MAKING SENSE OF *THIS* WORLD 29 January 2018

R&R Weekly Column
By Brunello Rosa

Lingering Currency Wars

As discussed in our recent publications, during the past week we have observed an abrupt resurgence of what we could call "lingering," or "low-intensity" *currency war*, initiated by the comments by US Treasury Secretary Steve Mnuchin in favour of a weak dollar (subsequently rectified, also following US President declaration in favour of a strong dollar and Draghi's disappointment during the ECB's press conference). What are the ingredients of this renewed *currency war*? In the immediate aftermath of the financial crisis (in London), G20 countries renewed their pledge not to indulge in competitive devaluations, but soon after engaged in a "currency war" by proxy, in terms of competitive increases of the central banks' balance sheets, another way of re-flating the economy, debasing the currency and ultimately induce a currency depreciation against all other currencies. All major DM central banks engaged in such a borderline acceptable practice, behind the fig leaf that ultra-expansionary monetary policies were motivated by domestic reasons, with the effect on the currency only being an unwanted (but welcome!) "collateral damage".

In this phase, central banks' behaviour is relevant from a different perspective: considering the diverging monetary path by the Fed (engaged in rates normalisation and balance sheet reduction) and the ECB (still adopting a negative policy rate and balance sheet expansion) one would expect EUR/USD to depreciate, rather than appreciate. However, the policy path expected by the market given the stage in the economic cycle, compared to what the central bank actually does, could make the difference. The Fed continues delivering "dovish hikes," while the ECB is engaged in a slow exit from its extraordinary accommodation. Besides this and other cyclical factors (e.g. inflows into equity markets) there are two structural factors behind the lingering currency war: one is the trade policy, the other the tax policy. On *trade*, the Eurozone continues to exhibit a current account surplus (a result of the German-mandated fiscal austerity imposed to the continent) that structurally strengthen the currency, while the US has still a current account deficit which favours a weaker currency, in spite of the threatened "protectionist" measures that would make the USD, at the margin and *ceteris paribus*, stronger. On *fiscal policy*, the recent US tax cuts is likely to create a fiscal and current account deficit that would, over the medium term, favour the weakening of the USD in spite of all declarations by US officials. The German-led Eurozone will find it hard to respond to this round of US fiscal easing in spite of the re-emerging grand coalition.

We will likely observe other episodes of this new lingering currency war in coming months. Being a fiscal and political union, the US is much better equipped than the Eurozone (a sub-optimal currency area) to fight this war. Other jurisdictions, such as the UK (busy with Brexit) and Japan (still battling with low inflation) will try to respond with their more limited weapons to this new challenge.

Our Recent Publications

- *Fed Preview: On Hold in January, Door Open in March*
  by Brunello Rosa, 26 January 2018
- *ECB Preview: Taking Stock on the Strong Euro*
  By Brunello Rosa, 22 January 2018
- *ECB Review: Strong Euro at the Forefront of ECB's Attention*
  by Brunello Rosa, 25 January 2018
- *Turkey's Attacks In Afrin Will Be Small-Scale And Unlikely To Move Markets, By A. Magnoli Bocchi and P. Gallego Cuervo, 22 January 2018*

The Week Ahead

US – FOMC, ISM, NFP and State of the Union. On January 30-31, the US FOMC meeting will take place. Investors expect guidance on the Fed's view on USD weakness. The probability of an interest rate hike in March (according to Fedwatch) is 76.8%. On February 3, Janet Yellen's term as the Fed chair will come to an end, following the Senate's confirmation of Jerome Powell last week. In the US, January ISM (*c*: 59.0; *p*: 59.7), NFP (*p:* 146k) and unemployment rate (*c*: 4.1% y-o-y; *p*: 4.1%) will also be published. On Tues, President Trump will hold its State of the Union address.

Eurozone – Inflation. Inflation data for the EZ—preliminary January CPI (*c*: 1.3% y-o-y; *p*: 1.4%) will be released.

Commodities – Oil prices to ease. Oil prices are likely to ease from current three-year highs (Brent rose 2.8% w-o-w to USD/bbl. 70.5), reached after Saudi Arabia and Russia signalled that cuts might be extended beyond end-2018.

The Quarter Ahead

Global economic outlook remains positive - The IMF lifted its global growth forecast for 2018 to 3.9% (*p*: 3.7%). In the US, growth prospects for 2018 are favourable at 2.7% (*p:* 2.3%), supported by tax cuts and domestic investment. The US Congress will need to: *a)* pass measures to avert a new government shutdown (the current funding runs out on February 8); and *b)* reach a budget deal before late-March or early-April.

EZ's economic recovery will last, supported by ECB's QE - Recent ECB's statements reduce the probability of a faster-than-expect end to asset purchases and future hikes. A "*grand coalition*" in Germany—likelier following the SPD's congress approval, on January 21, to engage in formal talks with the CDU—increases the probability of deeper political reform in the EU. In the UK, Brexit negotiations uncertainty will weigh on growth. In China, President Xi will start implementing reforms.

In the GCC, tension in Saudi Arabia will continue to ease. Last week, Prince al-Waleed was freed following an undisclosed settlement with the government that allows him to remain chairman of his company.

