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Kallum Pickering, Senior Economist | Kallum.pickering@berenberg.com | +44 20 3465 2672

HAS THE BOE STARTED A CURRENCY WAR? NOT AT ALL

Berenberg Macro Flash

A weaker currency during a downturn can limit the downside for a flagging economy. Higher import costs and more competitively priced exports often improve the trade balance as imports decline while exports rise, resulting in a plus for GDP. After last week's rate cuts and new asset purchases (QE), the BoE has been accused of entering a 'currency war'. This is a little odd. The notion ignores historical evidence for the UK and elsewhere.

As we showed last week, past QE in the UK has been followed by a stronger sterling 12 months down the line – see report. Why? Because GDP growth improved after QE started, raising demand for sterling assets, which led to a sterling appreciation.

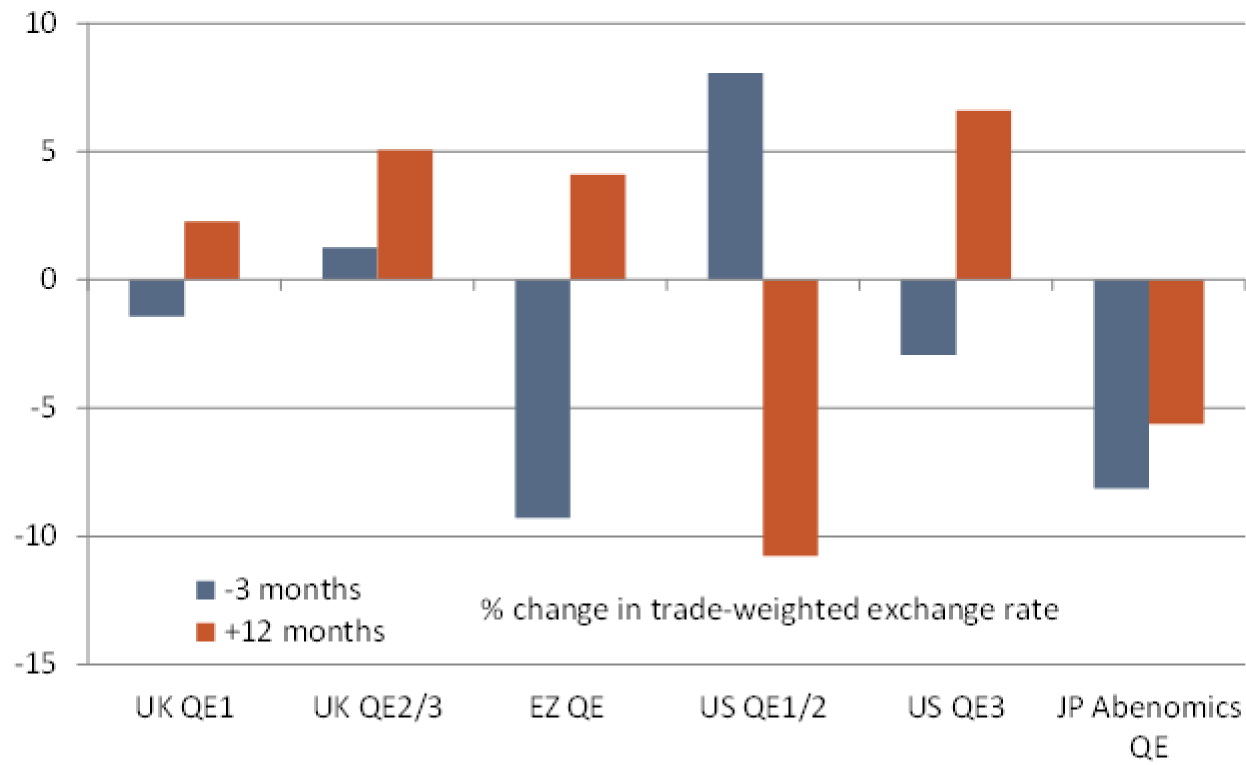
The chart below reiterates this argument for the UK. But it goes further. It also shows how currencies changed before and after QE began for all asset purchase programmes for major developed economy central banks since the Lehman-crisis.

The argument does not just hold for the UK. As the chart shows, on four out of six occasions, the currency has appreciated by 5%, on average, within 12 months after the start of a QE programme. The weaker currency effect mostly comes during the run up to the decision. But on top of markets pricing in central bank easing to come, the pre-QE depreciation could also reflect the worsening economic climate that prompted QE in the first place, rather than expectations of QE. When the economy improves, the currency appreciates. The Eurozone's QE and the US's final QE fits this argument well.

On the two occasions where the currency depreciated 12 months after purchases began, we should pay careful attention to the underlying economic conditions at the time. The Fed started QE in November 2008. At that time, the US economy suffered its worst crisis in a generation. Similarly, after the BoJ started QE in April 2013 as one of Abenomics' three arrows, the economy continued to sink for a year thereafter.

Monetary policy can drive exchange rates. Much of the effect usually comes in the run-up to a decision as markets price in the expected change in the monetary stance. But there is no substantial evidence that the actual asset purchases have a further effect on exchange rates. On-going asset purchases do not seem to weaken a currency on a sustained basis. Instead, the evidence suggests that the opposite may happen. By contributing to a rebound in confidence and demand growth, QE can even help to stabilise the external value of a currency over time.

Change in trade-weighted exchange rates 3 months before and 12 months after QE begins



Monthly data. Source: Bank of England, Berenberg calculations.
UK: QE1 = Mar 09 to Feb 10, QE2/3 = Oct 11 to May 12 + Jul 12 to Nov 12.
EZ: QE = Mar 15 to Mar 17.
US: QE1/2 = Nov 08 to Jun 10 + Nov 10 to Jun 11, QE3 = Sep 12 to Oct 14.
JP: Abenomics QE = Apr 13 to open ended.

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Joh. Berenberg, Gossler & Co. KG
60 Threadneedle Street
London EC2R 8HP
Phone +44 20 3207 7878
www.berenberg.com
Kallum.pickering@berenberg.com