BHF BANK

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FX Briefing

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Highlights

- US government continues to work on rescue plan
- High financing costs are burdening European banks
- Markets worried about how EMU would tackle possible escalation of crisis

US bailout: good or bad for the dollar?

In the last fortnight, the dollar has lost a lot of ground. Against the euro, the US currency fell about 5% from 1.39 to around 1.46. However, considering that from March to August the exchange rate was usually over 1.55, and given the extent of the US financial market crisis, the setback seems remarkably small. One wonders whether a more marked drop is still to come, or whether the dollar's relative strength is fundamentally justified.

At first glance, everything seems to be against the dollar at the moment: the banking system is in a structural crisis, which is hampering all financing operations in the US significantly. The problems in the financial markets and the housing market crisis are now exacerbating each other; the credit crunch is slowing down activities in other economic sectors too. Furthermore, the high energy and commodity costs are weighing down the economy. In summer, it had looked as though the tax cheques would avert a recession, but in autumn, the economy seems to be losing steam again. The labour market situation in particular is deteriorating rapidly. In August, the unemployment rate rose to 6.1%, and initial jobless claims are increasing (they are currently at 490k), which suggests that the situation could get even worse.

However, forced by the pressure of events, the US government is now trying to find a comprehensive solution to the credit crisis, and this could support the US currency. The policy of bailing out banks "relevant to the system" from case to case is no longer sufficient. If further erosion of confidence in and among banks and an increase in macroeconomic damage are to be avoided, there is no alternative to the US government's proposal to buy up the troubled assets. This poses enormous fiscal risks, but doing nothing would do so too.

In Europe, possibly with the exception of the UK, the situation does not look quite so dramatic at the moment: firstly, because the negative feedback loop between the housing market and the financial system is less pronounced, and secondly because the banks are not as highly leveraged and less dependent on money markets than the (former) US investment banks.

Other factors, however, are hitting Europe just as hard as the US. Excessively high financing costs are affecting banks' earnings. The ECB is offering liquidity at 4.25%, but in fact it only has control over the overnight rate. It has lost control over banks' financing costs: the 3-month money market rate is now almost 100 basis points higher than the ECB's refi rate, and the spread is around 125 basis points for 12-month money. And while rates for 3-month repos and Eonia swaps are increasingly pricing in interest rate cut expectations, the Euribor is going up. But financing costs of well over 5% are way too high for an economy whose financial system is having to cope with heavy burdens as it is, and which at the same time is heading for a recession.

Economics Department
+49 69 718-3642
volkswirtschaft@bhf-bank.com

Foreign Exchange Trading
devisenhandel@bhf-bank.com

Jörg Isselmann
+49 69 718-2695
Matthias Grabbe / Klaus Näfken
+49 69 718-2688

Political power to act is seen as limited in the eurozone, and this could have a negative impact on the euro. Having raised interest rates in July, it is now more difficult for the ECB to react promptly and decisively to the deterioration in the economic situation. Moreover, market participants also fear that, if the financial market crisis escalates, the European Union's ability to make decisions could be hampered by national clashes of interests, the large number of authorities responsible and the limited involvement of the European Central Bank.

In times such as these, exchange rate predictions are even more difficult than usual. There is less liquidity on the forex market, which can go hand in hand with stronger exchange rate movements. At the moment the focus is on the risks in the US. But the problems in the eurozone (and elsewhere) are increasing, and governments are doing nothing to counterbalance them. Thus we do not see the dollar being at a particular disadvantage at present.

Stephan Rieke +49 69 718-4114

Key indicators and important events

Country	Indicator / Event	Release date	Forecast (in % mom/yoy)	Prev. period (in % mom/yoy)	Comments
EMU	Economic sentiment / Sep	29/9	86.8	88.8	
US	PCE core deflator / Aug	29/9	0.1 / 2.4	0.3 / 2.4	
GE	Labour market / Sep >absol. change unempl. sa >unemployment rate sa	30/9	 –15k 7.6	 –40k 7.6	
EMU	HICP flash estimate / Sep	30/9	3.8	3.8	
US	Chicago PMI / Sep	30/9	52.0	57.9	
US	Consumer confidence / Sep	30/9	54.0	56.9	
US	ISM manufacturing / Sep	1/10	49.0	49.9	
JP	Tankan index / Q3	1/10	–2	5	
EMU	ECB interest rate decision	2/10	4.25	4.25	
US	Labour market / Sep > change non-farm payrolls > unemployment rate	3/10	 –100k 6.1	 –84k 6.1	
EU	Euro group/Ecofin	6-7/10			
JP	BoJ interest rate decision	7/10	0.50	0.50	
UK	BoE interest rate decision	9/10	4.75	5.00	

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Money and foreign exchange market quotations

	Spot vs. EUR	Change vs. EUR		Interbank offered rates	
	26/09/08	in % week-on-week	1 month	3 months	6 months
EUR	–	–	5.00	5.14	5.29
USD	1.4588	-2.5	3.70	3.76	3.88
JPY	153.80	-0.5	0.85	0.94	1.02
GBP	0.7929	-0.2	5.97	6.26	6.34
CHF	1.5875	0.5	2.70	2.86	3.00
SEK	9.6725	-1.3	5.35	5.40	5.51
PLN	3.3658	-1.3	6.38	6.58	6.60
CZK	24.400	-0.2	3.70	3.83	3.85
CAD	1.5115	0.3	3.90	4.10	4.40
AUD	1.7632	-0.2	7.81	7.71	7.72
NZD	2.1312	-1.1	9.45	9.15	8.54
SGD	2.0835	-2.0	1.50	1.50	1.56
ZAR	11.8927	-3.0	12.25	12.35	12.35

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volkswirtschaft@bhf-bank.com

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+49 69 718-2688