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THE PESSIMISM TOWARD THE GREENBACK IS NOT JUSTIFIED: THE CURRENCY WILL STAY STRONG AGAINST THE EURO AND YEN

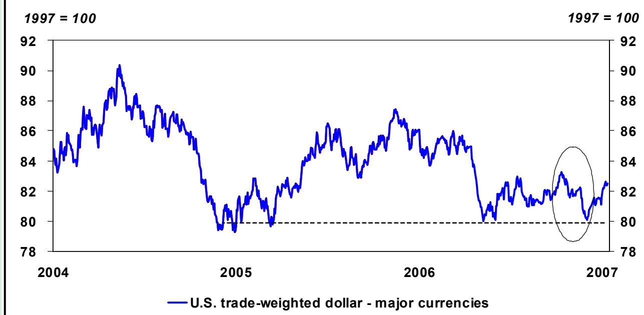
Introduction

At the end of 2006, rumours about some central banks overseas, particularly China, diversifying their reserve portfolios had a marked impact on the American dollar (USD), causing a number of market players to wonder whether the currency was back on downward trend.

In this *Economic Viewpoint*, we will first show that the market's concerns about the potential diversification of China's currency portfolio are not justified. Among other things, it seems that purchases by the People's Bank are already well-diversified. We then show that the relative situation of the U.S. economy in comparison to the economies of the most industrialized nations remains to the advantage of the U.S. dollar, as do interest rate expectations.

Of course, at nearly 6.8% of the GDP in the third quarter of 2006, the American current account deficit was none too reassuring, but the current context suggests that the greenback will continue to hold its own against the major currencies for some time to come.

Graph 1
At the end of 2006, pessimism about the greenback was justified



Sources: Federal Reserve Board and Desjardins, Economic Studies

Diversification rumours: momentary panic on the markets

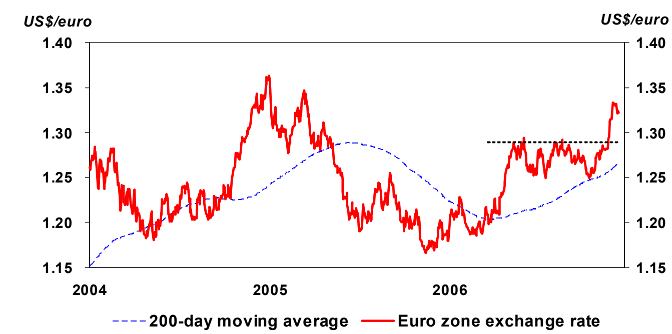
At the end of 2006, certain speeches by the People's Bank of China (PBoC) monetary leaders created some panic on the financial markets. The USD took the hit, pushing all major currencies upward.

More specifically, on November 9, PBoC Governor Zhou Xiaochuan, stated that:

> "China has a clear plan to diversify its $1 trillion foreign exchange reserves and is considering various options to do so."

Later, on November 17, a comment from a member of the PBoC's monetary policy committee, Fan Gang, to the effect that U.S. dollar's heavy weight in the denomination of Asian countries' reserves made them vulnerable to a sharp greenback depreciation. Another blow to the greenback, one that was hard enough to temporarily generate a wind of pessimism about the USD.

Graph 2
The euro got the most out of renewed pessimism about the greenback



Sources: Datastream and Desjardins, Economic Studies

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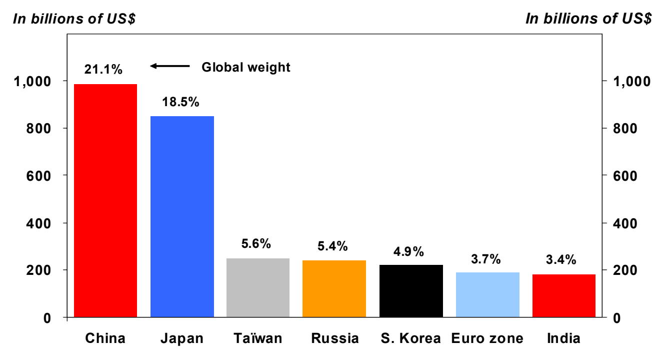
Thus, the euro, which had crossed a major resistance barrier (US$1.30), continued to ascend to close to US$1.34 at the start of December. The pound sterling climbed to almost US$1.98, a record that has stood since 1992; the yen, a cyclical currency, appreciated in spite of the current U.S. economic slowdown.

