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The calm on foreign exchange markets is about to end

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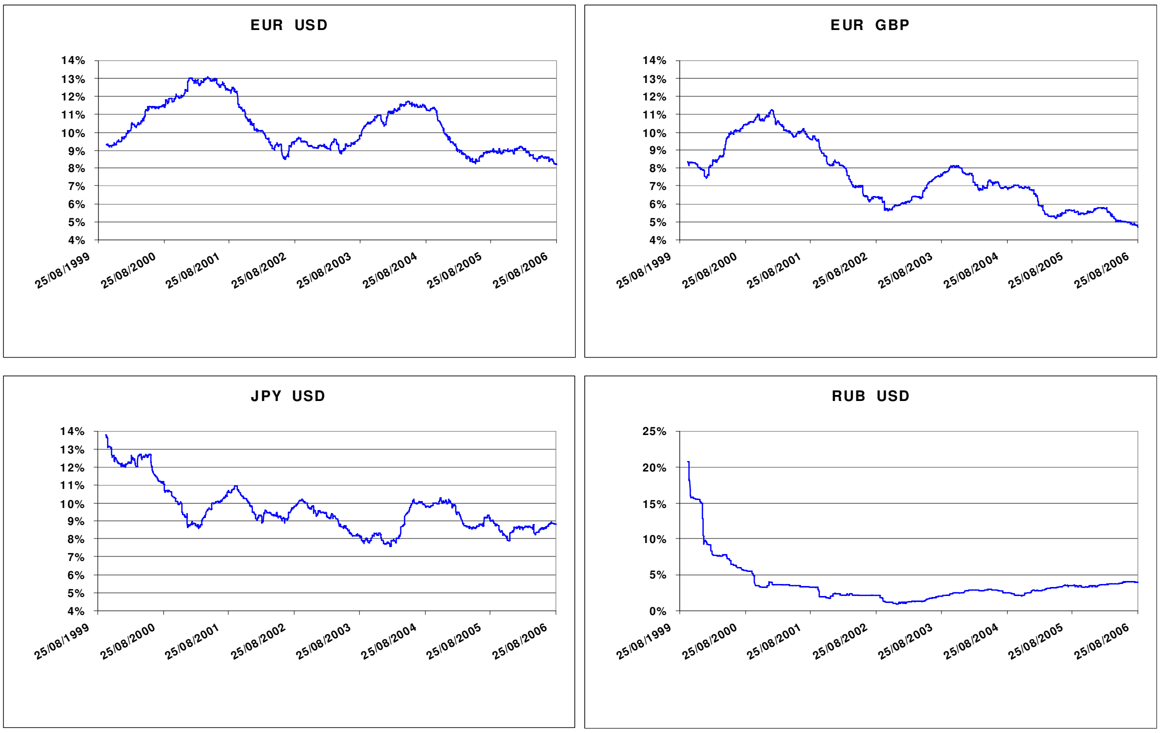
1. The longer the present stability on foreign exchange markets lasts, the more participants will begin to believe that it is here to stay. As the chart on this page shows, the volatility of important exchange rates has gone down correspondingly. It is always **a mistake to extrapolate such periods of relative calm, though, as any look at longer FX time series will show.**

