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Dollar Behaving Badly

ACCA CPD Event

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Dollar Behaving Badly

- The Dollar dropped below 108 Yen for the first time since 2005 and dropped to \$1.4967 per Euro, the weakest since the single European currency's debut in 1999. (Nov. 23 – Bloomberg)
- The US \$ has declined by 11.7% since the September 18 Fed rate cut.
- The pace of the Dollar's drop has surprised economists. The median forecast of 41 analysts and strategists was for the currency to trade at \$1.45 to the Euro by year-end, according to a Bloomberg News survey.
- Nations such as the United Arab Emirates with fixed exchange rates to the Dollar are considering revaluation to curb inflation. Japan, the world's second largest shipbuilding nation, plans to use the Yen for new contracts to stop a weaker Dollar eroding earnings.
- With the Euros' 3.1% rally this month the Airbus SAS's Chief Executive Officer Tom Enders was reported by Der Spiegel magazine as saying the company may have massive losses due to the Dollar's fall versus the Euro.
- The European Commission this month cut its forecast for euro-area economic growth next year to 2.2 % from 2.5 % (Financial Times Nov.23).

WHAT IS BEHIND THIS ????? & WHAT CAN BE DONE

U.S. Economy: Leading Index Fell More Than Forecast (Nov. 21 - Bloomberg)

- Home prices fell in one third of U.S. cities last quarter as ***stricter lending standards*** caused a 14 % decline in sales nationwide. Prices dropped in 54 of 150 metropolitan areas in the third quarter and the median sales price tumbled 2 % nationwide, National Association of Realtors).
- The U.S. economy may continue to slow into 2008, over the next 3 to 6 months. ***“There is a definite pattern of weakening here,” said Edward McKelvey, a senior economist at Goldman Sachs Group Inc.***
- The figures, coming a day after the Federal Reserve lowered its growth forecast for next year, add to concern that the ***credit collapse is causing consumers and businesses to cut spending***. The deepening housing recession will constrain the expansion again this quarter, slicing growth to about 1%, from around 5 % in the previous three months, economists predict.
- Rising fuel costs and the housing slump spurred a drop in the Reuters/University of Michigan final sentiment index to 76.1 in November, the lowest level since October 2005, following Hurricane Katrina. The index was at 80.9 in October ***“The data are pointing to a continued slow economy,” Ken Goldstein, a Conference Board economist,*** said in a statement, ``It might even slow a little more after the holidays.”

Why??? Is what happens in the USA important to us sitting 1000sssss of miles away ??? (Slide 1)

- 70% of US total consumptions come from consumer spending.

J.C. Penney Co., Starbucks Inc. and FedEx Corp. recently lowered profit forecasts. Cisco Systems Inc., said earlier this month that declining orders from automobile and financial companies are curbing growth.

- US economy is 10 times bigger than China or India.

Nov. 18 (Bloomberg) Toyota, Japan's largest automaker, lost 4% to 6,480 Yen. The company generated about a third of its fiscal 2006 revenue in North America. Hon Hai, the world's largest contract electronics manufacturer, dropped 5.9 % to NT\$225. Taiwan Semiconductor Manufacturing Co., the biggest supplier of made-to-order chips, fell 4.1% to NT\$61.60. The company makes about three quarters of its sales to U.S.

Nov. 21 (Bloomberg) -- Russia's Micex Index fell the most in 8 weeks, led by OAO Sberbank and VTB Group, as investors sought the safest investments on speculation that the U.S. economy may sink into recession.

Why??? Is what happens in the USA important to us sitting 1000sssss of miles away ??? (Continued)

The slow down in the US economy made Fed to reduce rates twice since September 18 : this accelerated the decline in the US \$:

- If the dollar continues to weaken, the potential costs to the Group of Seven rich nations quickly will wipe out any benefits gained - Morgan Stanley.
- GCC currencies losing its value in the range of 16% & 25% against the Sterling, Rupee and Euro during the past two years.
- Domestic inflation above 9% is wiping out a significant share of expatriates' earnings, the reduced purchasing power has also fuelled higher inflation through rising import costs.
- Despite this, the UAE was forced to cut interest rates by 0.6% this year following the US interest rate cuts of 0.75% (to maintain the Peg), fuelling further inflation.
- Dollar vulnerability is heightened by the massive Dollar reserves held by other countries - These excessive reserves put the US economy at the mercy of foreign central bank policies,- Noble DraKoln of Liverpool Derivatives Group

Mixed signals from the central banks; the Saudi Arabian Monetary Agency (SAMA) has repeatedly said a revaluation would not help, but the UAE Central Bank Governor, Nasser al-Suweidi, recently said this is a live issue (Reuters, Nov. 15).



Cause & Implications

So What is Causing All This – What are the Consequences ??

