

# USD (Hi)Story

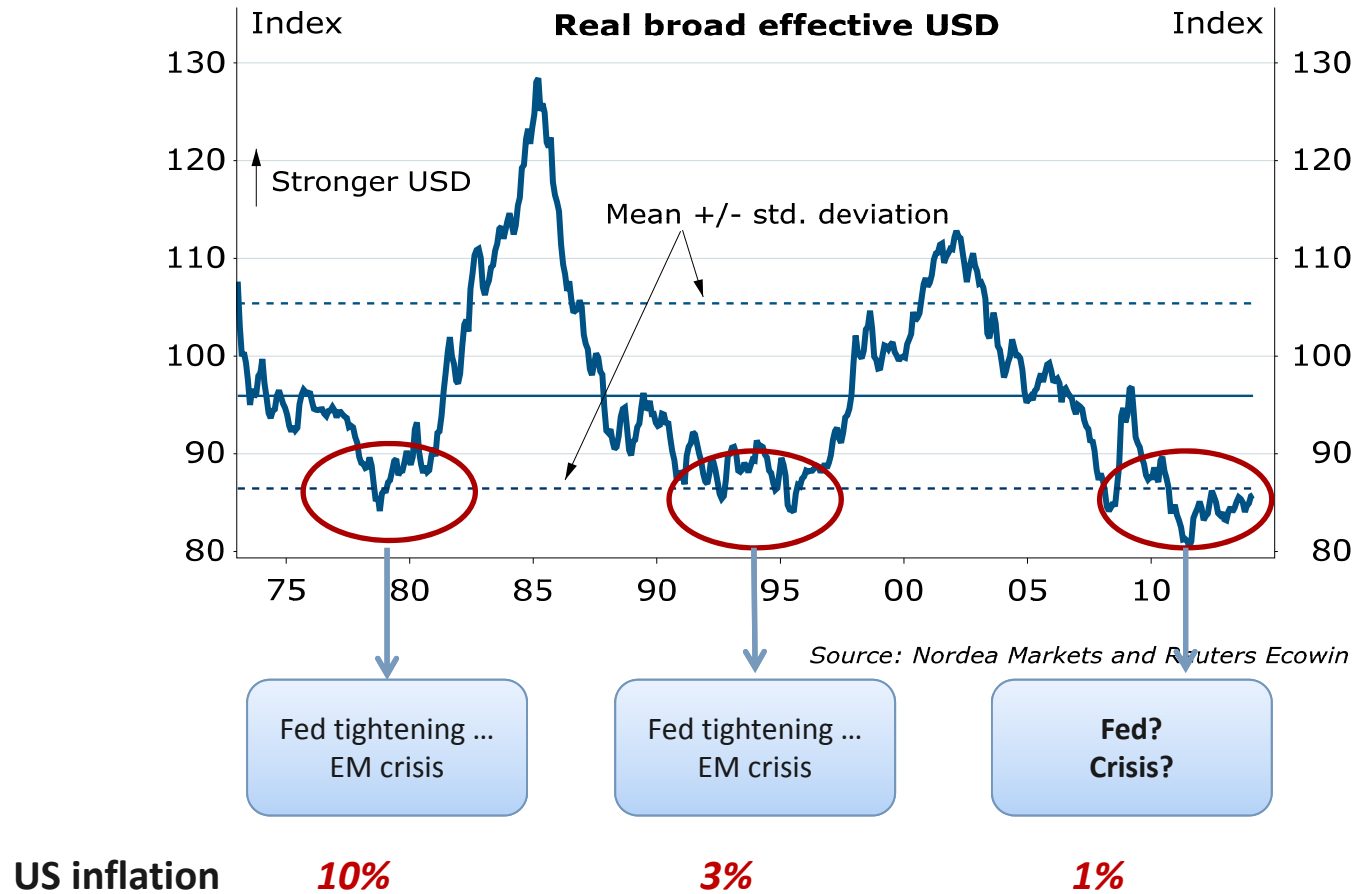
*When dollar bottoms...*

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March, 2014



# USD bottomed? Ehm...



# USD historic lows: sketches

- **Late 70s:** productivity growth in US was low after the severe Nov 73-Mar 75 recession, mostly attributed to "energy shocks". Stagflation (cost push). USD weakening was then explained by "inflation premia", excess money supply growth. Rapid oil price increases led to surpluses in OPEC countries, recycled to developing countries. Fed hiked rates in 1977, but USD began to strengthen broadly only in 1979 when Fed had raised rates by 250bps. But pronounced USD strengthening came only after 1981, when Fed was already cutting rates and amid turmoil in Emerging Markets (culminating in Mexican default in autumn 1982). "Lost decade" for LatAm. Effective EURUSD was trending up all the way with Fed fund rate hikes – and down with cuts.
- **Mid 90s:** Fed surprised the Markets by a rate hike in March 1994, all USD market rates rose sharply. Inflation was accelerating, and Fed was afraid to stay "behind the curve". Fed tightening what was afterwards called one of key triggers for Peso/Tequila crisis in 94/95 (Mexico devalued by 15% in December 1994). The UST10Y yield rose sharply 160bp from February to May. But USD broad index was stable, EURUSD rose together with the UST10Y yield throughout 1994 as Fed was hiking rates (while Bundesbank cut by 75bps in H1 1994!).
- **Current:** after Lehman collapse, Fed cut rates to zero and carried out 3 rounds of QE, "chase for yield" and "high growth" stories about EMs escalated capital inflows. QE recycling – debt/GDP in Emerging Markets expanded rapidly, especially Asian EMs. The Fed "taper" talk in May 2013 showed the first signs of vulnerability...probably not the last. USD has strengthened against EMs, but not as much as in previous EM crises yet. EURUSD declined alongside Fed cutting rates, and has ranged higher on expectation that Fed easing is coming to end. Good news for the US and Chinese economy is good news for EURUSD. Fed rate hikes will likely be associated with higher EURUSD too.

