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MACRO MORNING BRIEFING

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Trade Risks Moving Up Policy Agenda

BoK, ECB now looking at cutting rates in response to tariffs

- Potential export income loss a bigger risk than pass-through
- Many exporter currencies have room to adjust lower
- Economies shouldn't miss the big picture in rebalancing away from exports

Tariff risk to bring in additional policy volatility

As we approach the home stretch of the year, central banks are fully aware that their decisions will set the tone for 2025, so core assumptions underpinning rate paths must be sufficiently anchored. While the general principle and guidance surrounding inflation, wages and labour markets remain in place, the possibility of radical changes in global trade patterns can no longer be ignored. President-elect Trump's comments last week surrounding immediate tariffs for China, Canada and Mexico are already an indication of the challenges to come.

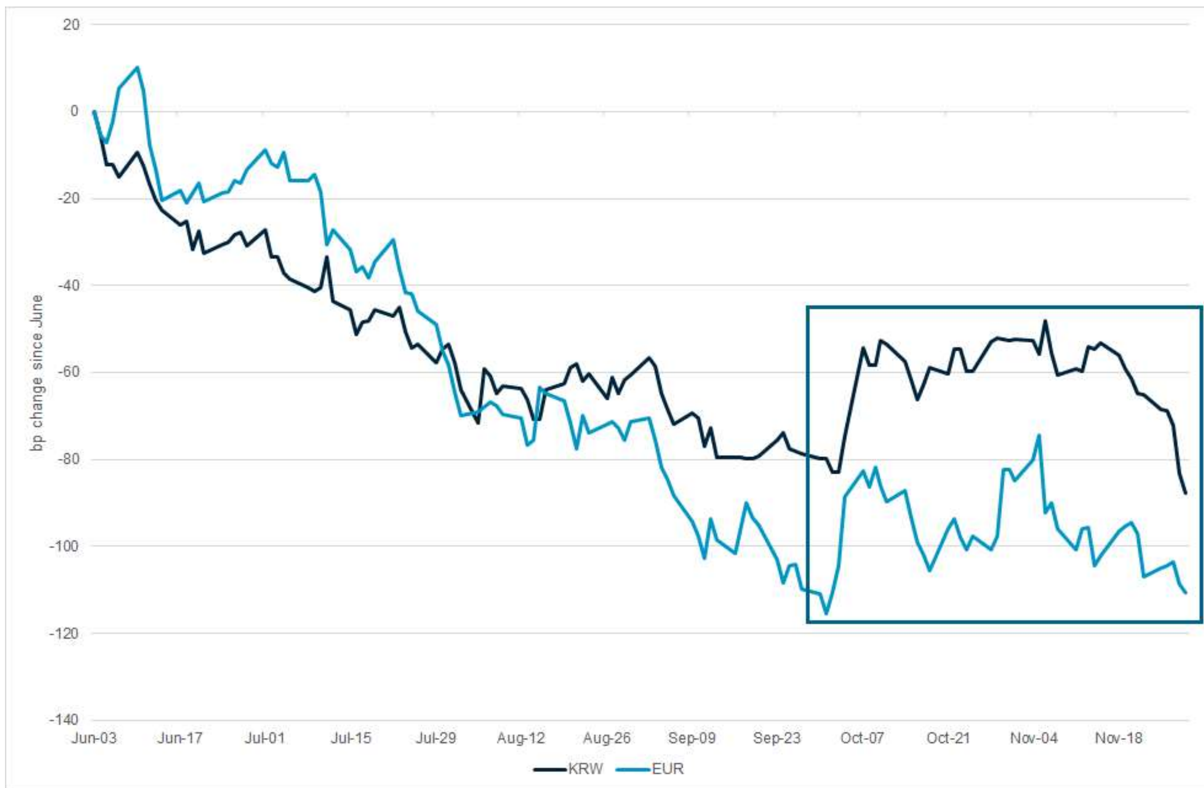
Since the US election, the biggest challenge for central banks has been to manage the dollar's strength and potential risk into pass-through inflation. Not only is such strength being realised due to rate differentials in the dollar's favour, but the risk of tariffs also requires an exchange rate offset as exporting nations attempt to maintain competitiveness. To limit additional weakness and pass-through risk, central banks across emerging markets, in particular, have started to become more cautious ahead of easing. We believe that changes in economic structures away from exports are also necessary, but this is beyond the purview of monetary policy and central banks.

