts hurriedly passed in December will widen inequality, which is inversely correlated with long-term growth.

The same criticism holds for the massive $1.3 trillion spending bill, which doubles down on the ill-timed stimulus, does not include funding for much needed infrastructure that might benefit potential GDP, and puts the US on an unsustainable trajectory of debt and deficits. According to estimates by Goldman Sachs (see Figure 1), US deficits will climb to almost 6% of GDP by 2020 under the new and tax spending bills, which would represent an unprecedented shortfall for the economy at full employment during peacetime.

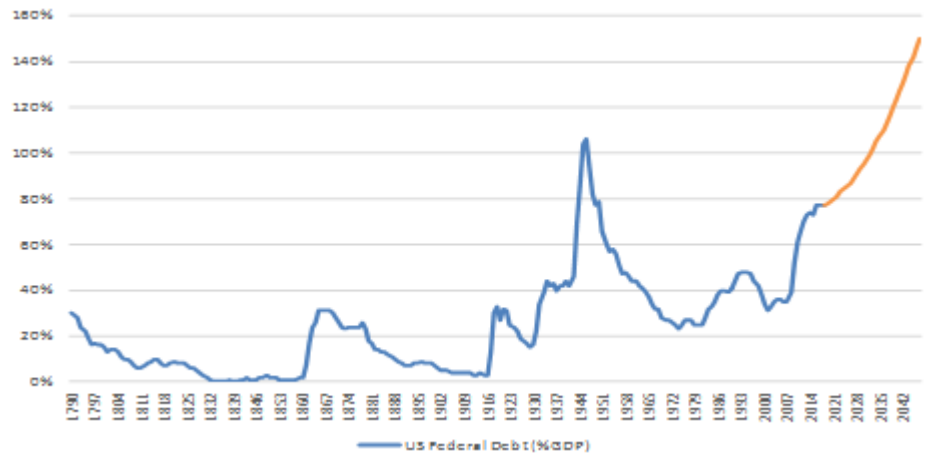
Figure 1: Projected US budget deficits



Source: Bloomberg, Goldman Sachs.

Moreover, those deficits will put the US on an unsustainable trajectory for debt and interest payments. Federal debt, as estimated by Congressional Budget Office, will soar beyond 150% of GDP as soon as 2042 (see Figure 2).

Figure 2: US federal debt projections (% of GDP)

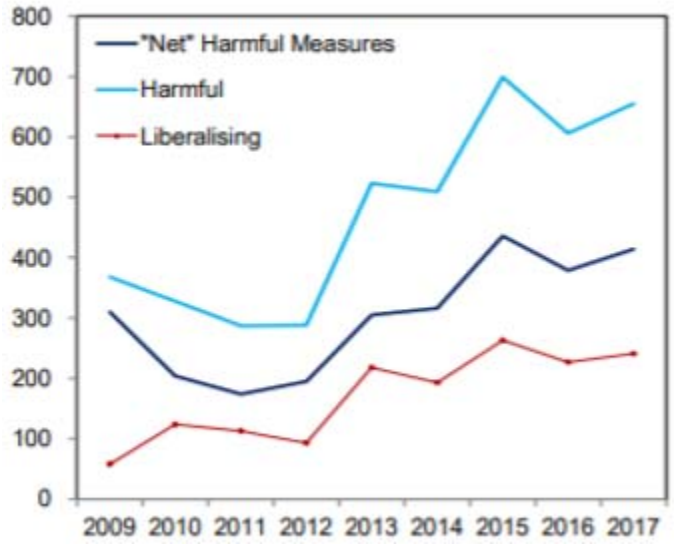


Source: Congressional Budget Office.

Likewise, self-inflicted trade disputes are unambiguous macroeconomic blunders. Contrary to President Trump's bluster, there are no winners in trade wars, only losers. The OECD

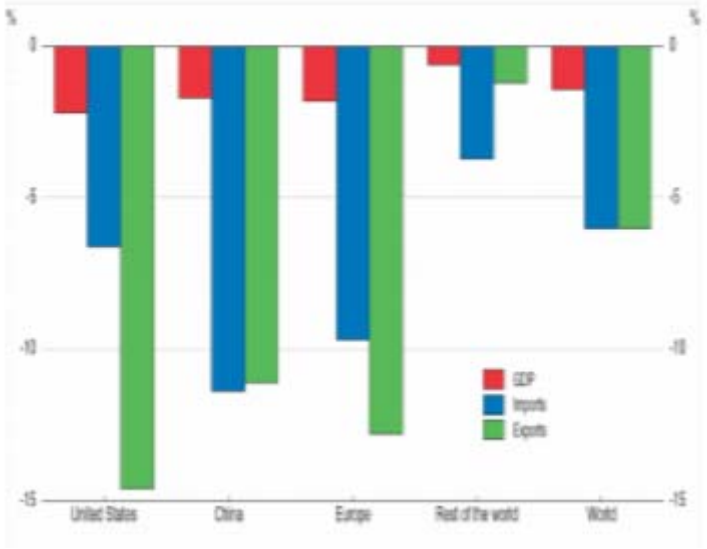
recently simulated the impact of an increase in trade costs of 10% on imports, exports and real GDP of major countries based on detail data on the composition of their international trade flows. Not surprisingly, the big loser is the US, where exports would decline almost 15% while imports would fall only half as much (Figures 3 and 4).

Figure 3: The consequences of higher trade costs
Global - Number of new trade measures Implemented, 2009-2017



Source: Global Trade Alert and Citi Research. Note: All new measures taken each year.