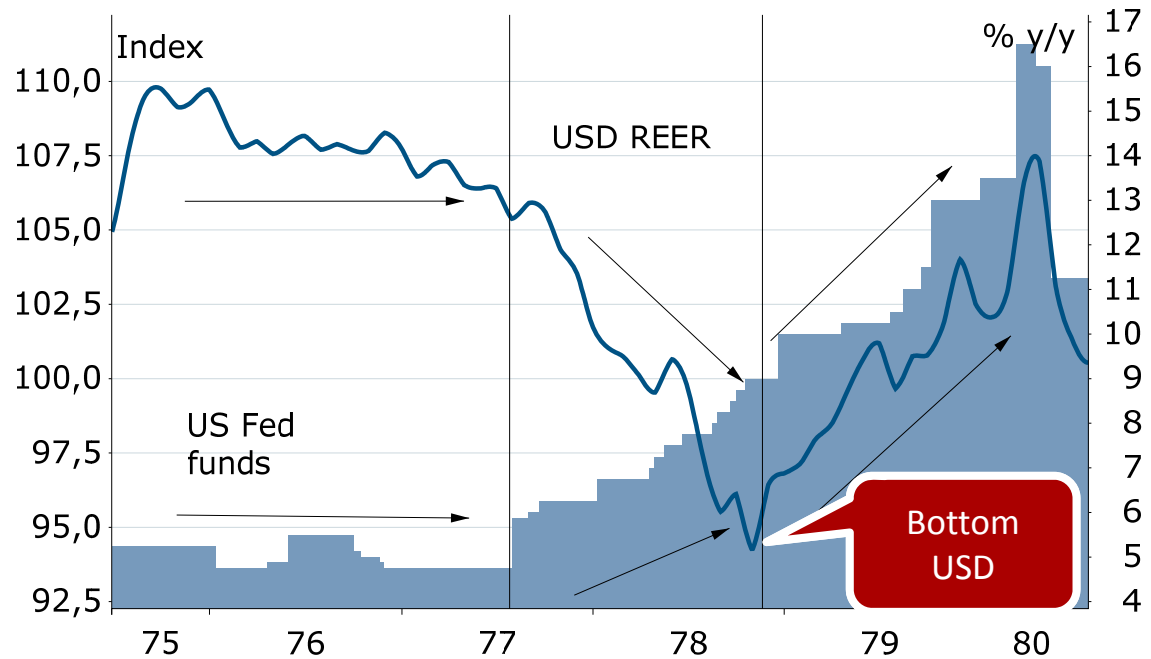
# USD bottoming epizode 1: 70/80s

## Highlights:

**1979 August:** Volcker becomes Fed chairman, starts raising key rates more aggressively.

**1979 November:** second oil price shock (Iranian hostage crisis).

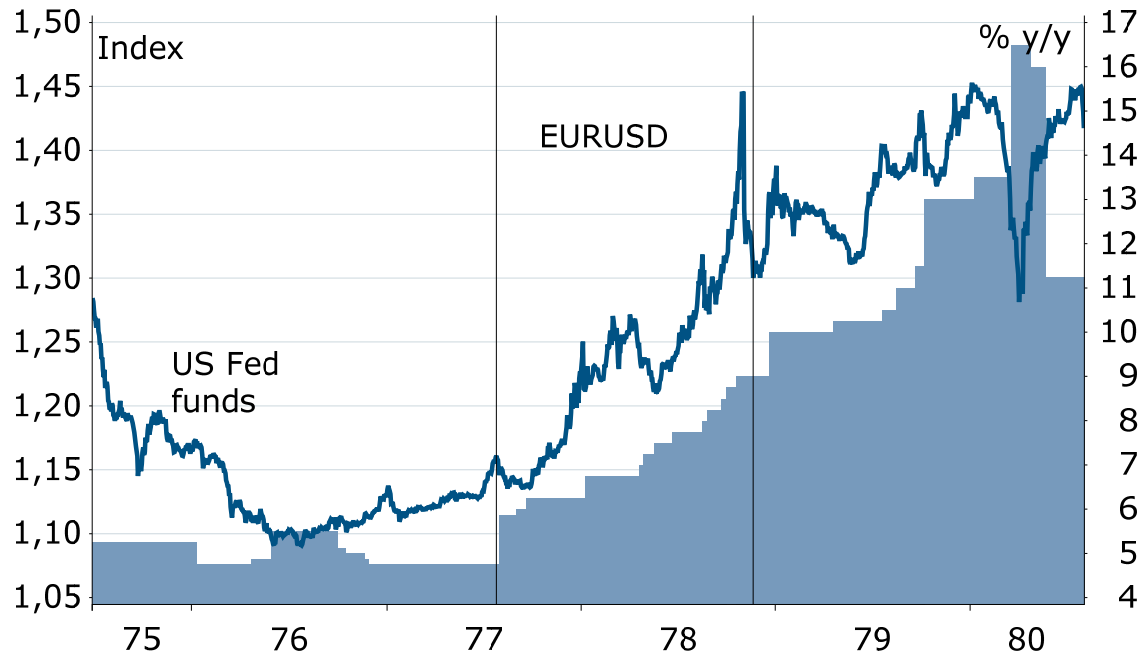
**1980:** US falls into brief recession (until July '80).



Source: Nordea Markets and Reuters Ecowin

Between the start of Fed fund rate hikes from 4.75% in 1977 to local peak of 17.5% in 1980, the USD REER has moved down and up, finishing at the same levels. It took 1 year of Fed fund rate hikes before the USD started to strengthen broadly.

# EURUSD kept strengthening as Fed was hiking!



Source: Nordea Markets and Reuters Ecowin

While the broad USD REER started rising in late 1978, the EURUSD continued rising. It was on an uptrend, rising steadily from 1976, and even accelerated once Fed started to hike rates.

Note: effective EUR, formerly European Currency Unit, ECU - an artificial basket currency used by the member states of the EU. When the euro was introduced on 1/1/99, it replaced the ECU at a 1:1 ratio.

# USD bottoming epizode 1: 70/80s

Peak USD

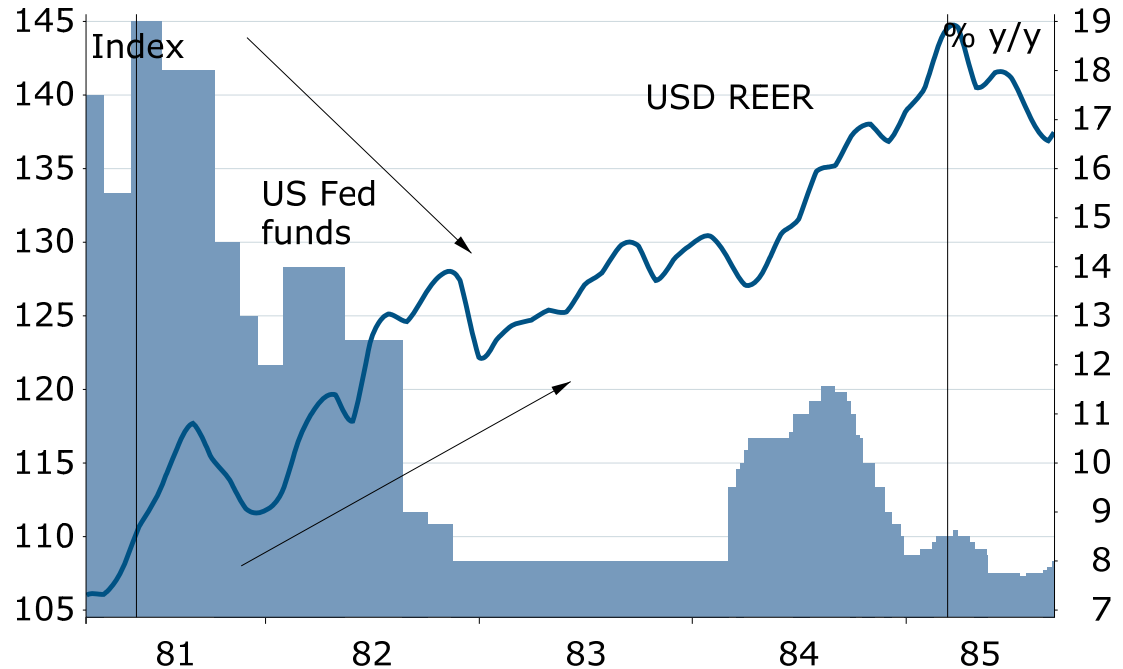
## Highlights:

**1981:** US in recession again . Global trade contracts. Fed starts cutting rates.

**1982 August:** Mexico devalues, declares default.

**1983:** Crisis goes global. More than 20 countries had debts rescheduled, mostly LatAm.

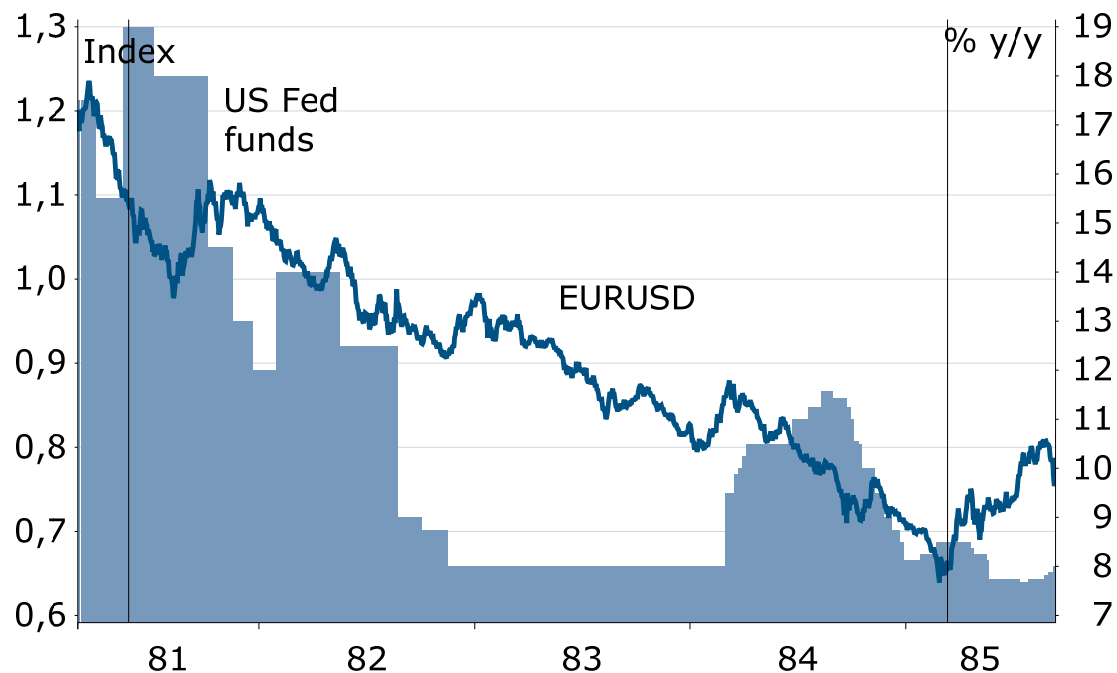
**1985 September:** Plaza Accord. Coordinated USD weakening after the USD had gained 50% against major currencies..