Collection of Thought 2 - Toxic – Credit Problem - 22 August 2007

The problem facing the US economy is that toxic waste has infiltrated the credit markets. Financial institutions are afraid both to lend and to buy financial paper, for fear that the borrowing or issuing institution has 'unknown' amounts of toxic credit in its portfolios and may default on a loan or paper obligation.

So What Created this Toxic Waster – the Credit Crisis ??????

Yen Carry Trade: Up until last year Yen-bore was at Zero % - Hedge Funds seeing no end to the Asset Boom (Brain Child of Alan Greenspan) borrowed in Japan converted into \$ introduced new financial products : derivatives , commercial paper and provided commercial banks and mortgage lenders the opportunity to pass their risk to the hedge funds and credit was given to many insecure and known credit-risk borrowers thus: the Sub-prime crises.

The liquidity was poured into investments in China (Manufacturing) and India (Soft Skill Outsourcing) creating the demand which lead to commodity price inflation and broke the conventional relationship between a US \$ rise and Commodity Price inflation.

Thus US \$ lost its natural hedging characteristics: this is critical for the currency which remain pegged to the US \$ - and therefore we are seeing a number of countries considering pegging to a basket of currencies as Kuwait did and as China is currently contemplating, resulting in further misery for the \$

What are the Consequences of the Credit Crises

➤ **Financial Institutes suffering leading to job losses & economy slowdown**

Citigroup Inc., the world's biggest bank, may have losses from asset-backed bonds of as much as \$13.7 billion. The shares have fallen 17% in a week, and reached a 4 year low. Bank of America Corp. the second-biggest U.S. bank, is expected to announce losses of \$5.4 billion and JPMorgan Chase & Co., the third-biggest, is expected to have lost \$4.1 billion. Merrill Lynch & Co last month reported \$8.4 billion of write-down's in the third quarter (Bloomberg Nov 17 to 22)

“Annual Audited Accounts may further open up the can of worms”

The losses are resulting in job losses and a reduction in wealth: this is likely to further dampen the consumption leading to the economy slowing down.

➤ **Good Business Starved of Essential Finances:**

With the Credit Squeeze and most leading financial institutions not really knowing either their own potential risk or the others have seriously curtailed their lending and they are lending at a risk premium which is likely to effect good business.

➤ **Mortgages are not now easily available and the cost has gone up**

This is causing house prices to fall bringing more pressure on the economy. The rise in cost is resulting in many foreclosures which is leading to a slow down in consumption.



What Can Be Done

So What can be done ??? Can the FED Save it ALL ????

(Collection of Thoughts -Two – 22 August 2007)

- There is very little that Fed can do; indeed it could do harm — pure and simple. As the old saying goes, “You can lead a horse to water, but you can not make him drink.” Despite the Fed Discount Rate cut and the availability of massive amounts of liquidity, banks would not lend — surprise, surprise.
- The dreaded Adjustable Rate Mortgages (ARM’s) and most HELO’s (Home Equity Loans) are geared not to the U.S government (Fed), controlled U.S financial market but to the free-market London Inter-bank (Eurodollar) Offered Rate, or LIBOR.
- LIBOR is a “free” market rate, related to the U.S. Fed rate, but not controlled by it.
- The mandate of Fed is to control inflation and to encourage a growth economy. A key element within these two, often contradictory mandates is to maintain the vital credibility in US currency. It is not the job of Fed to use taxpayers’ funds to “bail out” individuals and institutions who may now be counting the cost of irresponsible greed. That is the job of the “free” market.

Fed cut will seriously jeopardize the US dollar, to the great detriment of US economy.

FED Capitulated Under Political Pressure

(Collection of Thoughts - Four – 19 September 2007)

In essence, the US now faces two problems:

1. First, an economic recession, in which lower rates could help, over the long (six months to one year) term.
2. Second, and more importantly, a catastrophic fall in our dollar. It is catastrophic for three reasons.
 - I. First and most obviously, the costs of imports, including oil, will rise, fanning higher the inflation, already in the system, of which Ben Bernanke has long warned.
 - II. Second, an unleashing of inflation, in the face of recession, will lead the US straight into stagflation — the worst of economic woes.
 - III. Finally, the foreign holders of US massive government debts may be tempted to *sell out when they see both the capital value and now the interest yield on their investments falling*. This could pre-empt a catastrophic fall not just in the Dollar, but in the US government's ability to fund its massive debts, driving bond yields to highs not seen for many years.

**“ If only
Fed had not Capitulated under Political Pressure**

SO Where DO WE STAND NOW !!!!!!!!!!!!!!!!!!!!!!!

Immediate Future

- From the fall in the US \$ in the last few days it seems that the market has already factored in YET another FED cut in December.
- Much is depending of the Black Friday Retail Sales Performance. If the retails sales are not as per expectations then there is every likelihood of another FED cut. mainly because the main emphasis is on the slowing down of economy and political pressure, 2008 being the last year of Mr G W BUSH presidency.
- The US \$'s immediate future does not look rosy and unfortunately this means sadly enough OIL prices may rise as GCC countries try to recover the loss in their currency from increasing the OIL price unless of course the PEG is compromised (see later).

