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The unbalanced US$ policy

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THE last decade had seen a succession of financial imbalances. In 1995 it was Mexico, in 1997 Asia, in 1998 LTCM and Russia; then came the Nasdaq crash in 2000, followed more recently by Argentina's default in 2002.

Now, the big worry is the US dollar and the downward pressure it faces. The last time the US dollar was forced to correct due to a current account deficit was in 1985 when the Group of Seven (G-7) ministers met to announce the Plaza Accord and intervene to weaken the dollar.

The Group of Eight (G-8) finance ministers met on May 17-18 in France amid a weakening US dollar and a sluggish global economic outlook - a scene reminiscent of September 22 1985 when the so-called G-7 Plaza Accord pre-empted a US dollar correction due to "large imbalances in external positions which posed potential problems... among these were: the deterioration in its external position which the US experienced from its period of very rapid relative growth". Then the US dollar kept falling until the spring of 1987, when halted by the Louvre Accord. Fortunately, this time around, the US dollar's descent is already well underway without the need for G-8 action.

However, the nature of the US dollar's downward trajectory appears to be very different this time round. The US dollar's weakness is evident only against a handful of major currencies: the euro, Swiss franc, Australian and Canadian dollars that account for 37.2 per cent of the Federal Reserve's (Fed) broad trade-weighted dollar index. Unlike 1985, today it is the fixed pegs of China, Hong Kong and Malaysia that are growing in influence with a 13.8 per cent weighting in the Fed's broad US dollar index. Back in 1985 this group accounted for only 5.7 per cent. Adding to the difficulties of a much-needed US dollar adjustment is Japan's defence against yen appreciation. Given that Japan alone accounts for 12 per cent of the broad US dollar index, its active intervention policy against the yen strength is threatening to widen the imbalance between Asian and European currencies against the US dollar.

Nowhere, is this more apparent than euro/yen, which has appreciated 8.4 per cent this year. It is also interesting to note how euro/yen led the recovery of the euro higher ahead of euro/US$ in October 2000. The relative performance since then shows the euro gaining 41.7 per cent against the yen compared to 31 per cent against the US dollar. The unbalanced US dollar policy could continue to stretch the valuation between euro strength and relative yen weakness further.

Signs among the South-East Asian economies point to a shift from US dollar dependency. The past month had seen an announcement by Indonesia's state oil company, Pertamina, that it was considering switching to euros for its trading accounts instead of US dollars. This was later followed by a senior economic aide to Indonesia's Chief Economic Minister Dorodjatun also confirming that Indonesia itself was also considering the move. A similar note was also played by Prime Minister Datuk Seri Dr Mahathir Mohamad towards Malaysia's national oil company Petronas adopting euros. These moves would reinforce the euro's rally and could also mark the beginning of similar moves from other regions such as West Asia.

For a moment, the Kenyan shilling (KES) had stolen fourth place in the currency performance rankings against the US dollar in May, delivering a 15.9 per cent gain without even accounting for its 5.75 per cent 3-month interest carry against the dollar. However, recent profit-taking across the spectrum of currency yield plays had dented the shilling and South African rand's dominant position in the top five.

And it is too early to say how the KES will be impacted by recent terrorist worries. At present, Latin America's Brazilian real and Argentine peso continue to hold pole and second position respectively, while the KES and rand are now relegated to 14th and 16th place.

However, we believe that improving policy credibility and performance in Kenya and South Africa will help to narrow this gap again.

Policy remains a vital determinant for African currency performance as yield and commodity links alone have failed to alter the 93 per cent fall in the Zimbabwe dollar and the 6.3 per cent drop in the Nigerian naira.