FX Forecasts
Desjardins Economic Studies
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Monetary policies are affecting exchange rates

HIGHLIGHTS

- The latest exchange movements were primarily a reflection of increasingly divergent monetary policy developments. The Bank of Japan shifted into top gear and the Federal Reserve's third quantitative easing should run until next year. The yen and U.S. dollar depreciated against several currencies, with the yen falling further due to the magnitude of the easing measures.
- The greenback could still benefit from its safe-haven role if the risks to global economic growth increase or if the European crisis spikes again.
- The statistics should nonetheless improve over the coming quarters, a situation that will help the loonie to reach US$1.00 by year's end.
- The euro should continue to fluctuate around US$1.30 over the coming months. An improved economic outlook in the second half should enable the euro to start trending up again towards the end of 2013.

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Editorial

The banking crisis in Cyprus prompted a rebound in risk aversion, but that did not last and the safe-haven currencies did not benefit much. The latest exchange movements were primarily a reflection of increasingly divergent monetary policy developments. The Bank of Japan (BoJ) shifted into top gear and the Federal Reserve's (Fed) third quantitative easing should run until next year. Meanwhile, Europe is on the sidelines. In the end, the yen and U.S. dollar depreciated against several currencies, with the yen falling further due to the magnitude of the easing measures undertaken in Japan.

SURPRISE IN JAPAN

The liberal democrats return to power had raised expectations about the BoJ. They had asked to have the inflation target and quantitative easing increased. Doubts persisted about how much leeway the BoJ had, however. Since 2008, the impression may have been that its intervention was timid compared with other central banks. However, that overlooked the fact that, a few years previously, it had taken huge steps to combat deflation and kick start the economy. Its balance sheet was already very large when the other central banks fell into step.

If we look at how the size of the BoJ's balance sheet has evolved in comparison with the Fed's, adjusted to GDP since the start of the 1990s, it appears that the levels of monetary stimulus are similar today. Expansion will be proportional in 2013 assuming the BoJ does not announce any new measures and the Fed waits until fall to start tapering off its purchases. The situation will change in 2014, however, when purchases will maintain a sustained pace in Japan, but not in the United States (graph 1 on page 2). Moreover, the BoJ has even intimated that it could take additional action if inflation does not rise quickly enough to reach the 2% target by the end of next year.

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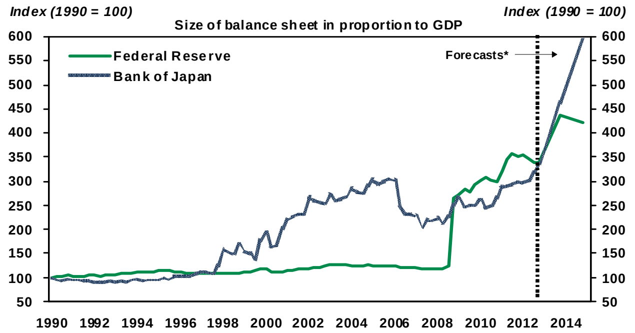
Graph 1 – The Bank of Japan's intervention will outstrip the Federal Reserve's



* Assumes the Bank of Japan will go through with what it has announced to date and the Federal Reserve will pursue its current purchases until fall 2013, then gradually wind them up.
Sources: Federal Reserve, Bank of Japan and Desjardins, Economic Studies

The unprecedented measures taken in Japan are weighing negatively on the yen. Today, the Japanese exchange rate is oscillating around ¥100/US$; it was at ¥78/US$ in the fall. This will certainly give Japan a competitive edge, which could fuel a currency war. Nonetheless, as long as exchange movements reflect normal adjustments associated with laudable monetary policy objectives, such as targets for inflation and reasonable growth, it will be hard to accuse a country of deliberately devaluing its money. However, watch the reactions from other Asian nations likely to be penalized by the yen's weakness. To date, the changes in other regional currencies are contained.