The situation has turned around somewhat since then, but the question remains: with China's portfolio at over US$1,000B in reserves, almost 70% of which are in U.S. dollars (according to some estimates), should we be worried about a realignment?

Unjustified reaction

With an international currency inventory of close to one billion dollars U.S., China is one of the largest currency holders in the world (graph 3). It is thus easy to understand the market's concerns about what China plans to do with its reserves. In reality, however, the reaction is not justified. The following points will help us to sort things out.

Graph 3
China has the largest currency reserves



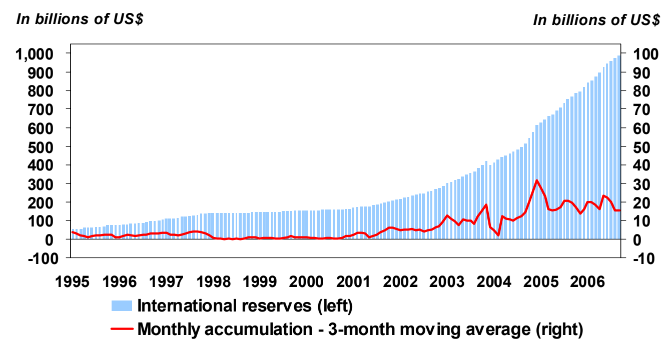
Sources: Bloomberg and Desjardins, Economic Studies

First, some perspective is required. The statement by the PBoC's Governor was taken out of context, in conjunction with a European Central Bank conference in Frankfurt. What's more, the full quote instead indicates that China has a long-standing, concrete diversification plan:

> "All central banks are trying to diversify. <u>We have had a very clear diversification plan for several years</u>. We are considering lots of instruments (for diversification)."

The make-up of China's reserves is a closely guarded secret, but it is easy to prove Governor Xiaochuan's point. We won't return here to the accounting obligation that China has to amass reserves (a point we have dealt with in depth previously[1]), but note that the exploding trade surplus combined with massive inflows of direct foreign investment mean that, in the framework of the exchange rate's rigidity, the PBoC has no choice but to accumulate currency (graph 4).

Graph 4
China has amassed reserves at a lightning pace



Source: Bloomberg and Desjardins, Economic Studies

That said, a simple comparison of China's reserves and purchases of U.S. debt securities is a clear indication of the fact that China has had a concrete portfolio diversification plan for several years.

China: a major buyer of Treasury securities... but not only Treasury securities!

China's accumulation of reserves picked up a lot of speed starting at the end of 2000, but its purchases of U.S. Treasury securities did not keep pace. In fact, of the US$219B in currencies amassed between September 2005 and September 2006, only US$37.9B were in U.S. Treasury securities (graph 5).

There are two possible explanations for this divergence: 1) China's purchases of U.S. debt securities are not limited to Treasury securities and 2) China's currency portfolio is already well diversified. When we take a close look at China's net purchases of U.S. securities, we can see that the PBoC is also a fan of agency and corporate securities (graph 6). Now, whether China favours purchasing Treasury securities to the detriment of agency or corporate debt securities, or vice versa, this has little impact on the USD.

