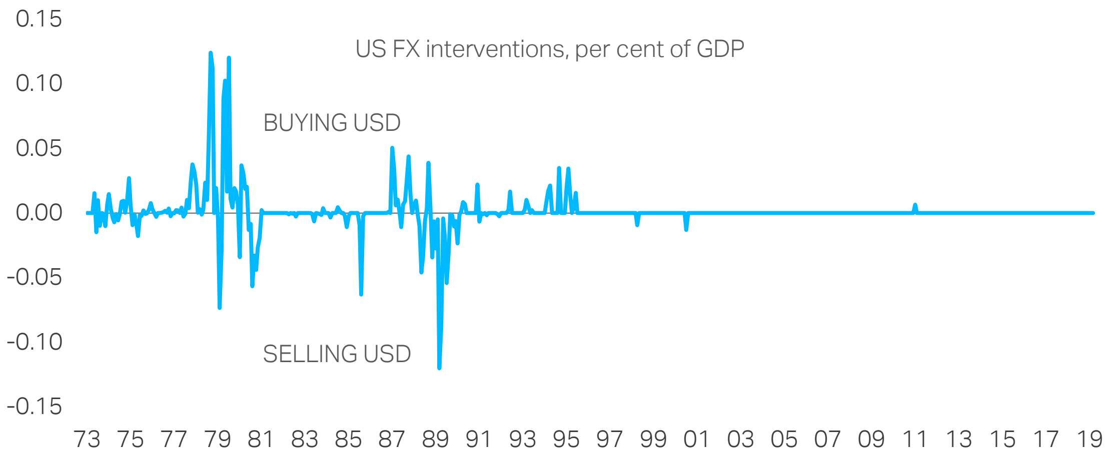
Macro Picture

DOLLAR GLARE

Dario Perkins

The world needs a weaker dollar but direct FX intervention is not the answer. History suggests currency intervention only works when accompanied by shifts in relative monetary policies and coordination across nations. The conditions for coordination do not exist today and unilateral US attempts to force the dollar down could get messy.

Chart 1: The 'post-intervention' era



Source: FRED, TS Lombard

DOLLAR PROBLEM

The US dollar has remained strong, as superior US growth rates and negative euro/Japanese yields have offset the impact of modest Fed easing. This is a problem for the global economy. The strong dollar undermines world trade, damages the balance sheets of international USD debtors, restricts cross-border lending and spreads 'secular stagnation' around the globe.

SOUND FX

Since a weaker US dollar might be good for the global economy, there is speculation the authorities might eventually intervene. Some commentators even hope for a repeat of the successful currency 'accords' of the1980s. Yet there are good reasons why DM policymakers have avoided FX intervention over the past 20 years (except during times of financial instability).

COORDINATION FAILURE

Intervention will only work if it is coordinated across nations and includes large (relative) shifts in monetary and fiscal policy. There is no appetite for such coordination today, especially as China and the euro area would rather see their exchange rates depreciate. With 'Trumponomics', we can't rule out unilateral US action, but this would further challenge the Fed's independence.

DOLLAR GLARE

For a financial system that operates on a Dollar Standard, it is not surprising swings in America's exchange rate have a powerful impact on global activity and risk appetite. In fact, the structural 'dollar shortage' has been a reoccurring theme in recent years, especially as periods of US currency strength have coincided with episodes of 'risk off' in global markets, including contractions in industrial output and world trade, and deteriorations in cross-border lending (through both banks and capital markets). Some investors hoped Federal Reserve easing would alleviate this problem in 2019, lowering the US currency and reviving global dollar liquidity. And for a time, the Fed's dovish pivot seemed to help. Yet with the US currency remaining stubbornly high, the boost to global markets is already wearing off. Negative yields in Europe and Japan are clearly an important part of the story. Rather than dollar weakness reflating the global economy, the strong US currency seems to be spreading Europe and Japan's deflationary draught to the rest of the world. Secular stagnation is becoming contagious. Ironically, President Trump is the only global policymaker who (sort of) recognizes the dangers of sustained dollar strength.

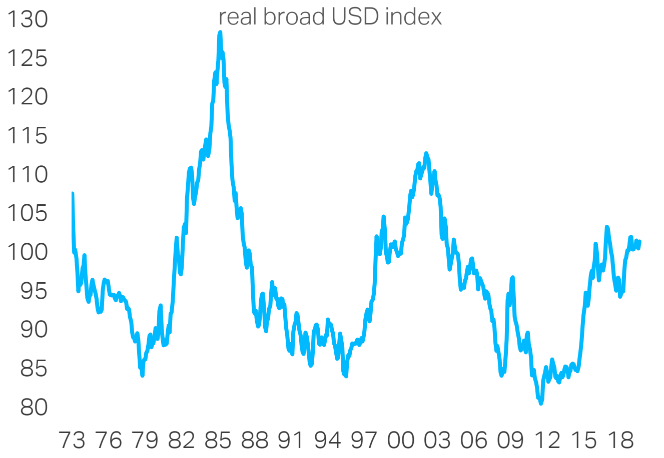
The US president's incessant jawboning about the strong dollar has intensified speculation about direct intervention in currency markets, something the authorities have tried to avoid for the past 20 years. Advocates highlight the experience of the 1980s, when co-ordinated policy action from the world's largest nations ended a previous episode of dollar strength. Yet there are good reasons why the world's major central banks do not like to intervene in currency markets, except during periods in which rapid exchange-rate moves threaten financial stability (such as in 2000, after the introduction of the euro, or in 2011, following a serious earthquake in Japan). The most important reason is that 'pure' (sterilized) FX intervention has never been particularly effective. Such action only works when it includes large shifts in monetary policy. Yet modern central banks target inflation, not their currencies. Even during the 1980s, it was arguably changes in relative interest rates – not direct intervention – that caused a realignment in exchange rates. Whenever the authorities pursue currencies that are inconsistent with other macro objectives, they run into serious problems, leading to speculative attacks and chaos.

For currency intervention to seriously curb the USD, it would need to be (i) coordinated across countries, and (ii) involve a significant easing in US monetary policy vs the rest of the world. There are problems on both fronts. First, neither China nor the euro area want to see their exchange rates rise. The RMB is already overvalued and the authorities would prefer to let their currency depreciate rather than reflate a credit bubble in order to revive China's economy. Meanwhile, policymakers in Europe are struggling with persistent below-target inflation and realize that a sharp appreciation in the euro would make their political climate even more challenging, particularly for the likes of Italy. Compared to other parts of the world, both China and the euro area have relatively modest amounts of USD debt. Still, just because America's two biggest trading partners would not support US intervention does not mean we can rule out unilateral US action – with 'Trumponomics', anything is possible. Yet, unless the Federal Reserve wants to have its monetary policy dictated to it by the US Treasury, it must surely sterilize any intervention in FX markets, blunting its effectiveness. And if Trump does pursue this policy path it could lead to all sorts of messy scenarios, including a more serious challenge to the Fed's independence and perhaps even capital controls and global market turmoil. The underlying issue is a conflict between the US administration's desire for a smaller trade deficit and the sustainability of a global financial system that routinely creates a structural dollar shortage.