A SUDDEN STOP TO SECURITIES PURCHASES SEEMS LESS LIKELY IN THE UNITED STATES

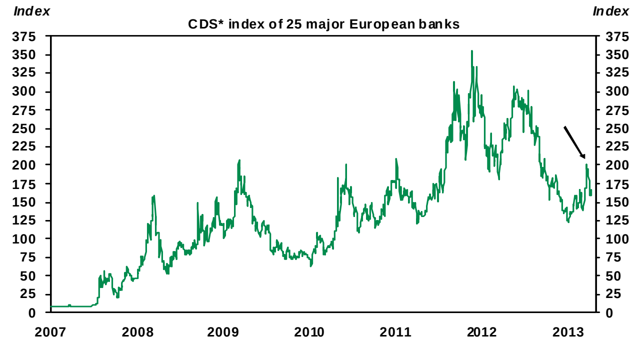
The U.S. economy got the year off to a hot start, despite the tax increases and budget cuts, which raised doubt about the Fed's ability to pursue its securities purchases for a long period. The same goes for the contents of the minutes of the latest monetary policy meetings. Several meeting participants were open to cutting back soon on the purchases. The U.S. dollar of course benefited from the situation. That being said, the latest releases on the ISM indexes, employment figures and retail sales set the situation straight. There now seems to be a risk that the economy will slow again this spring, as it has done in the last few years. In this context, the Fed will certainly not want to ruin the efforts it has already made and will wait until at least next fall before slowing the pace of its purchases.

This means the U.S. dollar has less of an advantage compared with several currencies. In the near term, it could still benefit from its safe-haven role if the risks to global economic growth increase or if the European crisis spikes again.

ASTOUNDINGLY, LITTLE FALLOUT FOLLOWING CYPRUS

The bailout of Cyprus' banking system could have further increased fears about the euro zone and its entire financial system (graph 2). The attempt to tax depositors without regard for deposit insurance left behind a bitter taste and, once again, solidarity among zone nations did not seem very sturdy. It is hard to imagine that the banking union project will make rapid progress after that episode.

Graph 2 – Pressure on European banks has not risen too much



* Credit default swaps.
Sources: Bloomberg and Desjardins, Economic Studies

The ground seems to be littered with obstacles in the Old World and the risk of an upswing by financial strains is high in the near term. The recession is making it harder to reach public deficit reduction targets, the political impasse continues in Italy, Portugal must overhaul its plan for returning to the financial markets, Spain is still grappling with a large inventory of unsold homes and, in general, it seems to be difficult to put through structural reforms. In this context, it will be hard for the European Central Bank to stay on the sidelines and the potential for euro gains against the U.S. dollar seems slight.

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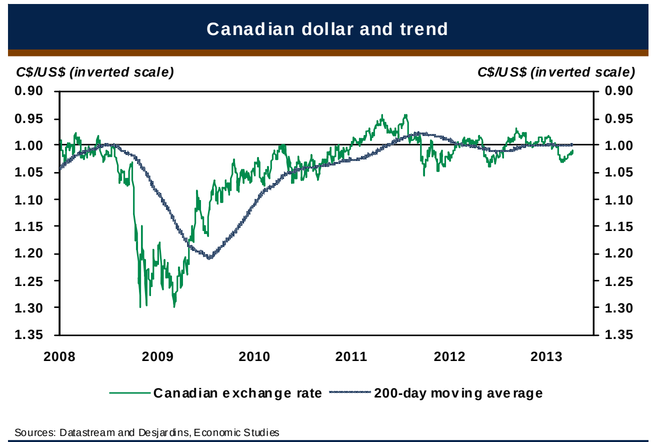
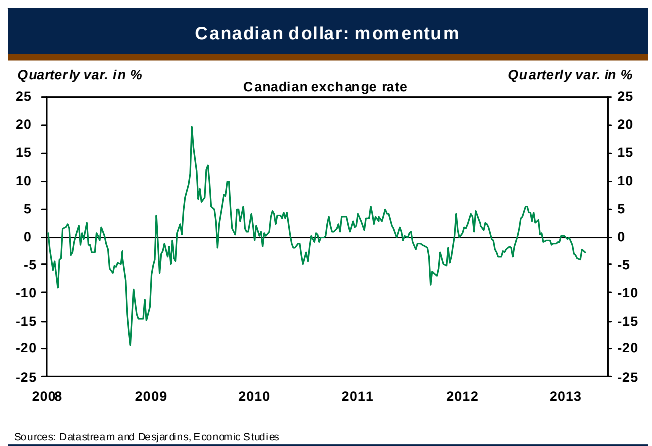
CANADIAN DOLLAR (CAD)