However, last week we saw the Bank of Korea (BoK) apparently move against policy

convention and surprise the market by cutting interest rates, despite ongoing weakness in the KRW. BoK Governor Rhee cited the risk of tariffs as one of the reasons behind the move. He directly linked "downward economic risks" being larger than expected with "the Red Sweep in the US," which was amongst "the biggest changes" to the central bank's underlying forecasts. Meanwhile, on Friday ECB Governing Council member Stournaras also noted that "tariffs could warrant aggressive rate cuts." Clearly, there is now a shift in thinking going on across the central banks of exporting nations with large exposures to the US. While "aggressive" rate cuts would only add to currency weakness and pass-through pressures, these central banks may now see the loss of export earnings as an even bigger risk, as the demand drag would likely offset inflation and inflation expectations. For example, even Canada, whose trade with the US is the largest bilateral trade relationship in the world, has seen some declines in its inflation break-even rates since the initial comments were made by the US president-elect.

Given that exports to the US of economies such as the Eurozone and Korea are heavily dependent on high value-added manufacturing goods, we can understand why there is now renewed concern from South Korea and the Eurozone regarding the impact of tariffs on economic outcomes. With energy prices remaining subdued and supply issues gradually mitigated over the past two years, there is less of a risk of a weaker currency contributing to any inflation spiral. Both economies will continue to monitor labour-market related risks, but if it is determined that wage growth developments will be highly contingent on how the manufacturing sector performs and the income generated, then a shift in the balance of risks to inflation is warranted if exports fall sharply. Even in the Eurozone, business surveys now highlight that the weakness in manufacturing is finally spilling over into services, which hitherto had been the key driver behind wage-based inflation. Even if it is public spending supporting services growth, the prospect of a fall in taxation could also act as a restraint on services inflation, especially in the Eurozone. If the ECB begins to flag the prospect of more aggressive easing due to US trade policies – along the lines of Stournaras' comments – then there is certainly greater scope for repricing in ECB rate expectations. We can see the sharp adjustment already in KRW forwards rates (Exhibit #1) over the past week, and the EUR could face similar pressures. The adjustment could be even stronger given markets were pushed in the opposite direction earlier in the week by comments from fellow ECB voter Schnabel wo seemed to suggest that rates were moving lower too aggressively.

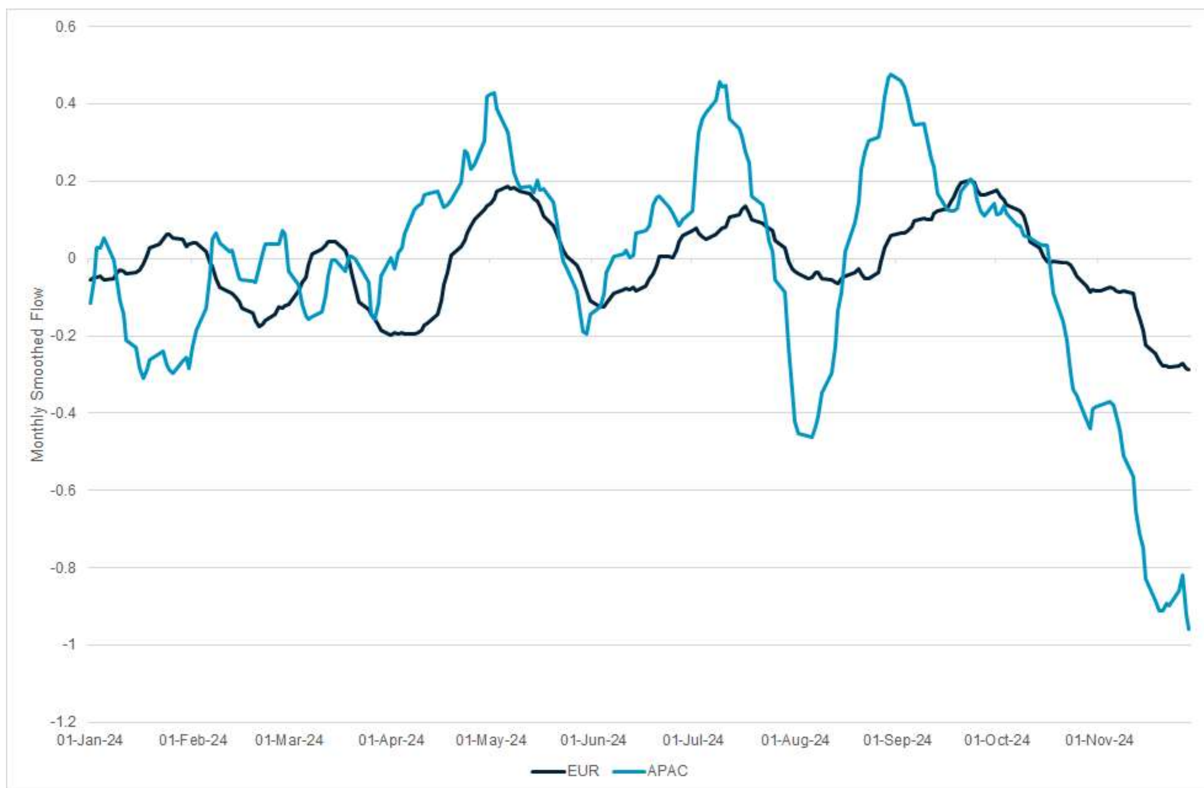
Exhibit #1: 1y1y Forward Swap, EUR and KRW