1. DOLLAR PROBLEM

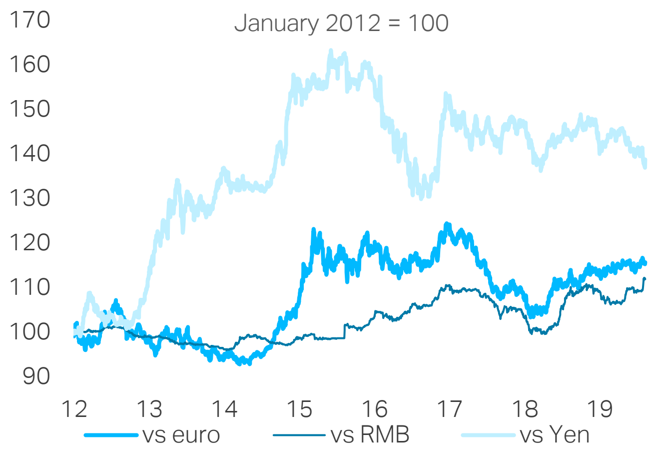
The 'dollar shortage' has been a reoccurring theme in recent years, something we have written about on several previous occasions (see e.g. here and here). The idea is that the world's financial system operates according to a Dollar Standard, which began after World War II, when the authorities decided to put America's currency at the centre of international trade and commerce. While initially the system was constrained by the value of gold, this ended in 1971 when President Nixon unilaterally froze gold convertibility of the USD. Thereafter, the dollar's dominance of the global financial system became unrivalled, with the 'eurodollar' market (the creation of US currency outside of the United States) becoming a critical source of international liquidity. Since much of the world borrows in dollars and invoices their goods and services in USD, it makes sense that America's currency should have a special role in the global economy.

Chart 2: Sustained dollar strength



Source: Federal Reserve

Chart 3: Bilateral exchange rates



Source: Datastream

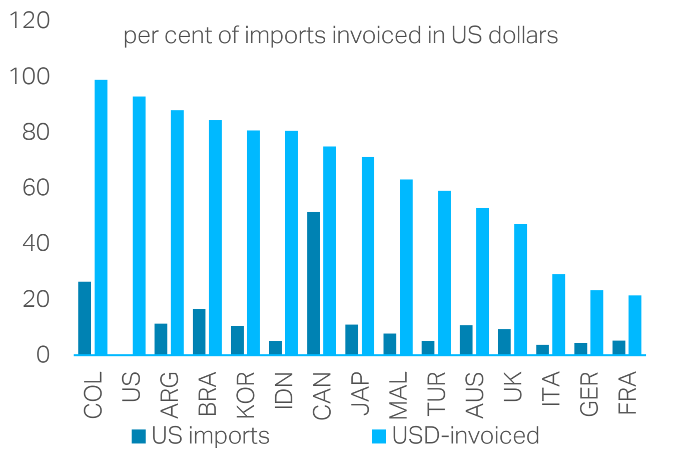
Why the USD is 'special'

Though the Dollar Standard has been around a long time and there have always been worries about whether the system might suffer from a structural shortage of liquidity[1], researchers have only recently started to understand the US currency's precise role in what is now recognized to be a true global financial cycle. In our previous analysis of this issue we outlined the three most important channels through which swings in the value of the dollar can drive global markets:

1. Dollar invoicing: Economists traditionally assumed, when currencies move, exporters would keep their domestic prices unchanged and allow their export prices to adjust. Their goods become cheaper (or more expensive) overseas and consumers responds accordingly – the Mundell-Fleming model. But the latest research suggests this is not how exchange rates work. Most international trade takes place in a handful of ('dominant') currencies, particularly the US dollar. This gives America's exchange rate a special role in world trade. For example, Boz et al found that a 1% appreciation in the USD reduces trade volumes between countries in the rest of the world by around 0.6-0.8% within one year. So dollar strength actually hurts everyone.

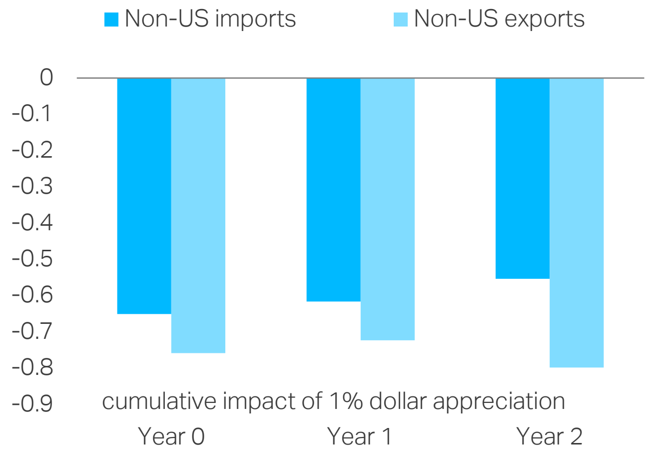
[1] In fact, these concerns first emerged in the 1940s, when the US was running a current-account surplus. Economists pointed out that America needed to run a current-account deficit in order to provide the rest of the world with sufficient dollar credit.

Chart 4: Dollar invoicing



Source: Emine Boz, Gita Gopinath, Mikkel Plagborg-Moller (2017)

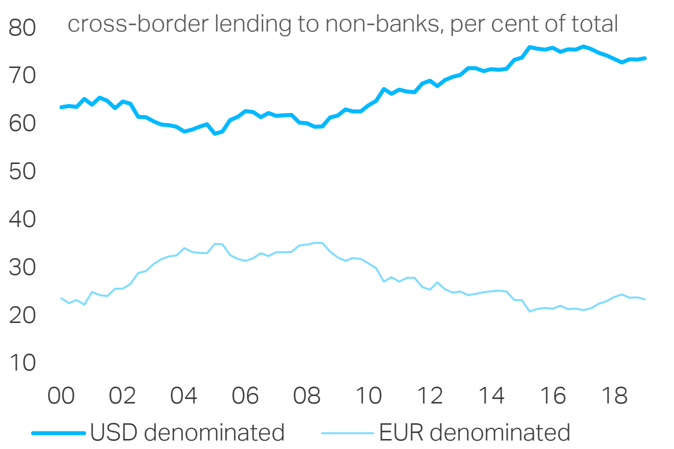
Chart 5: USD strength and world trade



Source: Emine Boz, Gita Gopinath, Mikkel Plagborg-Moller (2017)