In global financial markets, the probability of a correction in late 2018 is rising, as central banks reduce net QE - The net yearly liquidity injected by the Fed, ECB and BoJ will decline from USD 1,959bn in 2017 to USD 363bn in 2018. However, consensus remains positive about stocks: Bank of America raised its 2018 target for US stocks (S&P500) from 2,800 to 3,000 (a 5% increase from current levels). Inflows into EM fixed-income and equity funds will remain strong: over the past two weeks, EM inflows amounted to USD15.3bn, the largest since the end of July 2016 (+$15.5bn).

Last Week's Review

***US - Administration started applying new tariffs on imports*. On Monday 22, President Trump announced new tariffs on solar panels (up to 30%) and imported washing machines (up to 50%). Additional tariffs are expected, as the result of the ongoing investigations on China's violations of intellectual property rights. Treasury Secretary Mnuchin endorsed the depreciation of the USD as "*a benefit to US trade*", before rectifying; as the markets reacted, fearing a currency war, the DXY declined by 1.6% w-o-w.

Europe - The ECB did not change its guidance on future monetary policy actions. President Draghi hinted that Mnuchin's statement on the USD "*might violate the international convention on exchange rates*" (i.e.: IMF members cannot manipulate exchange rates for competitive purposes). The EUR reached its highest level since December 2014, ending the week at EUR/USD 1.243 (+1.7% w-o-w).

Turkey - The military operation in Syria had not impact on the markets. Turkey's campaign in the Kurdish-controlled area of Syria did not affect the TRY, which appreciated by 1.4% w-o-w to USD/TRY 3.751.

China - Stock market's continued rally: SHCOMP surpassed its end-2015 level, ending the week at 3,558 (+2.0% w-o-w, +7.6% y-t-d).

Japan - On January 22-23, the MPM/BoJ kept interest rates and asset purchases at current levels. BoJ Governor Kuroda said it is too early to consider policy normalization. Despite his words, the JPY appreciated 2.0% w-o-w against the USD, to USD/JPY 108.580.

Pablo Gallego Cuervo and Renata Bossini contributed to this Viewsletter. *The picture in the front page comes from this website.*

@RosaRoubini Rosa & Roubini Rosa&Roubini Associates

For more information, please call us on +44 (0)207 1010 718 or send us an email to info@rosa-roubini-associates.com

www.rosa-roubini-associates.com

118 Pall Mall, London SW1Y 5ED

Abbreviations, Acronyms and Definitions

bn	*Billion*	*IMF*	*International Monetary Fund*
BoE	*Bank of England*	*IPO*	*Initial public offering*
BoJ	*Bank of Japan*	*JPY*	*Japanese yen*
Bpd	*Barrels per day*	*k*	*thousand*
bps	*Basis points*	*m-o-m*	*Month-on-month*
c	*Consensus*	*mn*	*Million*
CB	*Central bank*	*MPM*	*Monetary Policy Meeting*
CBK	*Central Bank of Kuwait*	*M5S*	*Five Star Movement*
CBO	*US Congressional Budget Office*	*OECD*	*The Organization for Economic Co-operation and Development*
CBR	*Central Bank of the Russian Federation*	*Opec*	*Organization of Petroleum Exporting Countries*
CBT	*Central Bank of the Republic of Turkey*	*p*	*Previous*
CDU	*Christian Democratic Union of Germany*	*PCE*	*Personal Consumption Expenditures*
CNY	*Chinese Yuan*	*PM*	*Prime minister*
CPI	*Consumer Price Index*	*PMI*	*Purchasing managers' index*
CSU	*Christian Social Union in Bavaria*	*pps*	*Percentage points*
DFMGI	*Dubai Financial Market General Index*	*QE*	*Quantitative easing*
DJIA	*Dow Jones Industrial Average Index*	*q-o-q*	*Quarter on quarter*
d-o-d	*Day-on-day*	*SHCOMP*	*Shanghai Stock Exchange Composite Index*
DXY	*US Dollar Index*	*SPD*	*Social Democratic Party of Germany*
EC	*European Council*	*tb/d*	*Thousand barrels per day*
ECB	*European Central Bank*	*tn*	*Trillion*
EM	*Emerging Markets*	*TRY*	*Turkish Lira*
EP	*European Parliament*	*UAE*	*United Arab Emirates*
EUR	*Euro*	*UK*	*United Kingdom*
EZ	*Eurozone*	*US*	*United States*
Fed	*US Federal Reserve*	*USD*	*United States Dollar*
FOMC	*US Federal Open Market Committee*	*USD/bbl.*	*USD per barrel*
FRB	*US Federal Reserve Board*	*UST*	*US Treasury bills/bonds*
FX	*Foreign exchange*	*VAT*	*Value added tax*
GCC	*Gulf Cooperation Council*	*w-o-w*	*Week-on-week*
GBP	*British pound*	*y-o-y*	*Year-on-year*
GDP	*Gross domestic product*	*y-t-d*	*Year-to-date*
GOP	*Grand Old Party (US Republican Party)*	*YPG*	*People's Protection Units*