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On the dismal science of currency forecasting

Economics is often referred to as the "dismal science" – a term coined by the British Victorian historian, Thomas Carlyle in 1849.

In a more modern context, if economics is the "dismal science", I think there is a case that the economics of explaining currency movements is perhaps the most dismal of sciences.

Nowhere is this more evident than in the current debate regarding the US dollar.

In essence, there are two competing narratives on the US dollar versus euro exchange rate with which markets are wrestling.

The first is a positive US dollar view.

Certainly, with Janet Yellen taking the Treasury secretary's chair in early 2021, markets were right to expect a disavowal of the Trump era "devaluationist" rhetoric toward the USD.

From March 2020, in the wake of the US Federal Reserve's aggressive monetary accommodation to confront the pandemic (and where the Fed was in a position to enact more monetary stimulus than the ECB), the US dollar fell for much of 2020. However, with the new Biden administration, the US dollar appreciated through the March quarter of 2021.

In some measure that March quarter appreciation reflected the enactment of a US$1.9 trillion fiscal package by the new Biden administration. That came after stimulus measures of some US$3 trillion back in April 2020 and a further US$900 billion in December 2020.

Those packages will mean the maintenance of the US fiscal deficit at a peacetime record close to 15 per cent of US GDP. The Biden administration has also unveiled plans for a US$3 trillion infrastructure spend (admittedly more longer-term and possibly financed by tax increases).

In any case, those record US peacetime fiscal deficits need to be financed.

Bond yields impacted

Given the immensity of that task it is not surprising that this has seen some rise in bond yields, helped along by concerns that the fiscal stimulus may lead to an outbreak of inflation. And while the momentum for higher bond yields appears to have stalled, an appreciation of the US dollar (because of higher bond yields) is what the textbooks suggest – other things equal – is the consequence of a fiscal stimulus funded by bond sales to the public.

Indeed, that is precisely what happened with the Reagan deficits of the early 1980s, which kept a floor under US bond yields and saw a sharp appreciation of the US dollar that only came to an end with the Plaza Accord in 1985.

In the current circumstance, the Fed is also a big buyer of bonds as well as the public. In Paul Volcker, Reagan had a Fed chair that, fresh from the experience of the inflationary 1970s, who would not have entertained central bank purchases of bonds as a stimulatory tool. Were a Powell-led Fed disposed to increase its purchases, that would limit the rise in bond yields and therefore any appreciation in the US dollar, but it has a lot of bonds to buy to achieve that outcome and in the absence of increases in fiscal stimulus in other jurisdictions, such as the eurozone, that US dollar appreciation may well continue.

However, in April the US dollar momentum appears to have reversed.

This brings us to the second competing narrative.

Economic implications

In this competing narrative, the US has been a relative outperformer in economic growth terms: first, it could enact fiscal stimulus relatively quickly and didn't face the same institutional barriers to the enactment of such stimulus as the EU; second, it got its COVID vaccination program underway relatively quickly and the roll-out of the vaccine proceeded relatively smoothly unlike the missteps that have wracked the roll-out in the EU.

However, that relative economic outperformance has had consequences that in time might weigh on the US dollar. It has placed the US economy squarely as the engine of global economic growth, but the consequence has been a growing US trade deficit – which again the textbooks would say that, other things equal, should result in a depreciating exchange rate. Further, the EU after the early missteps appears to have got its COVID vaccination program in some form of order presaging better conditions for internally generated growth in the EU. Hence the tendency for a better performed euro through April.

Of course, in the real world, other things are rarely equal. What happens to the US dollar will reflect the interplay and relative influence of the allure of higher bond yields versus the consequence of a large and growing trade deficit.

My own view tends to favour the former narrative. I think US bond yields go higher from here – that the current pause in yields is just that: a pause – and second, the EU governance frameworks to me show a tendency to result in "the snatching of defeat from the jaws of victory". I am thinking particularly here of the convoluted pathway to the enactment of any meaningful EU-wide fiscal stimulus. That pathway remains complicated at best.

What of the Australian dollar?

Here there are further complications. Australia has had a governance framework that has allowed relatively quick fiscal and monetary stimulus to be applied. However, the fiscal stimulus is not of the same order of magnitude as applied in the US. Australia also looks to be contemplating budget repair at a much earlier stage than the US and the RBA has issued "guidance" that it does not expect to raise the policy rate until 2024. That may temper any tendency for the Australian dollar to rise.

On the other hand, the unprecedented global monetary and fiscal measures applied in the wake of the pandemic has many in financial markets on alert for higher global inflation, including commodity inflation, which would enhance Australia's already healthy trade position. That might prove a strong tailwind for further Australian dollar appreciation against both currencies regardless of the way in which the US dollar versus euro dynamic plays out.

So, while currency forecasters do their best, in digesting their prognostications it pays to keep in mind that currency forecasting is among the most dismal elements of the "dismal science".

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