Figure 4: The consequences of higher trade costs
The effect of increased trade costs in the United States, China and Europe



Source: OECD. Note: Effect of 10pp higher trade costs.

This net loss from trade disputes arises in large part from the collateral damage to international supply chains of domestic companies. Note that harmful trade measures have been on the rise since 2013, according to data from the Global Trade Alert shown in Figure 4. The latest spat of tariffs imposed by the US and China's retaliation are ramping up a dangerous trend that will undermine potential GDP growth at home and abroad.

LONG-TERM IMPLICATIONS FOR THE REAL ECONOMY

I envision at least three serious long-term consequences of current policy blunders for the US economy.

First, at some point, public deficits will crowd out the nascent recovery in private investment – perhaps not this year but by 2019, the burden of financing public debt will begin to interfere with private financing, especially if the private sector is expected to finance public infrastructure projects. Over a longer horizon, the burden of debt will shift to the younger generation whose earnings prospects already are below those of their parents.

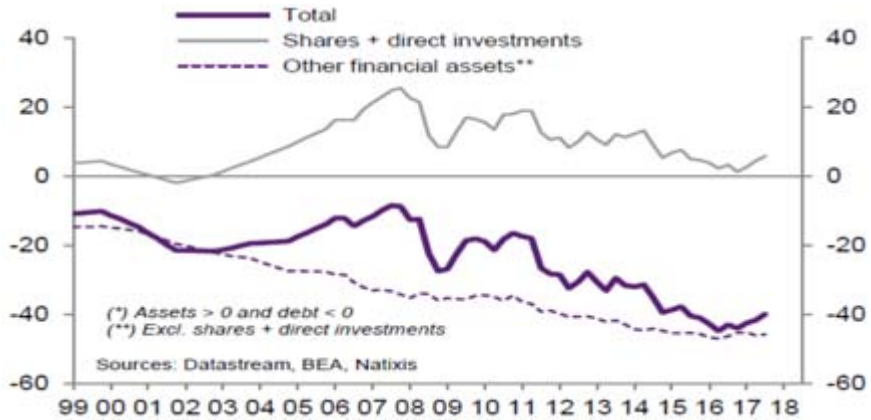
Second, public debt, trade restrictions and income inequality all impair potential growth.

Third, and most worrisome, unsustainable debt cycles always end in tears, especially when the requisite monetisation of public debt begins to creep into inflation expectations. We may be many years from that ominous outcome, but financial markets will reflect that inevitability long before it becomes a reality.

NET FOREIGN LIABILITIES AND FINANCIAL STRESS

Wealthy countries can make mistakes and still manage to recover their mojo. The reason these long-term consequences are a serious concern today is that the United States is a wealthy nation that increasingly has become dependent on foreign capital inflows. Figure 5 shows the net foreign asset position of the US, which has deteriorated more than 20 percentage points since the onset of the Global Financial Crisis.

Figure 5: United States net external assets or debt*
(as % of nominal GDP)



Source: Natixis.

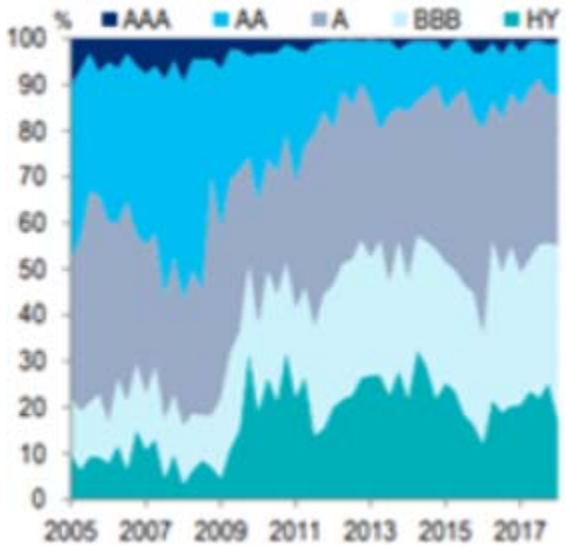
At 40% of GDP, US net liabilities are getting close to the tipping point for elevated risk for financial crises.[1] Unsustainable domestic debt will exacerbate that foreign dependence.

FINANCIAL MARKET DISCONNECTIONS

Until recently, financial markets seem to have been disconnected from these realities of the real economy and in denial about impending policy blunders.

Unfortunately, they cannot be ignored much longer. Signs of mispriced financial assets are mounting. In the world of credit, the quality of new issues is declining (Figure 6), which in itself is a telltale end-cycle phenomenon, while risk premiums continue to narrow (Figure 7). Credit indicators have particular significance because, at some point, commercial banks will cut back their lending as credit quality declines. When credit becomes less available, regardless of cost, business cycles end.

Figure 6: Credit quality of new corporate bonds



Source: Citi Research. Note: Covers issuance in USD, EUR and GBP.

Figure 7: Credit spreads

Source: Bloomberg and Citi Research.

The time has come to upgrade the credit quality of investment portfolios and to focus on the currencies of creditor countries.

I expect the currencies of China and some less-indebted EM countries to do well, along with yen and the euro. The US dollar is the loser. It may be premature to predict the demise of the US dollar's pre-eminence in global financial transactions, but one does sense that we now are coasting down the backside of the currency's pre-eminence as a store of value and safe haven in times of stress.

ENDNOTES

1. See External Crises and Financial Crises, Luis A. V. Catao and Gian Maria Milesi-Ferretti, IMF Working Paper 13/113.

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