Medium to Long Term Future

- A fall in the \$ will make US manufacturing competitive and imports more dear which will change the trade deficit. We are already seeing some improvement in this.
- With more exports and less imports the US \$ value will improve. We must not forget the fall in the \$ value is hurting Europe and they may decrease their rates to discourage the Euro deposits and this may also help US \$.

Further Fed cuts would bring the Dollar under more pressure. This may make US trade deficit financiers lose their appetite for the \$ and diversify.





GCC \$ PEG

Arguments for Revaluation

- It would neutralize the impact of the weak US dollar, - inflation. Although currency adjustment may not do much to bring inflation down.
- With the OPEC basket up almost 56% this year, there is likely to be growing pressure on GCC governments to increase fiscal spending. This could compound existing demand pressures and stoke inflation further. To put forward a more restrained expenditure programme, a revaluation would certainly help.
- Labour grievances concerning low pay and a depreciating currency. If the choice is to increase wages or revalue the currency, the latter is a better policy option since increasing wages would trigger another round of inflation.
- Revaluing the currency could slow the non-oil sector, but a degree of cooling off is required since some countries in the region are overheating.
- Global commodity prices are driving food price inflation in Oman, Kuwait and Saudi, where tolerance for inflation is very low. If the food price increase is a temporary phenomenon, revaluing the currency is a better option than increasing subsidies.
- It is the right thing to do. Running up large external surpluses with a depreciating currency goes against the principle of equilibrating prices. A revaluation should encourage a larger fraction of the oil surplus to be invested or spent abroad, which is required if policymakers want to reduce domestic demand.

Arguments Against Revaluation

- A De-pegging from the US dollar could be seen as a loss of confidence in the dollar. The “special relationship” that the region has with the US is based on regional security in exchange for a steady supply of oil and a healthy appetite for dollar assets.
- A free float of the GCC currencies is next to impossible, as fluctuating oil prices would create massive swings in the exchange rate and undermine any attempt to diversify. A basket of hard currencies will provide some flexibility.
- A stronger currency would do little to take the edge of rent increases.
- Each GCC country like to diversify away from hydrocarbons. This is not just to reduce exposure to volatile oil revenues, but to create jobs for the local population. Dubai has carved out a niche in the hospitality sector, in high-end retail shopping, travel/tourism and real estate. These sectors require a growing stream of visitors, which is being reflected in the massive investment drive to upgrade airport facilities and air carriers across the region. A stronger currency could undermine this strategy.
- Dubai’s real estate sector could be hit if fresh inflows slow. If a stronger currency interrupts this flow, there is the risk that profit-taking could hit the real estate market, which would undermine Dubai’s global image.
- Despite the diversification in foreign asset holdings, the GCC is still investing most of its surplus in US dollar assets. Whether these assets are managed by sovereign wealth funds (SWFs) or are private holdings, a revaluation would incur a valuation cost, which could be a significant deterrent.

GCC Peg to the US \$ - Is there a Need ?

There is clearly a cyclical challenge. Whilst the US is cutting interest rates in response to a slowing economy, the Gulf needs a tighter monetary policy to curb inflation. At present GCC Inflation is mainly driven by:

Food Price inflation: IMF estimated that 50% of the middle east inflation is due to food price inflation.

Capacity Constraints : real estate and labour. A Standard Chartered Study suggest that in UAE and Qatar 50% of inflation is due to capacity constraints.

Considering the above a change in currency pack is unlikely to have a huge impact on the over all inflation which seems to be a route cause for all the cries against the Peg. But with no end in sight in the Dollar decline these cries shall only get louder.

