Motilal Oswal

EcoScope
The Economy Observer

Long US Dollar? Not so quick!

USD should weaken due to worsening in US' twin deficit

- **Movements in the US Dollar (USD) index (trade-weighted against major currencies) are an important determinant for the Indian Rupee (INR) and other emerging market (EM) currencies. The recent weakness of ~5% in the INR vis-à-vis the USD also coincided with ~4% appreciation in the USD index. It is, therefore, imperative to incorporate the expected future direction of the USD in INR forecasts.**
- **In the absence of imminent US recession, as we had noted earlier, an expected deterioration in the US' twin deficit (sum of fiscal deficit (FD) and current account deficit (CAD), and stable growth differential and convergent monetary policy between the US and non-US developed world are likely to weaken the USD over the next couple of years.**
- **The USD, however, will rally if the non-US developed economies – read Eurozone (EZ), Japan, or the United Kingdom (UK) – witness significant growth weakening. The wider growth differential, along with divergent monetary policy, will then initiate long USD trades, which doesn't bode well for EM currencies, including the INR.**

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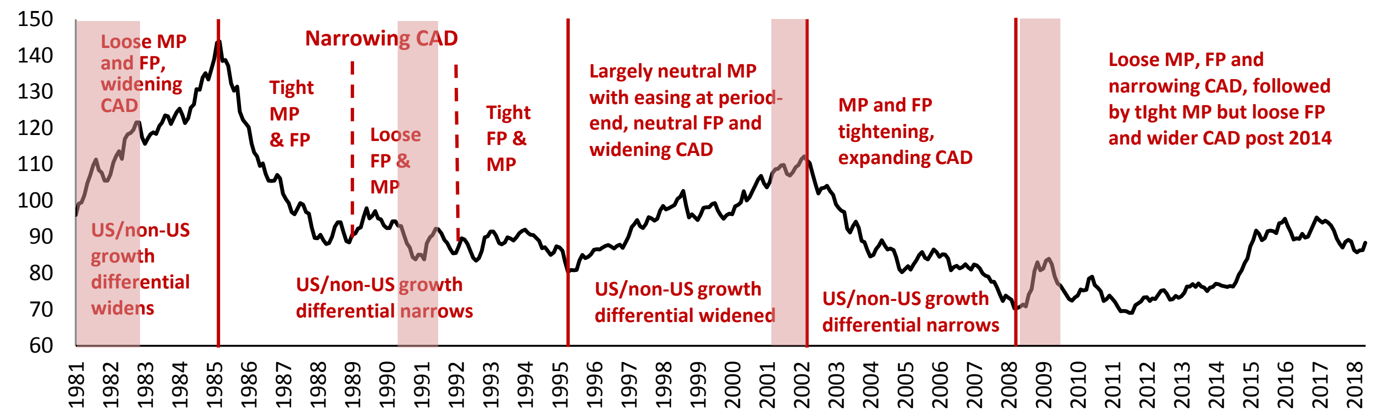
Though domestic macroeconomic fundamentals matter, the movements in the USD – the global currency – are as important a determinant, if not more, for the INR and other EM currencies. To predict the direction of the INR, thus, one needs to consider the potential future trends in the USD. In this note, we present our thesis on why we don't expect the USD to strengthen in the next couple of years.

What matters more for the USD – US' twin deficit or the divergent US monetary policy vis-à-vis non-US developed world?

The two most important factors – US' twin deficit and its monetary policy vis-à-vis non-US developed world – are providing contrasting signals for the USD

The answer to this question will decide the future direction of the USD. This is because the two most important factors responsible for movements in the USD index are hinting at different directions. US' twin deficit is expected to deteriorate sharply over the next couple of years – from 5.8% of GDP in 2017 to ~8% in 2019, while the interest rate differential between the US and non-US developed world in 2019 is expected to be at the highest level in two decades – up from 1.1% in 2017 to 2.6% in 2019. The former points to a weaker USD index, while the latter indicates a stronger USD. As most of the time, we fall back on history to make predictions.