Source: Bloomberg, BNY

If all central banks now adopt the view that aggressive easing is needed to help offset a sharp decline in exports to the US due to tariffs, then the EUR clearly has more downside risk here, along with other G10 currencies which have similar export exposures such as the CHF and DKK. Although the dollar cycle has been dominant throughout the year and the dollar has had an exceptional November, iFlow data show us (Exhibit #2) that the strength of selling in APAC currencies far outweighs that of the euro. This is probably due to greater policy space in the region because of weaker inflation, but the likes of South Korea, China and Japan are seen as being far more receptive to offsetting trade risk through currency adjustments.

Exhibit #2: iFlow APAC FX vs. EUR



Source: Bloomberg, BNY

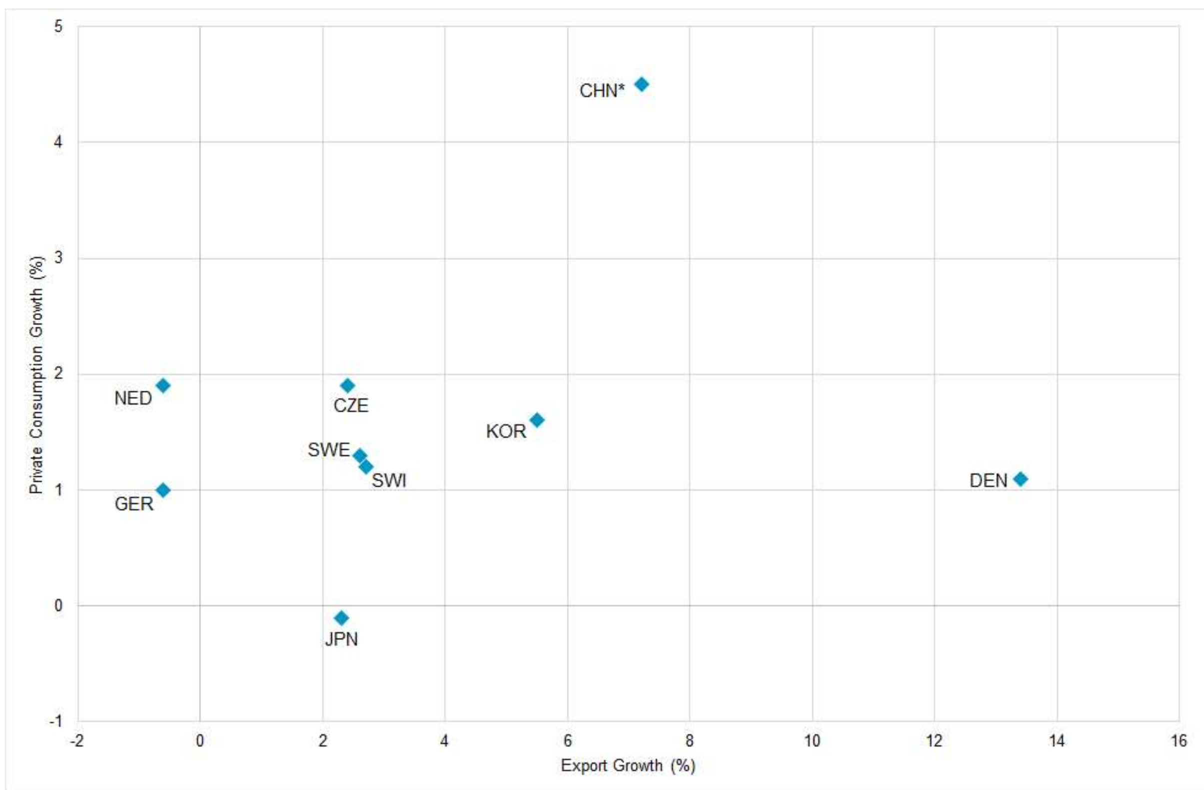
Another reason we believe these central banks feel able to move a bit more on rates, and by extension their currencies, is that in real terms valuations are still relatively robust. If we compared performance since the previous Trump administration, the only currency that has fallen materially since in real terms is the KRW. Even when inflation surged to 6% in 2022, it was certainly not the highest by developed market or OECD standards, even after the KRW had fallen over 30% between 2021 and Q4 2022. As such, it is understandable if the BoK doesn't see much pass-through risk and wants to focus on export income instead. For other "at-risk" currencies such as the EUR, CHF and TWD (Exhibit #3), further moves on the nominal to offset tariff risk would not push their currencies deeply into undervalued territory. In the case of Switzerland, for example, some pass-through would probably be a welcome development for the economy. The EUR, meanwhile, certainly has the greatest potential for downward adjustment and we expect more ECB members to start echoing Stournaras' comments on the policy reaction to tariffs.

