What will happen to EUR/USD if the Shanghai tanks again?

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October 13, 2015

Without guidance from Treasuries yesterday, the FX market was thin and nothing much happened—except we could see a deceleration in rising currencies that sometimes precedes a pullback. Maybe traders were getting ready for a big data week that includes Fed speakers all over the place, the Dems' first debate among presidential candidates tonight, the Beige Book tomorrow, plus a slew of other data, both soft and hard (PPI but also CPI, retail sales and Empire State, JOLTS and University of Michigan preliminary consumer sentiment). It's also the start of earnings season, with the big banks all week, Netflix, and GE on Friday.

Inflation doesn't really matter very much—the Fed has signaled that its concern is growth, which we know is decelerating. The question is whether it decelerates to low numbers that remove all hope of any inflation. It may seem silly but some analysts think retail sales is therefore the key data this week. As long as the consumer is feeling relatively upbeat, the Fed can still assert that a hike this year is a reasonable expectation.

Whether the dollar gets any lingering support from the rate hike story remains to be seen. So far the bond market is taking a fairly hostile "prove-it" attitude. Even if the Fed does hike in December, as now broadly expected, the effect on yields and the dollar could be short-lived.

We were asked last week whether the euro at 1.1700 is a good assumption. That's the level of the recent highest high from August 24, when Chinese financial markets were dominating the news. We say the euro can easily get back to that level and beyond (to the 38% retracement level of 1.1818) depending on any or all of several developments.

The first is China again. Today the Shanghai eked out a small gain despite the bad trade report, and perhaps we should suspect official interference in the market. While we do not expect China to push the yuan lower, at least not right away, the stock market is up for grabs. What will happen to euro/dollar if the Shanghai tanks again? A lot depends on whether the Chinese government does a better job this time managing the situation, or not trying to manage it, as the case may be. We get Chinese GDP next week and the world can go to hell in a handbasket, again, very fast.

Another factor is the fate of growth and inflation in the eurozone. If inflation remains near zero with little or no prospect of a rise, it's likely the ECB could increase QE or announce it will be extended, or both. At the IMF meeting in Peru, Mr. Draghi said QE is working just fine and there is no need now to change the plan, and if the ECB does see the need to ramp up QE, it has the tools to do it.

Draghi's stance is wait-and-see. But the euro counts heavily in the ECB's thinking and recent sub-par data from Germany suggests it must have some worries about needing to goose growth, even if flopping Asian demand is not affected by eurozone-area monetary policy. What does work as an antidote to flopping Asian demand is a weaker euro. This is not to say the ECB has a target rate, but it can't be happy with an obviously rising euro.

The ECB will have to increase QE in order to hold down an otherwise rising euro. This is the deduction of Morgan Stanley analyst Redeker, and he names 1.1700 as the key level. He doesn't say so in the Bloomberg interview, but if the ECB does take this action specifically to manage the euro lower, it will work and the old forecast of the euro at 1.10 or lower by year-end is not entirely dead. Couple rising QE with a Fed rate hike, and December will be a very interesting month in FX.

The problem is that a falling euro depends on greater divergence in policy actions by two central banks at the same time. Surely Yellen and Draghi talk about this on the phone, don't they? And it would be silly to assume Lagarde is not putting in the IMF's two cents more or less continuously. Bottom line—this scenario does not have a high probability rating. When each side wants a weaker currency, what is the outcome? Draghi probably wants it more than Yellen, but that doesn't mean he will act first or more strongly or the dollar level alone will inform the Fed's decision-making.

We continue to think the dollar is on a downward path for lots of very good reasons, including hedge funds and other global macro investors having as big a dollar position as they can stomach, while the euro is on an upward path for its own reasons—but the path could have some sharp switchbacks. We hate to admit it, but despite all the news and data this week, we have to wait for next Monday's Chinese GDP.

Economic History Rant: Last week The Economist magazine had a long cover story on the "dangerous" dollar and a lecture purporting to tell the US what it should learn from the UK about losing reserve currency status. This story should stick in the craw of anyone who knows financial history. For one thing, when sterling was the top reserve currency, the UK was an imperial power with the ability to tax a large part of the world—remember those schoolroom maps showing countries everywhere in red? The UK controlled most of the best ports outside the Western hemisphere. Aside from a few embarrassments like the Philippines, most of them emanating from Teddy Roosevelt's Spanish-American war, the US was never (as a matter of principle and policy) an outright colonial power.

The Economist puts the timing of the transfer from sterling to the dollar around the time of the founding of the Fed in 1913, but while a central bank may have been necessary, it was certainly

not sufficient. The real transfer started during WW I, when the newly founded Soviet state chose to put its gold reserves in New York (1919). At the same time, US banks had the financial wherewithal to lend to war participants, including the UK. The UK borrowed about $2 billion from the US in 1917 and after those loans were converted to "perpetuals" during the Depression, the UK was finally paying it all off with a payment of £218 or $349 million—in 2014, almost 100 years later. Compare with Germany, which eventually repaid WW I debt with a final payment on Oct. 3, 2010.

During the 1920's and 1930's, the UK failed utterly to contribute to orderliness in the global financial system, including re-introducing the gold standard at a stupid level that could do no good to the UK economy. In 1926, France withdrew its reserves from the UK and the UK didn't have it, so borrowed from the US. (This is exactly what France did to the US in the 1970's, by the way.)