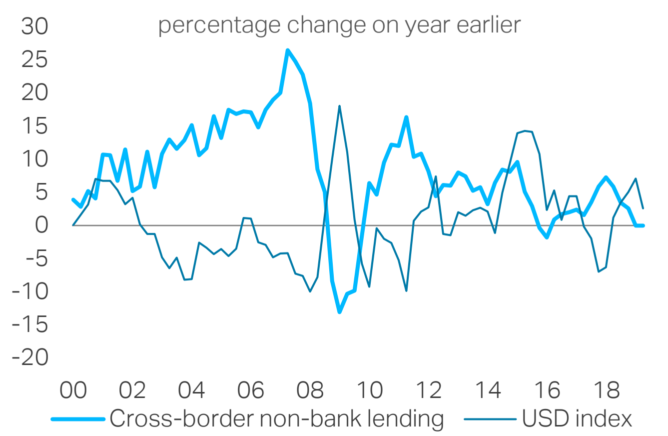
2. Risk-taking: The dollar is the also main funding currency, with USD-denominated debt surging over time. Avdiev, Bruno, Koch and Shin found that dollar strength is strongly associated with falling cross-border bank lending and lower real investment rates, particularly among the emerging economies. An appreciation in the dollar hurts borrowers' balance sheets, reducing both the global demand and supply of dollar credit. They show that these effects can more than offset the traditional positive impact that was supposed to come from an improvement in net trade (i.e. a depreciation in the domestic currency versus the dollar). Recent Bank of England analysis quantified the effect, finding that every10% appreciation in the USD cuts EM GDP by around 1.5 percentage points. More work is needed to investigate the DM impact.

Chart 6: Dollar dominates international debt



Source: TS Lombard based on BIS data

Chart 7: Dollar strength restricts credit

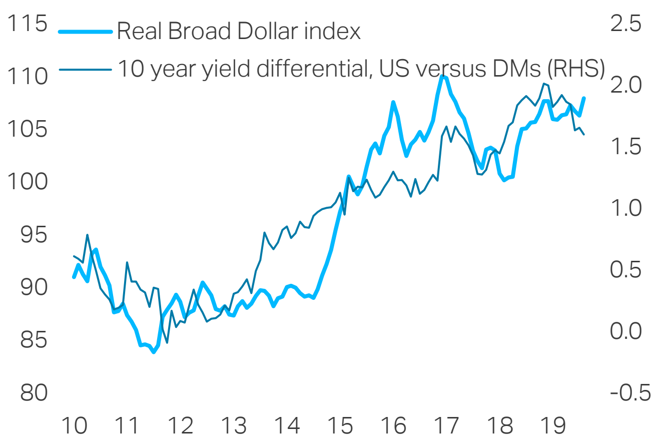


Source: TS Lombard based on BIS data

3. Global value chains: Related to the risk taking channel, dollar strength has a powerful impact on global value chains. Consider an auto manufacturer that makes engines in Japan, ships them to Canada (where the cars undergo further assembly), before sending the cars to be finished in Mexico. This process involves large inventories of engines, semi-finished autos and finished autos. These are assets which the company needs to finance and the longer the value chain the greater the financing needs. With global value chains (GVCs) expanding rapidly over the past two decades, the dollar has become even more important as an international funding

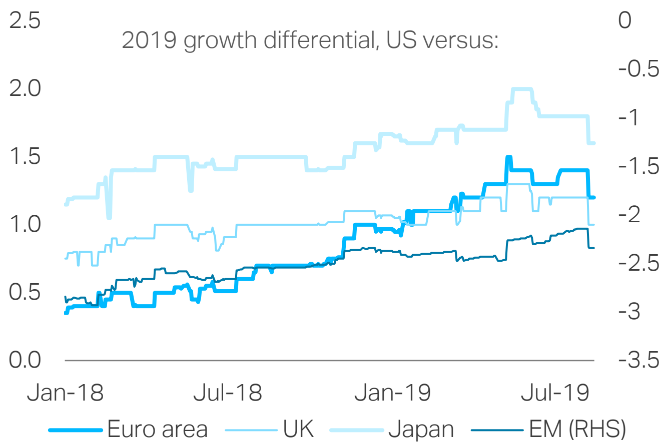
currency, strengthening the link between USD swings and global activity. GVCs further complicate exchange rate transmission, as we have seen with US tariffs and UK Brexit debate.

Chart 8: Rate differentials support USD



Source: Datastream, TS Lombard

Chart 9: Growth differentials have risen too



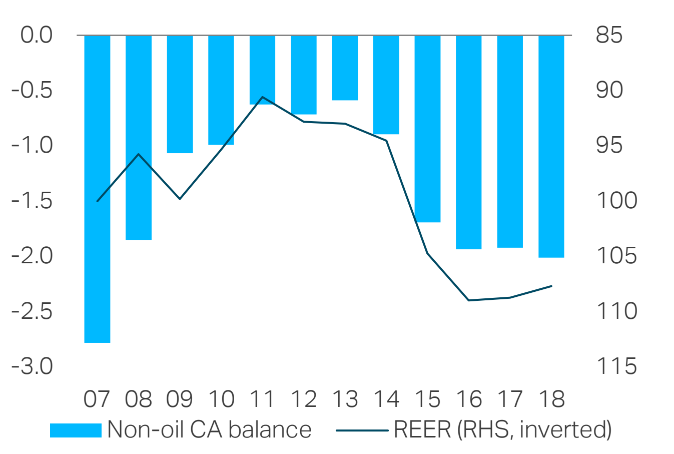
Source: Bloomberg consensus forecasts

USD and secular stagnation

It should be clear that a stubbornly strong dollar can be a problem for the global economy, restricting international trade, damaging the balance sheets of dollar borrowers, discouraging cross-border lending and hurting risk appetite. In fact, every time the dollar has appreciated in recent years, it seems to have undermined global economic activity and triggered periods of 'risk off' in financial markets. And when investors are nervous about the market outlook they tend to seek safety in dollar assets, which makes the situation worse. In the current context, there is also a worry that dollar strength might be spreading secular stagnation around the world. In fact, recent research has argued that there is a 'contagious' element to secular stagnation, in which capital flows and currency shifts play a decisive role. With Japan and much of Europe stuck with deflationary pressure and negative interest rates, investors look for higher yielding returns in the US, bidding up America's exchange rate and spreading deflationary pressures everywhere.

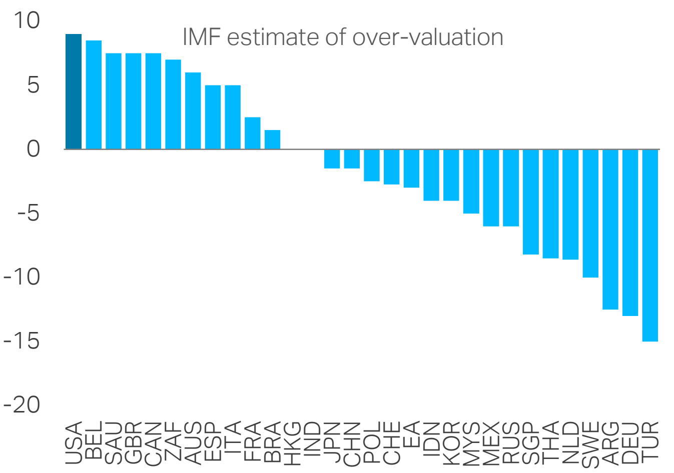
Since the strong dollar can be the source of so much trouble, it is clear why many investors were hoping for some Fed-driven relief in 2019. Yet, despite the Fed's pivot from tightening policy to cutting interest rates, the dollar has remained stubbornly high, recently approaching previous (2016) highs. According the IMF's latest estimates, the US currency remains significantly overvalued, by at least 10% on a broad trade-weighted basis (Chart 11). The issue, of course, is that it is not just the US authorities that are planning to ease monetary policy. The ECB is also set to announce a significant new stimulus package in the autumn, while the Chinese have recently allowed their currency to drift lower in response to new US import tariffs. With the US economy still relatively resilient compared to the rest of the world (Chart 9) and non-US yields dipping further into negative territory, there is still a strong international bid for dollar securities.

