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HD **GREENBACK POISED FOR SHARP RISE**

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The strong US economy will propel the currency THE US dollar is set for a massive rise that will parallel those that occurred in the late 90s and early 80s and will dwarf all other influences on the Australian currency.

Strong employment growth in October brought the US jobless rate down to 5.8 per cent, according to payroll data released on Friday night, and analysts are now predicting the US Federal Reserve will be worrying about lack of spare capacity in the economy by the first half of 2015.

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The strong contrast between the fortunes of the US and that of Europe and Japan, both of which are struggling to keep their economies out of recession, has already resulted in a 9 per cent rise in the US dollar on a trade-weighted basis since July.

The US currency is now up by 20 per cent since the low point in May 2011. However, in the 1990s the US dollar climbed 40 per cent while in the early 1980s the ascent from trough to peak reached 60 per cent. The divergence in economic outlook between the US and the rest of the world is greater now than it was then.

The Reserve Bank is fretting about the impact of Japan's quantitative easing program on the Australian dollar, which it suggests will result in large capital flows into Australia.

"Such flows could hold the Australian dollar at a higher level than real economic fundamentals would imply," the bank commented in its monetary policy statement, released on Friday.

Even if these flows do eventuate, which is far from certain, they will not stop the Australian dollar from falling further as the US dollar continues its rise against all-comers.

The Reserve Bank argues that the 5 per cent fall in the Australian dollar on a trade-weighted basis since July is not enough, given the 30 per cent fall in **iron ore** prices since then. Although the currency has risen by almost 9 per cent against the US dollar since the beginning of July, it has barely moved against the euro and has actually risen by about 2.5 per cent against the yen since then.

The expansion of Japan's quantitative easing program involves the injection of ¥80 trillion (almost $800 **billion**) over a year and is nearly as large as the US Federal Reserve's program at its peak, despite the US economy being nearly three times the size of Japan's. Japan also announced a big shift in the portfolio allocation of the government pension fund, which will also depress the yen.

However, the ANZ's head of global research, Richard Yetsenga, notes that on the day these announcements were made, the **gold** price fell. The market was not behaving as if a flood of liquidity out of Japan would inflate other assets. It was concluding that a weakened Japan meant a stronger US dollar and all non-US dollar assets fell.

Yetsenga says that in currency markets, the US dollar is the gorilla for which all others make way. Easing by central banks in Japan or Europe will only influence global markets at the margin. This partly reflects the US dollar's continuing role as the world's reserve currency. It is on one side of 87 per cent of all currency trades, according to the Bank for International Settlements foreign exchange survey. The US dollar is by far the biggest international exposure for virtually all non-US investors, with foreign holdings of US securities now approaching $US15 trillion. Yetsenga says the excess liquidity in world markets influenced by Japan's moves and, prospectively, those of Europe should keep bond markets well behaved and may support equities. But the US dollar's strength will be reflected in a continuing fall in the Australian dollar, which he says could easily drop below US80c. In the 1980s surge in the US dollar, the Australian currency dropped below US60c while in 2001 it reached an all-time low of US47.7c.

There are many differences this time around, among them the quantitative easing strategies of central banks in Japan and Europe and the rock-bottom rates worldwide. However, common to both periods were rising US rates and falling commodity prices.

A strong currency invariably hurts exporters and the US is no different. There were reports over the weekend of pressure for the US to introduce exchange rate management into the free trade agreement being negotiated with Japan, Australia and other members of what is to be called the Trans Pacific Partnership. US manufacturing is concerned about losing competitiveness against Japan.

However, domestic demand is such a dominant factor in the US economy that a strong currency does not have such a contractionary influence and has traditionally been associated with **firm** growth. The US's new-found **energy** self-sufficiency is an added source of strength this time around.

The rise in the US dollar will, however, cause pain in **China**, with the yuan still linked. Against the Australian dollar, the yuan has risen a bit further than the US dollar since mid-year.

So far, **China**'s exports have been holding up, but this could change as the US dollar's appreciation continues. The **Chinese** authorities could widen the allowable band of daily movement to allow the yuan to fall.

Although **China**'s economy is still growing much faster than most other economies in the region, it is slowing, and the state of its property market is the cause of increasing global concern. The Australian dollar has often been seen by global investors as a proxy for investing in **China**. With markets increasingly keen to sell **China** and buy the US dollar, the resilience of the Australian dollar's, which has troubled the Reserve Bank, is likely to give way.

RBS Asia-Pacific strategist Richard Gibbs doubts that the Japanese easing will bring a flood of funds into the Australian dollar. When the Bank of Japan first started its quantitative easing program in late 2013, there was a flow of funds back into Japan as Japanese investors repatriated foreign investments to buy Japanese **equity** and property. Gibbs says the big foreign trade then was selling the yen while buying Japanese equities, and the same trade is occurring now.

With Australia's terms of trade continuing to weaken, he says it is possible that US rates will rise to the same level as Australia's, as occurred in the 1990s.It is hard to see what can stop the rise of the US dollar, short of a sharp fall in US activity or a robust recovery in Europe and Japan along with a revitalisation of **China**'s economy.

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