

G7: OLD WHINE, NEW SKINS

For the first time in four years, the G7 changed their statement about the foreign exchange market. Rather than simply note that the foreign exchange market should reflect fundamentals and that excessive volatility was not desirable, the G7 raised their level of concern.

“Since our last meeting”, the G7 said, “there have been at times sharp fluctuations in the major currencies, and we are concerned about their possible implications for economic and financial stability.”

Some observers have suggested that a change in wording reflects a victory for the French, who had seemed the most adamant about the risks posed by the falling US dollar. While it does seem that after President Sarkozy’s initial volley to influence the ECB, he regrouped and appeared to be directing his animus toward the US and the dollar’s weakness. Nevertheless, this appears to give France greater influence than is due.

Given the dramatic change in foreign exchange prices within the context of a further deterioration in the investment climate and the continued increase in commodity prices, it was incumbent upon the G7 to alter their statement to reflect the change in circumstances. The change is clearly in the direction of greater concern rather than less. However, that level of concern still falls well shy of anything resembling material intervention in the currency markets.

Indications from contacts close to the meetings suggest that the discussion about the foreign exchange market was heated and more protracted than usual, but this seems to be a function of finding a new consensus after agreeing that the previous consensus had outlived its usefulness. Yet it appeared that there were no advocates for a Louvre-like agreement that seeks to put a floor under the dollar.

Indeed, to the extent that the G7 statements are, by their nature, a compromise formation, the greatest common denominator is often articulated. And here the take away point is about volatility, not levels. In addition the statement itself even modified the concern about volatility by noting that the sharp fluctuations occurred “at times”.

French Finance Minister Lagarde did not hide the fact that she hoped the G7 statement would put a floor under the dollar. However, judging by the G7 statement itself and the subsequent comments from various officials, the dollar’s weakness is a function of a number of other factors, including the credit crisis and the policy response to it. Moreover, the G7 warned that the crisis could be protracted.

Comments from ECB’s Mersch illustrate one of the key reasons why the euro is strong and why intervention is unlikely. Mersch, like Weber before the weekend, stated the ECB has no room to cut rates this year. This seems largely gratuitous and seems to break from the ECB’s declaratory policy of not pre-committing. Since the other major currencies did not confirm the euro’s new record high, if Europe has a problem, it is with a strong euro.

If they really wanted to cap the euro, there are two steps European officials can take that could be even more effective than intervention. First, they could simply change their rhetoric. Tone it down a notch or two. Yes we all know that inflation is above desired levels in the region. We also know that the economy has lost a great deal of momentum. Second, they could take advantage of the room the IMF says exists and cut interest rates on the conviction that price pressures will ease. By doing so they would also signal that sub-2% growth is not acceptable.

Some observers concluded that the changed statement implies a concern about the dollar’s weakness and an implicit threat that intervention is “not out of the question.” We do not agree. We think there is no such implication. There is no promise or commitment to act. There was no indication of a consensus to put a floor under the dollar. The real risk of intervention remains minimal at best and despite what French officials would have us believe; the dollar’s weakness was not specifically cited. Volatility was.

Ironically, the G7 statement initially generated the kind of volatility that it objected to as the greenback opened sharply higher in Asia. This is leaving a gap in the price action on weekly and daily bar charts and creating a bit of a panic as stop losses get triggered. After beginning off hesitatingly in Asia, those that got stopped out of short dollar positions, or bargain hunters in the foreign currencies began feeling more confident the dollar had surrendered all of its initial knee-jerk gains.

As we have outlined previously, in our view the US dollar is already in the process of bottoming. It has already bottomed, we believe against half of the non-US G7 currencies and several of the major emerging market currencies. The dollar's decline appears to be losing breadth. We suspect that many officials are playing for time; hoping to avert a currency crisis while the cyclical divergences narrow.

The next important policy development will be the FOMC meeting at the end of the month. We suspect with other policy tools having been created that it may take some pressure off the Federal Reserve. We think the risk is increasing that the Federal Reserve may signal a pause in its interest rate cutting cycle, that began last September and has already reduced the US real funds rate to below zero. There have also been some indications that at least some Fed members are reluctant to take the Fed funds target much below 2%, with inflation expectations rising and "the need to keep some powder dry", given the dramatic rate cuts that have yet to work their way through the system.

At the same time, there appears to be a growing realization by some ECB members, but not all, that the sharp headwinds to the regional economy will likely ease price pressures later this year and that the downside risks previously identified are in fact materializing. The Bloomberg consensus has the first ECB rate cut coming in September. Even if this is a bit aggressive, few if any really doubt the direction of the next ECB move.

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