Chart 10: Strong dollar and US deficit



Source: IMF global imbalances report

Chart 11: Currency over/under valuation



Source: IMF global imbalances report

2. SOUND FX

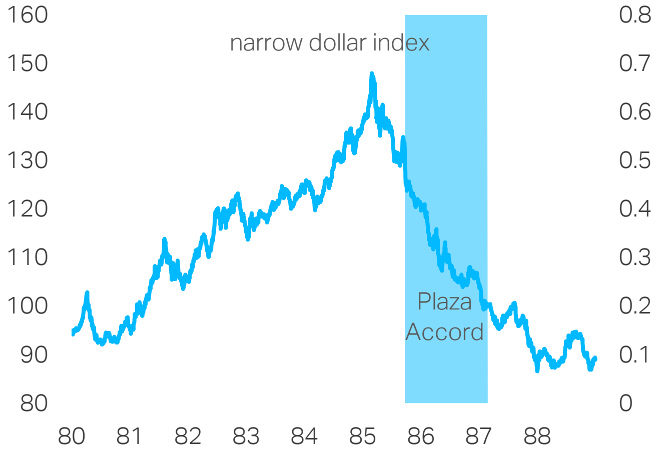
The Federal Reserve sets monetary policy according to its domestic mandate and the strong dollar is strictly only a problem insofar as it influences US employment and inflation. Fed officials certainly pay attention to what is happening in the rest of the world – perhaps more today than they did in the past – but they appear to believe that only modest interest-rate cuts are needed to fulfil their objectives. Yet the strong dollar is clearly a much more serious concern for the US president, who has voiced (and tweeted) his frustration with increasing hostility in recent months. Perhaps this is not surprising for a US administration that is fighting a trade war and has a rather unhealthy obsession with the current-account deficit. But President Trump's incessant jawboning about the exchange rate has led to speculation that the authorities might eventually intervene in markets in a direct attempt to reduce the exchange rate. Since a weaker dollar is not only in US interests, there is even speculation about coordinated move involving other nations.

Lessons from the 1980s

Whenever there is talk of coordinated USD intervention, sellside economists always harp back to the experience of the 1980s, the last time there was international action to relieve a period of persistent dollar strength. Recall, the US currency had appreciated rapidly during the first half of the decade, rising 50 per cent against America's main DM trading partners (Chart 12). Though the authorities had rejected the idea of official intervention just a couple of years earlier, downplaying its effectiveness, the G5 economies – the US, Germany, Japan, the UK and France – announced joint intervention at the Plaza hotel in New York City on 22 September 1985.

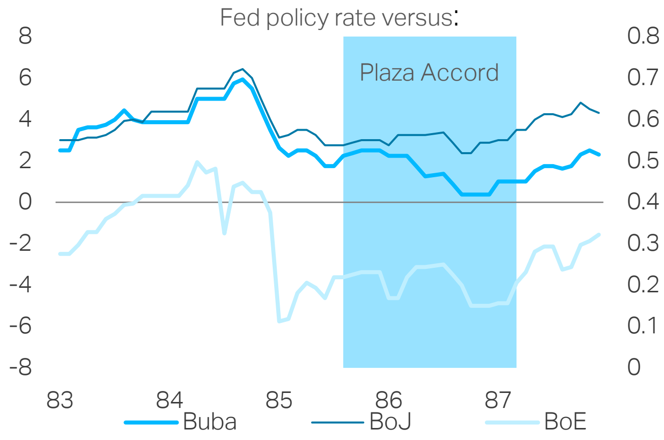
The stated aim of the Plaza Accord was to ensure that "exchange rates should better reflect fundamental economic conditions than [had] been the case'… which, 'in view of the present and prospective changes in fundamentals,' meant 'some further orderly appreciation of the main non-dollar currencies [was] desirable'. Given what happened to the dollar over the next two years – it had depreciated by 30 per cent by 1988 – the G5 intervention seems remarkably successful. In fact, the authorities announced a second agreement on 22 February 1987, the so-called Louvre accord, which claimed the major exchange rates were back at levels 'broadly consistent with economic fundamentals' and argued any further realignment would be 'undesirable'.

Chart 12: The 1980s currency 'accords '



Source: Federal Reserve

Chart 13: Interest-rate differentials



Source: Datastream

Currency intervention as a policy tool

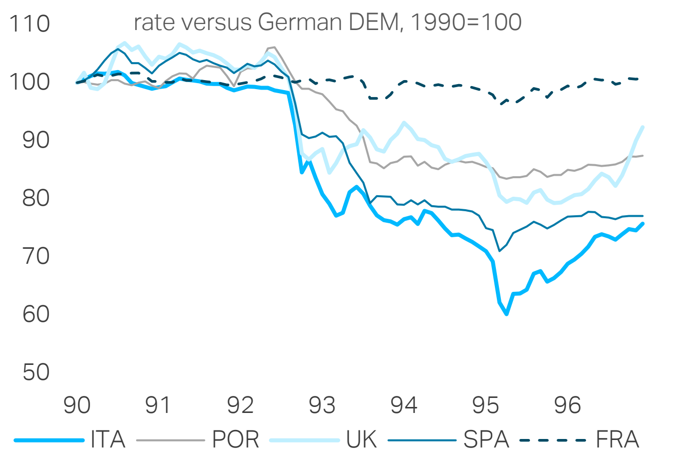
Despite the success of the Plaza accord, most DM central banks stopped using direct currency intervention after the 1990s. There were various reasons for this, but a series of speculative attacks – starting in Europe with the breakdown of the ERM and continuing in the second half of the nineties with the collapse of the Asian 'tiger' currencies – obviously didn't help. The adoption of formal inflation targets was also an important part of the story. While there was widespread agreement that 'unsterilized' intervention could influence exchange rates, there was less consensus about whether 'sterilized' action could have the same impact. In a sterilized FX intervention, the authorities try to prevent their actions from influencing the money supply. This means there is no change in interest rates. Unsterilized intervention, in contrast, is just an extension of monetary policy – the authorities change the monetary base and allow interest rates to rise (or fall), in an effort to strengthen (or weaken) the exchange rate[2]. Unsterilized action is more likely to influence the currency but could also contradict the central bank's inflation remit. By the 1990s, most policymakers had accepted the 'impossible trinity' in monetary policy and had chosen to target inflation directly, leaving their exchange rates to market forces.

Can sterilized intervention work?

