

## FX SPECIAL

## FX for paranoids and hopeless romantics

We venture into the extreme tails of potential FX outcomes, having outlined the baseline view in the *Global FX Quarterly*, December 10, 2009. Typically, there is a tendency to focus on worst-case outcomes, but many of the potential surprises we examine are asset market-friendly in the first instance.

Most investors focus on fat tails to the left (the paranoid side) but given how far expectations of growth and investor returns have been beaten down, investor returns may be unusually fat to the right as well (the romantic side). Below we look at some risks to our baseline views and how they might play out in G10 FX.

**Central banks kiss and make up with the USD**

We and many others have highlighted the long-term negative consequences on the USD stemming from reserve diversification by EM central banks and sovereign wealth funds. But this may treat reserve managers too much as profit maximizers and not enough as central bankers for whom economic stabilization is the first priority. Our EM colleagues see inflation as the crucial concern for many EM countries in 2010 (*The Emerging Market Quarterly: Sharpen your pencil*, 14 December 2009). However, an appreciating currency does not guarantee low inflation, as the euro zone discovered in the first half of 2008 (Figure 1).

Weak commodity prices have been associated with lower inflation, however. Commodity prices have been heavily correlated with USD moves, not just during the recovery this year, but also during the periods of USD weakness and strength in 2008 that pre-dated the Lehman crisis. Therefore, global central banks may view a strong USD relative to the EUR and other G10 currencies as an effective driver of lower inflation through the impact on commodity prices. Relative to either allowing currencies to rise or tightening domestic monetary policy, the more benign anti-inflation policy for EM countries may be boosting the USD within G10. Lower commodity prices would encourage growth by lowering producer costs, widening margins and lowering inflation without lost competitiveness or excessively tight monetary policy. The issue, of course, is the cost. The cost of buying USD is the additional overweight on USD and the potential additional losses on USD should the dollar fall again – significant costs, but costs that have to be seen relative to costs of alternative tightening policies.

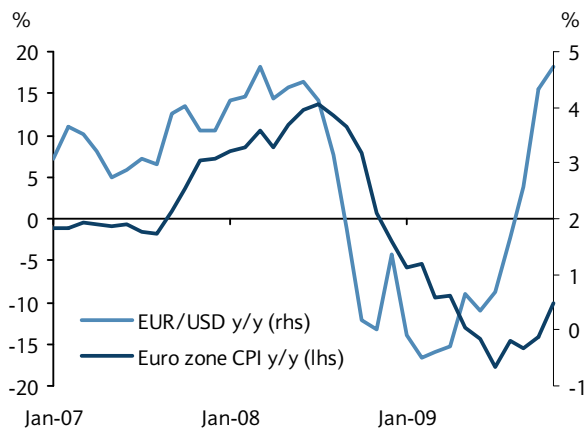
A major practical drawback is that a high degree of coordination is required among central banks for this policy to be put in place. Were some major reserve holders to sell USD for diversification purposes rather than buy to drive the USD higher, the policy would be ineffective. Hence, while there are incentives for this coordinated buying of USD to occur, so far, the mechanism is lacking. The other issue is the US policy stance, both overall with respect to monetary policy and with respect to the USD. If US monetary policy is as loose we expect it to be, central bank buying will have a temporary effect, but it will not affect the long-term equilibrium value. Also, the US authorities may be somewhat less than enthusiastic about seeing the strong dollar policy translated from rhetoric to reality.

Steven Englander  
+1 212 412 1551  
steven.englisher@barcap.com

Paul Robinson  
+44 (0) 20 7773 0903  
paul.robinson3@barcap.com

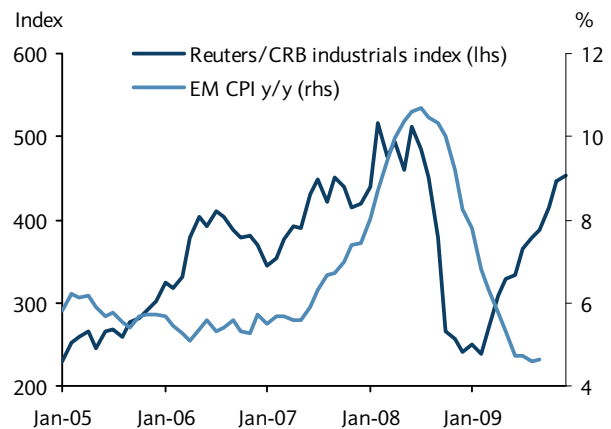
[www.barcap.com](http://www.barcap.com)