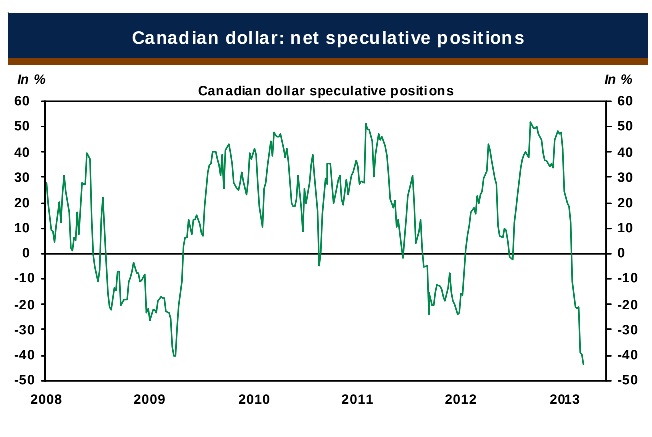
Better data puts a stop to the slide

- The Canadian dollar trended down from mid-January to early March against a backdrop of disappointing numbers on Canada's economy, taking the loonie to a cyclical low of US$0.9669. The situation then stabilized and even improved slightly in response to more reassuring figures, and the Canadian dollar rose back above US$0.9800.
- Technically, the Canadian dollar's momentum over three months is negative and the loonie is still below its 200-day moving average. Net speculative positions on the currency have kept falling and are now at a very low level, historically speaking. However, investor sentiment seems overly negative, increasing the chances of an upside correction.
- The state of the Canadian economy is the primary exchange rate determinant. The good employment figures released at the start of March (for February), followed by the rise by the inflation rate and slightly better economic growth than forecast for January have all helped the Canadian dollar lately. On the other hand, the employment numbers released in early April (for March) were disappointing. The U.S. data also has some influence on the loonie, given that it indicates whether or not Canadian exports will improve. In the context of soft domestic demand, international trade will be the key factor in ensuring Canadian growth over the next few quarters. The drop by the ISM indexes, poorer employment numbers and disappointing retail sales in the United States urge investors to caution and curb the Canadian dollar's rise.
- In terms of monetary policy, the excess capacity of production accumulated lately justifies pushing an initial key interest rate increase back to the end of 2014, with the result that interest rate spreads are not as good for the Canadian dollar as they used to be. The Bank of Canada (BoC) statement now mentions that the current monetary policy stimulus will likely remain appropriate for a period of time. Watch to see whether the reference to eventual key rate increases disappears when the next *Monetary Policy Report* is released this month.

Forecasts: The Canadian dollar could weaken more if the BoC further softens its stance. Some investors could get into position for an interest rate cut, especially since the latest data from the United States was disappointing. The statistics should nonetheless improve over the coming quarters, a situation that will help the loonie settle in at parity against the greenback by year's end.







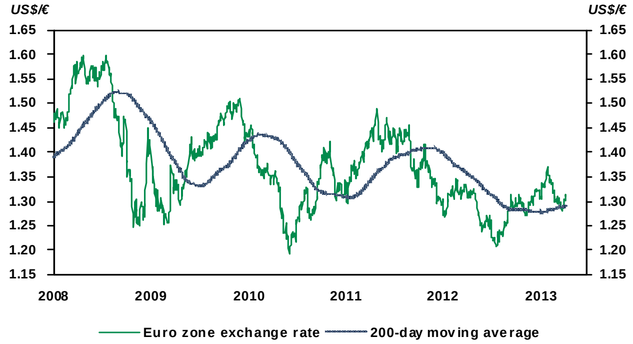
EURO (EUR)