So What is :Likely to Happen

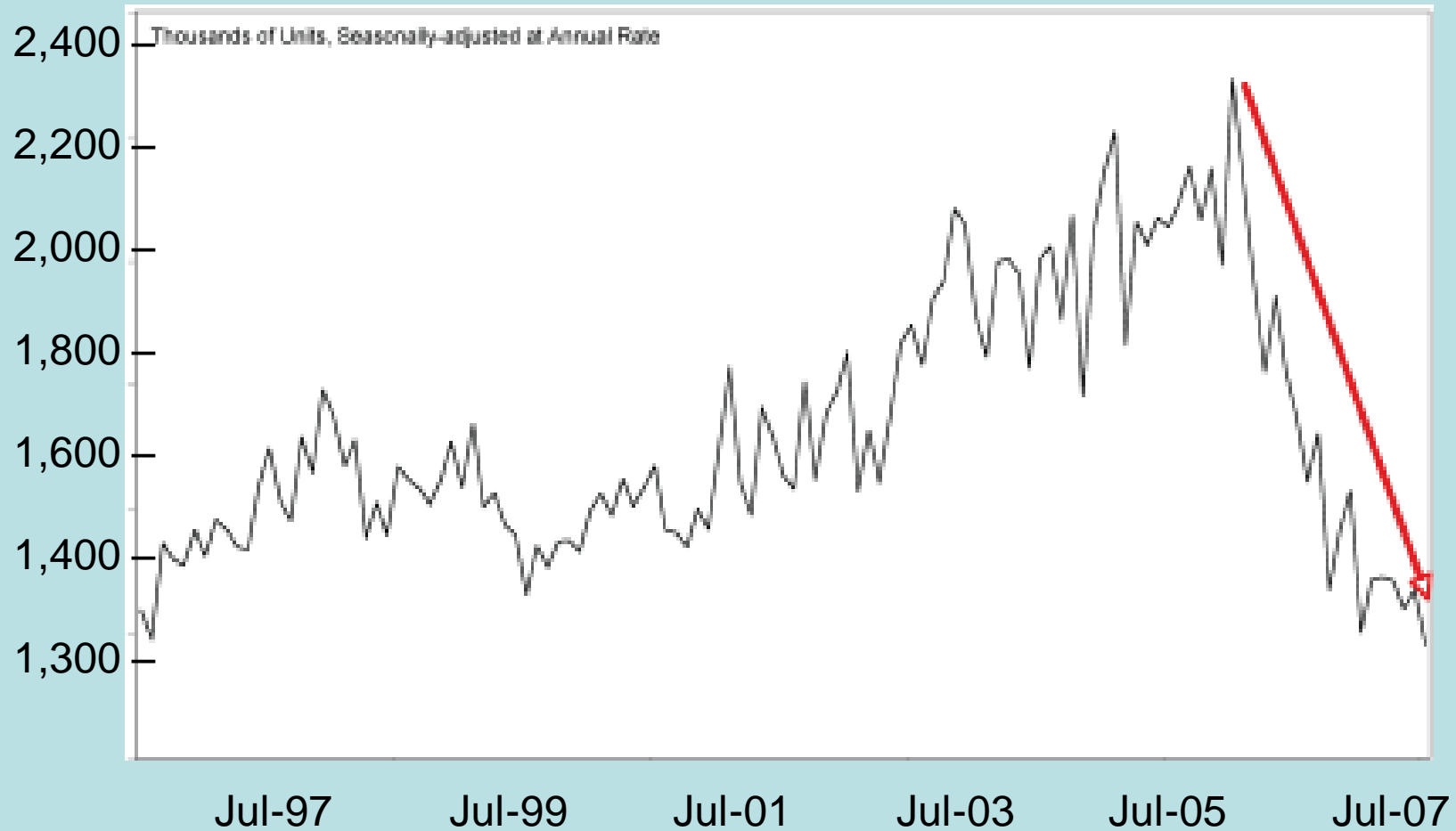
We expect Saudi Arabia & or UAE may either jointly or independently revalue by between 2-5% and a quiet move towards the Kuwait Model with US \$ still weighing around 70% in the basket of currency & the rest denominated by Euro, YEN & Yuan.

However in our opinion the above will not suffice and a more conventional monetary discipline is required by perhaps reducing the money supply by increasing cash reserve ratio like China and India to cool off the demand and slow the economy down a little.



Key Statistics To Watch

New Housing Starts and Building Permits for New Housing Starts Source: U.S. Census Bureau