200-day volatility of four major exchange rates over the past seven years

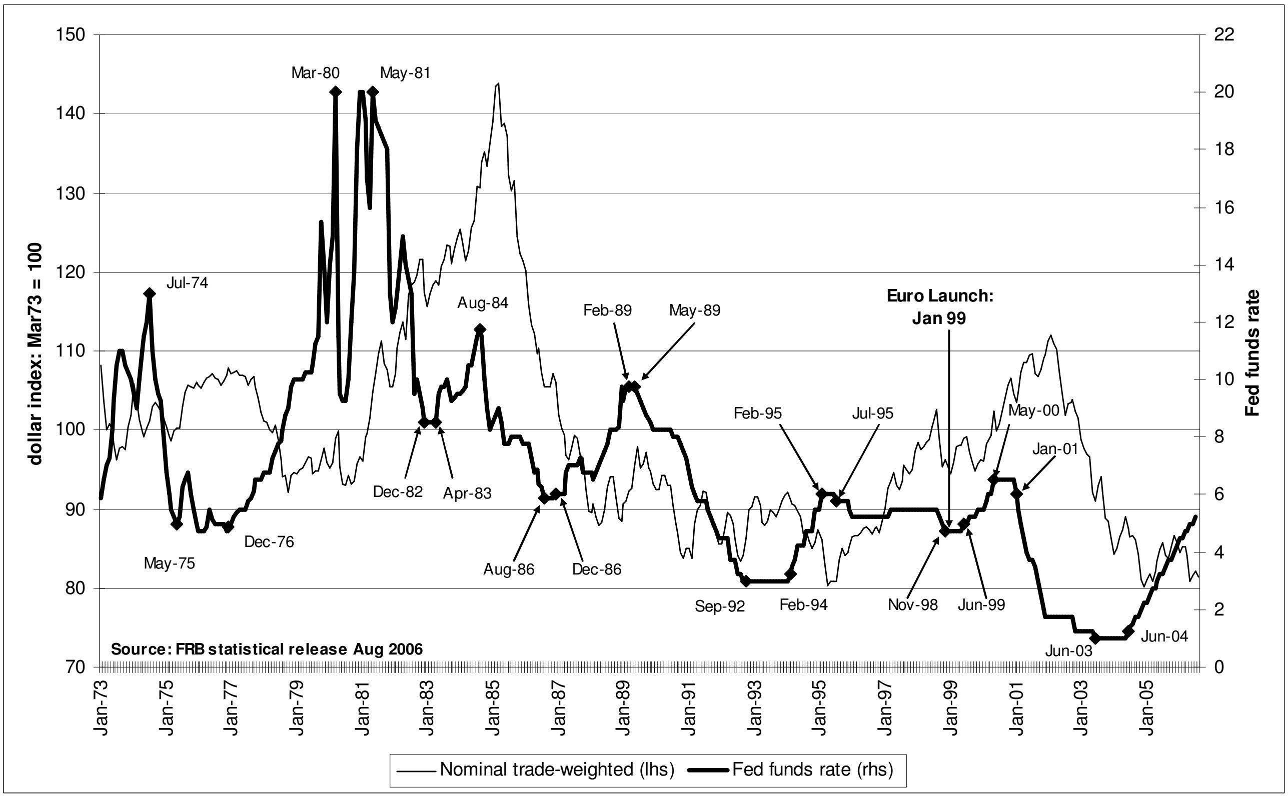


2. The main reason why **we will probably experience more turbulent times once again is that the unwinding of the world's imbalances requires major adjustments of exchange rates** beyond those that have already happened. Imbalances remain unusually large and relative prices have to change a lot more in order to achieve some sort of stable equilibrium. Exchange rates are not the only parameter that must adjust, but one of the more important ones. In the meantime, currencies of countries such as Japan, Switzerland, Sweden or China are not nearly as strong as they ought to be - the huge balance on current account surpluses of these countries therefore continue to increase rather than to shrink. Imbalances remain worryingly large.

3. Most worrying of all is the US situation. Since the American savings shortfall – or over-consumption – has produced the largest balance on current account deficit the world has ever seen, and this for several years by now, it is **obvious that incentives to save more must be strengthened further, just as the incentives to import less and export more.** The Fed has worked on the first part of the to-do-list by raising the funds rate in 17 steps from 1% to 5 ¼%. Going by the inverted slope of the dollar yield curve, US monetary policies are now restrictive. For consumers and business alike borrowing has become considerably more expensive than it had been two years ago, and there are clear signs that the American housing bubble is deflating and that consumers are finally tightening their belts.

