



Rolling the Dice in Japan & Germany

BMO Nesbitt Burns
Economics

1-800-613-0205

Voters in Japan and Germany head to the polls in September, as PM Koizumi and Chancellor Schroeder roll the dice on early elections. Of the two, Koizumi has the best chance of success. Following the Upper House rejection of the postal reform bill, Koizumi decided to put his political future on the line by calling a parliamentary election for September 11. An outright LDP majority is not likely, but with the support of the New Komeito party, he could well control the more powerful Lower House, which should support the yen. However, Koizumi only has one year to implement his reform agenda as he still plans to leave office in September 2006. A Koizumi loss would create a great deal of political uncertainty and cause the yen to give up some of its recent gains. In Germany, polls suggest that Chancellor Schroeder of the Socialist Party (SDP) won't muster another come-from-behind victory as he did in 2002. Instead, Angela Merkel, the candidate of the Christian Democratic Union and its alliance partner, the Christian Social Union (CDU/CSU), seems poised for victory on September 18. If so, the East German Merkel will become the first woman Chancellor. Polls have consistently shown her CDU/CSU, in partnership with the Free Democrats, ahead of Schroeder's SDP/Green Party alliance. Recent surveys indicate that the opposition could win a majority, thus avoiding the possibility of a reform-inhibiting grand alliance with the SDP, which has been likened to a marriage of elephants. A Merkel victory opens up hope that a reform agenda would be enacted, which could provide another sentiment boost to the euro.

U.S. Dollar

China's President Hu makes his first visit to the U.S. this month to meet with President Bush. Although China did revalue the yuan and introduce a basket peg, taking one issue off the table, U.S. policymakers are still likely to highlight many other outstanding trade frictions, including America's massive trade deficit with China. Unwinding the U.S. trade imbalances will remain a challenge to the US\$, as the interest rate boost fades. The Fed has hiked rates 10 straight times to 3.50%, and the market is already prepared for further moves, including one on September 20. A more recent concern is that soaring oil and gas prices—notably in the wake of Hurricane Katrina—are starting to bite into consumer spending, as highlighted by Wal-Mart trimming its second-half earnings forecasts. The greenback could receive some periodic support from repatriation of foreign earnings.

Some inflow has already occurred, but the firms with the most to do have barely started the process. Unfortunately, the currency impact of the repatriation flow might not be that large as some firms already maintain their overseas cash in U.S. dollars.

Canadian Dollar

The Bank of Canada is widely expected to raise its overnight target by 25 basis points to 2.75% on September 7, its first rate hike since October 2004. Another move is still expected in October, as the Bank's target rate is likely to be 3.0% at year-end. However, on the back of record oil prices, the C\$ is approaching 13-year highs, rising above 84 cents (US). The Bank of Canada thus faces a dilemma once again. While domestic demand remains solid, and there is now some evidence that wages are firming amid stimulative monetary policy, the robust currency and surging energy prices raise questions about the economic outlook. Since the recent move in the C\$ seems to be based largely on fundamentals, the Bank of Canada is not likely to be dissuaded from raising rates.

Europe

The euro has benefited from the improving outlook for the European economy, although energy prices loom as a prominent risk to the revival. The nascent turnaround has helped the euro rebound after it was hammered following the French and the Dutch rejection of the EU Constitution. As well, the late-July Chinese revaluation of the yuan has helped boost the euro's reserve currency prospects. In the U.K., the decline in the pound was stemmed by the minutes of the August MPC meeting, which showed that Bank of England Governor King had voted against the rate cut. This lowered the chances that another easing step was planned in the immediate future. But the U.K. economy continues to struggle, meaning further easing steps down the line cannot be ruled out.

Asia

The outlook for the Japanese economy has also improved in recent months, boosting the yen. Foreign investor interest in Japanese stocks, which helped lift the Nikkei to a four-year high, has also supported the yen. Improving sentiment will be dealt a blow if polls show Koizumi's popularity slipping, or if his grand election gamble fails. Even if he wins on September 11, Koizumi would still have to force the postal reform bill through the Upper House, which is where his previous attempt was scuttled. The Chinese government revealed some details about the yuan peg, showing that the US\$, the Japanese yen, the euro and the South Korean won dominate the basket. The U.K. pound, the Australian, Canadian and Singapore dollars, the Malaysian ringgit, the Russian rouble and the Thai baht are also included. The Chinese yuan remains very heavily managed, however, with only a minuscule move since the revaluation.