Source: Nordea Markets and Reuters Ecowin

The USD REER was strengthening from 1981 alongside the Fed cutting rates from 19% in 1981 to 8% until late 1982. The USD strength was arrested by the coordinated USD weakening in 1985.

## ...and EURUSD was going down



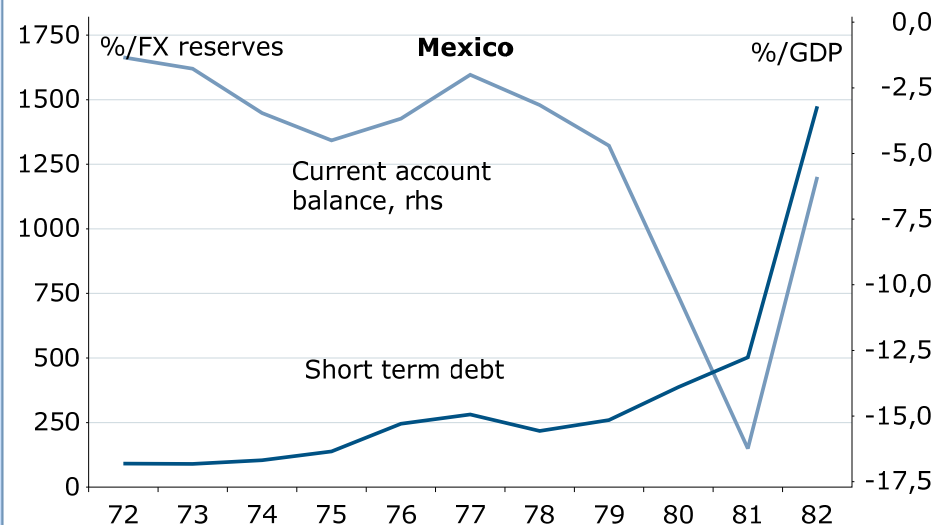
Source: Nordea Markets and Reuters Ecowin

The USD strengthening from 1981, when the US fell in recession and global trade contracted, was broad-based, including the EUR...EURUSD was going down as the Fed was cutting rates throughout.

# Mexico – in the limelight of early 80s EM crisis

*“For more than two years, the staff had been expressing concerns over the **debt buildup by Mexico**...In the January 1980 report on the 1979 consultations, the staff warned that “official external borrowing on the scale now being envisaged” could “lead to a level of domestic spending incompatible with the intended deceleration in the rate of domestic inflation.” In November 1981, the mission concluded that borrowing had been used to support domestic consumption and had led to a **widening of the current account balance**; and that in “light of the above a major reorientation of public sector financial policies is needed.”*

*IMF, The Mexican Crisis: No Mountain Too High?, 2001*



Source: Nordea Markets and Reuters Ecowin

## But Mexico was not alone...EM turmoil in 80s

*"It doesn't show on any maps, but there's a new mountain on the planet: a **towering USD 500 billion of debt run up by the developing countries**, nearly all of it within a decade ...to some analysts the situation looks starkly ominous, threatening a chain reaction of country defaults, bank failures and general depression matching that of the 1930s."*

*The Wall Street Journal , January 23, 1981*

*"An increase in public-sector and private borrowing combined has been necessary in view of economic policies in developing countries that have contributed to higher, **sustained deficits in the current account of their balance of payments.**"*

*David P. Dod, Federal Reserve Bulletin, September 1981*

# USD bottoming epizode 2: mid 90s

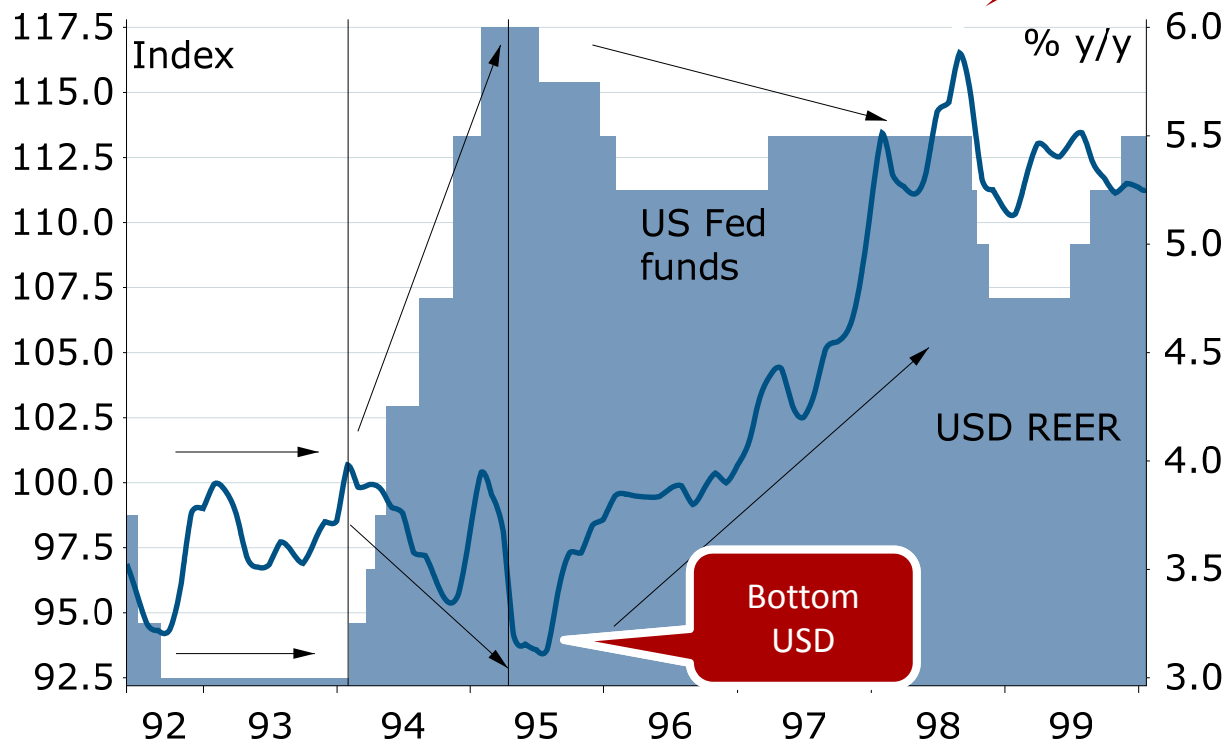
## Highlights:

