ODDO BHF CORPORATES & MARKETS

Economy

Currency war, Donald Trump's next obsession

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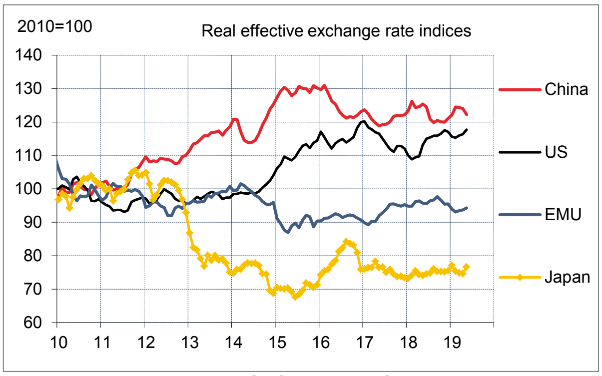
Yes, the dollar is overvalued, Donald Trump is right to say so. The misalignment with its fundamental value is about 10% at present. No, this overvaluation is not the result of a global conspiracy that purportedly unites Mario Draghi and Xi Jinping in a bid to stifle the US economy, as some of the comments made by the US President and his advisors might suggest. A step fall in the dollar would require either a much stronger monetary easing by the Fed than anticipated by the market, or a strong fiscal stimulus in the rest of the world (Germany), or a surge in oil prices. All of the aforementioned seem unlikely.

The strong dollar, a by-product of America First policy

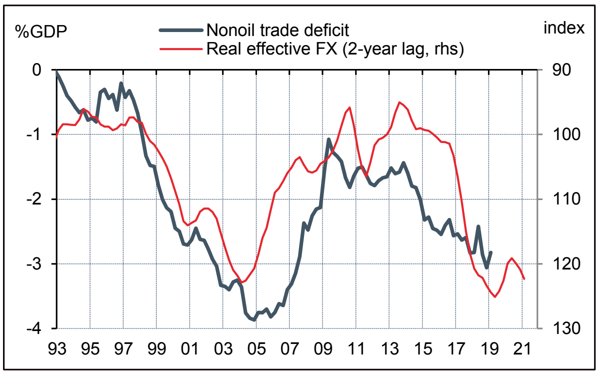
Since the general floating of currencies in the 1970s, the dollar has experienced two phases of strong appreciation. It is currently undergoing a third.

- At the start of the 1980s, the dollar appreciated vs major currencies following the sharp hike in policy rates conducted by the Fed under the aegis of then chair Paul Volker with a view to breaking inflation dynamics. There was certainly a speculative dimension to currency move. At the beginning of 1985, the dollar was 35% above its fundamental value. The return to normal was hastened by the so-called "Plaza Accord" (**Appendix 1**), which provided for coordinated action by central banks to depreciate the dollar in favour of the yen and the Deutsche mark. The upward phase lasted five years and the correction an almost equivalent period.
- At the start of the 2000s, with the creation of the euro, a currency which originally triggered massive distrust, the dollar saw its upward trend accentuated for around three years. In 2002, the dollar was overvalued by about 15% compared to the level equalising purchasing power parities.
- The current appreciation phase began in mid-2014 in synch with the fall in oil prices. The rise lasted for roughly two years. Since the end of 2016, the dollar has seen modest changes in relation to the oil market, but is no longer really on an uptrend. It is 12% above its fundamental value (**Appendix 2**). On the basis of the real effective exchange rates calculated by the BIS[1], the dollar has risen by 18% since 2010, the yuan by 22%, the pound is unchanged, the euro has lost 6% and the yen 23% (chart lhs). The dollar trend is fairly well correlated with the level of the trade deficit (rhs), which itself reacts to the impetus provided by monetary or fiscal policies depending on the state of the economic cycle.

Real effective exchange rates of major currencies



US trade deficit and effective exchange rate



Sources: Thomson Reuters, BIS, Oddo BHF Securities

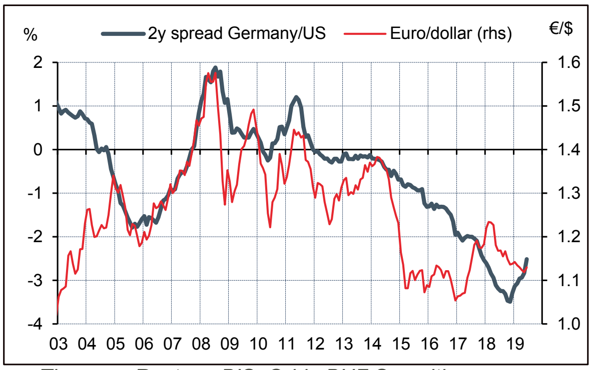
[1] *Basket of currencies (their weight reflecting the volume of trade between countries) after taking inflation differences into account.*

Exchange rates and the economy influence one another in too many ways for any claim that the US foreign deficit stems from the overvalued dollar to be possible. But the US president and his advisors are unperturbed by subtleties of this kind. Telling the following story is much simpler: there is a global movement of competitive devaluation against the US; since this drives the dollar up, US exports become less competitive and US imports are stimulated; the trade deficit is the result of unfair practices which must therefore be rectified. **With this kind of sophistry, almost anything can be justified: the hike in customs tariffs yesterday, the accusation of currency manipulation today and tomorrow who knows - possibly more direct intervention to bring the dollar's value down.** European policymakers, notably Mario Draghi, recently featured in a volley of tweets on the subject. Of course, criticising the ECB's president when he is considering monetary easing to support the European economy is also a criticism of the Fed's president when he does not ease US monetary policy on a sufficient scale or at sufficient speed.