Exhibit 1: Movements in the USD index over the past four decades



Shaded regions denote recession

Source: St. Louis Federal Reserve Economic Database (FRED), MOSL

Nikhil Gupta – Research analyst (Nikhil.Gupta@MotilalOswal.com); +91 22 6129 1555
Rahul Agrawal – Research analyst (Rahul.Agrawal@motilaloswal.com); +91 22 3982 5445

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Pre-2008, there have been four clear distinct episodes – USD strengthened in two such episodes (1981-85 and 1996-01), while it weakened in the other two (1986-95 and 2002-07)

Straight-forward simple relationships in the pre-2008 period

Exhibit 1 above shows the movements in the USD index over the past four decades. We divide this analysis into two parts – pre-2008 global financial crisis (GFC) and post-2008. Between 1980 and 2007, there have been four clear distinct episodes wherein the USD index witnessed sustained trends. It appreciated in two of these episodes – 1981-85 and 1996-01, and depreciated in the other two episodes – 1986-95 and 2002-07. *Exhibit 2* provides a snapshot of the four USD episodes between 1980 and 2007. The key highlights are:

1. Irrespective of significant widening of the US' twin deficit in the early 1980s, the USD index strengthened considerably by ~40% during the 5-year period up to 1985. The double-dip recession in the early 1980s followed by widening growth differential over 1982-84 help explain the strong USD.
2. For the next decade up to 1995, although the US' twin deficit improved significantly from its peak of 7.4% of GDP in 1985 to 3.6% in 1995, the USD index weakened by ~38%. The growth and inflation differential between the US and non-US developed world were broadly stable to lower.
3. Between 1996 and 2001, the twin deficit fell further to sub-2% by 2000, and the growth and inflation differential widened. The USD index continued to rally during this period with an increase of ~30%.
4. During the final episode of 2007-07, the twin deficit deteriorated sharply to ~8% of GDP in 2006, along with reduction in the growth and inflation differential. The USD index weakened ~30% during the period.

Exhibit 2: Snapshot of four USD episodes in the three decades up to 2007

	USD index	Twin deficit	Growth differential	Inflation differential
Episode 1 (1981-85)	Up ~40%	Higher	Higher	Lower
Episode 2 (1986-95)	Down ~38%	Lower	Lower	Lower
Episode 3 (1996-01)	Up ~30%	Lower	Higher	Higher
Episode 4 (2002-07)	Down ~30%	Higher	Lower	Higher

Source: US Bureau of Economic Analysis (BEA), Bloomberg, FRED, CEIC, MOSL

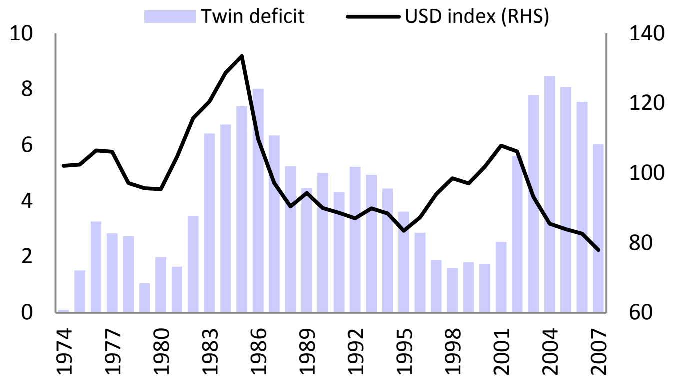
The growth differential was the most important determinant of USD movements in the pre-2008 period

Overall, the growth differential was the most important determinant of USD movements in the pre-2008 period, with higher US growth supporting stronger USD index and vice-versa. In contrast, the USD index strengthened in the early 1980s despite deteriorating twin deficit, while the USD weakened despite lower twin deficit in episode-2. The USD index, however, moved in line with the improvement / deterioration in the twin deficit during the last two episodes *(Exhibit 3)*.

