



Dollar Scenario

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Economic Research

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Sticker Shock Coming to Heating Bills

The economic impact of hurricanes Katrina and Rita will become clearer this month, although the effect is already seen as largely regional, apart from energy prices. The most nervously anticipated release is the September nonfarm payrolls report, due on October 7. The Federal Reserve has already acknowledged that *"spending, production, and employment will be set back in the near term"*. As a result, weak numbers will not derail the Fed from raising rates again on November 1. Nonetheless, there could be some volatility in currency markets, as post-Katrina economic data hit the headlines. The real test of the resiliency of U.S. consumers and the global economy will be this winter when sticker shock from sky-high heating bills due to record natural gas prices hits home.

U.S. Dollar

Beyond the post-Katrina economic reports, the U.S. dollar will be affected by the Federal Reserve and profit repatriation. Fed officials will reinforce the message that inflationary pressures are the most likely lingering economic impact of the disruption to Gulf oil and gas production. Given that Governor Olsen voted against the rate hike at the September 20 FOMC, the minutes of the meeting—to be released on October 11—will be scrutinized for clues on future policy decisions. The greenback will receive irregular support in the fourth quarter from U.S. firms' repatriating profits, taking advantage of the tax break under 2004's American Jobs Creation Act. The exemption runs out at the end of the year. However, the currency impact will be less than the dollar values repatriated, depending on the extent to which overseas profits are held in US\$. The U.S. dollar will also face headwinds in coming months. The cost of rebuilding New Orleans will seriously impair efforts to improve the budget deficit, and sky-high oil prices will cause further deterioration of the trade deficit. Looking ahead, the Q4 current account won't reflect the full worsening of the trade deficit, owing to payments received from overseas insurers paying off hurricane-related claims.

Canadian Dollar

The Canadian dollar is at 13-year highs and is basking in the glow of elevated energy prices. Commodity prices are broadly higher, boosted by plans to rebuild New Orleans, and generally strong demand amid tight supply conditions. The C\$ strength is offsetting

some upside inflation risks, but the economy is operating near capacity, and monetary policy is still stimulative. Accordingly, the Bank of Canada is set to raise rates again on October 18, lifting the overnight rate to 3.00%. This is still 75 basis points below the Fed funds rate, but is above rates in Euroland or Japan. So long as oil prices do not weaken materially, the C\$ will continue to hold its own versus the euro, the yen and the British pound. A concern for the Bank is that some of recent strength in the C\$ has a whiff of the Type II, or non-fundamental variety, and speculative activity is increasing.

Europe

The euro still feels the stress from the uncertain results of the September 18 German election. Although the most likely outcome will be a "grand coalition," with Angela Merkel as the first female Chancellor in German history, getting there is proving to be a tortuously slow process. The Bundestag meets on October 18 to choose a new Chancellor. If no candidate receives a majority during the first two rounds of voting, the candidate who gets the most votes in the third round is elected head of government. However, German President Koehler could reject the result as too unstable and instead call new elections. Beyond the political distraction in Germany, the ECB is setting the stage to start raising rates, although no move is expected in the next few months. ECB officials are feeding markets a steady diet of commentary on the upside risks to inflation and the possibility of second-round pass-through from high energy prices, laying the groundwork for the first hike since October 2000. Conversely, the Bank of England is likely to cut rates again in early 2006, suggesting that interest rate spreads with the Eurozone will begin to narrow. The pound is expected to continue to underperform.

Asia

Japanese PM Koizumi won a strong mandate for reform. However, this provided only a short-lived bounce to the yen, which fell for a third straight quarter in Q3. The strong domestic interest in foreign bonds outweighed the foreign investment in the Nikkei, which rose to four-year highs. Even so, the outlook for the yen is still bright as Bank of Japan officials have given clear signals that the almost five-year period of ultra-easy monetary policy is coming to an end, possibly before the close of the fiscal year in March. But, an extended rally in the yen or in the Asian currency bloc is held hostage by the Chinese yuan and regional competitive balance. Beyond the introduction of the basket peg, China has taken only baby steps toward currency reform. The basket peg has behaved much like a soft dollar peg. In May, the U.S. Treasury warned China that it could be designated a currency manipulator unless it made "*substantial alterations*" to the yuan peg. Treasury Secretary Snow visits Beijing this month and when he returns his department will let us know whether China's reform initiatives are substantial enough.

Currency Forecasts versus U.S. Dollar

	Actual	2005	2006			
	30-Sep	Dec.	March	June	Sept.	Dec.
CANADA	1.16	1.15	1.17	1.21	1.20	1.18
(US\$/C\$)	(0.860)	(0.870)	(0.855)	(0.826)	(0.833)	(0.847)
TRADE-WEIGHTED US\$						
(versus majors)	84.5	83.4	83.1	83.3	82.2	80.5
EUROPE						
Euro *	1.20	1.22	1.23	1.24	1.26	1.28
Denmark	6.21	6.10	6.05	6.00	5.90	5.80
Norway	6.55	6.30	6.25	6.20	6.25	6.35
Sweden	7.75	7.65	7.55	7.50	7.45	7.35
Switzerland	1.29	1.27	1.25	1.20	1.18	1.16
United Kingdom *	1.76	1.75	1.73	1.75	1.77	1.80
MIDDLE EAST/AFRICA						
Saudi Arabia	3.75	3.75	3.75	3.75	3.75	3.75
South Africa	6.36	6.40	6.45	6.55	6.65	6.80
ASIA						
China	8.09	8.05	8.00	7.95	7.90	7.90
Hong Kong	7.76	7.75	7.75	7.75	7.75	7.75
India	44.0	76.5	43.3	43.0	43.0	42.8
Indonesia	10,299	10,200	10,100	10,050	10,000	9,900
Japan	114	110	107	104	101	100
Korea	1,044	1,010	995	985	975	970
Malaysia	3.77	3.76	3.75	3.74	3.72	3.72
Philippines	56.1	56.0	55.8	55.6	55.4	55.0
Singapore	1.69	1.68	1.66	1.64	1.62	1.60
Taiwan	33.2	33.0	32.9	32.5	32.0	31.5
Thailand	41.1	41.0	40.8	40.3	40.0	39.8
SOUTH PACIFIC						
Australia *	0.763	0.775	0.780	0.790	0.775	0.770
New Zealand *	0.692	0.705	0.710	0.720	0.710	0.705
LATIN AMERICA						
Argentina	2.91	2.92	2.91	2.93	2.95	2.95
Brazil	2.23	2.20	2.40	2.50	2.55	2.60
Chile	530	535	530	545	555	560
Colombia	2,287	2,300	2,320	2,350	2,370	2,380
Mexico	10.76	11.00	11.05	11.15	11.20	11.20
Venezuela	2,146	2,146	2,250	2,250	2,250	2,250

* U.S. dollars per foreign currency

Cross Rates

VERSUS CANADIAN DOLLAR						
Euro (C\$/€)	1.40	1.40	1.44	1.50	1.51	1.51
United Kingdom (C\$/£)	2.05	2.01	2.02	2.12	2.12	2.12
Australia (C\$/A\$)	0.887	0.891	0.913	0.956	0.930	0.909
Japan (¥/C\$)	98	96	91	86	84	85
Mexico (Peso/C\$)	9.25	9.57	9.44	9.21	9.33	9.49
VERSUS EURO						
United Kingdom (£/€)	0.68	0.70	0.71	0.71	0.71	0.71
Japan (¥/€)	136	134	132	129	127	128

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