Headwinds and tailwinds could keep the euro close to US$1.30

- The euro continued to retreat in the final weeks of March as Cyprus turned into another euro zone hot spot and economic statistics remained disappointing. After dropping below US$1.28, however, the euro regained a little altitude following the April 4 European Central Bank (ECB) meeting. The publication of disappointing economic numbers in the United States also helped to put the euro back above US$1.30.
- The recent crisis in Cyprus confirmed that no country is too small to jeopardize the euro zone's financial stability. The rejection of a first plan to recapitalize Cyprus' banks by taxing depositors, even those who were covered by deposit insurance, and the ECB's threat to cut Cypriot banks off raised fears that the country would abandon the common currency. A last-minute agreement was finally reached to recapitalize the banks while protecting small depositors. However, the costs for major depositors and Cyprus' economy will be huge. The idea of a broad banking union that would solidify Europe's financial system retreated by several steps, a situation that could put more pressure on fringe nations. Moreover, the recent events in Italy, where the political impasse persists, and Cyprus confirm that there is a growing gulf between Europe's leaders and their populations, a situation that does not augur well for the future.
- While the financial situation remains unstable and nothing indicates any end to the recession in the euro zone, there is reason to wonder why the euro is not even weaker. The ECB's prolonged status quo, when other central banks are pursuing increasingly extreme quantitative easing policies, is giving the euro substantial support. The ECB opened the door slightly to further action at April's meeting, but is not contemplating taking action as aggressive as that being pursued by the Federal Reserve or Bank of Japan.

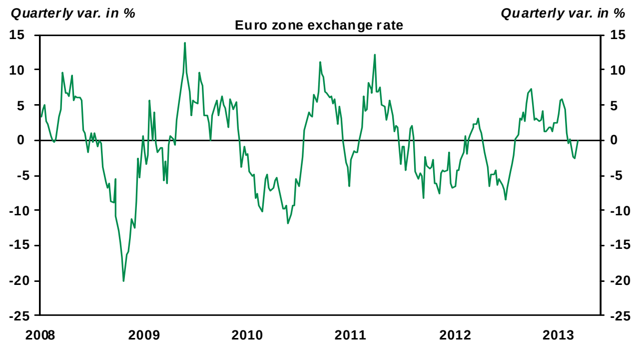
Forecasts: If there are no new political crises, the euro should continue to fluctuate around US$1.30 over the coming months. Economic difficulties will limit the currency's rise but the fact that the euro zone's monetary policy remains more traditional than that of the other major economies will give the euro some support. An improved economic outlook in the second half should enable the euro to start trending up again towards the end of 2013.

Euro and trend



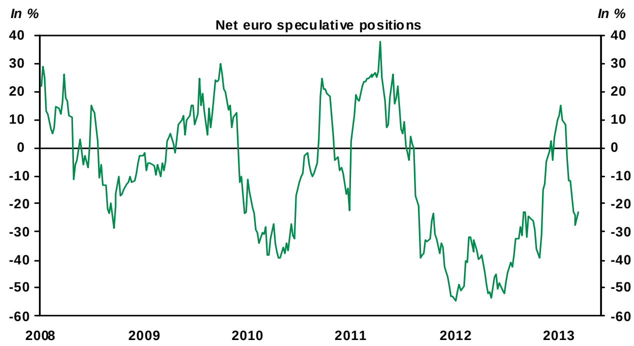
Sources: Datastream and Desjardins, Economic Studies

