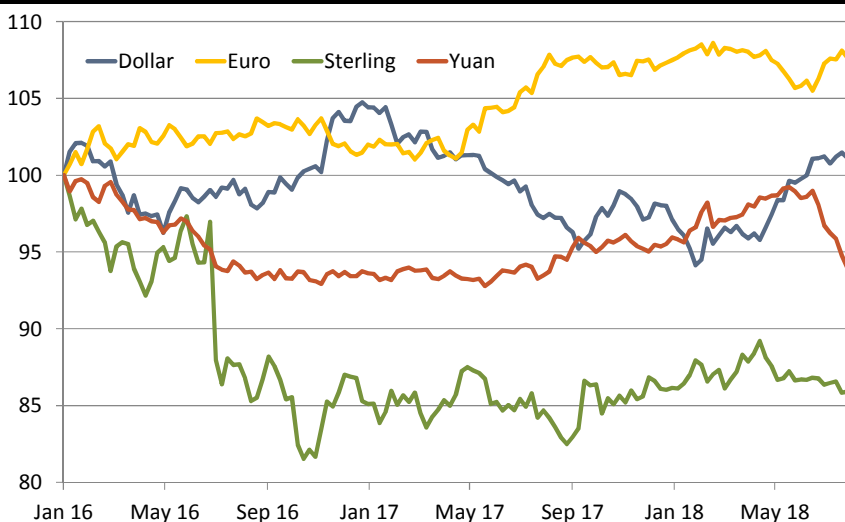


3 August 2018

The lessons from exchange rates

Nominal trade-weighted exchange rate indexes (100 = January 2016)



Source: Federal Reserve, European Central Bank, Bank of England, Wespac. All data show nominal trade-weighted currency indexes. 100=2016 January.

- **Key drivers:** Exchange rates reflect many factors, including the stance of a country's monetary and fiscal policies relative to that of its partners, supply-side reforms, long-term growth expectations and perceptions of risk.
- **US policies boost the greenback:** Gradual rate hikes, a fiscal stimulus and the pro-growth impact of deregulation and fiscal reforms have supported the US dollar so far this year. As the ultimate safe haven for global capital, the dollar also attracts additional inflows in times of heightened tensions even if these tensions have been stoked by the US itself. Although US President Donald Trump may prefer a weaker US dollar to help contain the US trade deficit, his unsettling trade war threats tend to boost the external value of the US dollar instead.
- **Softer Chinese yuan reflects domestic and external pressures:** As the Chinese economy seems to have lost some momentum and the People's Bank of China has modestly loosened its policy in response, the trade-weighted yuan has fallen in the past few months. Concerns about the impact of a US-China trade war may also weigh on the currency.
- **Battered by Brexit:** Sterling has turned into a Brexit story. Correctly interpreting the June 2016 decision to leave the EU as a negative supply shock that will constrain UK trend growth for the foreseeable future, markets downgraded UK assets via the exchange rate right after the vote. Since then, sterling has oscillated around this new lower level largely in response to shifting market perceptions about the outcome for Brexit and its impact on long-term growth.
- **The euro is largely stable amid the cross-currents:** When global tensions put markets into risk-off mode and trigger capital flight into the dollar, the euro usually falls against the greenback. But as other regions and currencies tend to be much more vulnerable to such tensions, the trade-weighted euro can remain fairly stable even in such times.
- **Back to risk-on mode in late 2018?** Last year, the US dollar fell despite Fed rate hikes as markets celebrated the absence of negative surprises in the first year of the Trump Administration. A growing appetite for risk encouraged capital flows out of the dollar. So far this year, markets have partly reversed some of last year's trends as trade tensions have dampened investor appetite for risk. We expect these tensions to fade somewhat later this year. With the Juncker-Trump armistice in the US-EU trade conflict, the US and the EU have taken a key step in this direction.
- **The US-Chinese conflict now takes centre stage:** If the current escalation turns into the prelude to serious negotiations later this year as the Chinese seek to limit the damage, markets could move back towards a more "risk-on" mode. If so, the euro could recover some of its losses versus the dollar in line with some rebound in Eurozone export expectations and business confidence. At the same time, the deal for a semi-soft Brexit which we expect the UK and the EU27 to strike late this year could lift sterling by a couple of cents.

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