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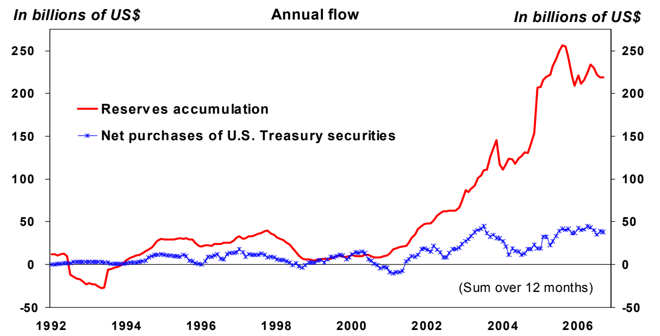
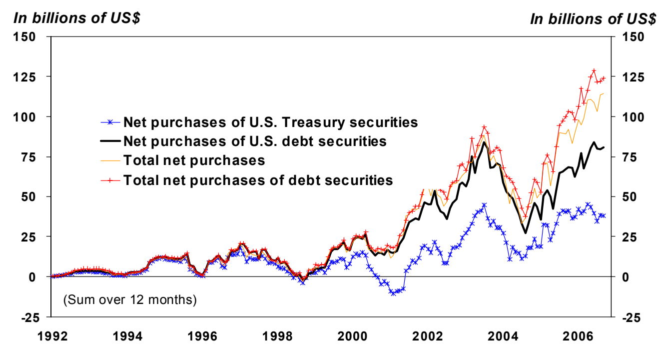
[1] See the May 2005 *Economic Viewpoint*, "Is it time for a Revaluation of China's Currency?".

Graph 5
Net purchases of Treasury securities constitute a small proportion of China's currency reserves



Sources: Datastream and Desjardins, Economic Studies

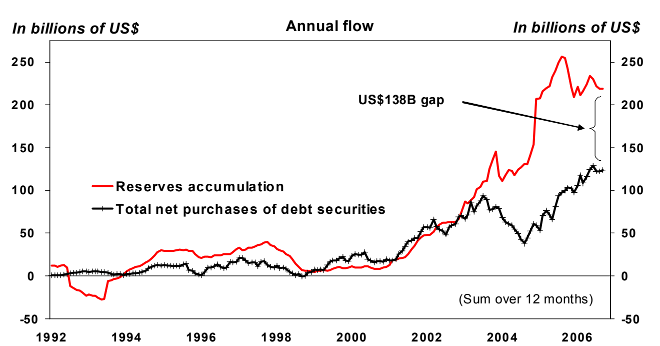
Graph 6
China's portfolio is already well diversified among U.S. asset classes



Sources: Datastream and Desjardins, Economic Studies

The combined purchases of U.S. Treasury, agency and corporate debt securities seem to be in line with China's currency accumulation until mid2003. Since then, however, the gap has grown sharply (graph 7). We could assume that the PBoC is keeping some of its U.S. dollar reserves liquid for trade transactions purposes. However, at US$138B, the difference seems too large.

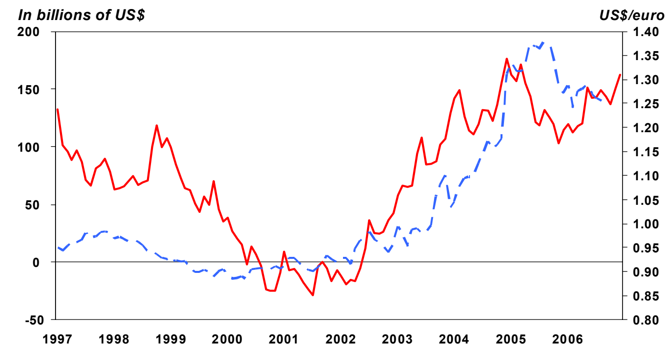
Graph 7
Total net purchases of U.S. debt securities do not match China's accumulation of currency reserves



Sources: Datastream and Desjardins, Economic Studies

This necessarily means that the PBoC's portfolio is also made up of other important currencies such as the euro and yen. A simple way to check is to take the difference between the annual flow of currency and net purchases of U.S. debt securities, and compare it to the evolution of the major currencies in recent years. It is then clear that China is also a major buyer of euros (graph 8).

Graph 8
The PBoC's currency portfolio likely contains large amounts of euros



Sources: Datastream and Desjardins, Economic Studies

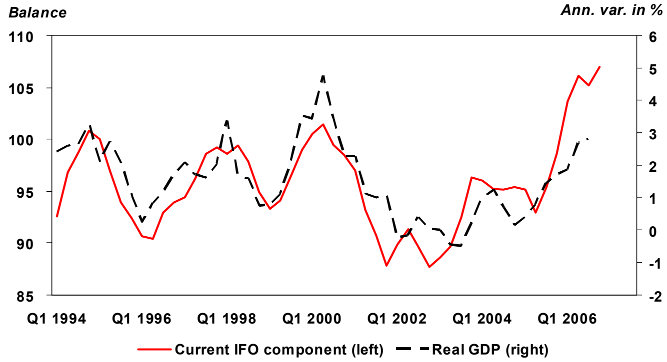
That said, it is unlikely that the PBoC will try to substantially change the composition of its portfolio. For one thing, why would it want to destabilize the economy of its largest trading partner? Also, China's need for greenbacks is so large (trade with the United States, U.S. dollar denominated purchases of raw materials, etc.) that it must keep a large share of its reserves in U.S. dollars.