The USD index and US' federal funds rate were inversely correlated during the pre-2008 period

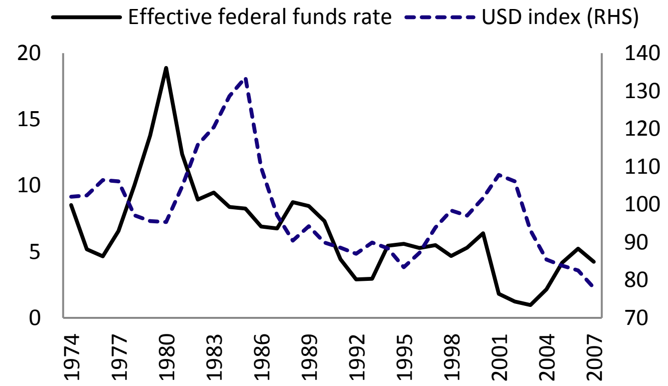
Further, the USD index and US' effective federal funds rate (equivalent to India's overnight call market rate) were inversely correlated during the pre-2008 period *(Exhibit 4)*. Between 1975 and 2007, the US has tightened monetary policy five times – 1976-80, 1987-90, 1993-95, 1998-2000, and 2003-06. Four out of five times, the USD index weakened during the monetary tightening. The only time the USD strengthened with higher policy rates was in 1998-2000, which coincided with a mild dot-com crisis. The opposite was also true – USD strengthened during monetary easing.

Exhibit 3: Comparison of movements in US' twin deficit and USD index during pre-2008 period



Sum of fiscal deficit (FD) and current account deficit (CAD)

Exhibit 4: Strong inverse correlation between Fed funds rate and USD index in the pre-2008 period



Source: Bloomberg, FRED, CEIC, MOSL

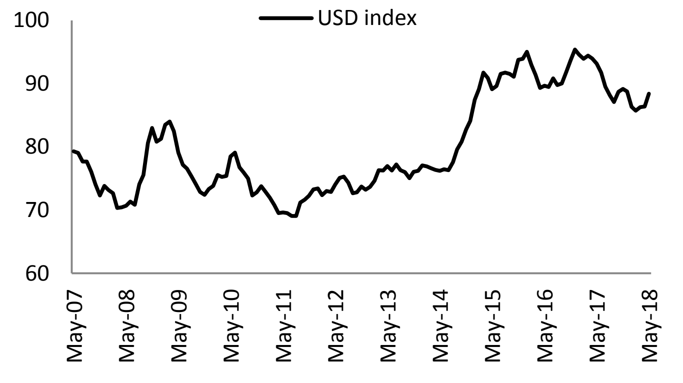
Relationships, however, altered post-2007

Post-2007, the worst economic crisis since the 1930s Great Depression changed many things. Barring the 2008-09 crisis period, when the USD strengthened because of the status of the global safe haven, there have been two key episodes – 2012-15 of stronger USD and of weakening since then *(Exhibit 5)*.

Post-2007, USD index movements have been in line with the US' twin deficit

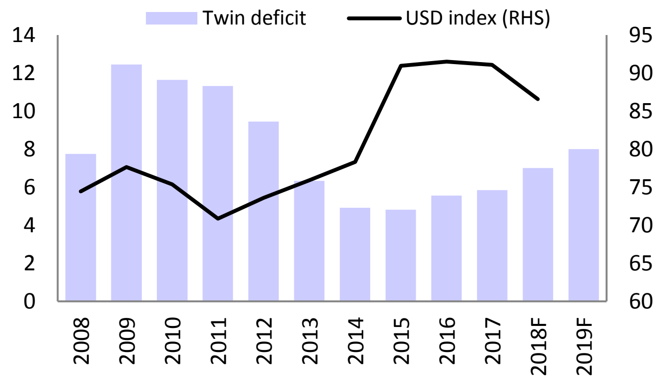
Interestingly, these two USD episodes have been in line with the movements in the US' twin deficit (sum of FD and CAD). US' twin deficit peaked at 12.4% of GDP in 2009 and eased sharply from 11.3% in 2011 to 4.8% in 2015 *(Exhibit 6)*. During the past two years, however, the twin deficit has widened again to 5.8% of GDP in 2017 and is expected to be ~7% in 2018. The USD, as discussed above, strengthened in the previous episode but weakened in the latter.