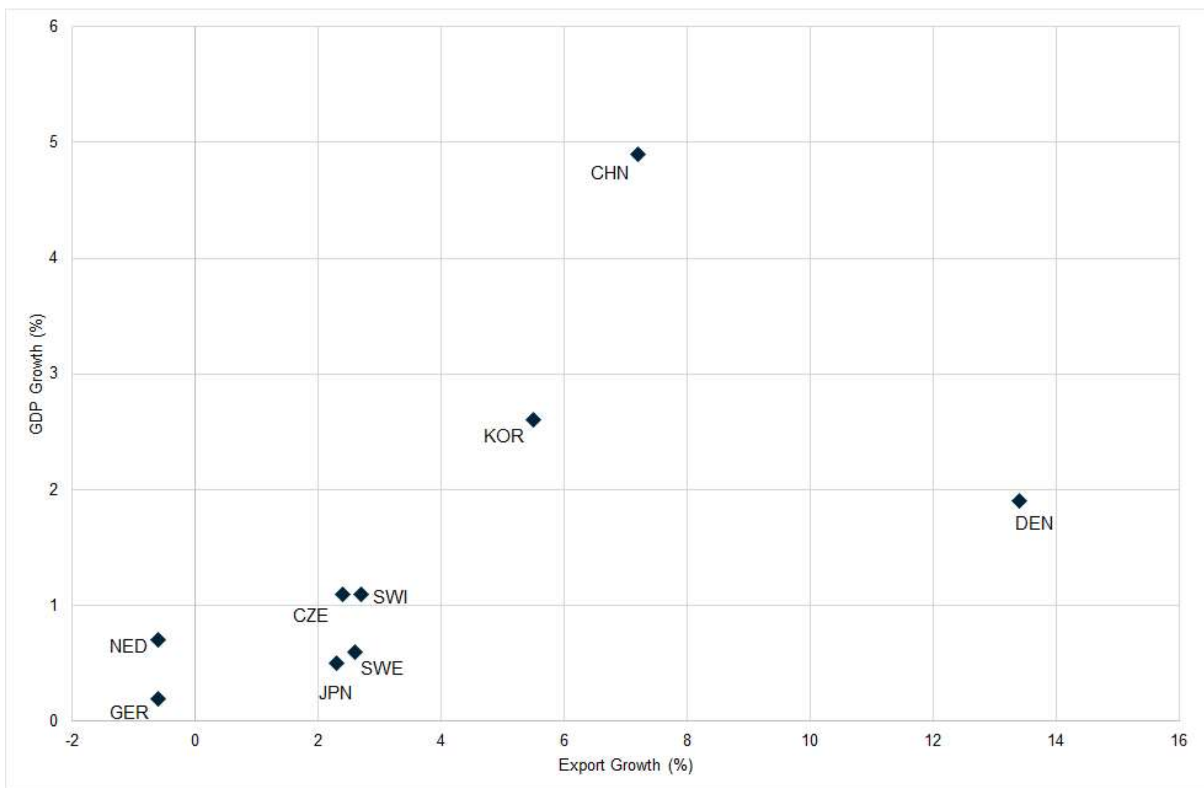
Exhibit #3: REER Evolution Since 2017

Source: Bloomberg, BNY

Over the medium-term, however, as highlighted above, there is still a need for structural transition in these economies away from exports and more towards domestic consumption, supported by fiscal resources, which are generally strong in these economies. Crucially, the link between export growth and private sector demand is dubious at best, and the impact on GDP is also mixed at present barring extreme and esoteric cases such as Denmark (Exhibit #4). As central bank commentary ahead of the December decision round picks up, we would expect to hear more about rate cuts as a tariff offset. While perhaps they can be executed without inflation risk in the near term, decision-makers in exporting nations should not lose sight of the bigger picture and continue to explore rebalancing growth.

Exhibit #4: Export Growth vs. Private Demand and GDP





Source: OECD, BNY

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