Writing in 1987, Maurice Obstfeld argued – fairly convincingly – that the Plaza Accord was only successful because it was unsterilized. Though the official agreement involved direct, simultaneous sales of dollars to the value of around $18 billion, it was the shift in relative monetary policy that proved decisive – a process that had started even before the formal Accord. Chart 13 shows that US interest rates fell sharply compared to those in Germany, Japan and the UK. Fiscal policies also played a supportive role, with the US government announcing a major deficit reduction programme in 1985. According to Obstfeld, this brought US policy more into line with Japan and Germany, in contrast to the sharp divergence markets had expected.

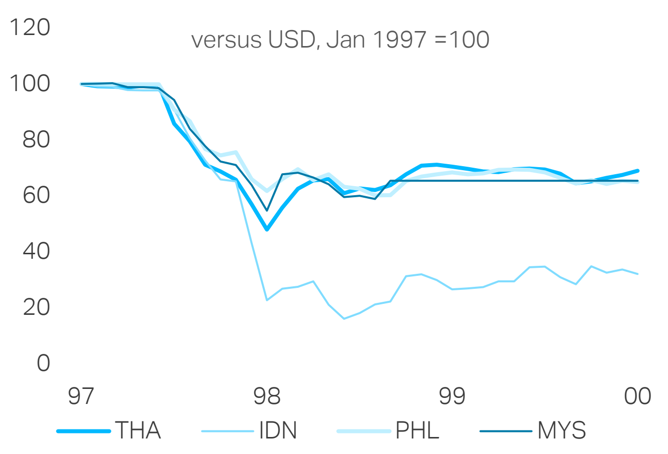
[2] When a monetary authority buys (sells) foreign exchange, its own monetary base increases (decreases) by the amount of the purchase. By itself, this type of transaction would influence exchange rates in the same way as domestic open-market purchases (sales) of domestic securities; yet most central banks routinely sterilize these operations – that is, they reverse the effect of the foreign exchange operation on the domestic monetary base by buying or selling domestic bonds. The crucial distinction is that sterilized intervention constitutes a potentially useful independent policy tool while unsterilized intervention is simply another way of conducting monetary policy.

Chart 14: First the ERM collapsed…



Source: Bundesbank

Chart 15: Then the Asian currency pegs



Source: Datastream

Today, if monetary policy continues to target domestic inflation, then coordinated unsterilized FX intervention is not really an option. Central have do what is needed to hit their mandated level of inflation, not make forays into the world of FX markets. Yet formal inflation targeting does not rule out sterilized interventions, which might even provide an additional policy tool. In fact, there is an extensive literature on sterilized currency intervention and researchers have come up with at least two ways in which the policy might – in theory at least – have the desired impact:

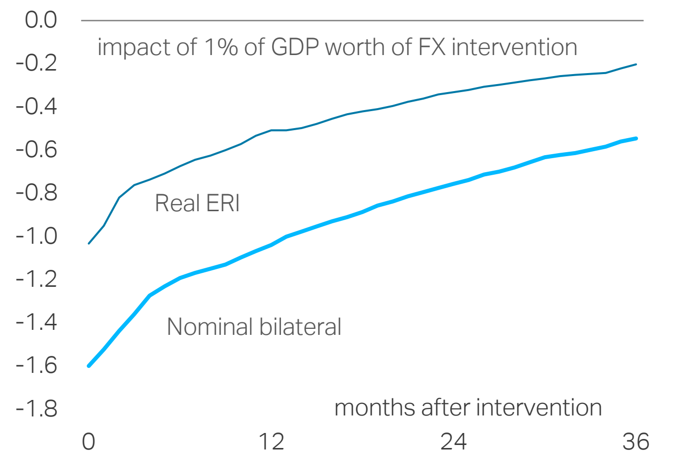
(i) The 'portfolio balance' channel – fully sterilized intervention does not directly affect the domestic money supply or short-term interest rates, but it will alter the relative availability of foreign and domestic government bonds. If, for example, the Fed buys Japanese securities and issues more domestic bonds to sterilize the domestic impact, investors must be compensated with a higher expected return to hold the relatively more numerous US bonds. To produce a higher return, the yen price of the US bonds must fall immediately – that is, the dollar price of yen must rise;

(ii) Policy signalling – investors might view exchange rate intervention as a signal about the future stance of policy. Because the exchange rate is forward-looking, a shift in expectations concerning future movements in variables affecting the exchange rate – such as relative money supplies – will affect the level of the currency today.

If these theoretical ideas sound familiar, they should be – they are the same 'transmission mechanisms' have dominated the QE debate. Like QE, sterilized intervention is supposed to work by changing the availability of government bonds (in this case, their *relative* scarcity across countries), or by providing a credible signal about future interest rates. But as with QE, there has always been deep scepticism about whether either of these channels operates in reality. In fact, when it comes to FX intervention, the case for scepticism is even stronger because the quantities involved are always smaller and the monetary policy signal is less creditable[3]. To illustrate, remember that most central banks have used huge sums of money since 2008 to try to reflate their economies, often spending up to 100% of their GDP in various QE programmes. Currency intervention, by comparison, has always been fairly trivial – usually less than 1% of GDP and virtually nothing compared to the daily turnover in modern international FX markets.

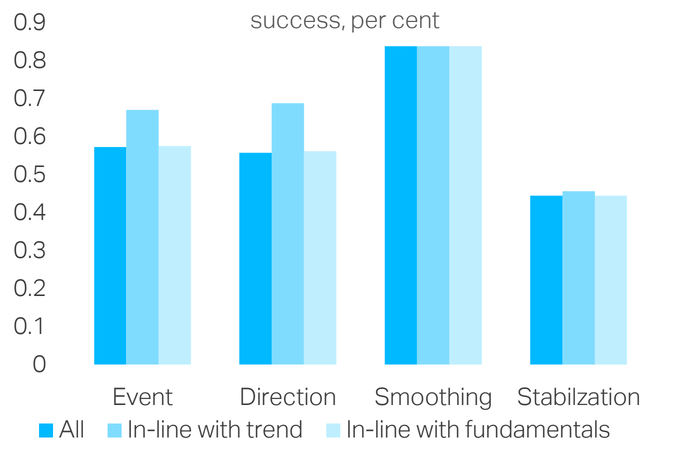
[3] Recent analysis suggests the average DM currency intervention is typically around 0.08 per cent of GDP (0.03 per cent of FX volume) and lasts 4 days. This compares to average EM interventions worth 0.05 per cent of GDP (0.06 per cent of FX volume) lasting 5 days.

Chart 16: Impact of sterilized intervention



Source: IMF study

Chart 17: Intervention success rates



Source: Fratzscher et al, see text for explanation

Academic evidence not compelling

Understandably, the empirical evidence for the effectiveness of sterilized currency intervention is 'mixed' at best. Early studies, such as those conducted in the 1970s and 1980s, were particularly pessimistic but this was partly due to poor data availability. Central banks didn't routinely publish the details of their actions and academics had to infer what they were doing from changes in official reserves, which can be problematic. Today, the academic evidence is slightly kinder to unsterilized intervention but investors should remember that – at least for the large developed economies – we have been living in a 'post intervention' era. The Federal Reserve, for example, has only intervened in FX markets three times since the late 1990s. In all three instances this was to protect global financial stability, not to realign bilateral exchange rates. And the Fed could rely on international support from the other major central banks.