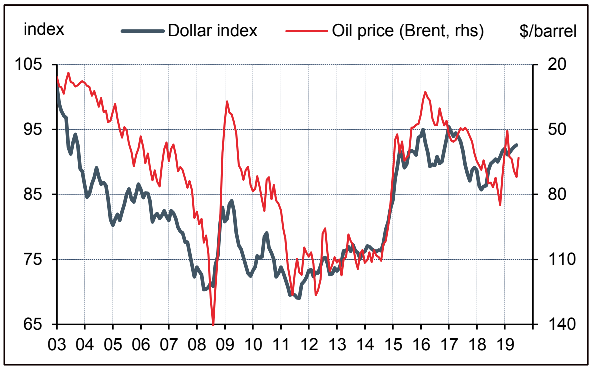
➤ **The dollar and monetary policy** – In the US, exchange rate policy – assuming that this concept is remotely pertinent – is a matter for the Treasury Department, not the central bank. The Fed's officials decline to comment on this subject. Nevertheless, the Fed's policy (the gap with that of the other central banks) obviously influences exchange rates. In the case of the euro-dollar, the relationship exists as a trend, but with periods of disconnection that are sometimes long (lhs chart). **The Fed would need to ease its policy, not only quickly but also on a unilateral and unexpected basis, for the dollar to be weakened towards its fundamental value**. According to a 2017 study by the San Francisco Fed[2], a 25bp rate cut would cause the dollar to drop by around 1%. A return to a zero interest rate policy, or even a resumption of QE, without triggering a response from the other central banks, would be needed for the overvaluation to be corrected. This is obviously out of the question given the current economic conditions in the US.

➤ **The dollar and fiscal policy** – A country's external balance reflects the gap between its savings rate and its investment rate. The US, as is widely known, has a national savings deficit. It needs to attract foreign capital or encourage US capital invested abroad to be brought back home. This was one of the goals of the tax reform voted in 2017, even though it has ultimately resulted in a massive increase in the federal deficit. The US fiscal policy is highly expansionist while in Europe, it is barely so (after years of austerity). To realign the dollar, fiscal tightening in the US would be needed to reduce the shortage in national savings – unlikely in the run-up to the elections[3]; otherwise, the US would need to have other countries show mass easing of their fiscal policies. Here, it is Germany, not the Fed, that is in the line of fire. Although the arguments on this subject are sound – or are at least defended by organisations such as the IMF or OECD– few major changes are on the cards.

Dollar and US-Europe short-term rates spread



Dollar and oil price



Sources: Thomson Reuters, BIS, Oddo BHF Securities

➤ **The dollar and oil** – Even though no theories are really able to explain it[4], it is true that since the beginning of the 2000's the dollar index has been closely (and inversely) correlated to the oil price (rhs). Under such conditions, the way to achieve a significant depreciation in the dollar would be to encourage an increase in the oil price. Donald Trump has often been vocal in his demands for ally Saudi Arabia, and OPEC in general, to introduce measures aimed at lowering the price of crude, rather than the contrary.

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[2] *See Fernhald & al. (2017), "Has the Dollar Become More Sensitive to Interest Rates?", FRBSF Economic Letter.*
[3] *Previously, the Republicans had the reputation of being allergic to "big deficits"; they are not even pretending anymore and supported without demur the tax cuts Donald Trump was looking for. The Democrats are outdoing each other to find new ways of justifying more spending*
[4] *See Fratzscher & al. (2014), "Oil prices, exchange rates and asset prices", ECB working paper. According to this study, the causality between oil and the dollar goes in both directions, with a low level of elasticity: a 10% increase in the oil price will lead to a 0.28% decline in the dollar.*

From an electoral viewpoint, the choice is easy: the US president would prefer a low oil price-high dollar combination, rather than the opposite.