New Housing Starts and Building Permits for New Housing Starts

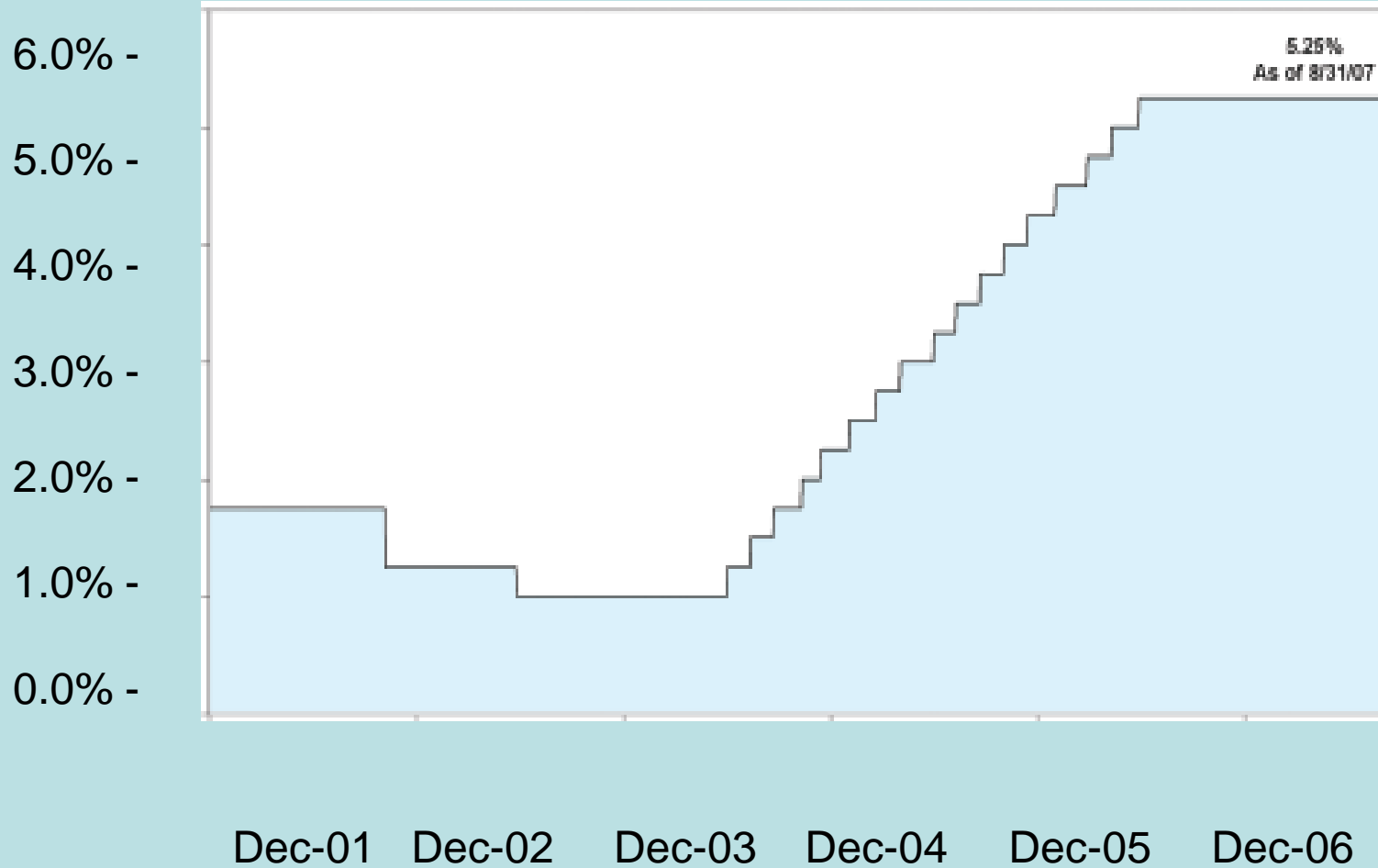
Source: U.S. Census Bureau

- Construction of housing increases the need for skilled construction workers, such as bricklayers, carpenters and electricians.
- Some estimates indicate that approximately 2,500 new jobs are created for every 1,000 new homes under construction.
- During the most recent housing boom, approximately 40 percent of all new jobs were related to the housing market.
- Although housing starts rose 57 percent between July 2000 and January 2006, they had fallen 74 percent through July of this year.
- During July alone, housing starts declined 21 percent from the same period a year ago.
- Meanwhile, building permits for new privately owned housing starts fell 22 percent in July.
- The housing slump appears to be far from over, especially after considering that the inventories of new homes on the market are near historic highs.

The above two indicators suggest U.S. economic growth will slow considerably over the coming months and that an economic recession may be just around the corner.

TARGET FED FUNDS RATE

(Source of Data: Board of the Federal Reserve System)

