The challenge of responding to FX volatility

Richard Grace, chief currency strategist and head of international economics and Andy Ji, Asian currency strategist at the Commonwealth Bank of Australia, offer their views on how the divergent economic fortunes of the world will impact foreign exchange levels.

FINANCIAL MARKET VOLATILITY AND ITS EFFECTS ON REAL ECONOMIC ACTIVITY

In the past month, volatility in global financial markets escalated sharply. Continued deterioration in Euro zone sovereign debt issues, evidence of a slower US economy and a historic downgrade to the US sovereign credit rating helped drive a precipitous fall in the Euro Stoxx 50, the S&P 500 and other major stock market indices.

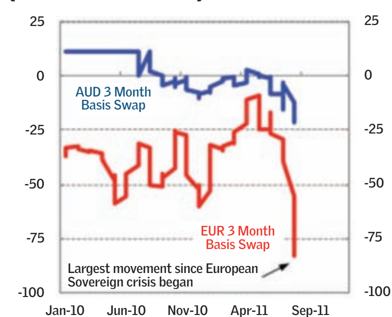
There are a number of ways volatility in global financial markets can affect real economic activity: (1) volatility weighs on business and consumer confidence, generating a delay in investment and consumption decisions; (2) volatility that results in rapid falls in global sharemarkets tends to generate negative wealth effects, which can impact consumer and business behaviour; (3) volatility generates risk aversion, which can increase global funding costs for some banks and/or economies that carry external funding requirements.

On the last note, there has been a noticeable strain on short-term cross-border funding between Europe and the US, evidenced by the widening of the three-month EUR basis swap to its largest levels since the Euro zone sovereign crisis first gained attention in early 2010 (Chart 1).

DOWNSIDE RISKS PROMPT POLICY RESPONSE

In response to a slower GDP growth outlook, the major central banks have made policy adjustments: (1) The US Fed has provided a commitment that the effective Fed funds rate is likely to remain between zero and 0.25% at "least until mid-2013"; (2) The European Central Bank has entered the secondary market to buy Euro zone member government bonds as part of its Securities Markets Programme (SMP), while at the same time re-commencing long-term refinancing operations (LTROs) as part of its euro liquidity-providing operations; (3) The Bank of Japan has further increased its Asset Purchase Programme, lifting it by ¥15 trillion (US$195 billion) to ¥55 trillion, and intervened in the foreign exchange market in an effort to weaken the yen; (4) The Bank of England's Monetary Policy Committee has tilted, by way of a vote, towards an easier-policy bias; (5) The Swiss National Bank has flooded the market with liquidity, helping to push Swiss two-year government bonds into negative rates of interest.

Chart 1:
BASIS SWAP
(SELECTED MARKETS)



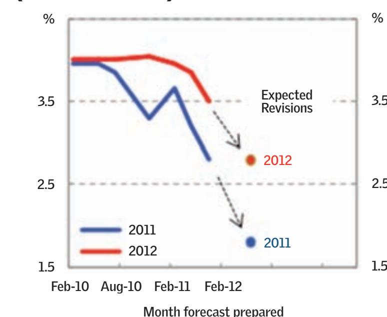
SOURCE: COMMONWEALTH BANK OF AUSTRALIA

GLOBAL ECONOMY STILL ON TRACK FOR ABOVE-TREND GROWTH

It will take quite a savage spike in volatility and quite a large fall in global share markets to result in a major shaving of global growth. However, downward revisions to the last three years of GDP data by the US Bureau of Economic Analysis (BEA) are material and will impact global growth.

In that regard, it is inevitable that the Fed will revise down its 2011 GDP growth forecasts from 2.8%, to something close to 1.8%. The Fed also forecasts for 2012 calendar year GDP growth will also be revised lower (Chart 2). While downside risks to the global economic outlook have significantly increased, our central scenario is for the global economy to still record above trend growth over the remainder of 2011 and in 2012. It is still likely that the global economy will record close to 4.0% growth this calendar year, modestly below the International Monetary Fund's 2011 June forecast of 4.3%.

Chart 2:
EVOLUTION OF FED'S FORECASTS
(GDP FORECASTS)



SOURCE: COMMONWEALTH BANK OF AUSTRALIA

The majority (55.9%) of global growth is expected to continue to come from Asia (Table 1). Sluggish external demand from developed economies has heightened the downside risks to the non-Japan Asian (NJA) economies. Singapore and Hong Kong, in particular, could fall into a technical recession in the third quarter, after suffering a quarter-on-quarter contraction in the second quarter.

On the other hand, domestic demand has stayed relatively resilient across the region, reflecting a mainly measured monetary tightening so far in the current cycle. Policy interest rates are broadly in line with their ten-year averages, and real interest rates are significantly in negative territory. Against these backdrops, while we see heightened downside risks to the growth outlook, we expect Asian domestic demand to remain resilient and buttress the moderation in NJA economies over the medium-term. In China, the more recent economic data continues to suggest that a hard-landing of the Chinese economy is unlikely.

The risk of rising global inflation remains an on-going issue in emerging markets. Having said that, it is possible global inflation pressures have peaked, assisted partly by the 30% decline in the WTI oil price from its late April highs. A further easing in global inflation pressures may also come from two other factors: (1) the austerity measures being adopted in the advanced economies. Austerity measures will be a contributing factor in advanced economies maintaining a large output gap for at least the next few years; (2) Volatility in financial markets affecting participant behaviour.

