

The outlook for the dollar: risks and opportunities

15th December 2006

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Chart 1: The dollar has weakened sharply in recent years

Source: Thomson Datastream

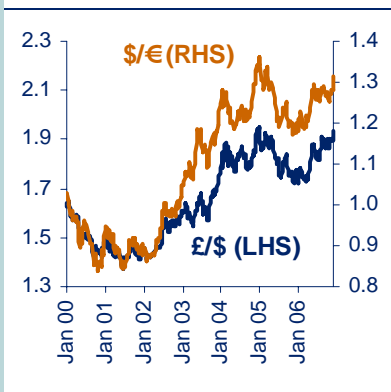
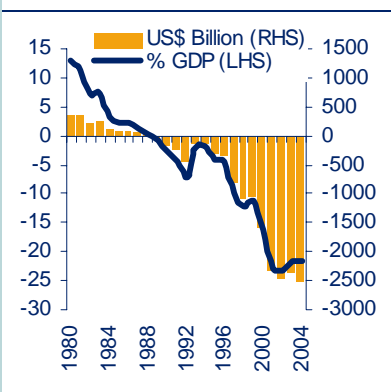


Chart 2: Net investment position - US moves from creditor to debtor

Source: IMF



- The dollar has been on a wild ride, sliding by almost 4.5% against the euro, 3.5% against sterling, and 3% against the yen between the end of October and the end of November. This shouldn't come as too much of a shock - dollar weakness has been a recurrent theme since 2000 (chart 1). Indeed, between September 2000 and November 2006 the dollar has slumped by around 35% against the euro, 30% against the Canadian dollar and 27% against sterling.
- The large US trade deficit leaves the dollar exposed to further declines against the major currencies in the near term. But eventually the greenback will probably be allowed to fall further against the managed currencies (especially in Asia). This will lift some of the burden of adjustment off the key floating currencies, allowing the dollar to make up ground against sterling, the euro and the Canadian dollar.

In this paper we use a simple framework to establish the level the dollar is likely to gravitate towards against sterling over a long term horizon.

Wild ride set to continue?

Exchange rate movements are extremely hard to predict, and it is not difficult to make a case for a stronger dollar in the near term. Interest rates in the US are likely to stay higher than most investors currently expect - futures markets point to three interest rate cuts by the end of 2007, we don't expect any. In addition, investors may increase their appetite for dollar assets in the months ahead if the US housing market achieves a soft landing and growth outside of the construction and auto sectors remains robust, as we expect. Nevertheless, the evidence suggests that from a structural standpoint, there is a significant risk of further sharp dollar declines in the years ahead.

At present the global economy is characterised by unprecedented imbalances. The action is centred on the US, which is running a current account deficit of over 6% of GDP. This requires net borrowing of almost \$3 billion every working day from the rest of the world to finance (around \$7,000 a year for every US household). This situation is not sustainable over the long-term. The US has already moved from being a global net creditor (i.e. owning more assets overseas than foreign investors own in the US) to a global net debtor to the tune of over 25% of GDP over the past fifteen years. On current trends the ratio could surpass 100% of US GDP within ten years (chart 2).

The dollar is unable to adjust where it needs to, so adjusts where it can.....

Eventually, for diversification reasons alone, global investors should become reluctant to devote an ever larger share of their investment portfolio to US dollars, prompting a decline in the greenback. A weaker dollar will likely play a central part in putting the US external accounts back onto a sustainable trajectory - by making US exports cheaper in international markets while making imports into the US market more expensive. The fact that the US is a relatively closed economy – total trade (exports plus imports) is equivalent to just 27% of US GDP compared to 39% in the Eurozone, 72% in Canada and 56% in the UK. This means that a quick resolution of the imbalance would be very difficult to achieve, requiring a severe US recession to have a dramatic impact on import demand. Similarly, rapid export growth can only help over a prolonged period

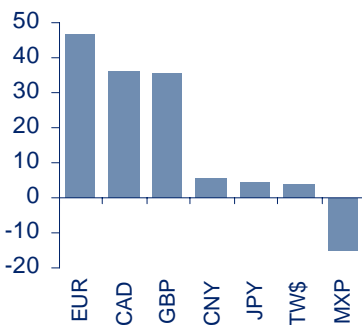
Chart 3: US\$ effective exchange rate (1996=100)

Source: Thomson Datastream



Chart 4: exchange rate appreciation (+) or depreciation (-) against US\$ since 2001 (%)

Source: Thomson Datastream



since imports are already around 80% larger than exports. If, for example exports grew at a consistent 10% pace (well above the 6.5% long-term average) and imports grew at 5% (half the long-term average) it would take almost a decade to cut the trade deficit in half. The fact that investors must hold their nerve for a prolonged period to ensure an orderly adjustment and, given the fickle nature of financial markets, an exchange rate “overshoot” is a significant risk in the years ahead.