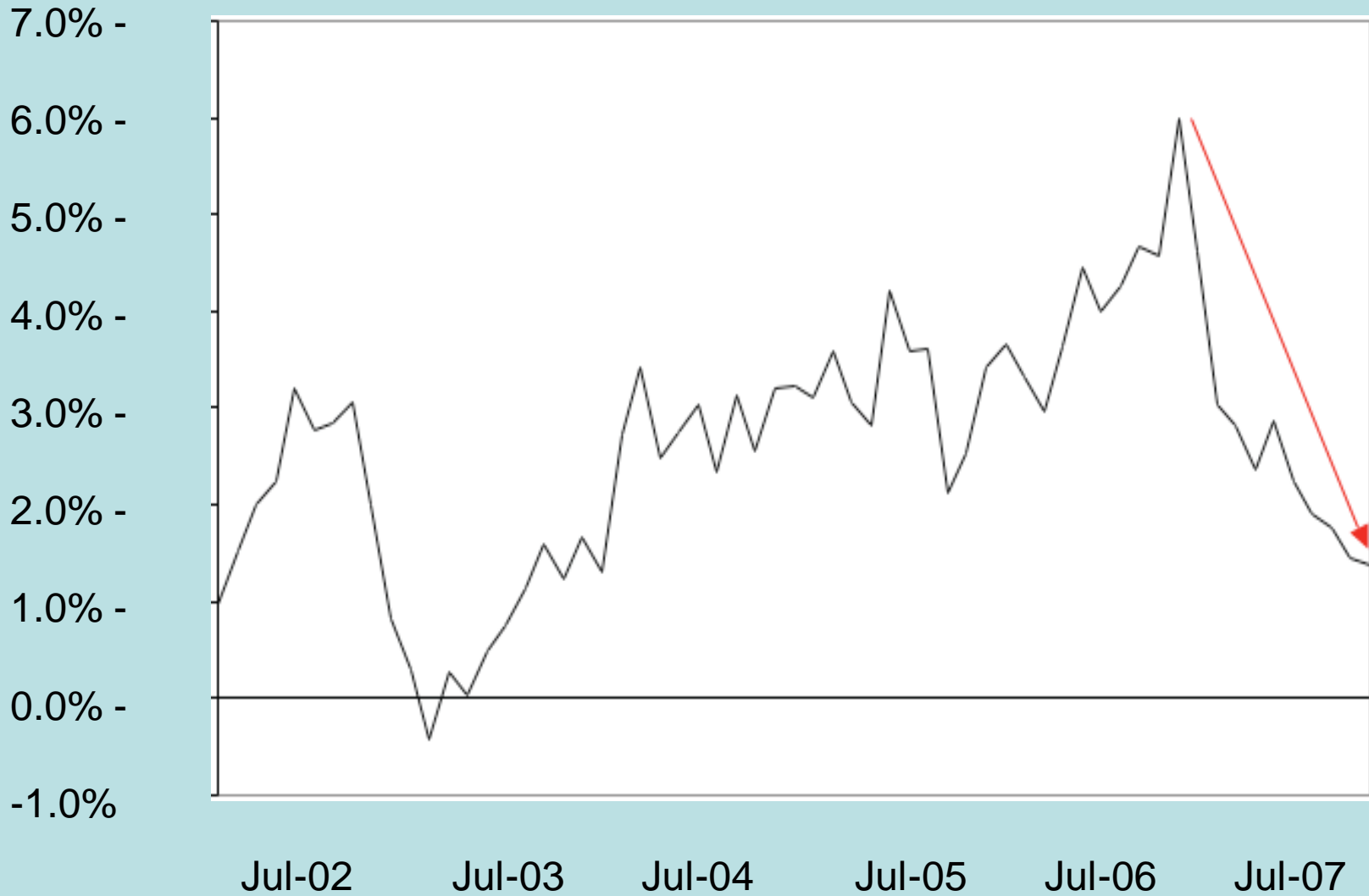


FED RATE IMPLICATIONS

- The Federal Reserve Bank of New York is responsible for conducting market operations for the central bank.
- Those operations help keep the Fed's key interest rate — called the federal funds rate — at its current target of 4.50 percent. The funds rate, the interest banks charge each other on overnight loans, affects other rates charged to millions of consumers and businesses.
- Thus, it is the Fed's main tool for influencing overall economic activity.

Fed's lowering of its target Fed funds rate by 50 basis points to 4.75 percent on Sept. 18 followed by another reduction of 25 basis points on 31 October reveals that the Fed recognizes the U.S. economy is contracting and could possibly enter recession.

INDUSTRIAL PRODUCTION INDEX: YEAR-OVER-YEAR CHANGE (Source of Data: The Federal Reserve)