**1990:** Gulf War and the spike in oil prices ...which contributed to US recession (ending spring 1991).

**1994 March:** Fed unexpectedly hikes Fed funds rates.

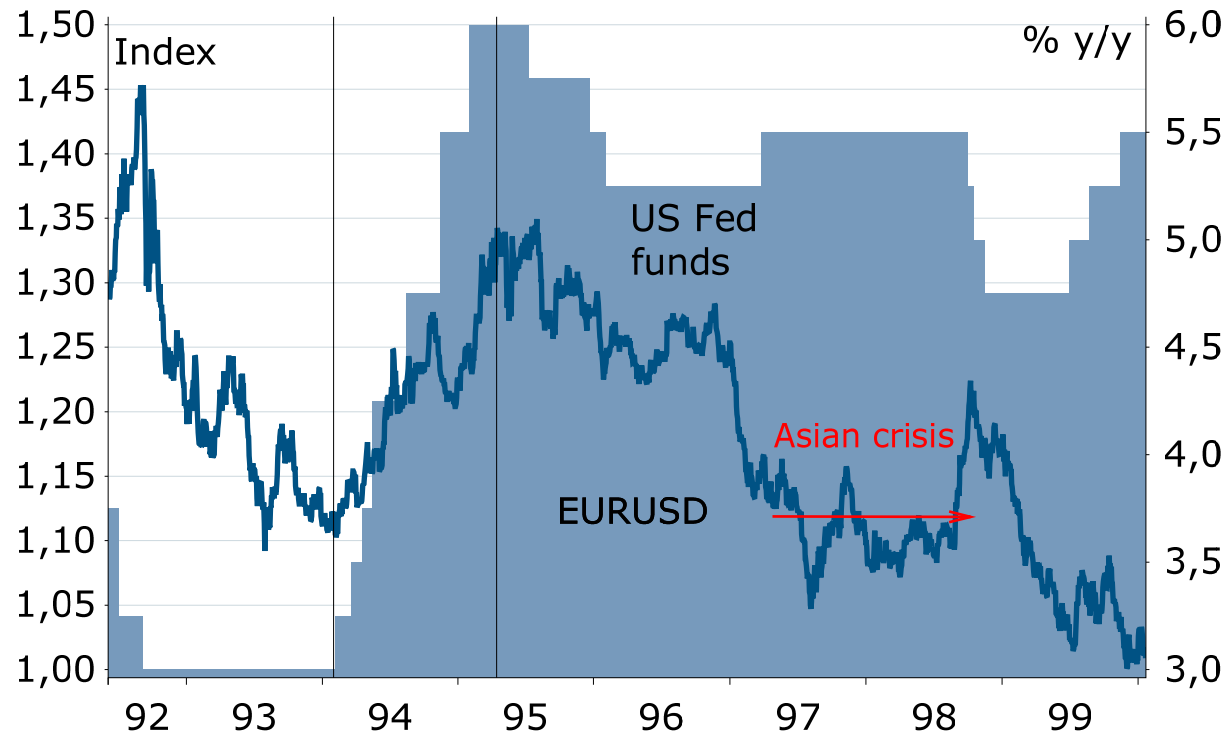
**1994 December:** Mexican peso devalued 15%, currency allowed to float freely.

**1997 July:** Asian crisis breaks out.



Unexpected Fed funds rate hike in March 1994 did not strengthen the USD broadly – the REER remained unchanged in 1994 for the year as a whole. The USD REER only started to strengthen in mid-1995 when Fed began cutting rates. And accelerated in 1997 with the Asian crisis.

# And...EURUSD was going up when Fed was hiking!

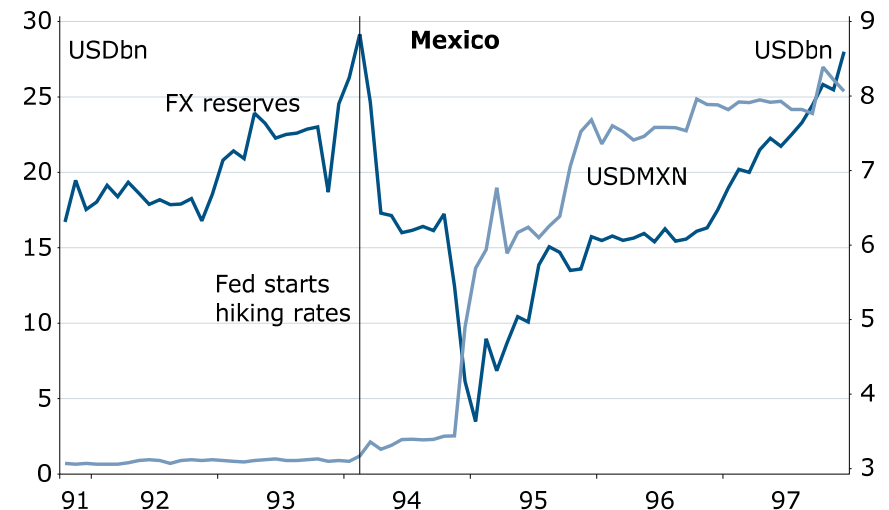


US Fed funds rate hike in March 1994 did not strengthen the USD vs EUR – in fact, EURUSD gained as Fed was hiking rates in 1994 (while Bundesbank was even cutting). USD only began to gain vs EUR in mid-1995 when Fed started cutting rates. EURUSD remained broadly stable during the Asian crisis.

# Mid 90s: Mexico in the limelight...again

*“...the **external current account deficit**, running at 6 1/2 percent of GDP in 1993, was very large by most standards...financed largely by **short-term capital inflows**. A steep real appreciation of the peso ...had contributed to the emergence of this deficit...Mexico's weak external position was exacerbated in 1994 ....partly owing to the **political hiatus** following the elections in August. The uprising in Chiapas at the start of the year was the first in a series of dramatic adverse domestic developments; and also from early 1994 Mexico was confronted with a **substantial rise in world interest rates**, which prompted international investors to reassess the share of their portfolios invested in emerging markets.”*

*IMF, Drawing Lessons from the Mexican Crisis, May1995*



Source: Nordea Markets and Reuters Ecowin

## ...from "Peso crisis" to "Tequila crisis". Mid 90s.

*"...devaluation of the Mexican peso...was followed by **slumps in the region's stock markets**, and concerned Argentine and Brazilian economic authorities met last Friday to prepare for what could be a new wave of the crisis..."*

*IPS News, 1995 October*

*"...with the blessing of foreign powers and international financiers protectionist barriers were being torn down. The result was that **foreign funds flowed in, rejuvenating local short-term consumer credit**, and high exchange rates slashed the costs of imports while crippling exports. Dismantling old populist and nationalist supports and protection for local industries opened the floodgates for cheap consumer imports..."*

*J. Adelman, Tequila Hangover:  
Latin America's Debt Crisis, 1998*

*"What was originally intended as a 15 percent increase in the exchange rate band's ceiling in a matter of days put Mexico on the verge of default. The **furtive flight of capital not only from Mexico but also from other emerging markets in Latin America** and elsewhere took governments and international financial institutions by surprise..."*

*...**The overexpansion of domestic credit** has been a phenomenon observed in past episodes of large capital inflows to countries in Latin America --particularly those with fragile banking systems and inadequate prudential regulation...*