Figure 1: EUR appreciation and euro zone CPI



Source: Ecwin; Barclays Capital

Figure 2: CPI and commodity prices



Source: Ecwin, Barclays Capital

### A central bank breaks discipline and pounds the USD

*Limited selling of USD by central banks so far...*

Central banks have been disciplined so far in limiting their USD selling. In Q2 the IMF COFER data showed that the USD represented less than 40% of incremental reserve accumulation, but there is little sign that reserve managers are selling enough USD to drive down the USD share in reserve portfolios significantly. Almost all of the drop in the USD share in reserve portfolios over the last 7-8 years has come from valuation effects rather than direct USD selling.

*... but will that continue to be the case*

The question is whether this discipline will continue to hold. At present, it does not appear that any major reserve manager wants to be responsible for creating a run on the USD by selling hand over fist. However, while no central bank wants to be the first to sell, no central bank wants to be the last either, so the risk is that if it becomes clear that there is significant official selling, other reserve managers will follow. Putting the two together, there is a potential “bank run” problem. If reserve managers lose confidence in USD strength there is a first-mover advantage in selling it. All know this and it could easily lead to a period of USD strength followed by a sharp fall as people run for the door.

This and the previous item point in opposite directions. The difference is that USD selling can be precipitated by a single reserve manager selling significant USD out of its portfolio, whereas the first risk requires some degree of coordination across central banks.

### What if a euro zone country defaulted but stayed in the euro?

*The euro area’s financial infrastructure is in focus*

The problems facing Greece have brought the infrastructure of the euro area into focus, as we discuss in “*Eventually all chickens come home to roost.*” The spirit of the Maastricht Treaty’s “no bailout” provision suggests that this is the tough love that is supposed to be an integral part of the euro. However, few investors believe this is a likely outcome. The collateral damage on the bond markets of the countries seen as having similar difficulties is likely to be immense. Even speculation on this score is likely to lead to significant EUR weakness, as most investors take the view that a bailout of some sort is the most likely outcome (although that certainly does not preclude some tough love, as any parent will be familiar with).

*What happens under the tough love prescription?*

However, even if the tough love provisions were followed, the EUR would not be in the clear. Countries with difficult fiscal situations that did not default could find themselves with pre-ERM interest rate differentials and post-ERM exchange rate inflexibility. In these circumstances, often an accompanying devaluation helps since it opens some upside to the

fiscal offender's currency and the appreciation risk can take some pressure of rates, but this would not be possible in the EUR world.

The incentives are immensely in favor of fiscal consolidation, tough love, and some exceptional aid, and these would be EUR negative, even in the absence of a default (which we do not expect by any means), but the FX consequences of a default would be an order of magnitude greater, even if it were thought that the default could be accomplished without an exit from the euro area.

### **The Japanese fiscal debt finally bites the JPY**

*Lowest bond yields and lowest  
sovereign credit rating  
in the G10*

If we are correct that fiscal problems are going to become an even more important theme in 2010, which currencies are most vulnerable? Most of the debate has centered on the UK and the US, and the possibility of either losing their AAA rating. But the real problem may lie with Japan, which has the slightly odd combination of the lowest bond yields and the lowest credit rating of any of the large G10 economies. The huge fiscal debt has not been a major issue for the Japanese authorities over the past two decades because: 1) there was never a hint of the Japanese authorities monetizing the debt (although there are some strong incentives to do so; see below), and 2) the combination of strong global growth and Japan's high propensity to save allowed very weak domestic demand without catastrophic overall growth. The first driver still appears to be in place – Japanese inflation is likely to remain very low for the foreseeable future. But the latter appears much more precarious.

