

# Some Estimates and Predictions of Changes in the Exchange Rate

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In 2005, the American showed signs of recovery after many years of cyclical recession. This article centers on the exchange rate of the euro to the dollar and makes predictions of their long-term positions. Main changes in the exchange rate in 2005 will be mentioned to help readers envisage factors that have frequent effects on the dollar. They will serve as a basis for the prediction of the future of the American economy and the price of the dollar.

## 1. Main changes in the exchange rate in 2005

January: The dollar rose against other hard currencies and the EUR/US\$ rate was 1.3384 because the ISM and new orders for goods and services reached the highest level compared with the previous 11 months. In this month, Chinese currency, a new factor, came into play. The dollar showed an downward tendency when the Chinese government refuted the statement that "China hasn't been ready to adjust its exchange rate" made by some Chinese high-ranking officials. Analysts said the renminbi hardly rose.

February: By the end of this month the dollar fell in comparison with other currencies although the American GDP of the previous quarter IV rose by 3.8% compared with the estimated 3.7%. Improvements in the trade balance and private investment helped the U.S. gain a growth rate of 4.4% in 2004. The fall in the dollar

price was due to the low growth rate as compared with what the FED predicted.

March: The dollar rose against the Euro because the increase in the EU money supply was set at 6.4% for February compared with an increase of 6.6% in January. Worry about low growth in the EU allowed the dollar to rise against the Euro. The EU inflation rate was under the 2% ceiling. Experts said the EU could face a possibility of deflation.

April: The dollar kept rising although the American inflation rate was high and its growth rate in the first quarter was 3.1% compared with 3.8% gained in the last quarter of 2004. The reason for this rise in the dollar price was a hope that the FED would raise the interest rate, which made financial assets in the dollar look more attractive in the eyes of foreign investors. Other supporting factors were the French failure to pass the EU Constitution, political risks in Germany and Canada and expectation for a rise in the interest rate in the U.S.

May: The euro fell against most hard currencies. The euro rate to the dollar reduced to 1.2400 (the lowest in previous seven months). This came from the fact that France said no to the EU Constitution, which could encourage other members to do the same. This meant that the EU could hardly become a strong counterpart of the U.S.

June: The dollar fell against the euro when the

king of Saudi Arabia died and Prince Abdullah who didn't share a pro-America view with his father, took the throne. The world was afraid of a sudden change in the Saudi Arabian foreign policy. In addition, employment report from Germany said the unemployment rate fell, which made investors feel more confident in the euro.

The dollar was still strong because its GDP in the first quarter rose by 3.8% compared with an estimated level of 3.5%. Analysts predicted that the

dollar would rise when the FOMC didn't suggest any change in its view on the interest rate after its ninth successive rise. The euro rate to the dollar rose to 1.2111- 1.2000 at the end of this month.

July: The dollar fell against most hard currencies because investors felt pessimistic about the American growth rate in the second quarter and the unemployment rate in Germany kept decreasing. In addition, the renminbi rose by 2.1% against the dollar, and the FED "re-



fused" to intervene when the dollar fell.

August, September and October: The dollar rose again when the consumers trust index was improved. One of factors that affected the price of the dollar was rises in the oil price.

In October, the dollar rose strongly against the euro and most other currencies when the American GDP looked favorable. The euro rate to the dollar varies between 1.2047 and 1.2170.

November: The dollar kept rising. The euro rate to the dollar varied between 1.1789 and 1.1775. The U.S. expected a high growth rate when overseas profits were transferred home. The euro rate was expected to fall below 1.1500 by the year's end.

December: The official income of the non-farming business in the U.S. was encouraging while the unemployment rate was kept stable, which made the dollar rise against the euro; while encouraging signs from Europe, especially from Germany, faded.

The analysts believed the dollar was still stronger than other currencies, especially by the year's end, when the inflow capital was on the increase because of rises in the interest rate and profits transferred from American overseas investments.

As predicted, the FED allowed the interest rate to rise for the thirteenth time, to 4.25% (the highest level since 2001). This decision made the dollar rise strongly, the euro rate to the dollar varied between 1.1986 and 1.1902. According to the FED Chairperson, the inflation rate in a long term must be controlled although for the time being it caused no worry.

The US official deficit of the balance of payments on current account was also lower than what was expected. That was why

the dollar rose by some 10% against most currencies at times. Analyses also predicted that the FED would not raise the interest rate any more and the dollar would lose its strength. The US interest rate was then considered as medium that didn't not only cause harm to the economic growth but also allow the economy expand too much.

When the interest rate didn't rise, trade and budget deficit became causes of falls in the price of the dollar, but many experts thought the FED would raise the interest rate to 4.5% when profits were transferred to the U.S. at the end of the fiscal year, which would make the dollar rise again.

In the meantime, predictions of the EU trade balance were not much encouraging, which made the euro keep falling. Analysts of major mutual trusts believed the euro could hardly rise remarkably and would vary between 1.2100 and 1.1900 in the last month of the year.

## 2. Estimates and predictions

Although the dollar fell at times, it had an upward tendency. This showed that the American econ-

omy gained encouraging growth rate after recession in 2004. However, various sources of information showed that the dollar can hardly rise against the euro in 2006 because of the following factors.

- Firstly, the renminbi comes into play and China has full ability to make its currency rise because the G7 causes pressure and China itself wants to enhance position of its currency regardless of the possible trade gap. It hopes a bigger inflow capital will help its economy grow faster.

- Secondly, many leaders of the world want to enhance the role of the euro in order to establish a new financial order although the dollar still accounts for some 70% of the world exchange reserves. This view is based on the fact that the EU has replaced the U.S. as the biggest exporter and importer.

European leaders have tried their best to bridge the gap between their views in order to build a stronger Europe and the euro. After a lot of controversies, the EU agreed on a budget of 862.3 billion euro (equalling 1.045% of the EU gross products) for 2007-2013 last December.

Economists thought this was an important agreement for the whole union because it would affect vital problems of the EU in the next seven years when its membership would rise to 27. This strategic change also produces great effects on the position of the euro in the future and most analysts said this was an agreement that helped the EU take a forward step.

The euro area now accounts for 30% of the world trading volume, which forces international banks to change US\$310 billion in their reserves into the euro. The biggest shortcoming of the EU, however, is its heavy dependence on political decisions by the EU leaders, which could prevent the euro from becoming a predominant currency. In addition, when fiscal and monetary policies of the EU are based solely on a currency, there will be dangers of monetary crises, like the crisis in September 1992, when a series of European hard currencies fell.

These factors make experts think that the dollar will stay dominant in a long run regardless of signs of new contenders.

