

Policy Rates Opinion Compendium: Impact on Currencies

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Prof. Barry Eichengreen
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Your entry to in-depth
knowledge in finance



Message from Phil Poole



In the years following the financial crisis, the European Central Bank (ECB), the US Federal Reserve Board (the Fed), the Bank of England (BOE) and the Bank of Japan (BOJ) broadly kept step in a synchronized pattern of low policy rates and, to one degree or another, additional "extraordinary" monetary measures such as quantitative easing. But things are changing and in 2015 monetary policy from major central banks looks set to diverge.

There has been an economic upswing led by the United States, but the pace of economic growth has not been uniform across the globe, leading to speculation about how monetary policy will play out differentially in the coming months and years. This leads us to ask the question of not only when but where policy rates will begin to normalize and what the implications will be for the global economy, financial asset prices and major currencies.

To offer investors a truly well-rounded, insightful perspective on this topic, I have launched an opinion compendium project together with Deutsche AWM. The compendium will tap the expertise of our key investment experts, product specialists and leading academics from the University of Cambridge and University of California at Berkeley, including New York Times bestselling author Professor Barry Eichengreen.

Deutsche AWM will publish a series of concise articles on this topic over the coming months, studying the global monetary policy story as it unfolds. It will approach the topic from three primary angles: 1) "How low for how long?", 2) "What will be the impact on global growth?", and 3) "How will financial asset prices respond?"

The first piece in this series is by Professor Barry Eichengreen (New York Times bestselling author from the University of California at Berkeley) and Dirk Aufderheide (Deutsche AWM's chief currency strategist). Eichengreen discusses his rationale for a strong US Dollar, and why he thinks the euro and Japanese yen follow a weaker trajectory. Aufderheide explains the Deutsche AWM house view that the US dollar will not only remain strong, but will continue to appreciate. For additional relevant insights on this topic and for Deutsche AWM's CIO house view, please visit Deutsche AWM's Thought Leadership website.

I am very pleased to be collaborating with these leading international experts, both external and from within our own organisation, on this very relevant and timely topic.

Kind regards,

Phil Poole
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Phil joined Deutsche Asset & Wealth Management in January 2014 with 30 years of industry experience. Prior to his current role, Phil was a managing director at HSBC, where he served as Global Head of Macro and Investment Strategy for its Global Asset Management business, preceded by a period as Global Head of Research and Chief Economist for Emerging Markets on the sell-side. Prior to HSBC he worked in senior sell-side research roles for Barings / ING Barings, and Barclays.

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Barry Eichengreen is the George C. Pardee and Helen N. Pardee Professor of Economics and Professor of Political Science at the University of California, Berkeley, where he has taught since 1987. He is a Research Associate of the National Bureau of Economic Research (Cambridge, Massachusetts) and Research Fellow of the Centre for Economic Policy Research (London, England). In 1997/98 he was Senior Policy Advisor at the International Monetary Fund. He is a fellow of the American Academy of Arts and Sciences (class of 1997).

Professor Eichengreen is the convener of the Bellagio Group of academics and economic officials and chair of the Academic Advisory Committee of the Peterson Institute of International Economics. He has held Guggenheim and Fulbright Fellowships and has been a fellow of the Center for Advanced Study in the Behavioral Sciences (Palo Alto) and the Institute for Advanced Study (Berlin). He is a regular monthly columnist for Project Syndicate.

Professor Eichengreen was awarded the Economic History Association's Jonathan R.T. Hughes Prize for Excellence in Teaching in 2002 and the University of California at Berkeley Social Science Division's Distinguished Teaching Award in 2004. He is the recipient of a doctor honoris causa from the American University in Paris, and the 2010 recipient of the Schumpeter Prize from the International Schumpeter Society. He was named one of Foreign Policy Magazine's 100 Leading Global Thinkers in 2011. He is Immediate Past President of the Economic History Association (2010/11 academic year).

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Dirk joined Deutsche Asset & Wealth Management in 1994 with five years of industry experience. Prior to his current role, Dirk served as Portfolio Manager Money Markets and before that in DB Global Markets Exchange Traded Derivatives. Dirk began his career in Institutional FX Sales at Dresdner Bank AG.

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Should we expect dollar strength against the euro and the yen?

Prof. Barry Eichengreen
January 2015

The pundits and their investment newsletters are united in predicting that the dollar will strengthen against the euro and the yen. When market commentators are all but unanimous in predicting a certain outcome, it is worth stepping back and asking whether they could be wrong.