*An argument for monetizing  
Japanese fiscal spending?*

An even lower-delta possibility is that the Japanese monetary and fiscal policy authorities decide that inflation credibility is highly overrated when core CPI is falling faster than ever and embark on a major monetization of Japanese fiscal spending. With the October national core CPI falling 1.1% y/y, matching the 2001 low, the academic argument in favor of central bank credibility rings hollow. Anchoring long-term inflation expectations is hardly attractive when the price level on a y/y basis has been flat or falling for 79 of the last 84 months. Out-and-out monetization – QE on steroids – may mitigate the impact on long-term bond yields and ease debt service concerns, and would certainly be effective in terms of raising long-term inflation expectations. It would also likely be very effective in weakening the JPY, as it would be a significant injection of high powered money.

*JPY's outperformance seen  
during the global crisis unlikely  
to be repeated*

Furthermore, our house view is that Asian growth will continue apace, but what happens if the view of many of our clients is proved correct and the recovery runs out of steam? During the height of the crisis, the JPY was a big winner, but we think that history is unlikely to repeat itself – either as tragedy or farce. Partly that is because the starting point of the JPY would be very different this time. But it also reflects the fact that a significant weakening of Asian growth would be terrible news for the Japanese economy, which would then be faced with weak export demand, a strong real exchange rate and a huge fiscal deficit. That may lead to weak exports and growth, and a sharp reduction in the current account surplus. Domestic savings may not be enough to fund the government deficit, which would lead to a significant fall in the price of JGBs in order to attract investors. If so, JPY depreciation would appear to be desirable all round: it would make exports and Japanese assets more attractive relative to those denominated in other currencies, to both Japanese and foreign investors.

**Analyst Certification(s)**

We, Steven Englander and Paul Robinson, hereby certify (1) that the views expressed in this research report accurately reflect our personal views about any or all of the subject securities or issuers referred to in this research report and (2) no part of our compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this research report.

**Important Disclosures**

For current important disclosures regarding companies that are the subject of this research report, please send a written request to: Barclays Capital Research Compliance, 745 Seventh Avenue, 17th Floor, New York, NY 10019 or refer to <https://ecommerce.barcap.com/research/cgi-bin/all/disclosuresSearch.pl> or call 212-526-1072.

Barclays Capital does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that Barclays Capital may have a conflict of interest that could affect the objectivity of this report. Any reference to Barclays Capital includes its affiliates. Barclays Capital and/or an affiliate thereof (the "firm") regularly trades, generally deals as principal and generally provides liquidity (as market maker or otherwise) in the debt securities that are the subject of this research report (and related derivatives thereof). The firm's proprietary trading accounts may have either a long and / or short position in such securities and / or derivative instruments, which may pose a conflict with the interests of investing customers. Where permitted and subject to appropriate information barrier restrictions, the firm's fixed income research analysts regularly interact with its trading desk personnel to determine current prices of fixed income securities. The firm's fixed income research analyst(s) receive compensation based on various factors including, but not limited to, the quality of their work, the overall performance of the firm (including the profitability of the investment banking department), the profitability and revenues of the Fixed Income Division and the outstanding principal amount and trading value of, the profitability of, and the potential interest of the firms investing clients in research with respect to, the asset class covered by the analyst. To the extent that any historical pricing information was obtained from Barclays Capital trading desks, the firm makes no representation that it is accurate or complete. All levels, prices and spreads are historical and do not represent current market levels, prices or spreads, some or all of which may have changed since the publication of this document. Barclays Capital produces a variety of research products including, but not limited to, fundamental analysis, equity-linked analysis, quantitative analysis, and trade ideas. Recommendations contained in one type of research product may differ from recommendations contained in other types of research products, whether as a result of differing time horizons, methodologies, or otherwise.

This publication has been prepared by Barclays Capital, the investment banking division of Barclays Bank PLC, and/or one or more of its affiliates as provided below. This publication is provided to you for information purposes only. Prices shown in this publication are indicative and Barclays Capital is not offering to buy or sell or soliciting offers to buy or sell any financial instrument. Other than disclosures relating to Barclays Capital, the information contained in this publication has been obtained from sources that Barclays Capital believes to be reliable, but Barclays Capital does not represent or warrant that it is accurate or complete. The views in this publication are those of Barclays Capital and are subject to change, and Barclays Capital has no obligation to update its opinions or the information in this publication. Barclays Capital and its affiliates and their respective officers, directors, partners and employees, including persons involved in the preparation or issuance of this document, may from time to time act as manager, co-manager or underwriter of a public offering or otherwise, in the capacity of principal or agent, deal in, hold or act as market-makers or advisors, brokers or commercial and/or investment bankers in relation to the securities or related derivatives which are the subject of this publication.

