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Prepare For More Volatile Forex World

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Currency volatility has remained relatively muted given the extent of the global financial crisis. Our belief is that it is about to explode as currencies start to oscillate more and more wildly, like a suspension bridge starting to self-destruct under increasingly severe harmonic wave action.

Why is this? Like all extreme events, it is more likely a combination of many factors acting in concert rather than any one particular cause. A dominant factor, however, has to be current central bank policy.

Central banks have two control levers which they can use to influence events related – hopefully - to their country's financial flows. One is the level of interest rates and the other is the currency rate. All that central banks can hope for is to control one or the other of these "policy levers" whilst the other is left free to find its own level in response. So, one could expect that if a central bank fixed the currency rate, interest rates would fluctuate in response to market activity and vice versa. If the central bank fixed the interest rates, currencies would fluctuate in response to market activity.

Such banks have set interest rates artificially low and that this will continue for some time. It is now clear that the interest rate policy lever is the one these banks wish to hold steady. This has come about in response to the crisis, their own funding requirements and how expensive the interest burden on government debt has become and, lastly, to forestall a depression or significant deflation.

This is all well and good but the unintended consequence, which will be unavoidable, is currency volatility. Currency fluctuations are a natural concomitant of holding interest rates steady.

Notwithstanding that, each country is going to endure different pressures and will undertake different policy actions in response to their own situations. Australia and New Zealand, whose central banks have a single mandate to keep inflation under control, will opt to raise rates a lot sooner, as has already been seen. (Australia raised its key borrowing rate again this week to 3.75 per cent).

The corresponding rise in the currencies will lead to a feed-back loop which will lead to greater and greater volatility. The Europeans will face different challenges to Japan or China. The Chinese renminbi is effectively semi-fixed to the dollar, which in turn adds an additional set of stresses and strains into the system.

Other factors which could cause greater currency volatility are sovereign defaults, investment "crowding", increasing use of currency as a investment vehicle and regime changes in economic conditions.

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If and when countries come under increasing pressure to devalue due to debt repayment or deficit pressure, currency volatility should increase markedly as the currency in question appears on the radar screen of potential hedgers and speculators alike. Investors with projects or businesses in the said currency will look to put on hedges and speculators will look to take positions.

Talking of speculators, there seems to be an increasing trend towards currency speculation and use of currency as an investment, which makes senses in an era of low interest rates. Look at the Aussie or Kiwi dollar this year as an example; notwithstanding interest rates, a simple decision to move capital to these currencies would have resulted in significant returns for dollar-based investors. With low global interest rates, investors will increasingly move to use currencies as a form of asset allocation.

A prevalent view is that we are in the throes of a V-shaped recession and that the world economic “regime” is intact. If this not true and something fundamental has changed i.e. the US consumer is knocked out and won’t be recovering anytime soon, then the US economy will roll over into a W-shaped recession. Currency volatility will pick up as we enter into previously uncharted economic waters. The potential for “black swan” like currency movements would then be probable.

Ultimately, the world capital will vote with it’s currency “feet” and, given the recent mobility of capital, no Central Bank will be able to control the flows, alone or in unison, against the tsunami of world capital moving “ad idem”.

Given the factors outlined above, currency volatility seems unavoidable.