Euro: momentum



Sources: Datastream and Desjardins, Economic Studies

Euro: net speculative positions

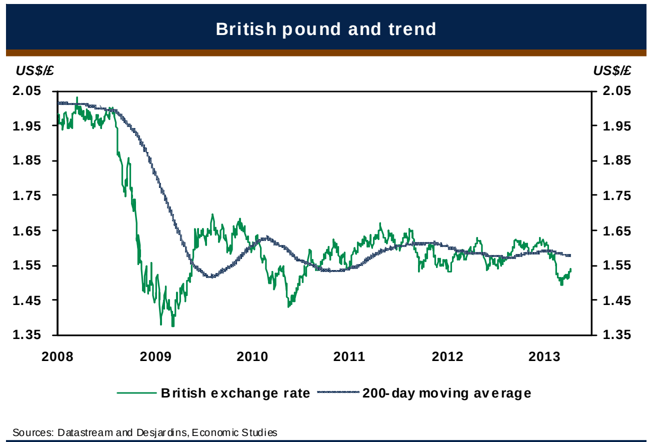


Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

BRITISH POUND (GBP)

Evolution not revolution at the Bank of England

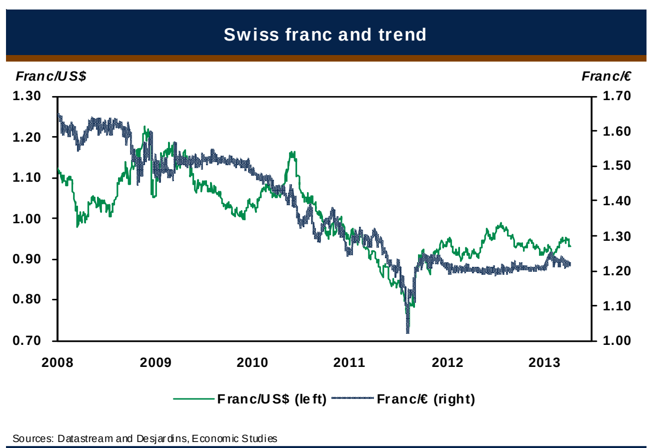
- After plunging to US$1.49 in mid-March, the pound sterling climbed over US$1.53 recently. The pound is also up slightly against the euro.
- The perception that the Bank of England (BoE) could take very aggressive measures to try to stimulate the economy, and even abandon its inflation target, had a big hand in the pound's plunge in the first few months of 2013. The British government, however, reaffirmed recently its absolute commitment to price stability over the medium range. The BoE will continue to aim for inflation at 2%, but its new mandate more explicitly acknowledges that the BoE has some flexibility in pursuing this goal. This change of mandate essentially acknowledges what the BoE has been doing for the last few years. It should not lead to any major change to British monetary policy, particularly as the latest economic statistics are a little more encouraging. **The pound could continue to rise in the next few months.**



SWISS FRANC (CHF)

Near to the floor again

- After weakening in March against the greenback, the Swiss franc edged up in early April. The USD/CHF pair returned to around 0.93 francs. The franc also rose against the euro, taking the EUR/CHF pair to around 1.21 francs several times, very close to the 1.20 franc floor set by the Swiss National Bank (SNB).
- Unsurprisingly, upside pressures on the Swiss franc resurfaced following the Cypriot crisis. Firstly, these events spotlighted the many deficiencies in the European monetary union, and the possibility of another financial crisis. The way foreign depositors were treated could also cause funds to flow out of the euro zone to other international banking centres, including Switzerland. However, the SNB can be expected to vigorously defend the 1.20 franc/€ floor with the latest economic figures confirming weak growth and inflation in that country. **The Swiss franc should thus not fluctuate much in the coming months.**

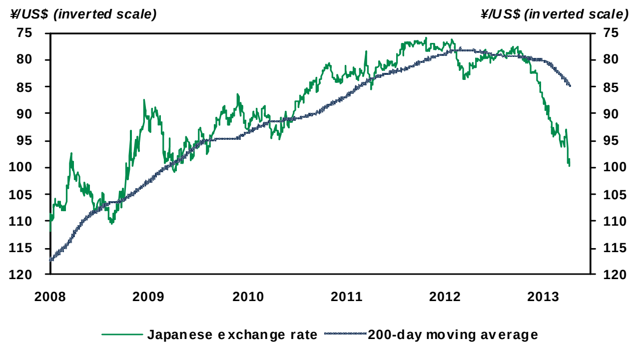


YEN (JPY)