4. At the same time, importing is still very attractive for them, apart from energy and energy-related goods. **The dollar has depreciated significantly since February 2002, but the downtrend ended at the end of 2004 (see graph on this page).** In real and trade-weighted terms, the dollar has actually appreciated since that time, not only because its nominal value has increased by about 2% but also because US inflation has considerably exceeded the average inflation rate of the country's main trading partners, ie that of Canada, Mexico, the euro area, Japan and China. Since the softening of US consumer demand has only just begun, it is likely that the current account deficit will not decline significantly for the next half year or so. It could actually get even larger.

trade-weighted US dollar exchange rate and the Fed funds rate since 1973



5. **So we are approaching a situation where, because of worries about growth and employment, the Fed stops to prop up the dollar by raising interest rates while the external accounts of the US continue to look very bad.** Going by the federal funds futures quotes, market participants now expect the Fed to pause for at least the next half year. In the past three interest rate cycles since the mid-eighties, the time that elapsed between the last rate hike and the first cut was between three and five months (see graph on previous page). In other words, the US central bank had typically tightened too much, and then tended to react quickly to the slowdown of the economy caused by rising interest rates, even though core and headline inflation were still on the way up. But inflation is a lagging indicator in any case, as markets are telling us once again. Today's dollar bond market reflects those improved inflation expectations: 10-year Treasury yields have fallen from a recent 5.25% high to about 4.80% even though headline inflation is 4.1% y/y while core inflation is about 2 ½% and thus above the so-called comfort zone of the Fed.

6. With support from central bank policies fading or maybe going into reverse this winter, the **fate of the greenback is in the hands of portfolio investors** who must be relied upon to take up all those dollars which are flooding world financial markets. So far, there has been no problem in this regard. Dollar holders are almost condemned to hold still because dumping their assets could result in their large devaluation.

7. **The temptation to diversify out of the dollar must be quite strong by now because the ECB will continue to raise interest rates.** It is aiming to "normalize" them. No one knows where a normal "refinancing rate" lies, but it is certainly higher than the present 3%. One rule of thumb says that it is in the neighborhood of medium term growth of nominal GDP. In the case of the euro area this is about 4%, the product of target inflation of a little less than 2% and the trend rate of real GDP of a little more than 2%.

8. At tomorrow's press conference, Mr Trichet will most certainly present more optimistic GDP forecasts than last March and thus feel reassured that the tightening does not do any harm to the real side of the economy yet. He will more or less clearly announce that **rates will go up further in October, and perhaps indicate that another step might follow in December, to 3 ½%.** The only factors that might stop the tightening process after year-end would be a very strong appreciation of the euro, to more than $1.35 or so, or signs that the world economy slows by more than expected in the possible wake of a steep decline of US imports. The latter is the less likely of the two events because the weight of the fast-growing emerging markets is so significant by now that they will largely fill the gap caused by the slow-down of US demand.

9. **So the trigger for a major re-alignment of exchange rates can be expected when three developments come to a head: clear signs that the next step of the Fed will be a rate cut, large or even rising US trade deficits, and signals from the ECB that European interest rates will have to go up more. The euro will appreciate almost by default because the euro area is also running a current account deficit – of 0.4% of its GDP – and because the present interest rate differential still favors the dollar.**

10. **The yen as institutional investors' natural alternative to the euro remains weakish as the Japanese economy has not yet convincingly overcome the threat of deflation.** In spite of the huge increase of commodity and energy prices inflation rates remain in the neighborhood of zero. The Bank of Japan has officially ended its zero-interest policy, but markets doubt very much that it will be able to follow up with further hikes any time soon. Base money growth of -17% y/y and broad money supply growth of 0.5% y/y suggest that there is not much, if any, room for tighter policies.

11. This means **the yen will continue to struggle.** Gone are the days when Japan seemed to be able to weather any appreciation of the currency, when the yen moved in one direction only: up. While foreigners' demand for yen is very strong, given that the current account surplus is close to 4% of GDP, Japanese investors are sending funds abroad at an even faster rate than the rate at which yen flow in, a result of the measly returns on domestic bank accounts and bonds. Equities have performed quite well in recent years but not everybody is able to participate fully. The all-important pension funds and insurers have fixed obligations - which limits the risks they can take.