Two recent studies, from the IMF and separately by Fratzscher et al, make a slightly more compelling case for unsterilized intervention. The Fratzscher study (Chart 17) is particularly interesting because it is based on a confidential (unpublished) database of interventions since the 1990s. Though their sample is dominated by EMs and uses an 'event study', which means it can only really tell us about the short-term market response, the researchers find that FX intervention had a success rate of around 50-80%, depending on prevailing market sentiment (whether the currency was already moving in the desired direction) and whether the authorities were acting in line with fundamentals ('smoothing' episodes). The paper also argues that the signalling effect of intervention is more important than any portfolio balance effects. The IMF study is also interesting, particularly when it comes to assessing the magnitude and durability of unsterilized intervention. Yet the results might be a little discouraging for proponents of these policies. The IMF finds that spending 1% of GDP on unsterilized intervention is only likely to reduce a currency by around 1.5 percentage points – offering pretty limited value for money.

Central banks only intervene when…

In the era of formal inflation targets and general scepticism about the effectiveness of sterilized intervention, it is not surprising most central banks have tried to avoid direct action in currency markets. The main exceptions have been Japan – which intervened regularly until the 2000s but today only does so on an informal basis[4] - and Switzerland. While the Swiss were generally able

[4] An NBER study found analysed the impact of BoJ intervention between 1991 and 2000. It found these actions were most effective when they were particularly large (greater than $1 billion in size) and involved US participation. Our strategy team argues that today Japan

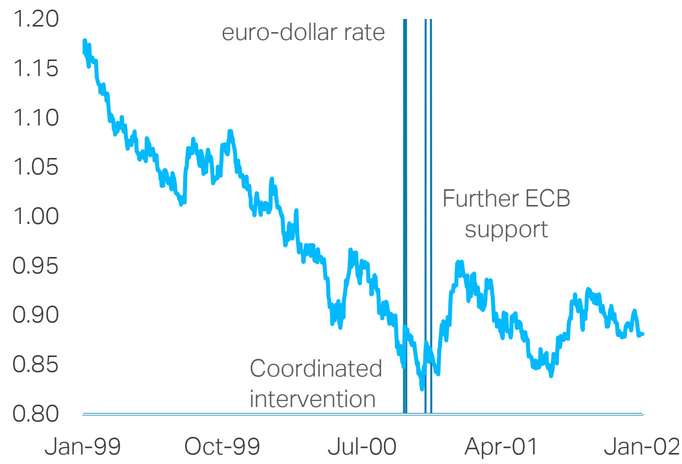
to hit their desired exchange rate, this policy also involved a massive expansion in the central bank's balance sheet (it was unsterilized). For other central banks, especially the Fed, ECB and Bank of England, direct currency intervention has only ever taken place when:

(i) Exchange rates were moving rapidly and there was a financial-stability argument for intervention rather than a desire to realign international exchange rates, and;

(ii) Central banks could rely on international support. Officials believed that coordinated intervention was more 'credible' and much more likely to work;

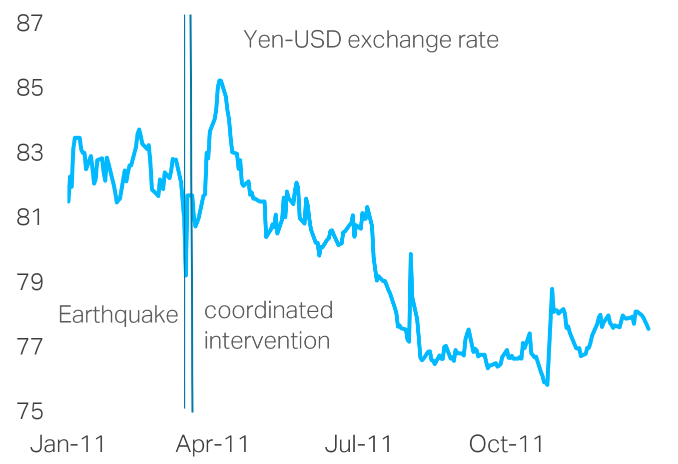
There are a couple of classic examples that illustrate this prevailing consensus on currency intervention. The first occurred on 22 September 2000, when the ECB, the BoJ and the Fed worked together to stabilize the value of the newly created euro. The second episode took place on 17 March 2011, shortly after a large earthquake hit Japan. The Yen was appreciating rapidly and the authorities coordinated their actions in an effort to stabilize the markets. Both of these interventions were reasonably successful. According to a popular study by Neely (2011), these action moved the relevant exchange rates by around 3-4% and FX volatility declined on a sustained basis, showing official intervention was able to calm market anxiety.

Chart 18: Intervention to support the euro



Source: Datastream

Chart 19: Intervention to calm the Yen



Source: Datastream

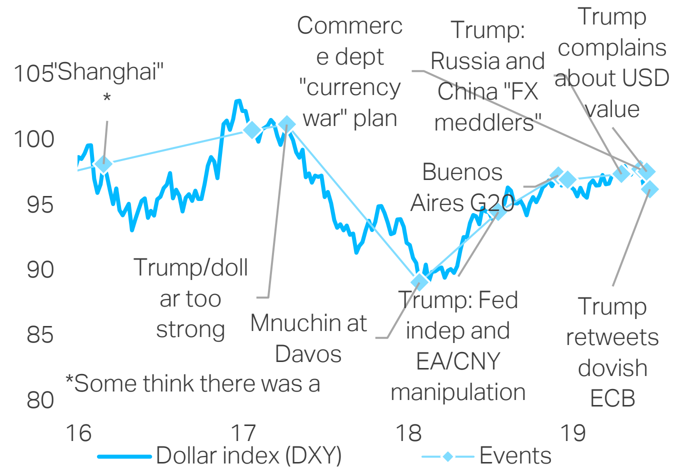
3. COORDINATION FAILURE

There is no doubt the prevailing consensus among global policymakers would reject currency intervention today. A 'no-deal Brexit', with a rapid decline in sterling threatening to undermine UK financial stability, is perhaps the only scenario that might elicit such action soon. Yet, we also know the US President wants a weaker dollar and is prepared to exert enormous pressure – on both the Federal Reserve and his international peers – to get his way. Since Trumponimics has already included various policies that have enraged the economics community, such as using tax cuts to stimulate the economy late in the cycle, or starting a full-scale trade war with China,

is more likely to use informal interventions, such as adjusting the foreign currency holdings of large nationally-owned life insurance companies and pension funds. This is a reminder that European governments once used their nationalized industries in a similar way.