In spite of the economy's current vitality, it is not clear sailing for the euro zone yet

In conjunction with diversification rumours, the ongoing improvement by Euroland's economy—especially Germany's economy—prodded international investors to favour European currencies in the final months of 2006. In December, Germany's IFO index hit its highest level since the index was introduced in 1991, intimating strong acceleration by euro zone economic growth in the final quarter of 2006 and early 2007 (graph 9).

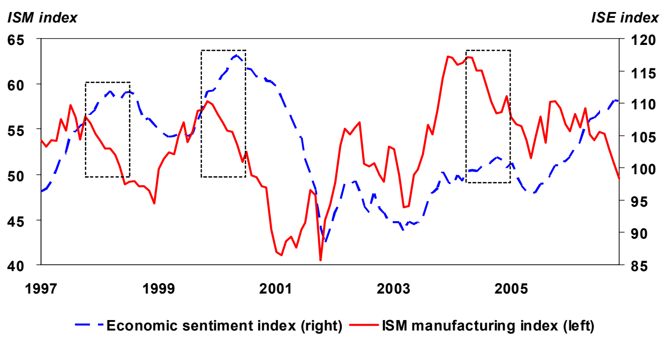
Yet the leading indicators are showing that growth should then slow down. The slowdown in the United States is now well underway. The euro zone, which lags about six months behind the U.S. economy, should be following in its footsteps later in 2007 (graph 10).

Graph 9
Germany's IFO index is compatible with strong economic growth



Sources: IFO, Bundesbank and Desjardins, Economic Studies

Graph 10
Euroland's economic cycle lags about six months behind the U.S. cycle



Sources: European Commission, Institute for Supply Management and Desjardins, Economic Studies

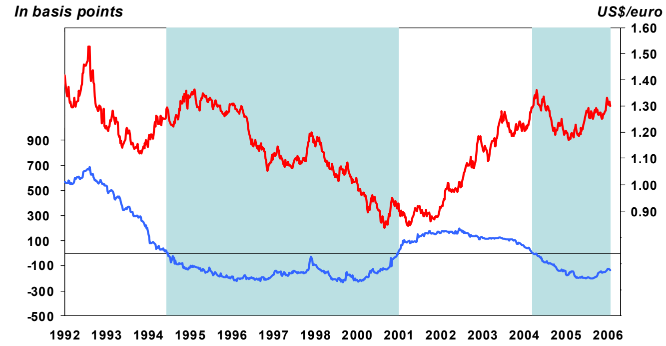
The ECB seems a little less decided on tightening its monetary policy gradually, but it will take clear, concrete signs of weakness before the Bank conclusively terminates the current firming cycle. It is thus likely it will tighten the screws one more time in early 2007, probably in March. The markets have, however, fully anticipated the news, which is largely reflected in the euro's current level.

On the other hand, the financial markets seem to be less categorical about the cuts to rates on federal funds expected at the end of 2006. As a result, the interest rate spread will continue to favour the United States in the coming months, a situation which has in the past helped to limit the euro's potential gains in the short term (graph 11).

The U.S. slowdown plays against the yen, a cyclical currency

In Japan, activity is expected to continue at a moderate pace for the next two years. In particular, high production

Graph 11
The interest rate spread remains favourable to USD stabilization



Sources: Datastream and Desjardins, Economic Studies

capacity utilization and increased profits signal that capital spending will continue to buoy growth. What's more, the increase in full-time employment and stabilization by wages should bolster consumption. But, after four years of continuous yearly growth—the longest recovery in post-war Japan—the economy's advance should slow to closer to the level of potential, i.e. around 2.0% in 2007 and 2008.

