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Dollar slides as short positions crumble

By Steve Johnson in London
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The currency market performed a passable impression of a rabbit caught in the headlights on Monday, seemingly paralysed by fear ahead of a barrage of set-piece events.

For weeks the market has been hanging on every word for hints as to whether China will come under renewed pressure to revalue the renminbi at the G7 meeting of central bankers and finance ministers on February 4-5.

The smart money is that G7 will change nothing. But regular comments, such as those by Herve Gaymard, the French finanace minister, that Europe has borne too much of the burden of dollar weakness and the issue should be addressed at the G7, have been enough to keep the issue bubbling.

Even outside the G7, event risk is rising. This weekend's Iraqi elections, President Bush's State of the Union address and the first Federal Reserve meeting of the year have all been cited as reasons not to trade.

Data released late on Friday suggested that traders had taken some of their chips off the table. Net short-dollar positions against six major currencies fell to $7.2bn as of January 18, from $10.9bn the week before, the smallest position since September 2004.

This was potentially dollar-bearish news, and indeed it contributed to a modest early sell-off. "This could signal a downturn in the dollar's fortunes as traders are now clear to initiate new short positions," said Chris Gothard, currencies strategist at Brown Brothers Harriman.

The dollar was also undermined by a report from Central Banking Publications, which showed that of 65 central banks surveyed, 39 increased exposure to the euro in their forex reserves between September and December, while 29 cut their exposure to dollars.

More importantly, a third of those who responded said they would raise the proportion of non-dollar currencies in 2005. The survey did not include Japan or China, the countries with the largest forex reserves.

The report caused barely a ripple in the market, however. "We think that the market has been aware of this diversification for some time," said Clyde Wardle, currency strategist at HSBC.

Monica Fan, head of FX strategy at RBC Capital Markets, argued the report could actually be positive for the dollar against the euro. With most of the surveyed banks

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expecting reserve growth to slow, “the pace of euro buying may slow and in turn the pace of the euro/dollar rally should moderate,” she said.

But with traders unwilling to increase their exposure at present, the dollar later firmed to sit virtually flat on the day at $1.3040 against the euro, $1.8778 against sterling, Y102.61 against the yen and C$1.2253 versus the Canadian dollar.

• Paul Lambert, global head of currencies at Deutsche Asset Management, believes that the initial consequence of a benign G7 meeting would be weakness among Asian currencies as revaluation fever recedes.

However he forecasts that worries over the twin deficits of the US, as well as the reserve diversification story, will then drive the dollar lower. His six-month targets are for the greenback to weaken to $1.35 against the euro and “below Y100” against the yen as Japanese data improves.

“The twin deficits will be the ultimate driver. There is no sign that the structural problems are getting any better,” he said.

• The Czech koruna rose 0.5 per cent to a 28-month high of Kc30.115 to the euro on corporate flows.

Tania Kotsos, senior emerging markets strategist at RBC, argued that a move below Kc29.50 would lead to “serious jawboning”, with the central bank raising the threat of interest rate cuts or direct intervention for the first time since July 2002. Physical intervention would be likely to occur beyond Kc29, she forecasts.

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