This degree of mismanagement was one of the key reasons why the US forced the dollar on the world at Bretton Woods. The Economists' editors should go read Benn Steil's **The Battle of Bretton Woods,** not to mention Steil and Hinds, **Money, Markets and Sovereignty.** The Economist opines that the US has a responsibility to stabilize global financial markets but instead is imposing its own unstable conditions on the rest of the world. The US should learn, among other things, that "insularity in the quickest way to hasten a reserve currency's demise."
We take issue with the foundation assumption, that somehow capitalism selects a leader to be hegemon and then imposes moral and ethical obligations on the hegemon. This is not how it works. The hegemon is selected by commercial interests that decide what currencies to use for payments and to hold. This is how governments get their hands on foreign currencies in the first place (aside from outright purchases, including intervention). If China's new transaction exchanges lead to a greater role for the yuan in payments and holdings, then so be it. China will be the new hegemon.

The Economist's charge of "insularity" arises in part from the US not participating in the new China-led infrastructure bank but doesn't say why the US is not participating, nor why China is not included in the new TPP regional trade agreement. The editors seems to think the US is acting out of childish pique rather than principles. But the US is acting on principle—that environmental and worker safeguards must be included (and they are not), not to mention a corruption-free project selection process.

As for excluding China from the trade deal, China is in the doghouse for theft of intellectual property, dumping, an improperly priced currency, and a whole long list of other trade abuses. The IMF/World Bank was set up to assist with infrastructure and China initiated the Asian Infrastructure Investment Bank because the US balks at paying more for the World Bank and IMF, where it already pays the lion's share of the total costs. In the case of the AIIB, China is contributing $30 billion of the $50 capitalization and some 57 other countries are contributing the rest. Ask yourself why they are not volunteering to raise their capital contributions to the World Bank and IMF instead?

The reason is obvious—the IMF pays less interest than most countries have to pay on sovereign issuance. Why would you borrow at 4% to invest at 2%? That is exactly why the US voted against raising quotas. The Cato Institute states "The Congressional Research Service has calculated that in this way the IMF has added at least $4.6 billion to the national debt." We don't know if Cato is right, but Congressmen voting against raising quotas did believe it. The US already pays three times as much as the next countries, about 17% of the total vs. 6% for Germany and Japan. IMF voting power is linked to the quotas and the quotas are set by a formula that considers "GDP (weight of 50 percent), openness (30 percent), economic variability (15 percent), and international reserves (5 percent). For this purpose, GDP is measured through a blend of GDP—based on market exchange rates (weight of 60 percent)—and on PPP exchange rates (40 percent)." Don't neglect that "openness" criterion.

It gets more complicated with a compression factor and some other nonsense, but bottom line, the IMF quotas and voting power is distributed with great care and thoughtfulness. Projects cannot be approved because some tinpot dictator wants to steal (or extort) money from the rest of the crowd. It still happens, of course, but at least an effort is made not to invest in paving over rivers, bridges to nowhere and irrigation projects in places lacking even a screwdriver. Let the local governments do those things. The Chinese-led AIIA will have none of those safeguards. In a very real way, the 57 countries joining the AIIA are riding the coattails of China in getting business opportunities for their own companies, just as they ride the coattails of the US at the IMF/World Bank.

This is not to say the IMF/World Bank are "good." They have done many stupid things and the process is ridiculously cumbersome. But at least an effort is made to be sane and reasonable.

To return to The Economist article, it asserts the US is weakening and unstable, and given the US's hegemony, the US is exporting weakness and instability. Really? Worse, The Economist says the US **system** is unstable. Golly, the US has not nationalized anything (as every European country has done), nor privatized to raise money (as every European country has done). The US cut unemployment from 10% to 5% after the crisis—Europe still has over 10%. We don't even know if the euro will be in existence 10 years from now, or 20—now there is, literally, an existential crisis.

Capitalism is like democracy—the worst idea except every other idea. Pure capitalism doesn't have any embedded moral imperatives or ethical considerations, which is one of the main reasons we have government (and safer food, cleaner air, and Madoff in jail). The Economist is making the pinko assumption that the system itself should seek to be both fair and stable. But there is no puppeteer pulling the strings of the US "system." This is one of its greatest virtues. This is not to say the US economic and financial system is "good." Still unjailed stupid bankers that caused the Great Recession and increasing systemic income inequality spring to mind. But we resent the accusation that the US system is unstable, either inherently or cyclically. Those who live in glass houses should stop throwing stones.

The Economist is trying to make the case that the US should accede gracefully to China as the top-notch reserve currency issuer. Okay, fine, but when will that be? Consider the bond market.

China is now the third biggest issuer, according to Goldman Sachs. We couldn't get confirmation, but we did find this little nugget showing the US share of bond issuance is falling as a percentage of the total world issuance (from http://www.nuveen.com/Home/Documents/Viewer.aspx?fileId=56087):

The same is true of equities. But note that the comparison doesn't show convertibility or liquidity. When China has a fully convertible and freely floating currency, and when its bond market is open to all with no restrictions on selling (as we just saw in equities in August), then we will consider China as a challenger. The reason nobody knows China is the world's third largest issuer is that this market is closed to outsiders and denominated in a controlled currency.

Diversification out of US assets and the dollar has not destabilized the world over the 10 years shown in the chart. The Economist is simply wrong to say dollar dominance is causing harm or will cause harm. The world is adapting just fine. And would it be churlish to point out that during Britain's reign as reserve currency issuer in the 20th century, we had two world wars and no world wars after the US took over at Bretton Woods? The US has paid nearly all of the cost of the wars we did have. Destabilizing, my foot.