Political tensions also increase the likelihood of a disorderly adjustment if we continue along the current trajectory. An optimal solution to the imbalances would see the dollar decline most against the Asian currencies with which the US has the largest trade deficits. However, policymakers in Asia favour a gradual process of currency appreciation – in part because some key export industries operate on very thin margins, so that any large move in the exchange rate could seriously dent their competitiveness. This suggests that only modest currency moves against the Asian currencies are likely to be permitted in the near term, causing more of the exchange rate adjustment to fall on the floating currencies. We can already see the pressures building. The dollar has weakened substantially on a trade weighted basis since the highs recorded in early 2002 (chart 3), but this has occurred almost exclusively against the major floating currencies (chart 4). This suggests that further declines would push the dollar well below its “fair-value” against these currencies in the years ahead.

What level will the exchange rate eventually gravitate towards?

In theory exchange rates gravitate toward an “equilibrium value” - even though significant deviations can persist for many years. The long time horizon makes it impractical for most financial market participants to exploit misalignments profitably. But if deviations can be identified, this is of value for long-term planning/strategic purposes. The current situation of unprecedented imbalances in the global economy, combined with the tendency for financial markets to overshoot during periods of adjustment, suggest that opportunities could arise in the years ahead. This may occur sooner rather than later since a number of key factors supporting the dollar are starting to wane (see annex) – especially as interest rate differentials narrow.

The idea that exchange rates revert to an equilibrium level rests on the concept of purchasing power parity (PPP). PPP states that a unit of domestic currency should be able to purchase the same quantity of goods in another country as it can in the home market when converted to foreign currency at the prevailing exchange rate. In other words, if PPP holds, then identical baskets of goods should sell for the same price in each country when expressed in a common currency. If they do not, then opportunities for “risk-free profits” will exist through international trade (arbitrage). Eventually, as people exploit these profit opportunities, the exchange rate and/or the prices of goods in the two economies will change so that PPP is established, as illustrated below:

