Multi-Asset Insights: Have central banks lost their potency in determining exchange rates?

This month's Multi-Asset Insights examines how the role of monetary policy as a significant driver of exchange rates appears to be breaking down.

Multi-Asset Investments
Schroders

Monetary policy has been a factor in driving exchange rates since the end of the Bretton Woods system (which dissolved between 1968-73). That was when central banks began to flex their powers and experiment with money supply, interest rate targeting or currency intervention to influence the development of macroeconomic variables such as domestic economic growth and inflation.

However, recent reactions - such as a stronger yen after the Bank of Japan's negative interest rate policy - have called into question the link between monetary policy and exchange rates. We also suggest that going forward, monetary policy will be less influential in driving currency returns because of increased perceptions of policy ineffectiveness in driving future economic growth and inflation.

Historical relationships between monetary policy and exchange rates

The link between interest rate differentials and currency movements has been fairly high over the past two decades, and in fact was higher in the period post the 2008 Global Financial Crisis. We show, below, the results of a regression analysis using the nominal interest rate differential (two-year sovereign, vs US) as an explanatory variable for spot FX returns vs USD for several major currencies.

Table 1 - Regression of spot FX returns vs 2-year interest rate differentials

	Full sample (2000 - 2016)				Post-GFC (2008 - 2016)		
	Beta	T-Stat	R^2		Beta	T-Stat	R^2
AUD	5.9	6.5	18%	AUD	8.4	6.9	33%
CAD	4.2	5.5	14%	CAD	8.3	6.3	29%
CHF	-3.0	-2.6	3%	CHF	-1.9	-1.0	1%
EUR	1.9	1.8	2%	EUR	6.8	4.6	18%
GBP	2.9	3.9	7%	GBP	5.4	5.5	23%
JPY	-4.1	-1.2	1%	JPY	-21.7	-4.0	14%
SEK	2.7	2.7	4%	SEK	5.5	4.1	15%

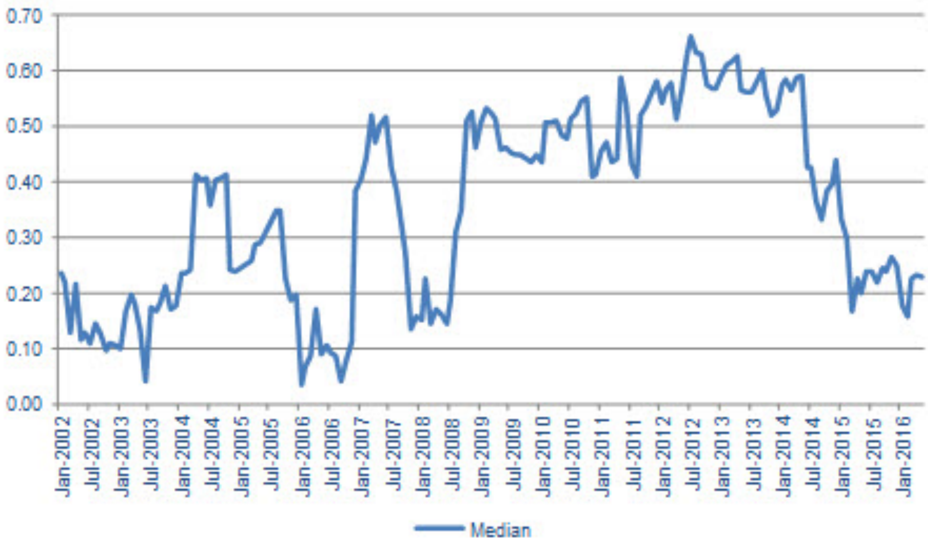
Source: Schroders. Monthly data from Jan 2000 to May 2016.

The results suggest that interest rate differentials have been highly significant for explaining currency returns.

Monetary policy less effective in recent months

We believe, however, that there is more to this story. Observing the median short-term correlation between G10 short term interest rate differentials and exchange rates suggests that monetary policy is a less effective explanation of currency returns than before.

Chart 1 - Short term correlation between G10 interest rate movements and FX returns



Source: Schroders. Monthly data from Jan 2000 to May 2016. Correlation is 2 year monthly (24 periods). G10 excludes Norway and New Zealand due to data availability.

We think that as developed market central banks are near the limits of conventional monetary policy (having pushed short term rates near or past the zero lower bound), exchange rates take over as the main transmission mechanism of monetary policy, but central bank efforts to manipulate exchange rates will be ultimately unsuccessful.

There are three key reasons for this:

1) Policy rates are likely to be kept low for longer, shrinking current and expected rate differentials;
2) Using unconventional monetary policy to influence currency volatility appears to fail; and
3) The response of exchange rates towards repeated central bank stimulus efforts are becoming less favourable or even reacting in an adverse manner.

Conclusion

Although monetary policy has historically been a significant driver of exchange rates, this relationship appears to be breaking down.

We suggest that exchange rates could trade more on fundamentals going forward. For example, many countries that have current account surpluses have seen currency appreciation (EUR, JPY) despite their respective central banks implementing more monetary easing, while many EM currencies that were severely hurt over the last two years have seen sharp appreciation due to a bounce-back in growth prospects (i.e. things are not as bad as they seem).

This should be good news for investors who can re-focus on fundamental economic drivers, rather than speculating on the actions of global central banks.