The basis for the prediction is straightforward. While the Fed is on course to start raising interest rates sometime in 2015, both the ECB and the BOJ are under pressure to ease. At some point, slack in the US labor market will diminish, and the Fed will have to raise rates to prevent a significant acceleration in inflation. Europe, on the other hand, remains at risk of deflation, and growth continues to disappoint. Quantitative easing à l'Amérique may not be politically acceptable, but the ECB has room to further ramp up its purchases of, inter alia, securitized bank loans. The BOJ for its part has no reluctance about engaging in quantitative easing and continues to struggle to raise inflation above 1%, giving rise to expectations that it will do more.

And higher interest rates in America relative to Europe and Japan will induce capital flows toward the United States. They will encourage fixed-income investors to allocate larger shares of their portfolios to the greenback. And that will cause the dollar exchange rate to rise.

But if investors expect the dollar to rise because the Fed will be raising interest rates next year, they have an incentive to buy it now, while it is still cheap. In fact, the dollar already rose by 9% against the euro and 7% against the yen in the second and third quarters of 2014, reflecting expectations of these diver-

gent central bank policy moves. It will rise further only if the US economy strengthens even faster than expected or if conditions deteriorate more radically than currently anticipated in Europe and Japan, forcing the ECB and BOJ to loosen even more dramatically.

In the US, uncertainty centers on the labor market and on whether labor force participation will rise as the economy continues to expand. The case that the Fed will tighten faster than the market currently expects is predicated on the idea that the decline in participation is secular, not cyclical, and that those who have left the labor force will not reenter. I myself am skeptical of this view; much of the decline in participation is among individuals aged 18 to 55 who have families to support and rent to pay. I think they will resume looking for work when the opportunity is there.

Europe's growth outlook is dismal, to be sure, but that fact is already in the market. And with the Asset Quality Review and bank stress tests, the Eurozone is finally on the road toward fixing its banks – the most important step it can take to prevent things from getting worse. The pessimists' case for Japan is predicated on the suspicion that Prime Minister Abe is not serious about his "third arrow" of structural reform. I do believe that he's serious, but he has strong political resistance to overcome, meaning that reform will take time.

So, absent further surprises on these fronts, the dollar strength on which so many investors are betting may have already happened.

Five reasons why the dollar will rise in the months ahead

Dirk Aufderheide
January 2015

Some experts, like Barry Eichengreen, say the dollar will remain strong but does not possess much upward potential for the next six to nine months. The argument is based in part on the idea that an interest rate hike from the Fed next year has already been priced in.

I see this a bit differently. I believe that diverging interest rate policy matters rather than when exactly the Fed is going to hike. The Fed could even use their large balance sheet first via reverse repo (RRP) in order to drain liquidity (The Fed is already using this via overnight RRP) rather than hiking Fed Funds. The widening of RRP transactions would signal a clear tightening.

The consensus view is that the ECB will expand its balance sheet, driving interest rates lower, while the Fed has finished quantitative easing and is preparing the market for a rate hike in 2015, or, depending on data, in 2016 or quantitative tightening via RRP.

The ECB shows a firm commitment to widen its balance sheet back towards levels from March 2012. It started buying covered bonds, will start purchasing asset-backed securities and will probably assess corporate bonds and/or sovereign debt as well. The volume of quantitative easing depends on what is raised with these instruments and also with the take up of the second targeted long-term refinancing operation (TLTRO) in December. But there are more strong arguments for further euro depreciation.

1. Macroeconomic evidence

The first piece of additional evidence I see for a gradual devaluation of the euro against the dollar is the macroeconomic situation. Economic data is improving in the US. Inflation is still close to the desired target of 2%, whereas in the Eurozone, we have low inflation and very high unemployment of more than 11%. No change is visible in the near and medium term: The European inflation path is moving closer to zero rather than achieving the 2% target of the ECB.

2. Negative interest rates and negative yields

Another very important issue is negative interest rates and negative yields. The ECB surprised the market by lowering the deposit rate into negative territory. As a result, commercial banks are increasingly charging clients with negative interest rates.