12. It is likely that the yen will appreciate against the dollar in the coming re-adjustment of FX markets, but there is **little to suggest that the on-going depreciation against the euro is about to end.** The interest rate gap between Europe and Japan will widen further before it starts to narrow. When that finally happens – surely some years down the road – the yen will once again be the world's strongest currency, considering how large the current account surplus and how high the Japanese economy's growth rate of the capital stock are.

13. **Sterling has moved in an ever more narrow band vis-à-vis the euro.** It begins to look as though the UK is planning to participate in the European Rate Mechanism and thus meet a key requirement for future euro membership. Over the past three years, the pound has moved in a range of +/- 3.2% around a central rate of 0.682 per euro , and over the past twelve months it has narrowed to +/- 1.8% around 0.685. Volatility has fallen dramatically (see chart on page 1).

14. If there is anything to this observation, sterling **has become a better-yielding proxy for the euro.** Britain's balance on current account remains stubbornly in the red to the tune of almost 3% of GDP which explains why interest rates have to be higher than in the euro area. It is a current account deficit, though, that is not threatening exchange rate stability because the UK continues to enjoy a surplus in private capital flows. Even for monetary authorities abroad sterling assets have become increasingly attractive because of the combination of a stable exchange rate and attractive interest rates. Against the dollar, sterling can be expected to appreciate just as much as the euro. Over time, the penalty the UK pays for not being a member of the euro system will disappear if present policies continue. The Danish experience points the way.

15. Sweden **is also outside the euro club but the krona has been a sort of honorary member as well.** Over the past five years it has moved in a range of +/- 3.2% around a central rate of 9.22 to the euro. For a while it had looked as though the range was about to narrow, but it does not look that way any longer. So the krona is somewhat further away from a de facto euro membership than sterling. Even so, Swedish government bond yields are lower than euro bond yields - a little lower at the long end and substantially lower at the short end. Sweden has one of the world's largest current account surpluses relative to GDP and an inflation rate that is almost one percentage point lower than that of the euro area. The krona is potentially a stronger currency than the euro and will appreciate significantly against the dollar.

16. **Finally a look at the rouble.** Since it is a currency with a tendency to appreciate the central bank of Russia has a relatively easy job stabilizing its exchange rate against – originally – the dollar and – presently – the euro, as long as it accepts that it does not have a say over the rate of domestic base money expansion. Countries which target a certain exchange rate cannot conduct an independent monetary policy. Volatility is very low, not only of EUR-RUB (where the fluctuation has been +/- 1.9% around 33.9 roubles over the past twelve months) but also USD-RUB (see chart on page 1).

17. **Since Russian monetary authorities are concerned about the latest pick-up of inflation resulting from 30 to 40% money supply growth, they try to get the permission from the government to let the rouble appreciate** – which it would, given the country's trade surplus of about 15% of GDP. Mr Putin is not convinced that this is a good idea because it would result in even more problems for those Russian firms outside the commodity sector which are exposed to international competition. In the end, though, accelerating inflation caused by a flood of liquidity and a near-stable exchange rate, ie a rising real exchange rate, will harm the economy just as much as a large increase of the nominal exchange rate, except that inflation will be much lower in the second case.

18. **Going forward, it seems that, as a minimum, the rouble will remain more or less stable against the euro, and appreciate against the dollar**. The main risk to this scenario is a steep decline of Russian export prices, something I do not foresee. It will be possible that the risk premium caused by problems in the Near East can disappear, but as long as the large emerging markets, the euro area and Japan continue to expand briskly, and as long as the US slow-down does not turn into a full-scale recession, commodity and energy fundamentals remain strong.

19. Further out, one has to **monitor the risk that at some point Russian imports will exceed exports**. If export prices stagnate from here on, and imports continue to boom, this point will be reached in less than three years. It is more likely, though, that imports will slow significantly once the big terms-of-trade effect which is boosting real incomes disappears. In other words, the Russian trade surplus is likely to persist for longer than just three more years, and there is, at least for now, no reason to question the future strength of the rouble.