Currency Forecasts versus U.S. Dollar

	Actual	2005			2006	
	31-Aug	Sept.	Dec.	March	June	Sept.
CANADA	1.19	1.18	1.18	1.17	1.18	1.20
(US\$/C\$)	(0.842)	(0.845)	(0.850)	(0.855)	(0.847)	(0.833)
EUROPE						
Euro *	1.23	1.23	1.22	1.23	1.24	1.26
Denmark	6.05	6.05	6.10	6.05	5.95	5.85
Norway	6.39	6.40	6.35	6.25	6.20	6.25
Sweden	7.55	7.55	7.55	7.50	7.45	7.50
Switzerland	1.25	1.24	1.23	1.17	1.16	1.16
United Kingdom *	1.80	1.80	1.79	1.82	1.85	1.87
MIDDLE EAST/AFRICA						
Saudi Arabia	3.75	3.75	3.75	3.75	3.75	3.75
South Africa	6.37	6.45	6.50	6.45	6.40	6.45
ASIA						
China	8.10	8.05	8.00	7.85	7.75	7.70
Hong Kong	7.77	7.75	7.75	7.75	7.75	7.75
India	44.0	43.5	43.0	42.3	42.0	41.8
Indonesia	10,299	10,200	10,100	10,100	10,000	9,900
Japan	111	110	108	105	101	99
Korea	1,039	1,020	1,010	995	985	975
Malaysia	3.77	3.73	3.70	3.67	3.63	3.60
Philippines	56.3	56.0	56.0	55.5	55.0	55.0
Singapore	1.68	1.67	1.66	1.64	1.62	1.61
Taiwan	32.8	32.5	32.0	31.0	30.5	30.0
Thailand	41.2	40.7	40.3	40.0	39.7	39.5
SOUTH PACIFIC						
Australia *	0.754	0.765	0.780	0.795	0.795	0.780
New Zealand *	0.696	0.700	0.710	0.715	0.715	0.705
LATIN AMERICA						
Argentina	2.91	2.93	2.92	2.91	2.93	2.95
Brazil	2.36	2.35	2.30	2.40	2.50	2.55
Chile	543	550	555	560	565	580
Colombia	2,303	3,210	2,330	2,340	2,370	2,380
Mexico	10.76	10.85	11.00	11.00	11.15	11.20
Venezuela	2,146	2,146	2,146	2,250	2,250	2,250

* U.S. dollars per foreign currency

Cross Rates

VERSUS CANADIAN DOLLAR						
Euro (C\$/€)	1.46	1.46	1.44	1.44	1.46	1.51
United Kingdom (C\$/£)	2.14	2.13	2.11	2.13	2.18	2.24
Australia (C\$/A\$)	0.896	0.905	0.918	0.930	0.938	0.936
Japan (¥/C\$)	93	93	92	90	86	83
Mexico (Peso/C\$)	9.06	9.17	9.35	9.40	9.45	9.33
VERSUS EURO						
United Kingdom (£/€)	0.68	0.68	0.68	0.68	0.67	0.67
Japan (¥/€)	137	135	132	129	125	125

The opinions, estimates and projections contained herein are those of BMO Nesbitt Burns Inc. ("BMO NBI") as of the date hereof and are subject to change without notice. BMO NBI makes every effort to ensure that the contents herein have been compiled or derived from sources believed reliable and contain information and opinions, which are accurate and complete. However, BMO NBI makes no representation or warranty, express or implied, in respect thereof, takes no responsibility for any errors and omissions which may be contained herein and accepts no liability whatsoever for any loss arising from any use of or reliance on this report or its contents. Information may be available to BMO NBI, which is not reflected herein. This report is not to be construed as, an offer to sell or solicitation for or an offer to buy, any securities. BMO NBI, its affiliates and/or their respective officers, directors or employees may from time to time acquire, hold or sell securities mentioned herein as principal or agent. BMO NBI may act as financial advisor and/or underwriter for certain of the corporations mentioned herein and may receive remuneration for same. BMO NBI is a wholly owned subsidiary of BMO Nesbitt Burns Corporation Limited, which is a majority-owned subsidiary of Bank of Montreal. To U.S. Residents: BMO Nesbitt Burns Corp. and/or BMO Nesbitt Burns Securities Ltd., affiliates of BMO Nesbitt Burns Inc., accept responsibility for the contents herein, subject to the terms as set out above. Any U.S. person wishing to effect transactions in any security discussed herein should do so through BMO Nesbitt Burns Corp. and/or BMO Nesbitt Burns Securities Ltd. To U.K. Residents: The contents hereof are intended solely for the use of, and may only be issued or passed on to, persons described in Part VI of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001.

© "BMO" is a registered trademark of Bank of Montreal, used under licence. "Nesbitt Burns" is a registered trademark of BMO Nesbitt Burns Corporation Limited, used under licence.