Flowchart: adjustment mechanism to restore PPP

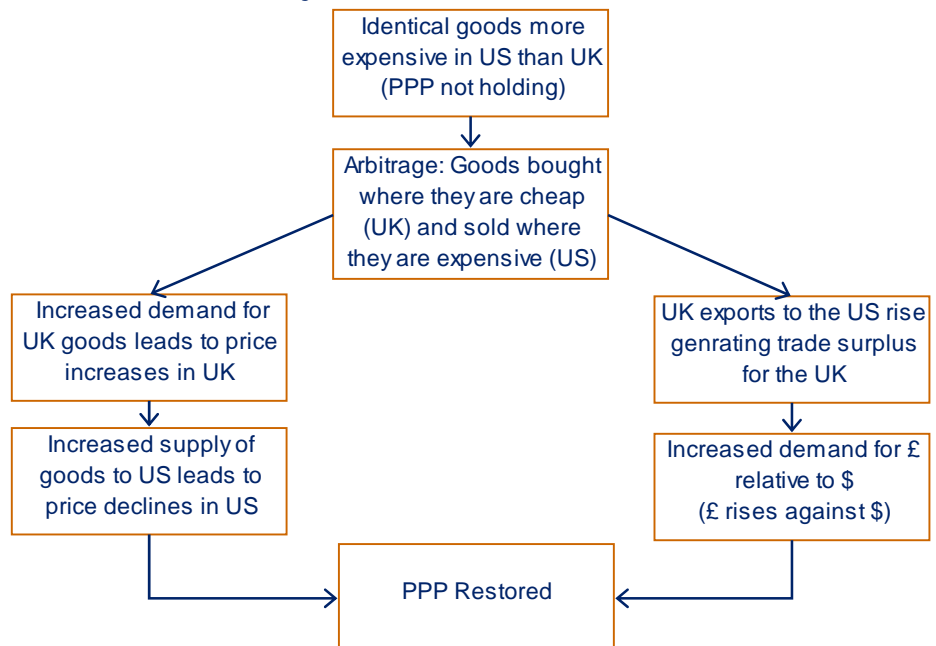


Chart 5: the sterling/dollar exchange rate since 1980

Source: IMF World Economic Outlook Database

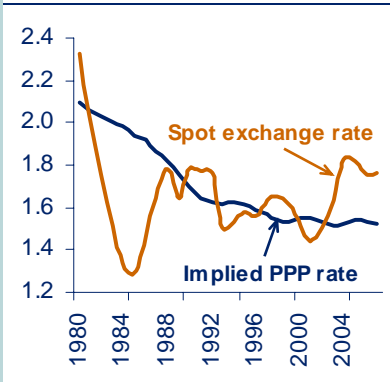


Chart 6: \$/£ PPP exchange rate implied by different price indices

Source: RBS Group Economics

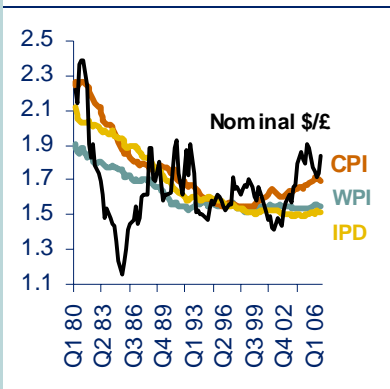
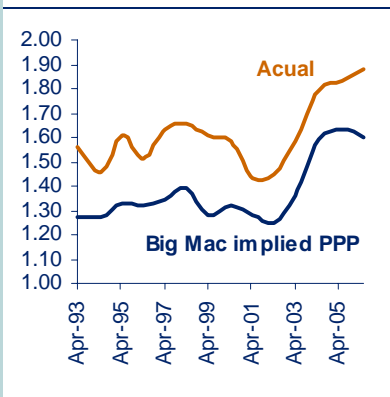


Chart 7: Big Mac implied PPP exchange rate vs actual \$/£ rate

Source: The Economist



The adjustment process comes through two channels – a movement in the nominal exchange rate and/or changes in the price level in each economy. Since central banks across the globe have made achieving price stability (usually a defined or implicit inflation target) their top priority, this suggests that, almost by default, exchange rates will probably vent most of the pressure if and when large misalignments occur. The fact that prices for individual goods tend to be downwardly rigid also favours the exchange rate channel, as it effectively changes the price of all domestic goods in international markets and the price of imports in the domestic market in one go.

PPP far from perfect, but can provide a useful tool for planning.....

In its purest form, PPP implies that the price of all goods will be the same in each country and therefore, the average price level in each country should be identical. In practice this is not the case. Not all of the things produced in an economy are tradable (like haircuts or housing), so arbitrage is not always possible. Even goods that are tradable often contain a significant non-tradable element – e.g. grocery prices reflect the labour costs of running the supermarket, as well as rent, local distribution costs and local taxes.

Nevertheless, there is compelling evidence that over the long-term exchange rate moves do tend to reflect inflation differentials across countries and gravitate towards a level more consistent with PPP (chart 5). Most empirical studies find that on average it takes three to four years for half of the deviation from the equilibrium rate to be eliminated. Larger misalignments tend to be resolved more quickly – reflecting the stronger incentives to act by the existence of larger arbitrage profits.

Where is the dollar’s equilibrium exchange rate against sterling likely to be?

Identifying the equilibrium exchange rate between two economies is not an exact science. Nevertheless, by using a range of measures we can identify periods of over/undervaluation. Chart 6 shows the nominal exchange rate for the US dollar against sterling, and the PPP rates implied by a range of different price indices. The Consumer Price Index (CPI) is the gauge most closely watched by policymakers –it tracks the price movements of items that matter most to consumers. Nevertheless, the wholesale price index (WPI) is often preferred as a gauge for constructing PPP estimates as it includes fewer non-tradable goods prices and distortions (like local taxes). The implicit price deflator (IPD) is the broadest measure of prices in the economy, but is typically only available on a quarterly basis, unlike the CPI and WPI, which are available monthly.

In 1985, PPP rates implied by three price indices all pointed towards a significant dollar overvaluation against sterling (chart 6), which was gradually corrected over the 1986 to 1989 period. At present, the PPP estimates suggest the dollar is “too weak” against sterling, although the extent of the undervaluation is less marked according to the consumer price index. Estimates from the OECD calculate the implied PPP rate as 1.60 in 2005, while the IMF estimated 1.54, which would also support this view. Similarly, the Economist publication’s light-hearted estimate, which is based on the price of only one good (the Big Mac), points to a rate of around 1.60 (see chart 7). Clearly if the dollar does weaken sharply against sterling – for example to 2.20 – without a corresponding surge in US inflation, then all indicators would agree that the dollar was significantly undervalued, with the dollar eventually expected to revert to the 1.50 to 1.70 range in the years ahead.