*IMF, Drawing Lessons from the Mexican Crisis,  
May 1994*

# USD bottoming (?) epizode 3: 2008-

## Highlights:

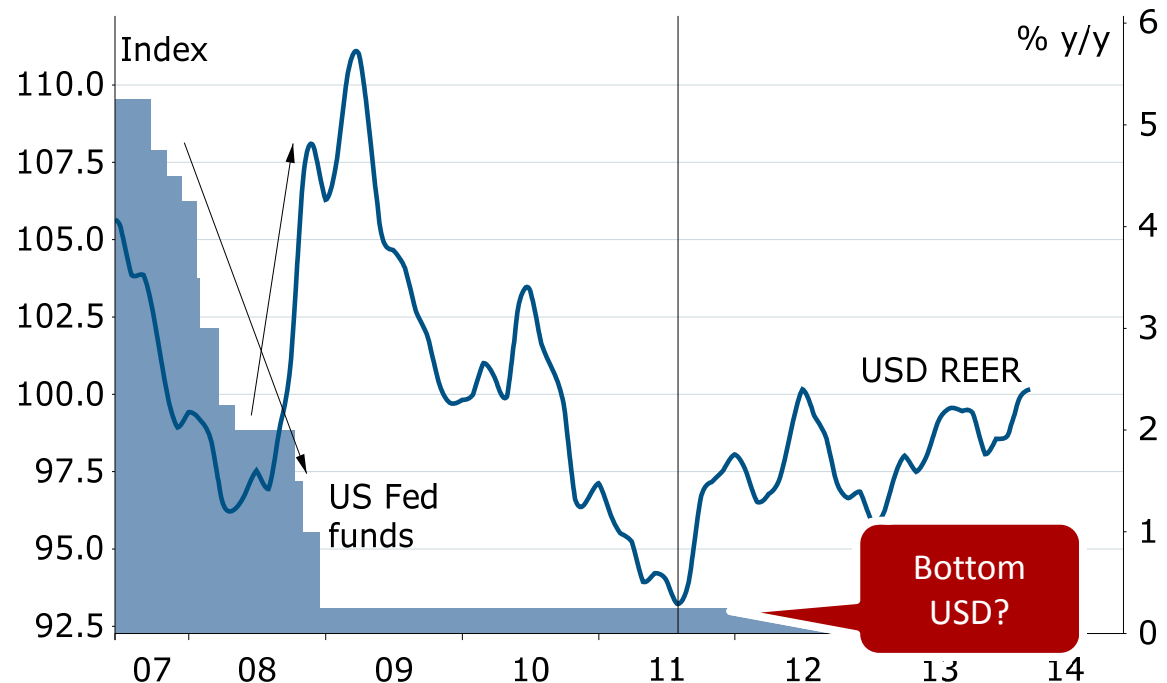
**2008** September: Lehman Brothers files for bankruptcy.

**2008** Nov-Dec: Fed cuts rates to 0.25% and announces QE1.

**2010:** EMU crisis intensifies AS EU finds "severe irregularities" in Greek accounting .

**2010-2013:** Fed runs Q1, QE2, QE3.

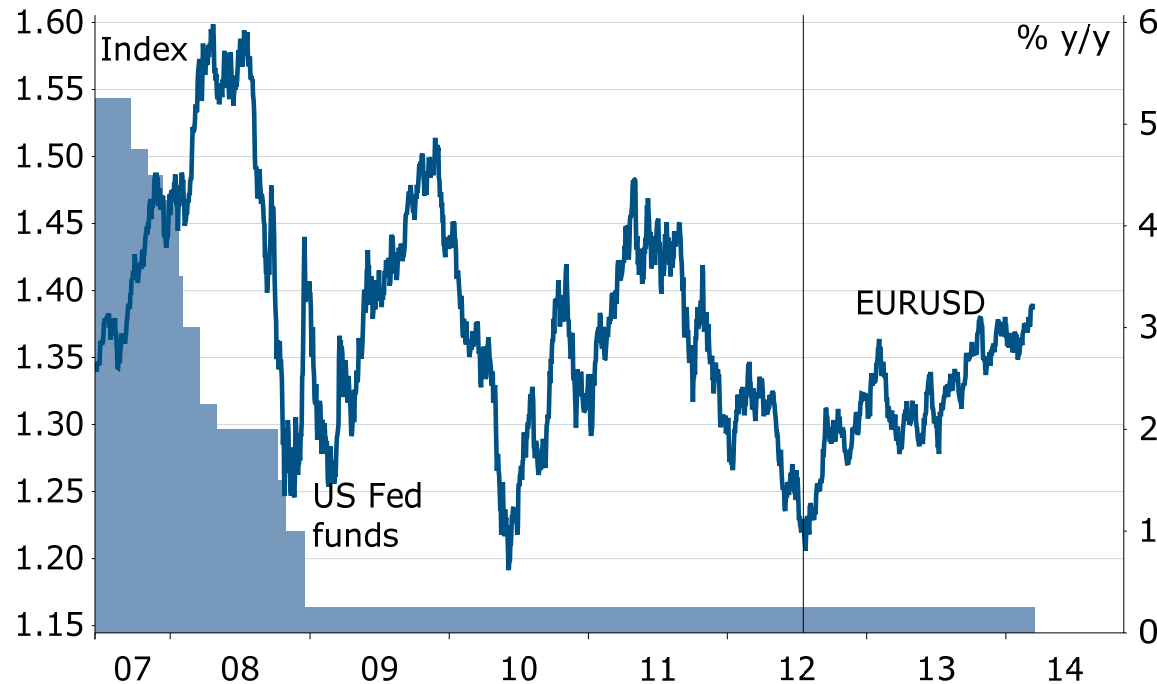
**2013** Dec: Fed starts to "taper".



Source: Nordea Markets and Reuters Ecowin

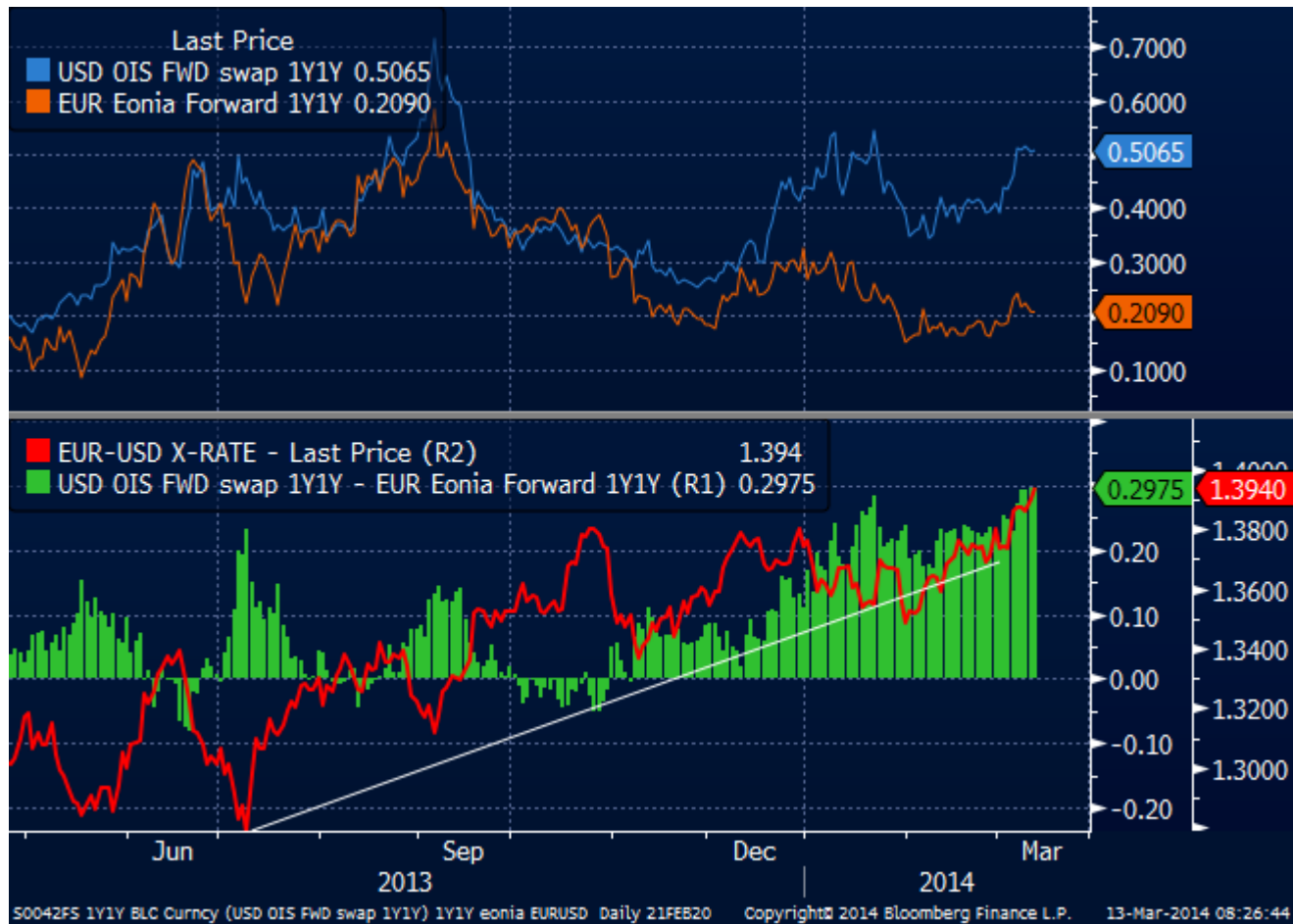
Global liquidity squeeze, culminating with the Lehman crisis, led to sharp strengthening of USD in 2008, forcing Fed to cut rates to 0,25% and start quantitative easing, bringing USD down. Since 2011, the USD REER strengthened gradually, on expectation of ultimate Fed exit, but...(see next slide)

This time no different. EURUSD down on Fed fund cuts.  
But higher on anticipation of eventual end to easing.