The analyst recommendations in this report reflect solely and exclusively those of the author(s), and such opinions were prepared independently of any other interests, including those of Barclays Capital and/or its affiliates.

Neither Barclays Capital, nor any affiliate, nor any of their respective officers, directors, partners, or employees accepts any liability whatsoever for any direct or consequential loss arising from any use of this publication or its contents. The securities discussed in this publication may not be suitable for all investors. Barclays Capital recommends that investors independently evaluate each issuer, security or instrument discussed in this publication and consult any independent advisors they believe necessary. The value of and income from any investment may fluctuate from day to day as a result of changes in relevant economic markets (including changes in market liquidity). The information in this publication is not intended to predict actual results, which may differ substantially from those reflected. Past performance is not necessarily indicative of future results.

This communication is being made available in the UK and Europe to persons who are investment professionals as that term is defined in Article 19 of the Financial Services and Markets Act 2000 (Financial Promotion Order) 2005. It is directed at, and therefore should only be relied upon by, persons who have professional experience in matters relating to investments. The investments to which it relates are available only to such persons and will be entered into only with such persons. Barclays Capital is authorized and regulated by the Financial Services Authority ('FSA') and member of the London Stock Exchange.

Barclays Capital Inc., US registered broker/dealer and member of FINRA ([www.finra.org](http://www.finra.org)), is distributing this material in the United States and, in connection therewith accepts responsibility for its contents. Any U.S. person wishing to effect a transaction in any security discussed herein should do so only by contacting a representative of Barclays Capital Inc. in the U.S. at 745 Seventh Avenue, New York, New York 10019.

Subject to the conditions of this publication as set out above, ABSA CAPITAL, the Investment Banking Division of ABSA Bank Limited, an authorised financial services provider (Registration No.: 1986/004794/06), is distributing this material in South Africa. Any South African person or entity wishing to effect a transaction in any security discussed herein should do so only by contacting a representative of ABSA Capital in South Africa, 15 ALICE LANE, SANDTON, JOHANNESBURG, GAUTENG, 2196. ABSA CAPITAL IS AN AFFILIATE OF BARCLAYS CAPITAL.

Non-U.S. persons should contact and execute transactions through a Barclays Bank PLC branch or affiliate in their home jurisdiction unless local regulations permit otherwise.

In Japan, foreign exchange research reports are prepared and distributed by Barclays Bank PLC Tokyo Branch. Other research reports are distributed to institutional investors in Japan by Barclays Capital Japan Limited. Barclays Capital Japan Limited is a joint-stock company incorporated in Japan with registered office of 2-2-2, Otemachi, Chiyoda-ku, Tokyo 100-0004, Japan. It is a subsidiary of Barclays Bank PLC and a registered financial instruments firm regulated by the Financial Services Agency of Japan. Registered Number: Kanto Zaimukyokucho (kinsho) No. 143.

Barclays Bank PLC Frankfurt Branch is distributing this material in Germany under the supervision of Bundesanstalt fuer Finanzdienstleistungsaufsicht (BaFin). This material is distributed in Malaysia by Barclays Capital Markets Malaysia Sdn Bhd.

IRS Circular 230 Prepared Materials Disclaimer: Barclays Capital and its affiliates do not provide tax advice and nothing contained herein should be construed to be tax advice. Please be advised that any discussion of U.S. tax matters contained herein (including any attachments) (i) is not intended or written to be used, and cannot be used, by you for the purpose of avoiding U.S. tax-related penalties; and (ii) was written to support the promotion or marketing of the transactions or other matters addressed herein. Accordingly, you should seek advice based on your particular circumstances from an independent tax advisor.

© Copyright Barclays Bank PLC (2009). All rights reserved. No part of this publication may be reproduced in any manner without the prior written permission of Barclays Capital or any of its affiliates. Barclays Bank PLC is registered in England No. 1026167. Registered office 1 Churchill Place, London, E14 5HP. Additional information regarding this publication will be furnished upon request.