

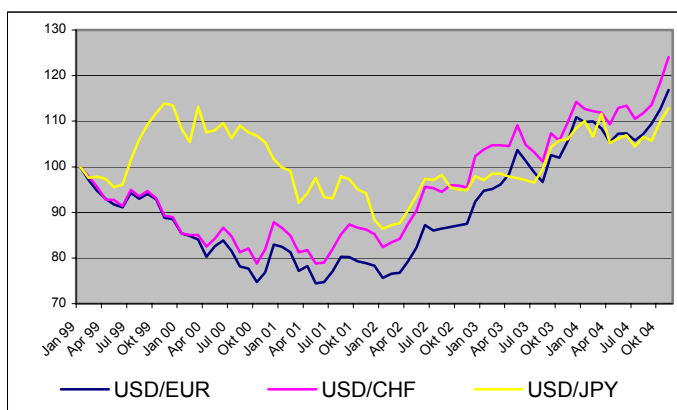
The Dollar on the slippery slope *Consequences for the financial markets*

- **The Dollar has suffered a massive devaluation in recent weeks. The main reasons are the ever larger budget and current account deficits in the USA. Various representatives of the American administration have repeatedly hinted that the USA can easily live with a weaker Dollar.**
- **A significantly weaker Dollar is not going to make a great deal of difference to the American current account deficit because about 40% of US foreign trade is with countries which have pegged their currencies in one way or another to the Dollar. In the medium- to long-term therefore, the upward pressure on the Chinese as well as other Asian currencies will increase. But in the final analysis, the Americans must have an interest in a controlled decline of the Dollar. An uncontrolled collapse of the Greenback would inevitably lead to China and Japan, which have been financing the US current account deficit practically on their own through the purchase of US government bonds, diversifying more strongly into the Euro.**
- **We believe that because of the structural imbalances and high volatilities, the Dollar will continue to tend towards weakness. In the medium- to long-term, the Asian countries will be unable to avoid a significant appreciation of their currencies. The continued strong Euro will ensure that the European Central Bank will have to keep to its low interest-rate policy until further notice. If the dams do not break as far as the Dollar is concerned, the moderately higher valuation of the European stock markets is likely to continue.**

A significant weakening of the Dollar

Since the re-election of US President Bush, the Dollar has - not quite unexpectedly - lost more value against most other currencies and, in the month of November alone, slid by about 5% against the Swiss Franc. Compared with its peak 4 years ago of more than CHF 1.80 to the Dollar, the US currency is now about 37% lower. Now that representatives of the American government have repeatedly hinted, with no signs of embarrassment, that a weak Dollar can only be favourable for the USA, the question arises as to how far the Greenback can still fall. The answer to that question is all the more pressing because the future development of the Dollar rate against the Swiss Franc and the Euro will have a sustained effect on the profitability of European companies as well as the interest rate policies of the major central banks.

1: Historical movement of the Dollar rate



Source: Bloomberg

"The jug goes to the well until it breaks"

The almost exclusive opinion is that the weakness of the Dollar is being caused by the current account and budget deficits in the USA which - because they are objectively associated - are called the "twin deficits". On the one hand, the budget deficits have grown significantly throughout the Bush era, after having recorded a budget surplus of \$200 billion in the year 2000. Experts believe that the forthcoming years will bring a further rise in the gap, resulting in a deficit of 500 to 600 billion in 2005.

On the other hand, the US current account deficit is showing a similar picture as it has, despite the weakness of the Dollar, in the meantime risen to \$640 billion a year or more than 5% of the gross national product. By definition, the current account deficit has to be financed by Dollar investments from foreign investors. Up until now, those who were "stuffing the gap" have been the Japanese and Chinese central banks which have been buying US government bonds in huge volumes. The Dollar currency reserves of the currency super-powers (Japan, China, Taiwan and Korea) have, in the meantime, reached about \$ 1,750 billion whilst those of the Euro countries are at a mere \$ 175 billion.

One might well argue that the American twin deficit hasn't just appeared in the last few days and the world economy has been able to deal with the phenomenon easily over the last two decades. But it is now the extent of the American deficits which is gradually causing the alarm bells to go off. Another factor is that to date, the US administration has shown no signs at all of concern about the massively higher budget deficit. The current weakness of the Dollar can therefore truly be explained with the proverb that the jug goes to the well until it breaks.

The growing structural imbalances have not remained unnoticed, especially by the major private and institutional investors in the Asian region. In the last few weeks there have been repeated rumours that the Asian central banks are going to further diversify their investments and currency reserves in the future and buy not only Dollars but increasingly Euros too in order to reduce their dependence on the USA. A similar situation exists for investors who are looking for investment opportunities out of the strongly increased Dollar flows from crude oil revenues (so-called "Petro-Dollars").