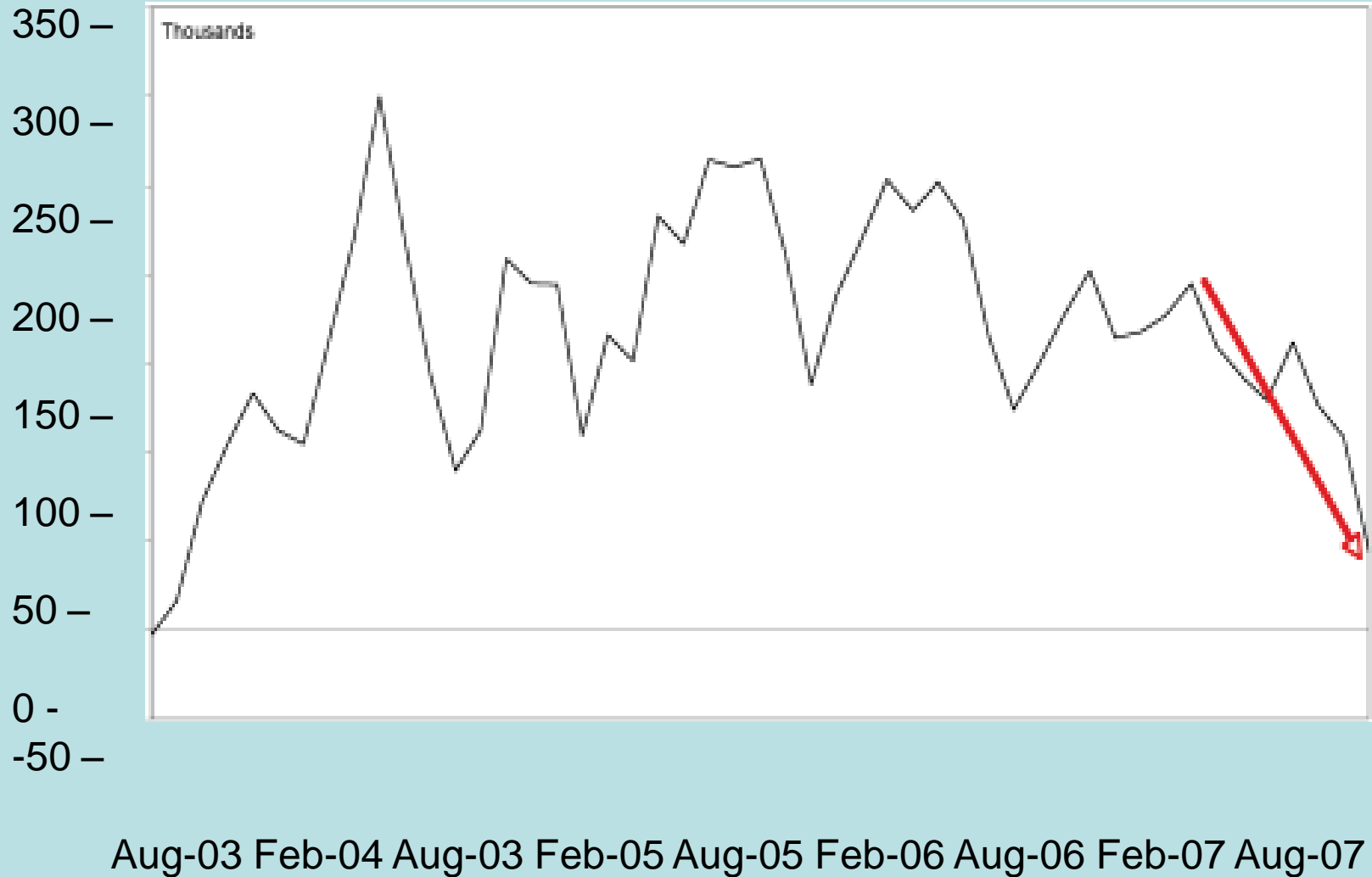


INDUSTRIAL PRODUCTION INDEX: YEAR-OVER-YEAR CHANGE

- The industrial production index measures output at the nation's manufacturing, mining, and utilities.
- The Federal Reserve closely monitors the industrial production index for input on setting monetary policy because, according to the Fed, "the industrial sector, together with construction, accounts for the bulk of the variation in national output over the course of a business cycle."
- In other words, the industrial production index tends to track GDP very closely, rising along with increases in GDP and declining when GDP falls.
- The year-over-year change in the industrial production index fell to 1.4 % during June and July, from 1.8 percent in May and 1.9 % in April.
- A year ago, this indicator was rising at a 4.7 % annual rate.

Hence, the industrial production index suggests the U.S. economy is in the contraction phase of the business cycle and that a recession may be right around the corner

3-MONTH AVG. OF CHANGE IN NON-FARM PAYROLLS (Source of Data: U.S. Department of Commerce)

