AIB Group Treasury
Economic Services Unit

Dollar Wobbles as Greenspan Becomes More Cautious

Last week was a difficult one for the dollar with a whole host of factors contributing to the breach of a number of key trend lines against both the euro and sterling. The reasons for the dollar sell-off were:

- Repeated calls from industry leaders that the overvalued dollar was hampering an economic recovery. President Bush's remarks about the impact of a strong currency on the export performance prompted speculation of a change in the administration's "strong dollar policy"
- *"There are signs that the bottom is beginning to structure itself……The period of sub-par performance however, is not yet over and we are not free of the risk that economic weakness will be greater than currently anticipate and require further policy response".* Alan Greenspan's cautious assessment of the economy at his bi-annual Humprehy-Hawkins address prompted fears that the much anticipated US recovery is further away, and will be less robust, than expected.
- A rapid acceleration in emerging market volatility, particularly in Latin American, an important market for the US economy.
- Concerns over US corporate earnings announcements. Granted a number of profit announcements came in ahead of expectation, but these expectations had been revised down significantly over recent months. A number of companies failed to match even lowered expectations. Furthermore, several companies have warned that they expect trading conditions to remain difficult in the second half of the year.

The combination of all of these factors does indicate that the dollar's bull run has come to an end. The more pessimistic outlook for the US suggests that $0.84 represents the bottom for the euro However, we do not expect to see significant gains in the euro.

- Monetary policy has not worked in the usual way during the current economic cycle. Some of the channels through which monetary policy normally works have become obstructed, in the US anyway. The dollar has not fallen in response to lower interest rates and long-term rates have remained stubbonarly high. However, we do not expect this to trigger a major turn in policy and do not believe that the US administration is even considering a weak dollar. "Talking a currency down" can be a dangerous game. You never know where it is finish and the US needs a reasonably strong currency to help protect against inflationary pressures. With both fiscal and monetary policy supportive of an upturn in coming months, it is likely that the US will wait and see whether these policy easings are effective before making any change to its view on the currency.
- Secondly, given that the eurozone economic cycle tends to follow that of the US, a prolonged downturn in there US means a similar outlook for European economies. This will be negative for the euro, particularly at a time when the ECB is focusing on its inflation target and refusing to cut interest rates.
- Thirdly, the 2.75% cumulative interest rate cut implemented by the Fed since the beginning of the year means that, bar Switzerland and Japan, the US now as the lowest interest rates of the major economies. However, in this cycle, where markets are concentrating on long-term growth potential, this has helped not hindered the dollar.
- Fourthly, eurozone banks are even more exposed to emerging markets than their US counterparts. Data from the Bank of International Settlements (BIS) show that the eurozone is 2.5 times as exposed to Latin American markets. What this exposure shows is that if there is a further reduction in tolerance to emerging market risk, then the dollar could actually benefit against the euro as a result.
- And finally, we have seen false dawns for the euro before. An ability to hold key support at $0.8605/40 will be crucial for it to continue to probe the upside.

Geraldine Concagh
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