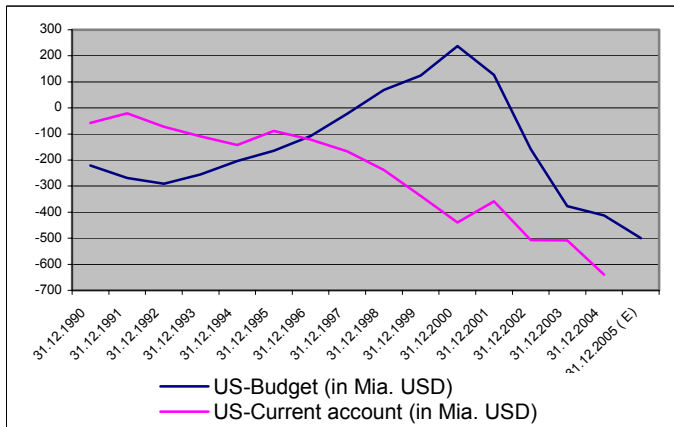
Pressure on European policies

The US administration sees things rather differently. The huge current account deficit has, according to them, its origins mainly in the weakness of growth in Europe. If that could be overcome, the demand for American products would increase and the direct consequence would be that the US current account deficit would diminish. The weakening of the Dollar against the Euro should therefore increase the pressure on Europe's politicians to do more for economic growth in Europe. At the forefront of their

thinking, the Americans want to see far-reaching structural reforms (more flexibility on the labour market, tax reforms, further progress in the creation of a common market, etc.). At the next level, however, they want to see more flexible interest rate policies which would provide the sluggish economy with more back-wind.

However, structural reforms do not work from one day to the next. As the example of Germany shows, they have to be reeled in step-by-step, with a great deal of effort and argument, in the daily political process. Most of the pressure to adapt will in the short term therefore lie on the European monetary and interest rate policies.

2: Development of the US twin deficits



Source: Bloomberg

Looked at from the American standpoint, the primary question is whether the irritating problem of the current account deficit can really be solved by a further, significant weakening of the Dollar. A glance back into history shows that the weakening of the Dollar resolved in the Plaza Accord of 1985, did achieve an effect. Whilst the deficit in 1985 was still at 3.5% of the GNP, it was practically balanced by 1990 and then disappeared for a long period of time. But whether a devaluation would still be an effective way to reduce the imbalance in foreign trade today has to be doubted. The American trade structures have undergone fundamental changes since the eighties. The main problem today is that numerous important trading partners of the USA, like China and other major Asian nations, have linked their exchange rates mostly to the Dollar. So in the meantime, the Federal Reserve is calculating with two different trade-weighted currency indices, on the one hand the tradable currencies (about 46% of US trade) and a further sub-index with currencies having a fixed rate regime (about 40% of US trade). Moreover, a large part of the trade flows takes place within multinational conglomerates, and they do not depend primarily on currency rates but on their long-term, strategic decisions and the selected, international production locations. The upward pressure on the Euro and the Yen is apparently insufficient to bring the US current account deficit back into line on its own.

One of the main reasons for the current account deficit lies in the high national deficits which encourage in particular the demand for foreign products. The savings of the Americans are far from sufficient to finance the high budget deficit and the domestic investments. About 80% of US investments must therefore be financed today from foreign sources.

Orderly decline reduces the risk of turbulences

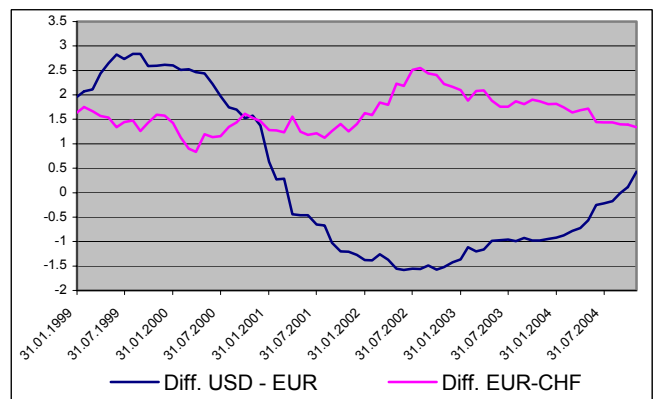
Since a weaker dollar cannot directly lead to a reduction of the current account deficit, the USA must be clearly interested in an "orderly decline" of its currency. The more difficult it becomes to

finance the US deficit from abroad, the stronger will be the pressure on the Dollar. A drastic collapse of the US currency would inevitably lead to heavy fluctuations in the international financial system and to hardly foreseeable, negative consequences for growth and inflation in all major economies. Since the Asian countries, above all China, are hardly prepared, for political and economic reasons, to accept a massive appreciation of their currencies, the pressure on the American Greenback will continue in the next few months. One must therefore reckon with a volatile Dollar rate because the fundamental imbalances also attract numerous "speculators" (e.g. Global Macro or Managed Futures Hedge Funds) who increase the rate fluctuations with major Dollar short positions.

The frail Dollar and the financial markets

It therefore seems clear that an appreciation of the Asian currencies is only a question of time. A phased and moderate appreciation of the Chinese currency will probably trigger an adaptation for other Asian currencies too because those economies compete directly with China. Furthermore, the trend, which has already begun, towards a stronger diversification of currency reserves of the major surplus countries is likely to lead to a continually strong Euro. The interest rate differential between the Dollar and the Euro will no doubt widen against this background because the ECB sees itself restricted in its leeway to raise the money market rates. Since the weaker Dollar also exerts a dampening effect on inflation, the interest rates in Europe should continue to stick at a low level.

3: Development of interest rate differentials (6-month LIBOR)



Source: Bloomberg

The most likely losers from the structural Dollar weakness are European producers who offer their products on the global market and whose costs are primarily in Euros. Their profit margins will tend to remain under pressure. Nevertheless, based on what is still a moderate valuation of the European stock markets, there is a certain degree of potential for an upward movement if the depreciation of the Dollar takes place in an orderly and timely manner. The currently low Euro interest rates speak in favour of stock market investments, a phenomenon that has prompted, not least of all American investors, to purchase shares in Europe in recent weeks.

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