Not one of the three key determinants on the dollar points to a significant depreciation in the short term. The cut in policy rates by the Fed is likely to remain modest, the disconnection between US-European budgetary policies is set to last and, assuming that there is no military-oil crisis in the Persian Gulf, there is little reason for the oil price to move far from the zone of around $ 60/b in which it has remained since 2015. **In 2019 the US appears to be in no position to impose another Plaza Accord on its partners and particularly not if it continues to use trade tariffs as a threat[5].** China - which today has the same status in Trump's nationalist rhetoric as that occupied by Japan during the Reagan years - is on an entirely different level. No military pressure is possible and trade tariffs appear to lack almost any logical sense, being dependent on the short term interests of the US president. **The "truce" reached this weekend in Osaka should help to avoid the risk of China encouraging/tolerating a decline in its currency, but implies no massive appreciation. It goes without saying that Europe is no more favourably disposed on this front**. No real surprises here. The "America First" policy, by stimulating domestic demand in the US and creating friction on international trade, is a policy that favours a strong dollar. Whilst this was not the initial cause of the appreciation, it has helped to maintain the US currency at a high level.

Appendix 1: The Plaza Accord

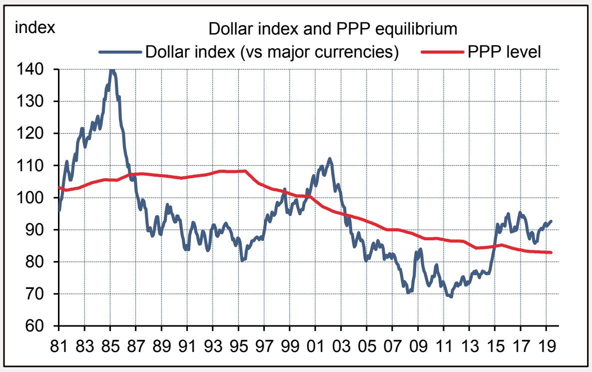
The Plaza Accord was signed in New York on **22 September 1985**. In prior years, the dollar index had appreciated strongly, peaking in February 1985. The five signatory countries, namely the US, Japan, Germany, the UK and France, undertook to intervene on the currency markets to push down the dollar against the yen and the Deutschemark. In the year that followed, the dollar lost around 33% of its value against the yen and 25% against the Deutschemark. To stem its decline, the same countries, plus Canada, signed the Louvre Accord ending the interventions on **22 February 1987** in Paris. By then, the dollar index had fallen back to its 1981 level. The yen continued to appreciate until 1988. This led to the formation of financial bubbles that burst at the end of the 1980s. The Japanese economy has never recovered from the upheaval.

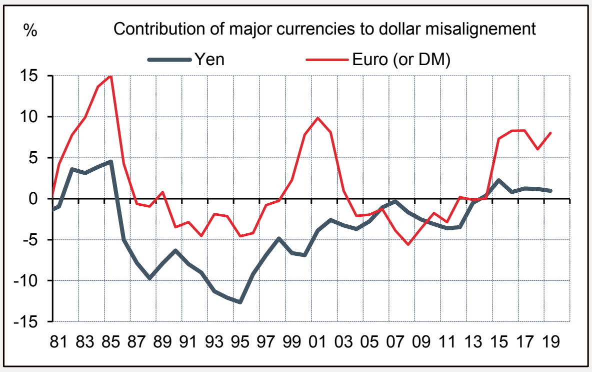
In the period that led to the 1985 accord, Robert Lighthizer, the current US Trade Representative, was serving in the Reagan administration as Deputy USTR. Back then he was reported to be just as tough a negotiator with Japan as he is today with China.

Appendix 2: The fundamental value of the dollar

In its latest External Sector Report published in July 2018, the IMF estimated that the dollar was overvalued by 12%. To this end, it looked at the variation in the exchange rate that would bring the current account deficit, which at the time was 2.4% of GDP, into line with the fundamental level estimated at 1.3%. Other models used by the IMF put the overvaluation of the dollar at between 8% and 16%. Since then, the dollar index has increased slightly. Over the same period, the Peterson Institute for International Economics estimated the overvaluation at around 6%. There is a convergence of views recognising that the dollar is modestly overvalued (compared with historical misalignments) relative to its fundamental value, by around 10%.

Another way to calculate the fundamental value of a currency is to use purchasing power parities (PPP). The basic idea is the law of one price: the quantity of goods and services that a dollar can purchase in the US is the same as it can buy in another country once converted into the other currency. The exchange rate that equalises purchasing power gives an equilibrium value for the exchange rate, at least between countries that do not have overly marked differences in living standards and level of development. Using the PPP approach to find the equilibrium value of the dollar-yuan exchange rate is fairly risky (strictly speaking, it suggests that the Chinese currency is undervalued by nearly 50%). Using OECD estimates suggests that the dollar's overvaluation against major currencies has risen from around 9% in 2017 to 12% today (chart lhs). The gap based on PPP is above all marked with the euro (18%). This accounts for 8 points of dollar overvaluation (chart rhs), the balance being attributable to the yen, sterling and the Canadian dollar.





[5] *The Trade department is considering the introduction of tariffs on the products of countries that "manipulate" their currencies. Not only will this be a complex measure to put in place but unilateral trade tariffs are an imperfect weapon against real monetary manipulation. See PIIE (2019), Comments on Proposed Modification of Regulations for Countervailing Duty Proceedings.*

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