Sceptics were confounded

- Japan's exchange rate is near ¥100/US$. It had dropped below ¥94/US$ prior to the April 4 monetary policy meeting, on the expectation that the Bank of Japan (BoJ) could disappoint. In the end, the sceptics were proven wrong. The BoJ will double the monetary base to ¥270,000B (US$2,725B) by the end of 2014 to try to get inflation back to the 2% target. The April 4 decision quickens the pace of the BoJ's securities purchases to around ¥5,800B (US$58.5B) per month for 2013 and 2014.
- Japan's monetary policy is more stimulating than the policies of the other major central banks. The difference will be even clearer in 2014, when the other central banks will have eased off the accelerator. The BoJ could also have to take further action if it takes inflation time to come up. **Japan's exchange rate should end the year above ¥100/US$ and, over the longer term, could return to the 110 to 120 band.** Note, however, that the yen has already depreciated by more than 10% in real terms from where it was in 2008 as Japanese inflation has been weaker than inflation in the United States.

Yen and trend



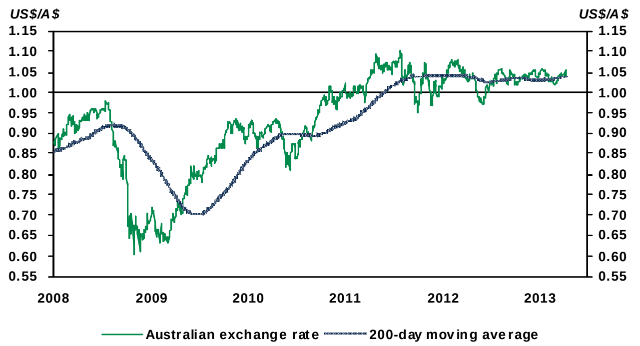
Sources: Datastream and Desjardins, Economic Studies

AUSTRALIAN DOLLAR (AUD)

Additional monetary easing is likely if the situation worsens

- The Australian dollar is oscillating between US$1.04 and US$1.05. It rose in March on strong Australian employment figures and the upswing by the Chinese purchasing manager indexes, which improves the outlook for Australian exports. The aussie remains highly sensitive to evolving global demand. Disappointing U.S. figures in early April and a lower than expected growth in China pushed the Australian dollar back to US$1.04.
- Even though the global economic situation is expected to gradually improve, the Australian dollar's potential for gains remains limited. Technically speaking, a resistance level has formed at US$1.06. More fundamentally, a number of commodity prices have lost steam, eroding Australia's terms of trade. Moreover, there is ongoing concern about the Australian economy's capacity to generate enough growth if investment in the natural resources sector hits a ceiling. Due to these concerns, the Reserve Bank of Australia is leaving the door open for additional interest rate cuts. **The aussie could retreat again in the near term but should end the year at around US$1.05.**

Australian dollar and trend



Sources: Datastream and Desjardins, Economic Studies

EMERGING CURRENCIES

Good performance by the Mexican peso

CHINESE YUAN (CNY)

- For the first time since revaluation began, China's exchange rate has dropped below 6.20 yuan/US$. Some statistics in China have been more encouraging in March, a situation that could have lessened the monetary authorities' resistance about letting the yuan rise.
- However, it would be astounding for the pace of revaluation to accelerate shortly. Competition between Asian nations is intensifying steadily as a number of regional currencies are trending down, such as the yen and South Korean won. **China's exchange rate will likely stabilize in the near term, until better statistics on U.S. and European demand help reassure Chinese exporters.**

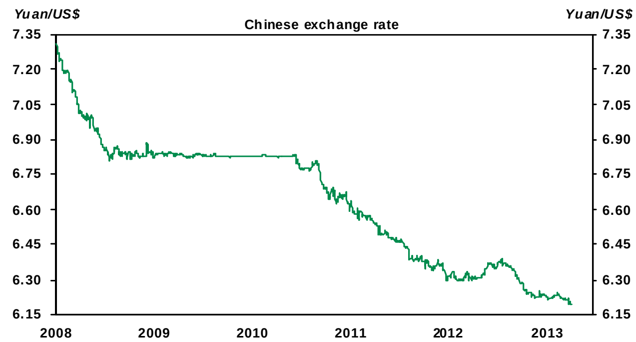
MEXICAN PESO (MXN)