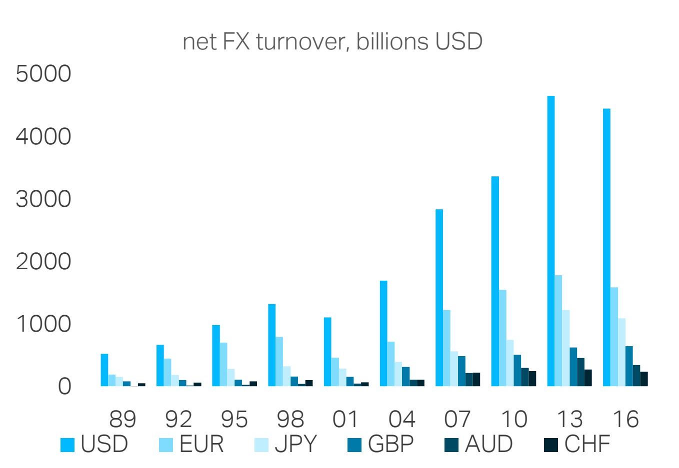
even the most outrageous ideas cannot be ruled out. Don't forget, not long ago, the Trump administration was even investigating the legality of replacing Jay Powell as Fed chair.

Chart 20: Verbal USD intervention



Source: Bloomberg

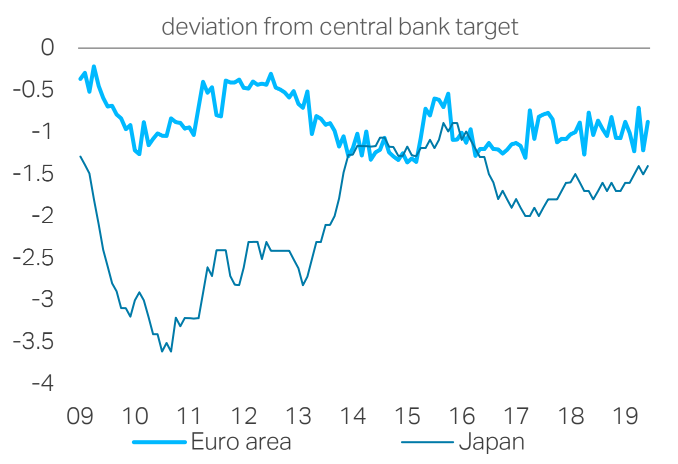
Chart 21: FX markets bigger than in the past



Source: TS Lombard estimates

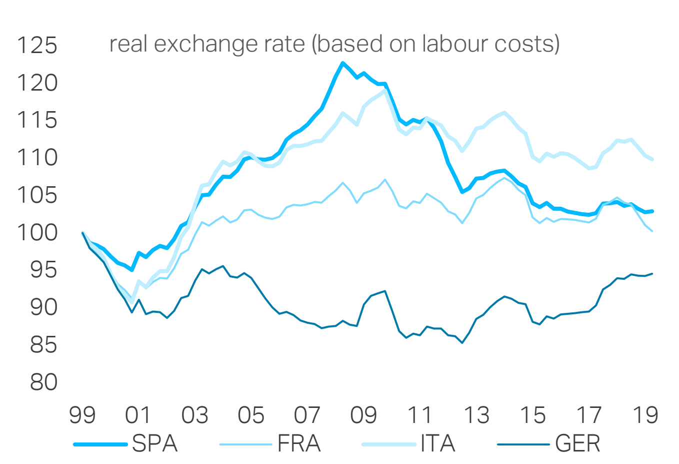
Investors should also remember that it is the US Treasury, not the Fed, which is responsible for the dollar exchange rate. This all means, even if direct currency intervention is not the most likely scenario over the next couple of years, it is not an idea we should dismiss out of hand. Given the unpredictable nature of the Trump administration, it probably makes more sense to try to assess the likely impact of any foray into currency markets, rather than try to assign a probability to such a move. With this in mind, we see too important factors that would limit the impact of any Trump-inspired attempt to weaken the currency: (i) The United States would almost certainly be acting alone, and (ii) The Federal Reserve would not adjust monetary policy in an effort to support Treasury FX intervention – to do so would essentially mean surrendering its independence.

Chart 22: Persistently low inflation



Source: Datastream, TS Lombard

Chart 23: Intra-regional euro imbalances



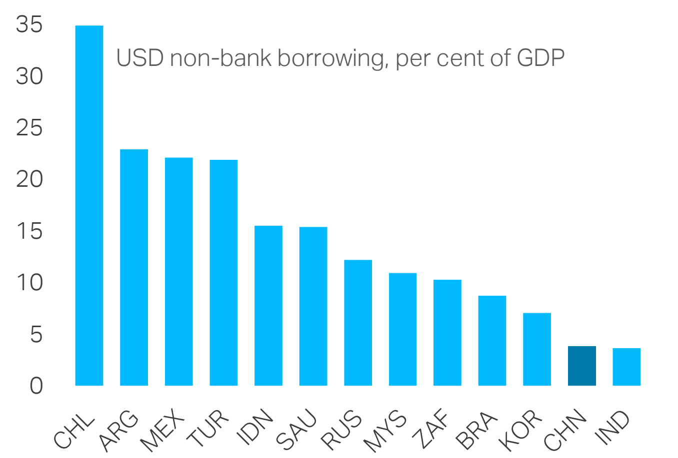
Source: European Commission

US intervention would be unilateral

At the time of the Plaza Accord, America's main trading partners agreed that a weaker dollar was desirable and were prepared to revalue their currencies to achieve this outcome. There is no consensus for such action today. In fact, both the euro area and China would rather see their currencies depreciate rather than rise in value against the dollar. The euro area, of course, is struggling with persistently sluggish growth and below-target inflation. Worse, some parts of the region continue to struggle with poor competitiveness and declining market share. Exchange rates have always been a politically sensitive issue in Europe and the authorities know that further euro appreciation would compound underlying EMU imbalances and perhaps even increase anti-EU sentiment in countries such as Italy. The euro area is also in a different position to many other parts of the world – European companies typically borrow in their domestic currency and invoice their trade in euros, which leaves them less exposed to USD strength.

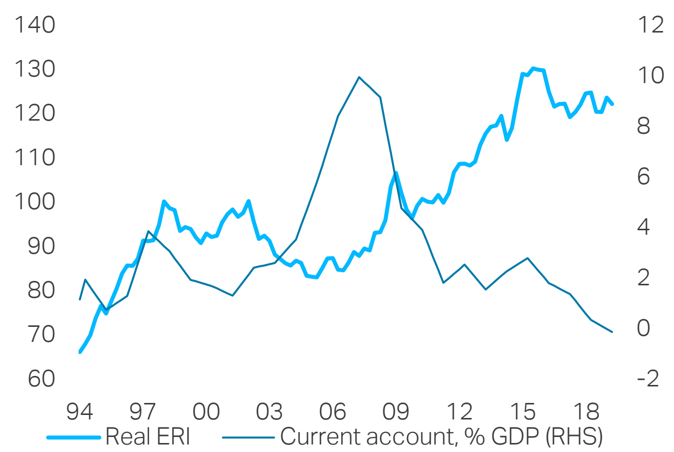
Chinese policymakers are also in a difficult position. In recent years, the authorities have tolerated an overvalued RMB largely for political reasons – they didn't want to antagonize America. But this means they have had to inflate a massive credit boom in order to meet overly ambitious GDP targets. Since this combination of policies has caused serious financial fragility in China's banking system, the authorities might now prefer to let the RMB slide lower, rather than to introduce another large stimulus programme[5]. This is particularly likely in a situation where China is engaged in a continued trade war with the United States – a conflict that surely makes coordinated currency intervention almost unthinkable. If both China and the euro area are unwilling to let their currencies appreciate as part of any effort to reduce the dollar, it is hard to see how the US administration could deliver a significantly weaker currency. Instead, US action might just provoke a full-scale global currency war to accompany their trade war.