We also see a vast amount of negative-yielding sovereign debt and deposits in the Eurozone – worth more than 1 trillion euros. Sovereign quantitative easing would push that amount sharply higher. That's a massive amount. For real-money investors focusing on a benchmark, this is not a huge issue, but for absolute return investors and central banks tasked with capital preservation, they cannot tolerate and accept negative interest rates. They will shift some of the capital. This means a central bank that has to invest in the euro can either extend duration for their AAA/AA assets like German or French debt or it can shift into periphery debt and increase credit risk.

3. Capital outflows

Third, massive outflows from the Eurozone into foreign equity and foreign bond markets are another option that shows negative sign for the euro. Investors are leaving the Eurozone to invest into liquid AAA markets, like Treasuries and Gilts. This indicates that the already massive amount of negative-yielding sovereign debt will rise with more quantitative easing by the ECB, accelerating outflows from the Eurozone into positive-yielding sovereign debt. The magnitude of these flows exposes the euro's, especially against the dollar, in the medium and long-term.

4. Political risk

These predictions are bolstered by a fourth point: political election risk inside the Eurozone and the unresolved situations in Russia. After the recent election in the eastern part of Ukraine, that situation seems further away from resolution associated with tighter sanctions against Russia and an escalation of the crisis.

The political risk inside the Eurozone is nothing less than the political will of the people in the individual countries. Personally, I doubt that Europe will manage to transform its policy from a fragmented national one into a euro-united financial policy. Next year we'll see three elections in the peripheries with the possibility that left-wing parties will make substantial gains. Greece will probably hold elections, and the anti-austerity Syriza party could gain majority, analysts say. Spain could also increase the representation of their extreme left-wing party opposed to fiscal consolidation and structural reform above 25%. Portugal will vote as well.

In Germany, politicians appear worried about gains by euro-skeptical parties. German Chancellor Angela Merkel is hesitating on a stronger commitment to the

unconventional ECB policy because she is afraid that the euro-skeptical Alternative für Deutschland (AfD) party will make inroads in Germany. All this shows that it's a possibility that the political will of the people challenge the course on financial unification in Europe.

5. Dollar to remain world's reserve currency

As for the dollar's fate as the world's reserve currency: The United States is the biggest economy. It's the largest bond market. It plays a vital role for parking currencies and liquidity. I am very confident that the role of the dollar as a currency reserve will be extended during the next two or three years.

I see the dollar further strengthening, also against the yen, given the BOJ's very aggressive easing path in order to desperately generate inflation. I have my doubts as to whether that will work with quantitative easing. It was not the case in the US, and it was not the case in the UK.

In the end, the exchange-rate development is more important. Devaluation of the currency has a stronger impact on inflation and this is feeding through in Japan. I also believe that real interest-rate widening between the US and Japan will play out in favor of the dollar.

Where the dollar could lose some ground is against the renminbi. I expect the renminbi to stabilize further against the dollar in the next to six to nine months. The renminbi is one of the most remarkable currencies in the world. It was the only currency that was able to withstand the dollar strength during summer 2014. The Chinese administration is committed to opening its economy and financial markets, paving the way for the renminbi to be a freely tradable currency in local terms and for it to serve as a reserve currency at some point in future.

If the renminbi really became a suitable reserve currency, we would see a rebalancing of global reserves that would diminish euro holdings for sure and to some extent, diminish dollar holdings as well. The timeframe for that is very difficult to assess.

Of course, the offshore Chinese renminbi, the CNH, is tradable globally, but China still needs to open its onshore panda bond market to foreign investors. As soon as there is more evidence that China will do this, I expect a change in reserve diversification behaviour globally.

Looking forward: the Eurozone

Let's return to the Eurozone. The euro is the second-largest reserve currency globally and a financial market heavyweight. The large current account surplus does not require external funding flows, which is a clear structural signal for a stable currency. Nevertheless, national political leaders and the European Commission are facing large structural challenges. Heterogeneity in bond markets, budget balances and structural unemployment have to be managed and coordinated. A firm commitment by the ECB, national central banks, national governments and ultimately the will of the individual voters is required to maintain the euro a success story. The path toward a common Eurozone financial policy combined with the option to issue Eurobonds has to be the unanimous political goal. In general, a depreciation of a currency should be seen as a normal market-adjustment process for imbalances. This has always been the case since the end of the gold standard in 1973. Any euro weakness is therefore part of a necessary adjustment process in order to regain inflation and growth momentum rather than discounting a kind of risk premiums. I therefore strongly believe that the euro, accompanied mid-term by the renminbi, will remain a major currency reserve alternative and contender to the still-dominating role of the US dollar.

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