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DAILY COMMENTARY

US$ RISKS FOR 2005

After hitting successive new lows over the holiday period, the selling pressure on the US$ has quickly abated. Suddenly, it seems, talk of a US$ crisis seems misplaced. In trade weighted terms, the so-called 'US$ crisis' was in anycase something of a misnomer in 2004. The Federal Reserve's broad trade-weighted index fell by just 4.5% over the course of the year. Even against the major currencies, the US$ slipped by a comparatively modest 7.0%. Of course, these numbers disguise some very wide swings, and 2005 could well see more of the same. It is just possible that the US$ could continue to rally sharply during the first half of this year, as the Fed gears up for more rate hikes and US companies repatriate funds under the Homeland Investment Act. Indeed, the willingness of foreign central banks to support the US$ over the past two years or so has prompted some commentators to talk of a new 'Bretton Woods-II'. The succession of record monthly trade deficits will not matter so much, as it is not in the interest of central banks overseas to let their currencies appreciate. However, these comparisons with the Bretton Woods era are ultimately misleading. The very flaws in the fixed exchange rate system, which eventually led to the US$ being devalued in August 1971, are even more apparent today. So long as the trade numbers fail to show any visible improvement, the risk remains that foreign central banks will cut and run, precipitating a significant overshoot in the US$ later this year, down towards US$/Euro1.60 and Y/US$85.0.

Reserve Diversification

The sharp rally in the US$ during the first two trading days of this New Year has been reminiscent of the sudden reversal witnessed in currency markets last February. In the end, the trade numbers just carried on widening, and the poor external backdrop ultimately took its toll. After hitting a high on May 11th, the US$ started to drift down again, and by the end of the year, it seemed as if the US currency might be going into freefall. Given the sheer scale of the deterioration in the US external finances, it is perhaps surprising that the US$ did not fall further. Compared to the mid-1980s, today's US depreciation is proving to be a far more drawn-out and protracted affair. In broad trade-weighted terms, the US$ has fallen 15.9% from its peak on January 27th 2002, nearly three years prior. By contrast, during the first two years of the reversal that began in March 1985, the US$ fell 31.4%.

None of this is very surprising, given the Herculean effort made by central banks across the world - particularly in Asia - to buttress the US currency. But this apparatus of support, which has led some to compare today's currency regime with the Bretton Woods era, will eventually crumble. And when it does, the US$ could well fall even further than in the mid-1980s. The risks were highlighted by the first deputy chairman of the Bank of Russia, Alexey Ulyukayev, who recently admitted that the bank had sharply reduced its reserve holdings in US$s. Indeed, the proportion of reserves being held in euros had now risen to "between 25-30% from 10% two years ago". The Russian central bank's reserves are not insignificant either, after they hit a record US$117.4bn at the end of November. Reserve diversification has also been taking place in Beijing, where the Bank of China is reported to have purchased just US$17.4bn of US Treasuries during the first ten months of this year. By contrast, total foreign exchange reserves had climbed by US$111.3bn over the corresponding period.

This should not come as a great surprise in light of how events mapped out during the late-1960s, prior to the collapse of the original Bretton Woods regime. The system came under pressure because there was no incentive for countries to keep their reserve holdings in US$s. The temptation for individual nations to cut and run was too great. Of course, reserve diversification - into gold on this occasion - ultimately triggered the very US$ devaluation central banks were seeking to insure against. But quasi-fixed exchange rates, particularly ones based around

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a reserve currency, will always tend to break down, in the same way that cartels ultimately prove difficult to marshal. The US$ peg was preserved throughout the 1960s due to a series of ad hoc measures, such as the Gold Pool established in 1961. But the "Gentlemen's Agreement" among European central banks reached in May 1968 not to convert their US$ reserves eventually unravelled in the early months of 1970, when first Belgium, then the Netherlands, Germany and France signalled a determination to switch US$s into gold. Ironically, the US had been running current account surpluses for most of the 1960s. But the US was a heavy net investor abroad. US-based companies were expanding aggressively overseas, and these capital outflows offset the current account surplus. By 1969, a sharp rise in military expenditure during the Vietnam War had eroded the current account, and pushed the overall basic balance heavily into deficit. In August 1971, President Nixon was forced to announce a *de facto* devaluation, and that the US$ would be allowed to float, which it did - downwards.

This episode is interesting because many politicians and economists argued at the time that the peg would not break, since it was not in the interest of countries to sell assets held in the reserve currency. A similar claim has been made today with respect to China and Japan. On the contrary, it is precisely because these central banks have presided over such a mammoth increase in their foreign exchange reserves, that they now have a much higher exposure to currency risk and, therefore, a correspondingly greater incentive to start diversifying.

Furthermore, there are a number of reasons why the managed exchange rates of today are *more* likely to breakdown. In the late-1960s, price pressures were clearly building, and the US administration was keen to maintain the peg, to avoid a further acceleration in core inflation. Today, the US authorities seem more than happy to let the US$ slide, secure in the knowledge that in a world of overinvestment, inflation pressures may not accelerate too far. As we warned in yesterday's commentary, the heavy reliance on personal sector borrowing and the pressure on short-term rates suggests that a falling US$ may not be quite the free lunch envisaged by officials. Even so, the mere observation that the US administration is happy to experiment with a policy of benign neglect will hardly foster cohesion among the 'peggers'.

The second key point is the lack of institutional cohesion among the countries that have been intervening heavily in the past two years or so. While the Bretton Woods system eventually crumbled, many of the peggers on that occasion were bound together by much closer ties than in Asia today, for example. In mitigation, the Chinese authorities have been working hard to cement trading ties with fellow ASEAN countries. The first building blocks towards a free trading zone within SE Asia have been put in place. Nevertheless, Europe was much more tightly bound in the 1960s, through the Common Market. Finance ministers and central bankers worked closely to underpin the peg. A multilateral surveillance system was devised to try and detect 'cheating'. By contrast, the Asian community is much more fragmented. The animosity between Beijing and Tokyo over a range of issues - which at times, the Chinese government has been only to happy to foster - is typical of the mistrust that ultimately will help tempt countries to cut and run. In addition, the very fact that China has a more redoubtable currency peg and tight capital controls increases the risks that Beijing will diversify. So long as the capital controls remain in place, it is quite feasible to argue that reserve diversification will help depress the Renminbi on a 'trade-weighted' basis. In this regard, it is small wonder the Chinese authorities have been somewhat tardy in meeting their WTO obligations, to lift a range of capital controls. In this sense, the speed of the deterioration in the trade deficit between the US and China over the coming months could prove pivotal. A steady rise in this politically sensitive bi-lateral imbalance could precipitate more calls for a Renminbi revaluation, which of course, the Chinese authorities will resist. That in turn will put more pressure on the ‘floaters’, and the temptation for central banks - not just in Beijing - to sell US$ reserves will intensify. Ultimately, the New Year US$ rally will give way to renewed selling.