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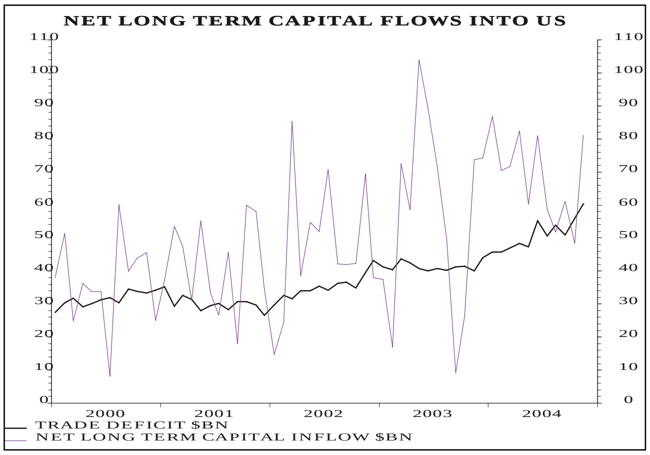
GFC ECONOMICS

DAILY COMMENTARY

THE DOLLAR'S PROBLEMS TO CONTINUE

This week's capital flow data from the US Treasury has eased worries of a US$ crisis fuelled by last week's record trade numbers. Net long term capital inflows to the US picked up strongly in November to $81.0bn from $48.3bn, comfortably exceeding the $60.3bn goods and services deficit. While these numbers are superficially encouraging, they do not change the basic picture. The support garnered by the US$ in recent weeks from the pick up in the US economy and expectations of Fed tightening looks suspect. Long term inflows to the US are virtually all into bonds, and higher interest rates are very much a mixed blessing because of the resulting increase in the debt service burden. In addition, central bank intervention is no longer the support it once was. Not only is there pressure from the West on the Asian central banks to curtail their intervention, but central banks have also started to diversify their reserves away from the US$. With the trade deficit set to hit new highs over coming months, recent gains in the US$ look certain to be no more than a short-term reprieve.



Capital Inflows Recover

After the October data, which showed net long term capital flows into the US dropping to their lowest pace in a year, the latest numbers have restored confidence in the US$. Net foreign purchases of US long-term securities totalled $99.7bn, their highest level since May 2003. However, central banks accounted for $27.9bn of these inflows and, while some reassurance can undoubtedly be drawn from these numbers, two key points should not be forgotten. Firstly, long-term capital flows are only part of the story. Short-term flows swamp long-term flows and, despite this surge in support from portfolio capital, the US$ fell 3.6% in tradeweighted terms during November. Secondly, 'long-term' refers to the maturity of the instrument, not the duration of the holding. Large portfolio flows into the US yesterday are no guarantee of large flows tomorrow. Indeed, the composition of these long-term inflows highlights their potentially fickle nature as a prop for the US$.

Since 2000, foreign purchases of US equities have been swamped by inflows to US bonds. Private foreign purchases of US bonds totalled a massive $639.2bn in the year to November, compared with only $32.0bn of inflows to US stocks. And on top of this, there were official purchases of US bonds of $238.9bn. The fact that bonds accounted for 96.4% of US portfolio inflows over the last year highlights the limited support to the US$ likely to come from the superior growth performance. To be sure, the American economy has looked more attractive in the last few months, as US growth has surprised on the upside while the UK, European and Japanese economies are showing signs of slowing. It also cannot be denied that the focus of the foreign exchange markets does regularly swing from one obsession to another. And over the last month or two, growth differentials are back in favour and may be one reason for the better performance of the US currency. However, an alternative and equally plausible explanation is simply that this recovery is no more than a temporary correction to the US$'s sharp decline in October and November and - in very thin markets - during late December.