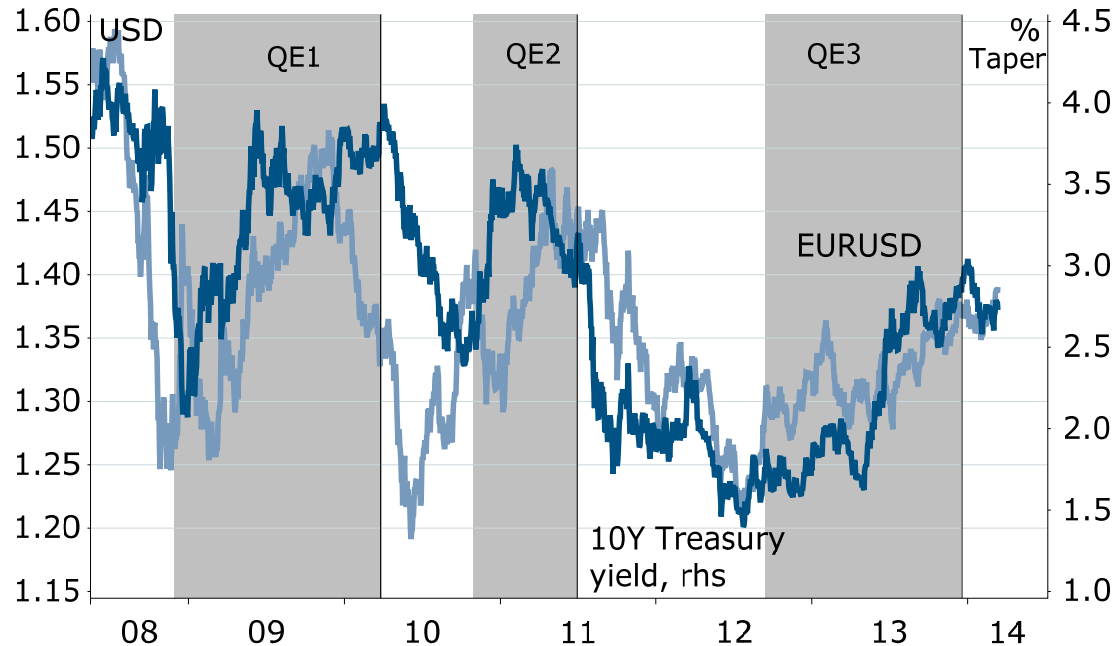


...since 2012, where USD REER hit local minimum, the EURUSD has kept gaining. Reminder of 1980s!  
With Fed starting to hike rates, will EURUSD just continue up (with USD REER also up)?  
Again, history rhymes.

# EURUSD rather immune to Fed funds repricing



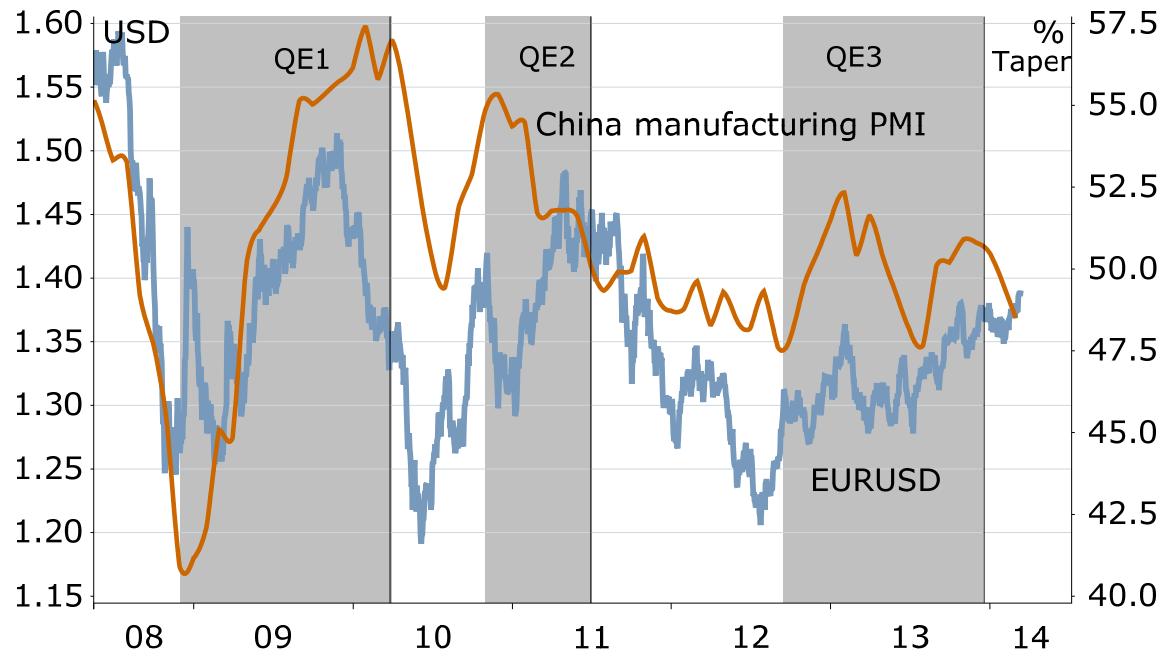
## But now we also had QE, signalling "growth"



Source: Nordea Markets and Reuters Ecowin

Fed cutting rates after Lehman's brought EURUSD lower. But this time Fed also implemented QE1, QE2, QE3. Each round of those was associated with higher EURUSD, and higher US Treasury yields – probably, growth premia? Better US (global) growth expectations are positive for EURUSD.

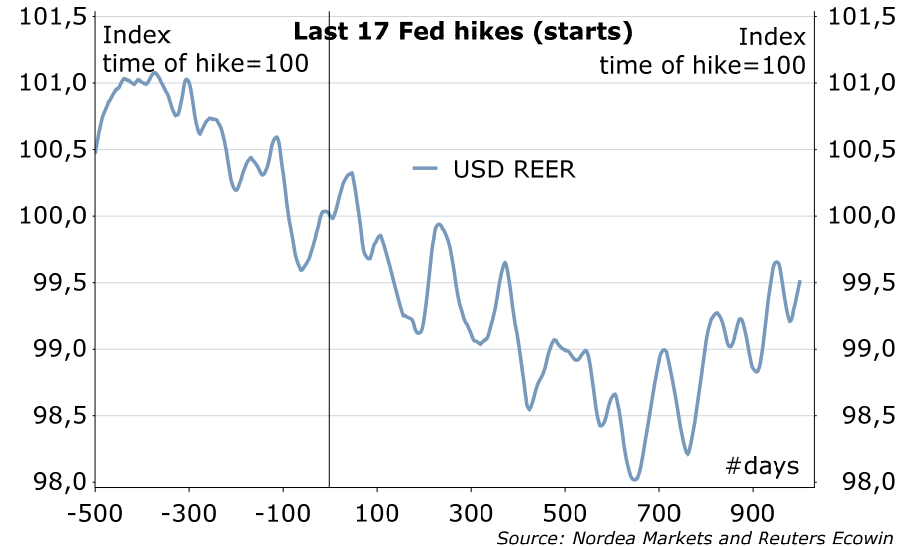
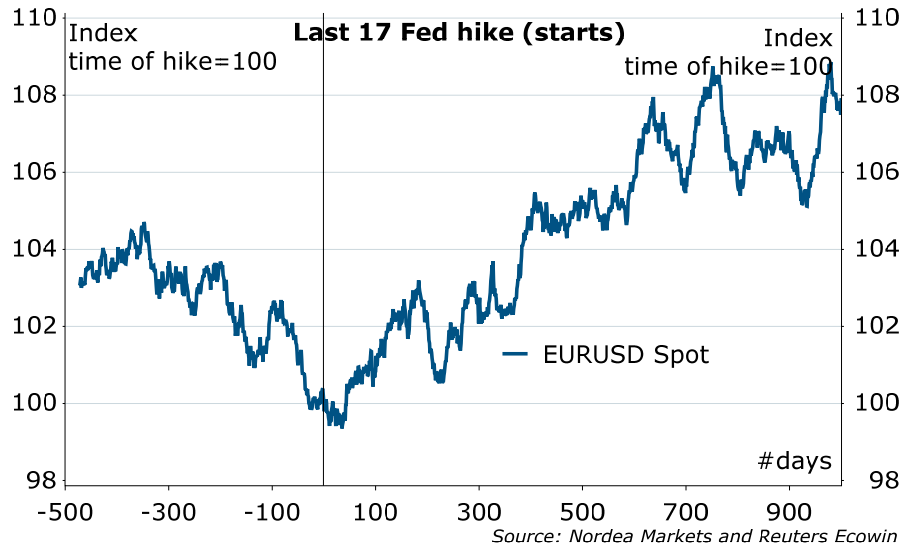
# Because, it's not just QE...also growth.