Exhibit 5: USD index strengthened between 2012 and 2015 but has weakened since then



Source: Bloomberg, FRED, CEIC, MOSL

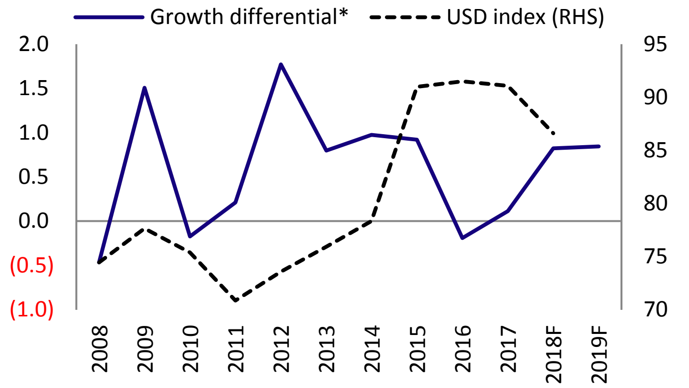
Exhibit 6: US' twin deficit and USD index strongly inversely correlated post-2007



Sum of fiscal deficit (FD) and current account deficit (CAD)
USD index 2018 data up to May 2018

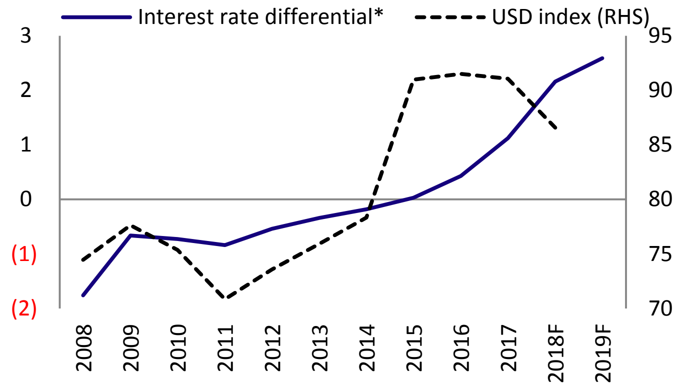
Further, while the USD strengthened between 2012 and 2015, when the stable US economy but weak non-US growth led to higher growth differential and divergent monetary policy *(Exhibit 7)*, the USD index has weakened since 2016. This is despite the fact that the interest rate differential between the US and the non-US developed world has risen sharply between 2015 and 2018 *(Exhibit 8)*.

Exhibit 7: There is no clean relationship between GDP growth differential and USD index post-2007…



* Between the US and non-US developed world

Exhibit 8: …but USD index has weakened since 2015, despite rising interest rate differential



Source: Bloomberg, FRED, CEIC, MOSL

Although the rate differential has increased, the monetary policy of the US and non-US developed world have converged, not allowing the USD to strengthen

There could be two possible reasons for the weaker USD since 2016: (a) the twin deficit has deteriorated, which is expected to deteriorate even faster in 2018 and 2019, and (b) though the rate differential has increased, the monetary policy of the US and non-US developed world have converged, with the latter also expected to withdraw monetary stimulus and hike policy rates.

If so, unless there is renewed fear of a global economic slowdown, the USD index is unlikely to witness any substantial rally. In other words, if the non-US economic recovery slows down, leading to the divergent monetary policy again, the USD index will rally. Further, if the US economic recovery slows down, it will lead to a risk-off scenario again, helping the USD to appreciate.

Unless there is renewed fear of a global economic slowdown, widening twin deficit is likely to weaken the USD index

However, since there is no such threat as yet, the current scenario of anemic economic growth – even if the recovery in the non-US developed world is weaker than in the US, the deterioration in the US' twin deficit is likely to weaken the USD index over the next couple of years. The trade of 'long USD', thus, is not yet a certain winner! And this is good news for the INR and other EM currencies.

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