Even if the superior growth performance of the US does continue, its boost to the US$ is liable to come only from increased short-term inflows. And these may not last for long. The US trade deficit looks set to hit yet new highs and the attention of the markets is all too likely to swing back again from growth to trade. The apparent health of the US economy may do little to fuel

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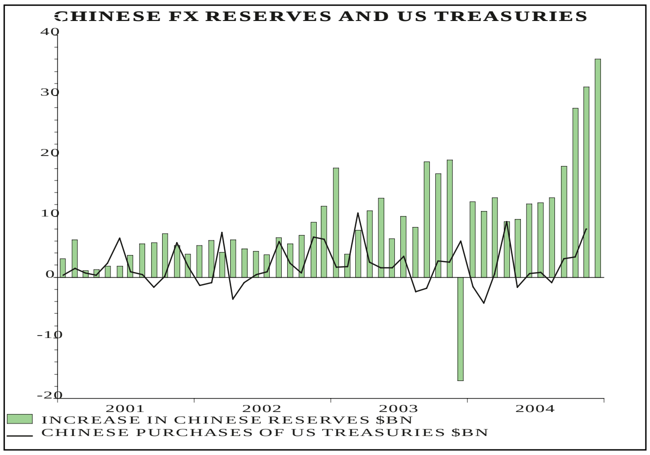
long-term inflows. The most obvious beneficiary would be equities, rather than bonds, and foreign buying of US stocks did recover sharply in November to $14.5bn, its highest level since May 2001. However, relatively high valuations, along with rising interest rates and slowing profit growth, leave Wall Street looking vulnerable and should curtail foreigners' enthusiasm for US equities. Certainly, the stock market has got off to a poor start this year. Of course, any rise in foreign purchases could be compounded by reduced buying of foreign stock by American investors re-enamoured with the attractions of their own country. The only problem here is that US buying of foreign equities also picked up in November to $16.1bn - the largest outflow seen since July 2000. Net direct investment inflows are the other area to gain from a stronger US economy and they did increase in Q3 to $37.3bn (ex-reinvested earnings). This was a three year high and, if sustained, will help support the US$. Even so, these flows remain swamped by bond purchases, for which the support from higher US growth is much less clear-cut.

Expectations of Fed tightening are assisting the US$, as it is fuelling the reversal of carry trades, which have undoubtedly helped undermine the currency over the last year or two. However, it is also spurring a sharp rise in short and medium dated bond yields and this is a mixed blessing. While the rise in yields makes US bonds that much more attractive for yield hungry investors, it will also raise the financing costs of the US current account deficit significantly. As of June 2003, the US Treasury estimated 58.6% of foreign holdings of US debt securities were of less than 5 years maturity (see commentary of December 1st). Since then, heavy central bank buying, which will have been largely at the short end, can only have increased this proportion further. Debt service costs are already rising. Income payments on foreign assets in the US (ex-direct investment), which had been falling in the three years to mid 2003, have increased steadily since then. In Q3, they amounted to $57.8bn, up $3.5bn on the quarter and $11.9bn on the year. Much of this gain has been offset by increased receipts on US-owned assets abroad, which rose $8.3bn from a year earlier. A good part of the latter, however, will be just down to the decline in the US$, which fell around 10% over this period. Of course, rising rates will not be the only factor pushing up the US debt service burden. It will also be boosted by the rise in US debt associated with the financing of the deficit. This could raise annual debt servicing costs by a further $20bn or so.



Last but not least, politics will continue to play a major role in dictating the fortunes of the US$. Central bank purchases of Treasuries are no longer the source of support for the currency that they once were. Between September and mid-January, official buying of Treasuries (according to the weekly Treasury data) totalled only $32.0bn and may well remain relatively small scale (assuming the BoJ plays ball with the other G7 countries). Certainly, some Asian central banks are kowtowing to the increasingly strident demands of the West. That said, China continues to amass foreign exchange reserves at an ever faster pace - their reserves rose $36.1bn in December alone. US Treasury data, however, shows Chinese purchases of Treasury notes and bonds amounting to only $11.3bn in October and November, despite their reserves rising $59.4bn. Part of this discrepancy may be down to the fact that the reserves have gone into T-bills and dollar cash, rather than Treasury securities. But it may also reflect a diversification of their reserves out of dollars into other currencies. This portfolio shift, not only by China but also by the likes of Russia and maybe others too, is just one more problem besetting the US$, and is a further reason to believe the recent stabilisation of the dollar is likely to prove shortlived.