

## Dollar Set for Further Declines

The trend has moved more decisively against the US dollar. The risk of further declines has intensified. This remains a weak dollar story, rather than one of renewed confidence in the euro. Currencies tend to overshoot and a move to well beyond \$1.20 is now possible. With the sterling/dollar rate topping out around the \$1.61/1.62 level, further weakness in the dollar will drag sterling lower against the euro.

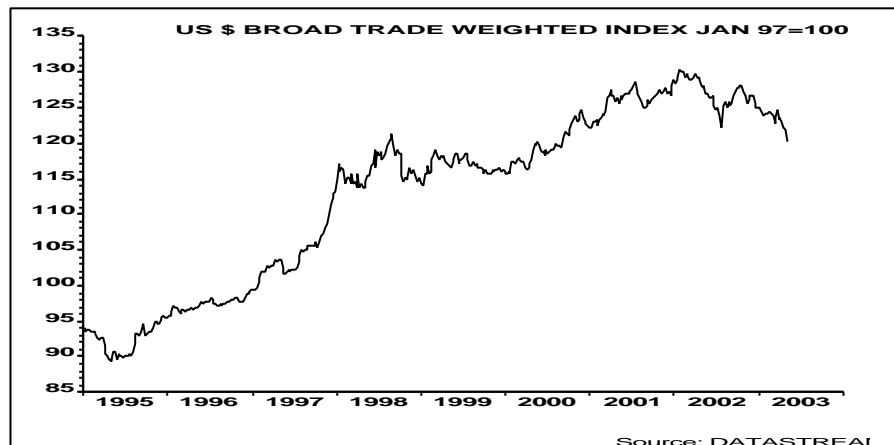


The dollar has come under significant downward pressure of late, not just against the euro, but against a host of currencies including the yen, the Swiss franc, AUD, CAD, and NZD. We believe that the euro's rally has further to run, possibly to \$1.20 and well beyond by mid year. At current levels, indicators do not point to an over sold dollar situation. The Fed's move to a weakening interest rate bias compared to the ECB's unchanged stance at last Thursday's policy meeting has only added to the euro's upward momentum. A number of other factors point to further dollar weakness over the coming weeks.

- The US economy continues to grow at a below trend rate and despite a bounce in consumer confidence we have yet to see a meaningful post-war improvement in economic data.
- Thus, although we envisage steady rates over the year, there is a risk that the Fed will cut interest rates again, possibly at its June meeting. Any weak US data released in the run up to that meeting would therefore be seen as increasing the chances of a rate cut and will weigh on the dollar.
- With the exception of Japan, interest rates in the US are the lowest in the major economies. This puts the dollar at a distinctive yield disadvantage. This situation will remain unchanged for some time.
- The US current account deficit is approaching 6% at a time when capital flows into the US are slowing. Foreign capital flows into the US took a big hit in February relative to the strong trend seen over the last several months, revealing net inflows of just \$22 bln. Compare that to the US current account deficit running at around \$40 bln a month. February marked the lowest net inflow since January of 2002. Thus, the US external account deficit looks set to continue to weigh on the USD.
- The dollar has decoupled from the US equity market, which has put in a reasonably good performance since the Iraqi war.

- Comments from ECB head Wim Duisenberg indicating little concern with the euro's appreciation will be interpreted as a green light to buy euros.
- Meanwhile, the US appears to be pursuing a policy of benign neglect with regard to the dollar. "Our position on the dollar, going back many years, is to support a strong dollar but to **recognise that the dollar's value is best set in an open, competitive currency market,**" U.S. Treasury Secretary John Snow, 6 May 2003.
- While the dollar has depreciated by some 22% against the euro over the last year, on a broad trade weighted basis it is only 5% lower. It is still about 28% up on its low of 1995. With little sign of a strengthening in demand conditions outside the US, a further decline in the dollar is seen as necessary to rebalance the external position.
- The deterioration in the US fiscal position as a result of tax concessions and increased security spending is also a negative for the dollar.

The euro, however, is only gaining by default with economic conditions in the eurozone no better than those in the US. If the US economy picks up momentum over the second half of the year and the eurozone economy continues to grow at a very weak pace, there could be scope for a recovery in the dollar. However, given the current weight of sentiment against the US currency, we have revised our year end forecast up from a \$1.00-1.05 range to \$1.08-1.12 range.



	End May 03	End June 03	End Sept 03	End Dec 03
USD/EUR	1.18	1.22	1.15	1.10
GBP/EUR	0.72	0.73	0.71	0.69

*Forecasts (mid-point of +/-2.5% trading range)*

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