Source: Nordea Markets and Reuters Ecowin

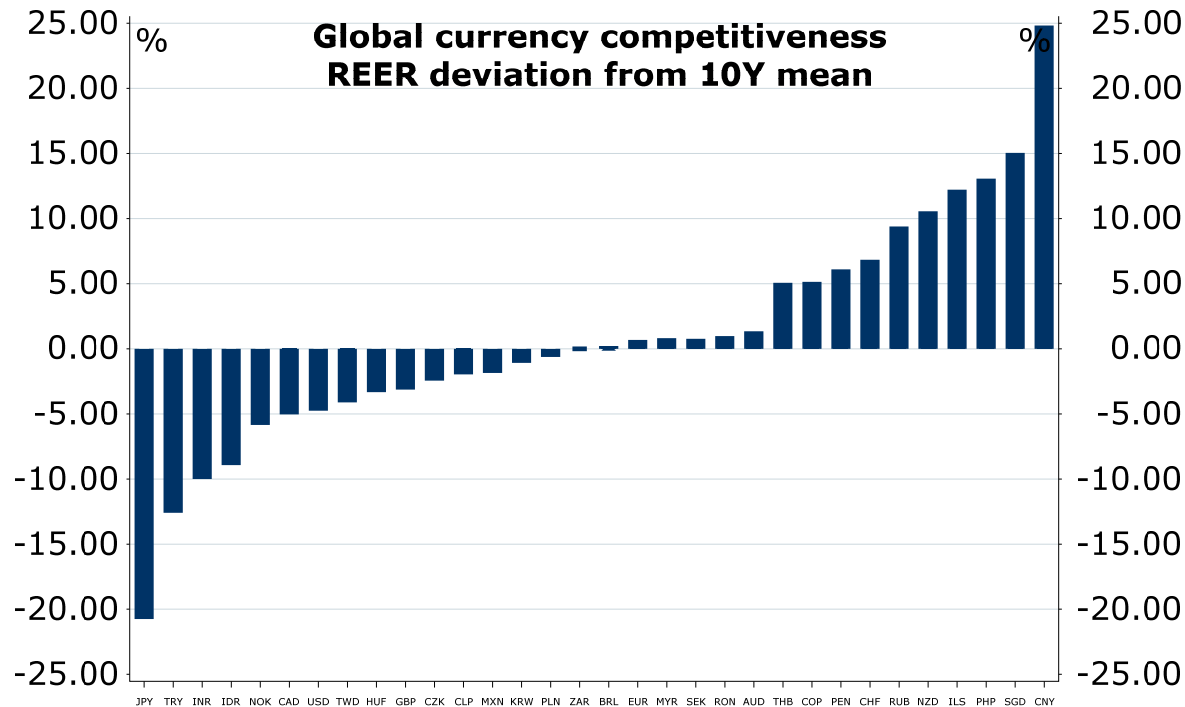
Here we also see why growth matters. It was not just QE1, QE2 stops that brought about risk-off, lower yields, lower EURUSD...it was also concerns about global growth, mostly China and the euro area. This time around, it could as well be the US, given the high expectations for it at the beginning of 2014.

# Sum up: No. USD does not gain when Fed is hiking rates.



Fed raising rates since early 70s has actually been, on average, consistent with EURUSD going stronger, not lower! Broadly, the USD also went weaker...at least in the initial year of hikes. Only with a lag, tightening spilled over broadly to EMs like in early 80s or mid 90s.

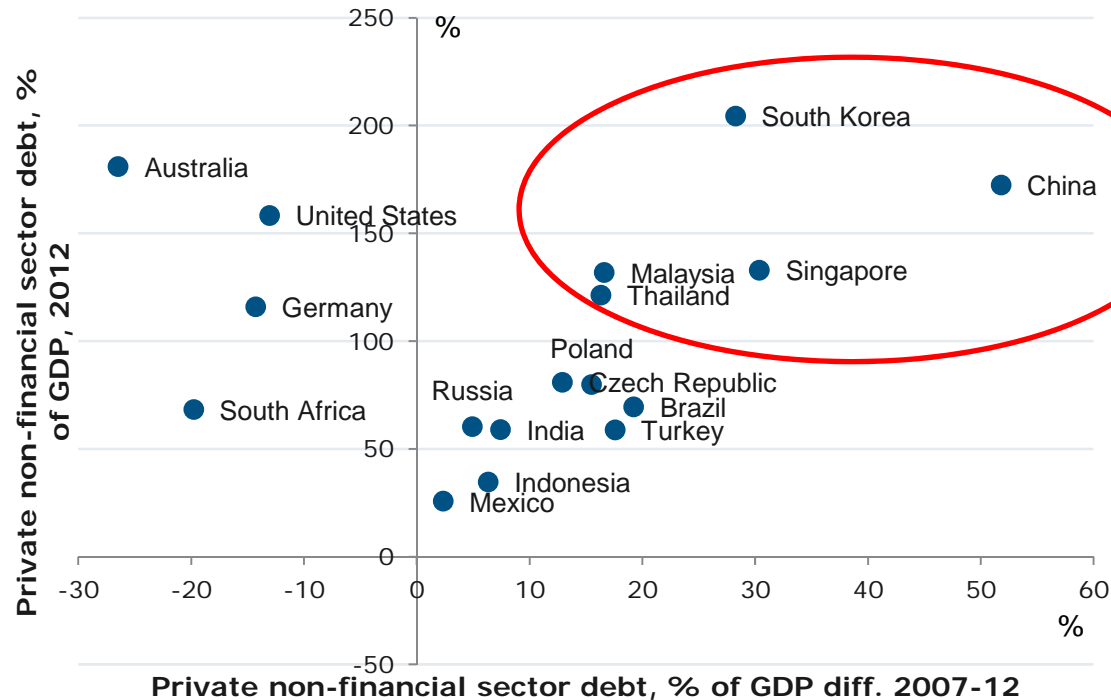
# Once/If Fed raises rates...Asian FX will suffer most