THE US DOLLAR WEAKER OVER 2012

The slowing US economy, the Fed's guidance about the Fed funds rate remaining between zero and 0.25% for two years and the downgrade of the US's sovereign credit rating are negatives on the US dollar.

In our view, these influences imply an extended period of negative real interest rates in the US, which should maintain downward pressure

on the US dollar. However, if the US enters recession, the US dollar will likely spike higher as participants seek funding in the US dollar and the relative "safe haven" of liquid US treasury securities.

The US dollar is heavily influenced by real interest rates and the US two-year swap yield relative to the US's weighted G7 trading partners. The US-G7 swap spread is temporarily under some upward pressure driven by a widening in the euro basis swap. This reflects the scramble for US dollar funding relative to euro demand.

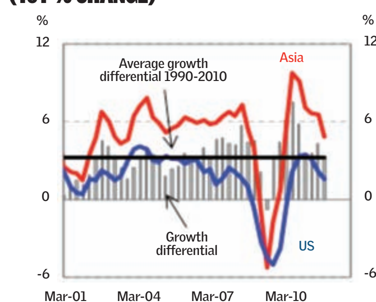
These developments are providing the US dollar with some temporary strength. However, once risk aversion subsides, the US-G7 weighted two-year swap spread should move lower, guiding the US dollar lower.

COMMODITY-LINKED AND ASIAN EXCHANGE RATES TO REMAIN RESILIENT

While downside risks to the global growth outlook remain heightened, it will be difficult for the Australian dollar to lift. Having said that, once the current global concerns subside, sustained weakness in the US dollar is a driving factor behind our higher medium-term Australian dollar forecasts.

In addition, while the risks to growth in many developed economies are tilted to the downside, NJA economies are expected to continue to grow at above trend rates (Chart 3). This should support commodity prices, and in turn, underlying growth in the Australian economy. In addition, Australia's relative economic health, Australia's relatively high interest rates, and further diversification by global central banks into 'AAA'-rated non US dollar holdings, should provide additional avenues of support for the Australian dollar over the medium-term.

Chart 3:
NON-JAPAN ASIA & US GDP GROWTH (YoY % CHANGE)



SOURCE: COMMONWEALTH BANK OF AUSTRALIA

In China, despite recent developments in global sharemarkets and in the US economy, the People's Bank of China (PBoC) has surprised investors by setting the swap rate of US dollars and Chinese renminbi (USD/CNY) consistently lower, effectively accelerating the pace of renminbi appreciation. The substantial inter-day moves demonstrate the Chinese authorities' confidence regarding the medium-term growth outlook.

With the USD/CNY midpoint having been lowered by a combined 479 basis points in the second week of August, the non-deliverable forwards (NDF), especially those of shorter tenors, fell quickly to price a faster appreciation path in the near-term.

We believe the accelerated renminbi appreciation pace reflects three considerations: (1) Rising intervention costs; (2) An appropriate monetary policy tool to combat high commodity prices denominated in US dollar and core inflation pressures, and; (3) The PBoC's commitment to a gradual renminbi appreciation path.

For exchange rates in NJA, a weaker US dollar essentially implies further Asian currency appreciation. We feel confident in forecasting further Asian currency appreciation based on a weaker US dollar because the correlation between Asian exchange rates and the US dollar has tightened significantly this past year.

Our NJA currency forecasts imply general strength over 2012, not simply because of a weaker US dollar, but due to favourable local factors as well. We expect the Korean won, Thai baht, and Malaysian ringgit exchange rates to outperform this year.

Table 1:
CONTRIBUTIONS TO GLOBAL GDP GROWTH

	2000-2009	
	average	**%**
Asia	1.9	55.9
North America	0.6	16.3
Europe	0.5	15.3
Latin America	0.2	4.7
Rest of the World	0.3	7.8
Total	**3.5**	**100.0**

SOURCE: IMF; COMMONWEALTH BANK OF AUSTRALIA RESEARCH

In South Korea the momentum in both growth and inflation continues unabated. The won remains undervalued relative to its medium-term fundamentals; South Korea's real effective exchange rate (REER) is currently 20% below its pre crisis levels, yet South Korea's account surplus, at 3.4% of GDP, continues to widen. The current account surplus is more than one percentage point above its 2000-07 average.

In Thailand and Malaysia, the respective central banks have shown greater restraints toward large scale foreign exchange intervention. We believe that the reluctance to intervene in the foreign exchange market represents an important shift towards greater tolerance of local currency strength because of rising inflation pressures. ◢

Ranked as one of the best currency forecasters by Bloomberg[1], the 'FX Week'[2], and the Peter Lee Survey[3], the Commonwealth Bank is well positioned in the global foreign exchange market to provide a wide range of business banking solutions to customers globally.

The largest Australian bank and one of the world's largest banks by market capitalisation, as well as one of the few AA-rated banks in the globe, our in-depth knowledge of the Asian and Australasian markets has been a key strength for our clients globally. We continue to attract Asian and Australian clients who are keen to get exposure to offshore markets, and global clients that have Australian interests.

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Notes:
1 Ranked in July 2011 by Bloomberg as 5th overall for accuracy of Asian currency forecasts (1st for CNY and KRW, 3rd for HKD, 4th for PHP), and 9th overall for G8 currency pair forecasts out of 50 banks surveyed.
2 Won the 'FX Week' one-month forecasting poll, (which covers 35 banks) twice in 2010 and 2011, and featured within top five banks for the past four and half years.
3 Ranked first in 2010 Peter Lee Institutional Survey for forecasting and quality research.