- The Mexican peso has kept shooting up in the last few weeks. The USD/MXN pair recently dropped below 12.15 pesos for the first time since the summer of 2011. The peso is posting an impressive 4% gain against the greenback since the surprise 50 basis points cut to the Bank of Mexico's (BoM) key rate on March 8.
- Initially, it was primarily good U.S. economic figures that allowed the peso to rise, despite the BoM's action. The peso then capitalized on a credit outlook upgrade for Mexico's debt by Standard & Poor's, and domestic figures that are generally encouraging. Inflation's rebound to 4.25% in March is also limiting the risk of additional monetary easing. **A dip by the peso is however likely in the short term, as the international environment could be less favourable for risk assets.**

BRAZILIAN REAL (BRL)

- Brazil's real fell in March on the upswing in financial strains in Europe and a weaker outlook for capital flows to emerging nations. Brazil's exchange rate thus started April above the 2.00 real/US$ mark, but the situation quickly reversed.
- As with the other currencies, the real is feeling the effects of divergent monetary policy developments. The recent disappointments in the United States argue in favour of extending the Federal Reserve's quantitative policy, while high inflation in Brazil is driving up the chances of a key interest rate increase. In March, inflation was 6.6%, just above the target range. **The context favours the real, but it would still be surprising for monetary authorities to let it rise too much.**

Chinese yuan and trend



Sources: Datastream and Desjardins, Economic Studies

Mexican peso and trend

Sources: Datastream and Desjardins, Economic Studies

Brazilian real and trend

Sources: Datastream and Desjardins, Economic Studies

Table 1
Currency market

Country – Currency*	Spot price	Percentage return since				Last 52 weeks		
	April 15	1 month	3 months	6 months	1 year	Higher	Average	Lower
Americas								
Argentina – peso	5.1513	1.1785	4.0446	9.3393	17.2471	5.1513	4.7448	4.3915
Brazil – real	1.9783	0.1341	-2.9270	-2.9437	7.6159	2.1108	2.0173	1.8367
Canada – dollar	1.0213	0.2061	3.8225	4.1507	2.3861	1.0411	1.0021	0.9685
Canada – (CAD/USD)	0.9792	-0.2056	-3.6818	-3.9853	-2.3305	1.0325	0.9979	0.9605
Mexico – peso	12.1625	-2.2020	-3.9050	-5.2322	-7.5295	14.4463	13.0435	12.0644
Asia and South Pacific								
Australia – (AUD/USD)	1.0310	-0.9846	-2.3867	0.6237	-0.6289	1.0593	1.0317	0.9704
China – yuan renminbi	6.1867	-0.4321	-0.4337	-1.3356	-1.8537	6.3885	6.2835	6.1867
Hong Kong – dollar	7.7624	0.0174	0.1355	0.1458	0.0387	7.7696	7.7560	7.7500
India – rupee	54.5500	0.9624	-0.1007	2.9537	5.8196	57.1250	54.4896	51.3950
Japan – yen	96.7750	1.5744	8.9931	23.0530	19.5786	99.7850	83.6426	77.4900
New Zeland – (NZD/USD)	0.8408	1.6059	0.1682	2.7325	2.1187	0.8629	0.8148	0.7514
South Korea – won	1,121	0.9185	6.0719	0.9117	-1.2556	1,185	1,115	1,055
Europe								
Denmark – krona	5.7196	0.2796	1.9746	-0.7152	0.5715	6.1688	5.7911	5.4693
Euro zone – (EUR/USD)	1.3084	0.1377	-1.9779	1.1441	0.0076	1.3696	1.2873	1.2085
Norway – kroner	5.7515	-0.1493	3.2771	0.7233	-0.5911	6.1228	5.7795	5.4572
Russia – ruble	31.3657	2.4103	3.5770	0.9014	6.0397	33.7117	31.1960	29.3075
Sweden – krona	6.4253	0.4801	-1.1371	-3.5313	-5.4408	7.2694	6.6840	6.2899
Switzerland – swiss franc	0.9298	-0.9534	0.2264	-0.4550	1.1587	0.9938	0.9410	0.9029
United Kingdom – (GBP/USD)	1.5312	1.1929	-4.8384	-4.6102	-3.6103	1.6284	1.5779	1.4886