Source: Nordea Markets and Reuters Ecwin

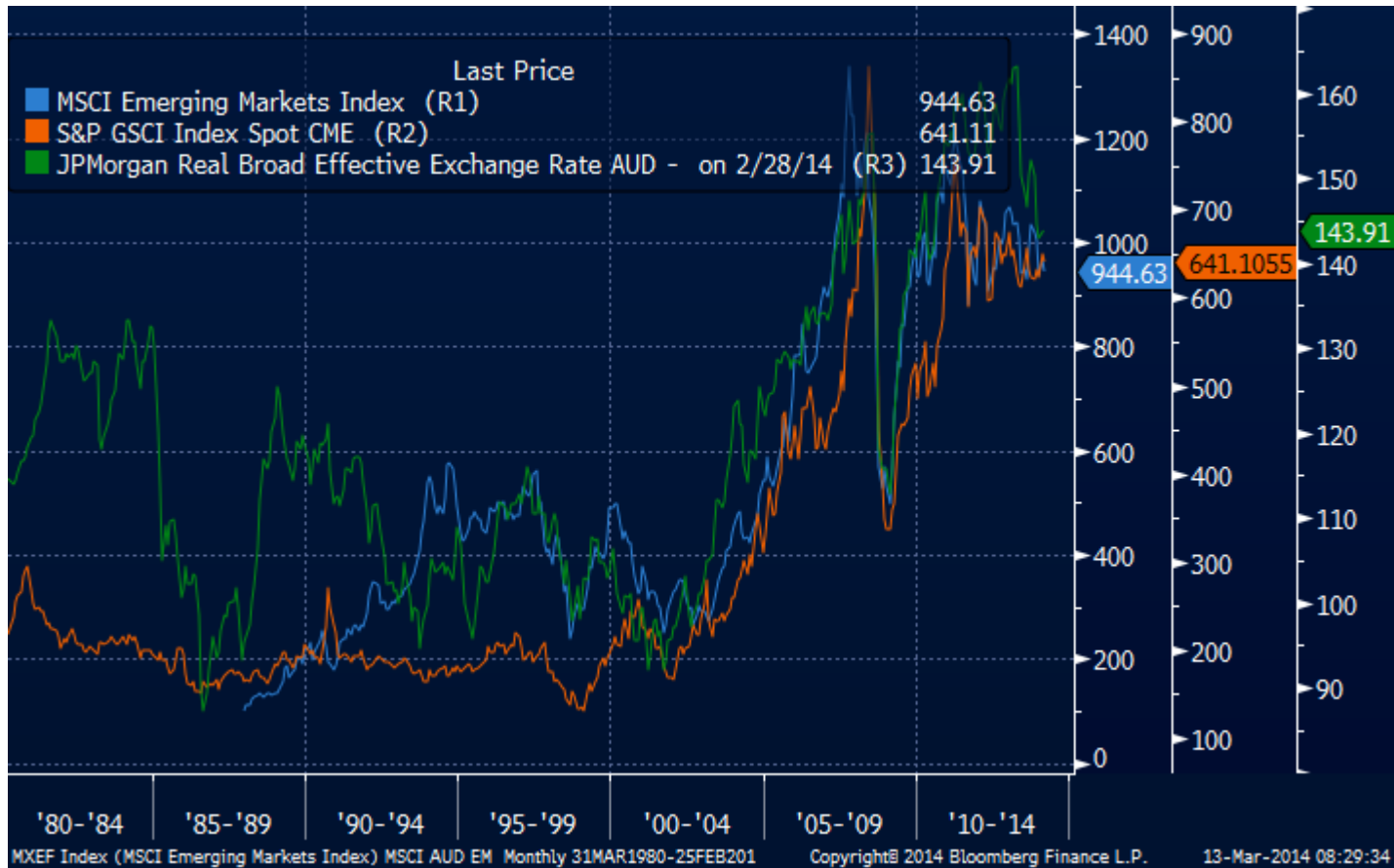
If Fed hikes rates or market starts repricing Fed quickly, the USD is to strengthen more... most likely against currencies which are overvalued. This concerns mostly Asian Emerging Markets and commodity currencies which have benefited from the commodity price boom since early 2000.

# "Safe haven" Asia...oh wait

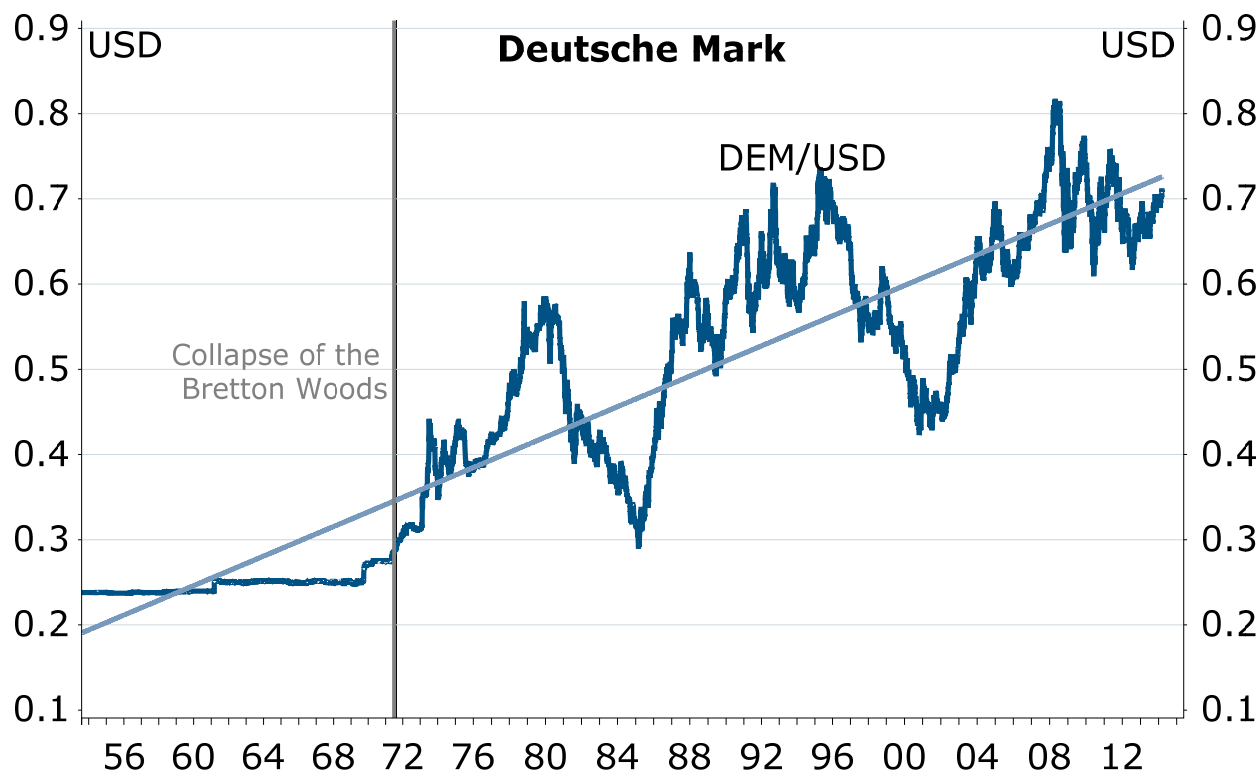


The increase in credit in some Emerging Market economies has been spectacular over the past few years, Emerging Asia stands out. E.g. household debt in Malaysia, Thailand, Singapore, South Korea, Taiwan...around 80%/GDP, too high (too fast, too much), relative to their living standards.

# The EM/commodity bubble: are we there yet?



# Long live, EUR...aka, DEM.



From the collapse of Bretton Woods system (system of fixed exchange rates), the USD has been on a depreciating trend against European currencies, notably the DEM – the anchor of the single currency area. This probably lies in the relative monetary policy stance, in good times and bad.

# Key conclusions

- **Fed starting rate hikes is no reason for broad USD strengthening**, in particular not against the EUR. If history is any guide, USD strengthening is prompted by the consequences of Fed starting tightening. First, it only affects most vulnerable (like Mexico in 80s and 90s), eventually – with a lag of a year and more – spills over to some “most vulnerable” EMs.
- **USD strengthening needs panic, recession, volatility**. In normal times, the EURUSD will trend higher. Normal times means US growth, with US being consumer of last resort – running current account deficit. For many years before Lehman this has been associated with the USD weakening.
- Emerging Markets will be between a rock and a hard place in coming years. They probably prefer the US Fed not to tighten, as the QE has facilitated buildups of domestic credit bubbles, too fast, too much. **EM/commodity bubble will burst further**, if/when Fed tightens. EM Asia most vulnerable.
- Broad USD strengthening, while Fed is cutting rates, and vice versa, is consistent with the **USD being world’s reserve currency** after the collapse of Bretton Woods System in early 70s. Fed is the central bank of last resort, and is forced into “leaning against the wind”: easing global monetary conditions when they tighten too much.

End. Of. Story.



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