

Currency Manipulation and Its Meanings

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Politicians like to throw around the phrase “currency manipulation” when they feel that some other nation has developed an unfair trade advantage by way of [an artificially weak exchange rate](#). In the currency markets, though, it has a more benign meaning and can help explain some of the seemingly head scratching moves of late such as the dollar's weakness.

That's because when it comes to [hedging](#), “manipulation” is fairly common as a result of the natural arbitrage that exists between the different levels of interest rates of nations, and their relation to spot and forward exchange rates.

Consider the yields on 10 year US Treasuries and Chinese government bonds, both hedged to Japanese yen. Japan has a bilateral trade deficit with China, but a surplus with the U.S, meaning Japan is borrowing from China at close to 7% and lending to the US at a little more than 1%. The interest differential could be arbitrated by Japanese exporters who fund Japanese goods at a low rate in dollars and sell those goods to Chinese customers who finance at a higher rate in China. In that sense, manipulation and arbitrage are close counterparts. And, there are other areas of the currency where such ‘manipulative arbitrage’ can exist.

[Arbitrage](#) opportunities abound in “currency basis swaps,” which in general terms can be viewed as a measure of supply and demand for dollar funding in offshore markets. The demand for dollar funding has waned somewhat of late because of the Donald Trump administration's intention to deregulate the US

financial industry, alleviating the need for heavy quarter and year end funding of banks' balance sheets.

The global “shortage of dollars,” as [measured by basis swaps](#) expressing either demand or supply for dollar funding, has also waned because of a combination of dollar weakness and lower real interest rates, while foreign banks appear to have finished building large dollar deposits in the wake of recent US money market reform. These factors have created a sweet spot for currency arbitrage between the dollar and other currencies.

Take blue chip US dividend stocks denominated in euros hedged to dollars and Japanese Treasury bills hedged to dollars. Then, compare that to a weighted average of currency basis swaps from Group of 10 and emerging market currencies. Recall that financial conditions eased significantly in late 2016, and as a result, foreign yields hedged in US dollar terms became high enough that the acute need for dollar funding lessened. In other words, it could be an attractive to invest in lower yielding foreign assets and hedge those to dollars at a higher rate, and efficiently lower the cost of the hedge.

Ever since former Brazilian Finance Minister Guido Mantega popularized the phrase ‘currency war’ in 2010, political pundits have been critical of exchange rates to influence economic output. That matters less for the foreign-exchange market because a presumptive currency war is more relevant to returns implied from [spot and forward exchange rates](#). These returns can be seen from “implied exchange rate yields’, or the [difference between the spot and forward rate](#).

Consider the Czech koruna and Swiss franc. In both cases, the central bank “manipulated’ the currency by [setting a cap](#) to the euro (1.2 to the euro for the franc and 26 to the euro for the koruna) [to counter the threat of deflation](#). In the case of the Swiss, ending the currency cap by surprise, resulted in [a sharp drop](#) in the implied currency rate, revealing [the extent of the manipulation](#). It also

shows the [opportunity for arbitrageurs](#) to borrow at a negative interest rate and reinvest in currencies with a higher, real implied rates.

Perhaps the ultimate currency manipulation has to do with the Chinese yuan, which has been on a weakening trend since 2016 as measured against broad set of currencies. Less discussed is how this is potentially a net positive to the US, and by extension, the world economy, in terms of lower long term borrowing costs in the form of a flatter US yield curve.

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