Chart 24: External USD-denominated debt



Source: BIS

Chart 25: RMB overvaluation



Source: BIS, OECD

The Federal Reserve would sterilize intervention

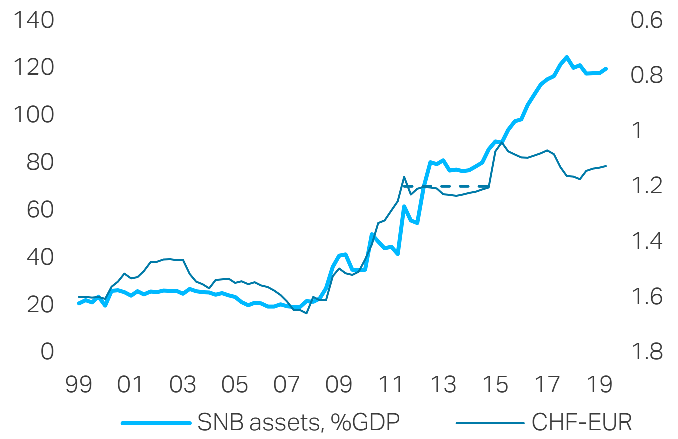
A unilateral attempt to weaken the dollar would also create a difficult situation for the Federal Reserve. Officially the New York Fed acts as an agent for the Treasury, intervening in currency markets under instruction from the government. The administration has an account at the Federal Reserve – the Exchange Stabilization Fund – which provides the funds for intervention, though the central banks tells us that in practice any intervention is a joint venture, in which the Fed matches the Treasury's funds using its own balance sheet. This makes it hard to assess the 'firepower' available for intervention, especially because – in a situation where the United States

[5] Like the euro area, China has relatively modest amounts of dollar-denominated external debt. BIS data (Chart 24) show total non-bank private exposure of around 5% of GDP. If we add the banks and the public sector, the numbers are obviously higher. Our estimates, published in a recent Daily Note, show total private borrowing (including banks) of around 1 trillion dollars (i.e. 8 per cent of GDP) plus another 0.9 trillion (7.3 per cent of GDP) if we include the PBoC. This is still relatively low compared to other emerging economies.

is selling dollars to weaken the currency – the balance sheet is technically unlimited. Still, the important thing to note is that the Federal Reserve routinely sterilizes any US forays into the FX markets. Put another way, the central banks does not allow Treasury-directed currency intervention to influence the level of interest rates or the domestic money supply. Why? Because doing otherwise would effectively forfeit the Fed's independence.

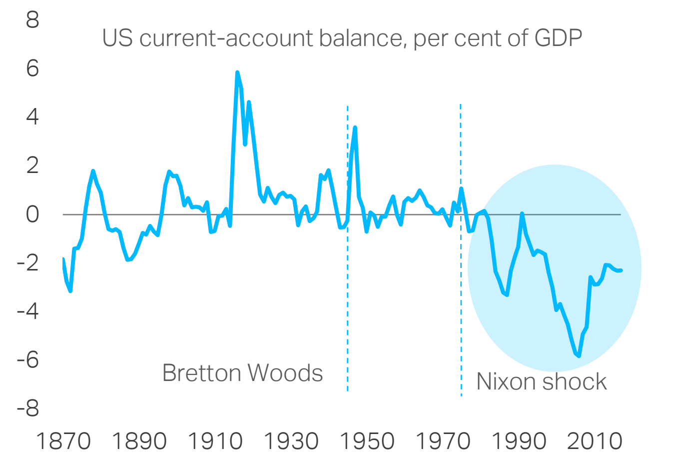
While there is no doubt the United States could engineer a weaker dollar if the Federal Reserve supported currency intervention by cutting interest rates, it seems much less likely the policy would work if the central bank continued with its existing policies. And since the Federal Reserve believes it can achieve its existing mandate without currency intervention, why would it adjust its policies just to support Trump's desire to weaken the dollar – unless it is acting for 'political reasons'. So, not only would US currency intervention antagonize America's international peers, it is also potentially a much more serious threat to the Federal Reserve's independence – much more alarming than the President's anti-Powell tweets or his public demands for interest rate cuts. Unsuccessful sterilized intervention potentially leads to all sorts of nasty scenarios, which could easily become a source of uncertainty and volatility in global financial markets.

Chart 26: Unsterilized SNB intervention



Source: Datastream, TS Lombard

Chart 27: Dollar standard involves US deficits



Source: Macro History database, TS Lombard

Perhaps the underlying problem is that there is an inherent contraction between a world that is structurally short of dollars and an US administration that wants to weaken the currency and eliminate the current-account deficit. While the link between the US trade position and the dollar's role in the global financial system is certainly not one-for-one, for a variety of reasons[6], it has always been clear that the United States must run a deficit if it is to remain the world's reserve currency. The US president is already threatening to undermine the Dollar Standard with his import tariffs and trade war and unilateral FX intervention could only make the situation worse, particularly if it led to the imposition of capital controls. While this all sounds a bit far-fetched, perhaps it is the inevitable endgame for a situation where the US is importing secular stagnation from the rest of the world. Perhaps the world ultimately needs to find a replacement for the post-Bretton Woods Dollar Standard, but right now it is not clear what that might be.

[6] The Eurodollar system can create dollar liquidity independently from the US trade deficit by, for example, 'round tripping'. This is what euro-area banks were doing in the run up to the subprime crisis, an activity than didn't show up in net trade imbalances.

Bottom line

There is no doubt the persistently strong dollar is a problem for the global economy. Since a large part of the world borrows and invoices its trade in USD, US currency strength damages global economic activity and discourages cross-border lending. Yet, unlike in the 1980s, this does not mean there is any appetite for coordinated international action to weaken the dollar. In fact, both China and the euro area would prefer to see their currencies depreciate, especially as they are already struggling with below-trend growth and have relatively low levels of dollar denominated debt. Of course, in the world of 'Trumponomics', this doesn't mean we can rule out the prospect of unilateral US intervention – with President Trump, anything is possible. But without international support, and with the Fed unlikely to divert monetary policy from its existing mandate, we suspect such action would be unsuccessful. Worse, it could set the US on a potentially dangerous policy path that would create major upheaval in global markets.

Authors

Dario Perkins
Managing Director,
Global Macro