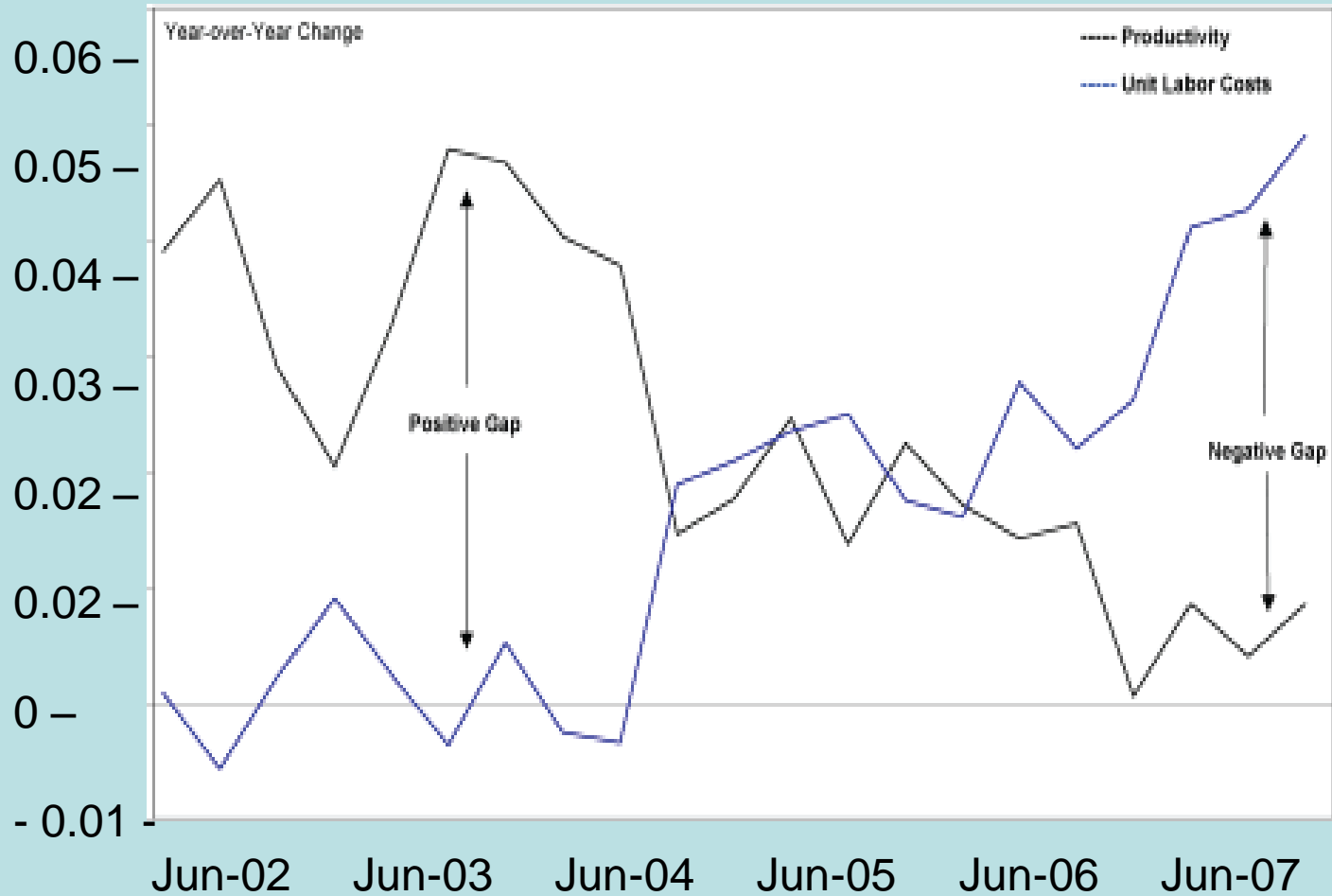


3-MONTH AVG. OF CHANGE IN NON-FARM PAYROLLS

- Non-farm payrolls, which are computed by the U.S. Department of Labor's Bureau of Labor Statistics (BLS) by conducting a monthly survey based on a sample of 400,000 business establishments, is used to gauge near term employment conditions.
- Non-farm payrolls obviously affect the economy through their impact on consumer incomes (and therefore consumer spending).
- However, the degree to which non-farm payrolls affect the financial markets is largely determined by the phase of the business cycle and economists' expectations for the most recent payrolls figure.
- As you can see in the chart, job creation has clearly slowed since the beginning of 2007, with the three months average of the monthly change in non-farm payrolls falling to 44,000 during August, from 188,000 this past May and 226,000 in December 2006.

Non-farm payrolls fell by 4,000 during August, versus an increase of 68,000 in July and 69,000 in June. August's job losses indicate the U.S. economy is in the contraction phase of the business cycle.

NON-FARM PRODUCTIVITY VS. UNIT LABOR COSTS (Source of Data: U.S. Department of Labor)



NON-FARM PRODUCTIVITY VS. UNIT LABOR COSTS

- Non-farm business productivity measures the output per hour of all non-farm business entities, while unit labor costs measures employee compensation per hour divided by the number of goods or services produced per hour.
- Productivity and unit labor costs are important indicators because of their impact on inflation, the growth rate of the economy, and employment.
- When productivity is growing at a faster pace than unit labor costs, businesses are generally able to increase (or at least maintain) their profit margins.
- On the other hand, when productivity growth slows considerably and unit labor costs rise significantly, businesses generally need to raise the prices of their products in order to maintain their profit margins, and inflationary pressures will rise during such periods.

As you can see in the chart, productivity growth has been trending significantly lower during the past year, while unit labor costs have been rising. If this trend continues, businesses will either need to raise the prices of their goods or continue to cut their workforces.

Consumer Price Index and Producer Price Index

- CPI compares a household's cost for a specific basket of goods and services with the cost of the same basket during an earlier benchmark period. PPI uses a similar benchmark approach, but instead measures price changes reported by establishments at the wholesale level.
- Both the PPI and CPI are indexes that track the purchasing power of the dollar by measuring the change in producer and consumer prices.
- These indicators determine an economy's annual rate of inflation by computing their percentage change over the prior year.
- The FED regularly monitors these price indexes, when these inflation indicators rise at a rapid rate, the Fed tends to increase the Fed funds rate. Conversely, when they fall beneath a level at which the Fed often lowers the Fed funds rate.
- Both the CPI and the PPI have risen considerably over the past year. CPI has risen to a 2.7 % annual rate during the previous two months. Meanwhile, the PPI rose at an annual rate of 5.7 %t during July — its fastest pace in more than a year.

The significant increase in CPI and PPI suggests the economy is in either the late expansion or early contraction phase of the business cycle



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Final Words

The views expressed in this presentation are purely of the presenter and does represents the views of either the ACCA or the Ministry of Finance.

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QUESTIONS



THANKS





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