* In comparison w ith the U.S. dollar, unless otherw ise indicated.
Note: Currency table base on previous day closure.

Table 2
Currency market: history and forecasts

End of period		2012		2013				2014			
		Q3	Q4	Q1	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
American dollar											
Canadian dollar	(USD/CAD)	0.9838	0.9922	1.0175	1.0204	1.0101	1.0000	0.9901	0.9804	0.9709	0.9615
Euro	(EUR/USD)	1.2865	1.3184	1.2841	1.3000	1.3100	1.3300	1.3400	1.3500	1.3500	1.3600
British pound	(GBP/USD)	1.6148	1.6255	1.5185	1.5400	1.5600	1.5800	1.6000	1.6100	1.6200	1.6300
Swiss franc	(USD/CHF)	0.9351	0.9153	0.9495	0.9300	0.9400	0.9400	0.9500	0.9500	0.9600	0.9600
Yen	(USD/JPY)	77.92	86.75	94.22	100.00	102.00	105.00	108.00	110.00	111.00	112.00
Australian dollar	(AUD/USD)	1.0376	1.0398	1.0419	1.0400	1.0500	1.0500	1.0500	1.0400	1.0300	1.0300
Chinese yuan	(USD/CNY)	6.2845	6.2303	6.2108	6.2000	6.1500	6.1000	6.0500	6.0000	5.9500	5.9000
Mexican peso	(USD/MXN)	12.86	12.87	12.32	12.30	12.20	12.00	12.00	11.90	11.70	11.50
Brazilian real	(USD/BRL)	2.0303	2.0432	2.0135	1.9900	1.9800	1.9600	1.9400	1.9200	1.9100	1.9000
Effective dollar*	(1973 = 100)	72.71	73.44	76.23	76.50	76.20	75.80	75.70	75.70	75.60	75.30
Canadian dollar											
American dollar	(CAD/USD)	1.0165	1.0079	0.9828	0.9800	0.9900	1.0000	1.0100	1.0200	1.0300	1.0400
Euro	(EUR/CAD)	1.2657	1.3081	1.3065	1.3265	1.3232	1.3300	1.3267	1.3235	1.3107	1.3077
British pound	(GBP/CAD)	1.5886	1.6128	1.5449	1.5714	1.5758	1.5800	1.5842	1.5784	1.5728	1.5673
Swiss franc	(CAD/CHF)	0.9505	0.9225	0.9332	0.9114	0.9306	0.9400	0.9595	0.9690	0.9888	0.9984
Yen	(CAD/JPY)	79.20	87.43	92.60	98.00	100.98	105.00	109.08	112.20	114.33	116.48
Australian dollar	(AUD/CAD)	1.0208	1.0317	1.0601	1.0612	1.0606	1.0500	1.0396	1.0196	1.0000	0.9904
Chinese yuan	(CAD/CNY)	6.3880	6.2793	6.1043	6.0760	6.0885	6.1000	6.1105	6.1200	6.1285	6.1360
Mexican peso	(CAD/MXN)	13.07	12.97	12.10	12.05	12.08	12.00	12.12	12.14	12.05	11.96
Brazilian real	(CAD/BRL)	2.0637	2.0593	1.9790	1.9502	1.9602	1.9600	1.9594	1.9584	1.9673	1.9760

f: forecasts; * Trade-w eighted against major U.S. partners.
Sources: Datastream, Federal Reserve Board and Desjardins, Economic Studies