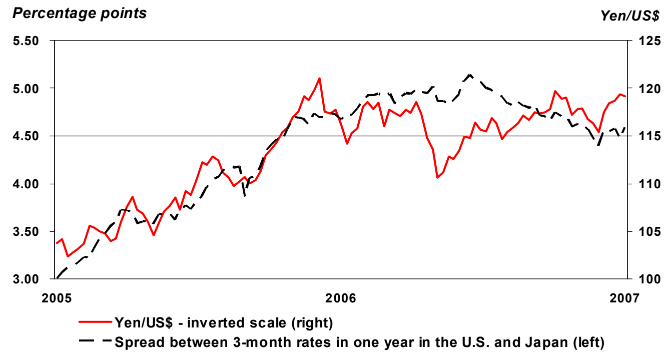
For prices, the livelier economic growth of the last few years has allowed inflation as measured by the Bank of Japan's core CPI (the index that excludes fresh food) to move into positive territory, but it is not clear that the country has definitively put deflation behind it.

That said, inflation's overall trend is to the upside, and the growth outlook is compatible with the goal of moderate growth by Japan's economy. As a result, it is likely the Bank of Japan will strive to gradually lessen the accommodating stance of its monetary policy in 2007. In our view, the release of its national accounts could be a prelude to the next rate hike. If the results are in line with expectations, the Bank of Japan could be prodded to bring its key rate up 25 basis points to 0.50% in February.

The yen will still have trouble appreciating. First, February's increase is largely anticipated by the markets and already appears to be reflected in the currency's price. Now, since there is nothing to suggest the Bank of Japan will pick up the pace on monetary firming in the short and medium term, the interest rate spread between Japan and the United States is too large to encourage Japan's currency to go up (graph 12).

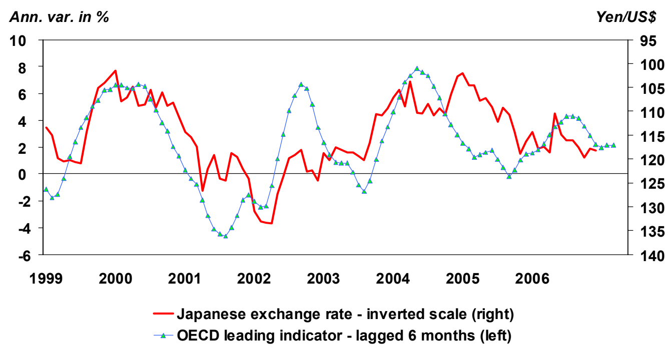
The yen's structural weakness will continue. Note that the global economy's slowdown should take the yen, which is a highly cyclical currency, downward (graph 13).

Graph 12
The interest rate spread is too much in favour of the United States to support the yen



Sources: Bloomberg and Desjardins, Economic Studies

Graph 13
The global economic slowdown should limit the yen's opportunities to gain



Sources: Datastream and Desjardins, Economic Studies

Conclusion

In our view, the markets' concerns about rumours of portfolio diversifications by some central banks do not have much of a foundation. Under these circumstances, it is unlikely the rumours will force further depreciation by the trade-weighted USD against the currencies of the United States' major trading partners.

That said, it would not be out of the question for the USD to see some upheaval in the short term, due to interest rate expectations. For now, the fact that the expected cuts to U.S. federal funds rates have been put off means that the interest rate spread between the United States and the euro zone, as well as Japan, remains favourable to the USD. But it is possible that, on one hand, the ECB will go further than expected with monetary firming and that, on the other hand, the U.S. real estate market slowdown will force the Federal Reserve to bring down its rates more quickly than anticipated.

In the longer term, international investors' concerns with the unprecedented size of the U.S. current account deficit risk plunging the U.S. dollar back into a downward trend. There again, however, any depreciation in the effective USD will be moderate. We will take a more in-depth look at the issues associated with the U.S. current account deficit in a later study but, for now, it is a good bet that the Asian nations' mercantilist policies will mean that the deteriorating current account deficit will not be matched by a greenback nosedive. What's more, reaching a record deficit in recent years has not prevented the USD from stabilizing.

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