Business implications:

Increased cross-border M&A activity would be likely. A dollar overshoot would provide a window of opportunity – perhaps several months/quarters but more likely several years - where US acquisitions would be much less expensive for overseas firms. For US firms, overseas acquisitions would become prohibitively expensive, except those that rely heavily on exports for their earnings.

A good time to hedge. Increased volatility in financial markets would probably go hand in hand with a disorderly decline in the dollar (the world’s reserve currency), generating an increased demand for hedging instruments.

Manufacturing revival? The expectation that the US manufacturing sector is in perpetual decline could prove wrong-headed. In all probability the resolution of the imbalances issue will require the US to produce more of what it consumes and export more to service its overseas obligations. A significant dollar decline is likely to provide the impetus for a necessary shift of resources towards the production of tradable goods in the US. The Midwest and Northeast of the country could receive a boost since manufacturing activities are concentrated in these regions.

Annex Table: Key factors influencing the US dollar exchange rate

Current Factor: US\$ supportive (+) Negative (-)	Evidence	Likely evolution and impact
Short-term interest rate differentials (+)	US policy rate at present = 5.25% vs. 5% in UK, 4.25% in Canada, 3.5% in Eurozone, 0.25% in Japan.	Rate-hiking cycle underway in Eurozone, Japan and almost complete in Canada and UK. Short-term interest rates in most regions likely to converge over next two to three years, removing a key area of support for the \$
Long-term interest rate differentials (+)	Yield on US 10 year notes = 4.6% compared with 4.5% in UK, 4% in Canada, 3.7% in the Eurozone and 1.7% in Japan.	As short-term rates edge up in other key regions, it is likely that long rates will follow suit, putting further downward pressure on the \$ against the other major currencies
Long-term growth prospects (+)	US trend growth rate is around 3% compared with 2.8% in Canada, 2.7% in UK, 2% in Eurozone, 1% in Japan	Positive growth differential in favour of the US due to stronger productivity growth and more favourable demographic trends. This is likely to remain a modest \$ positive over the longer term, providing the promise of modestly higher risk-adjusted returns from US assets (other things being equal).
Central Bank intervention in FX market (+)	Global FX reserves have doubled in five years – largest rise in Asia. Japan and China now hold 39% of all reserves up from 26% in 2001. China's have increased from \$163 billion (14% of GDP) in 2001 to \$843 billion in 2005 (35% of GDP).	Current pace of reserve growth is unsustainable. Sharp appreciation of domestic currency would expose key central banks to enormous capital losses (several percentage points of GDP). Large scale intervention can also put domestic financial system under pressure. Eventually reduced intervention will remove vital support from \$, but \$ appreciation must be allowed if intervention is to end.
US current account Balance (-)	Current account deficit is already above 6% of GDP – few signs of stabilisation let alone sustained improvement.	US is already a net debtor to the tune of 25% of GDP. This could rise to over 100% in ten years without corrective action. Investors are likely to become reluctant to buy ever larger volumes of US assets. Sharp \$ decline doesn't require a large liquidation of \$ assets, just a refusal to buy more in sufficient quantities.
US fiscal position (-)	US running a structural fiscal deficit - not due to economic cycle, but fundamental mismatch between revenues and expenditures. This will widen sharply as baby-boomers retire in years ahead without higher taxes/govt spending reductions.	Public finances on unsustainable trajectory – suggests downward pressure on \$ against some countries (e.g. Canada). It is important to note that a number of developed countries have worse outlook/trajectory – Japan, Eurozone – as a result the relative fiscal outlook will be neutral or even positive for \$ vs these currencies
Decline in home bias (-?)	Increasing ability/willingness to hold assets overseas due to impact of financial liberalisation/integration	Likely to have an important impact on currency movements but US\$ not automatically a beneficiary. Effect could be \$ positive/negative/neutral – depends upon evolution of investor preferences. Rise of the euro as a reserve currency may suggest modest dollar negative (see below)
Rise of the € as a reserve currency (-)	Holdings of € reserves has increased steadily from 18% of world holdings to 25% in mid 2006 – largely at expense of the \$, which has seen its share decline from 72% to 65% over the same period	Central banks likely to continue to diversify into euros to reduce currency risk. This trend may be replicated by private investors (€ denominated assets are more heterogeneous - they are issued by twelve countries representing varying levels of risk - likely to grow in diversity as accession countries eventually adopt €)