Hysteresis of Exchange rates

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December is usually a month to look back at the events that have made an impact during the year. One of the major economic changes of 2003 is the depreciation of the USD especially against the euro and also against a broadening range of currencies. The continued damage to the USD in the face of improved US economic outlook is similar to the early 2002 scenario when the Euro remained passive to the positive Euro zone outlook. It also highlights the structural and cyclical short comings hampering the USD. US trade deficit (there is amounting gap of USD 557 billion) has become the prime reason listed amongst trades, investors and others for each and every southward movement of the USD. Investor confidence has been for the afore-mentioned reasons coupled with what is seen as risks on many USD based assets.

These roller coaster rides in currency markets have forced investors to once again repose their faith in the 'savior of last resort' — Gold. Gold has recently touched the magic mark and its resistance of USD 400/-. The other times when the USD has been at and above the resistance was when it traded at $ 422 in December 1989 – January 1990 during the Gulf war, $ 415 in August 1990, $ 403 in August 1993 and $ 414 in February 1996. Gold continues to fascinate investors, reminiscent of classical economic theory.

The appreciation of many currencies w.r.t USD can be attributed primarily to the interest rate differentials. The recent rise in the GBP vis-à-vis USD has been explained by the customer sentiment and stronger retail sales in UK. Is there any camouflaged design behind the appreciation of the GBP? Mr. Gordon Brown recently said that the UK's economy had passed his financial services test, but it failed the tests on sustainable convergence, economic flexibility, investment and employment. Hence UK cannot adopt the Euro with its current economic policies. He has also stated that he shall attempt a re-examination during the 2004 budget. Theoretically, UK should plan to adopt the Euro by 2005. In the event of UK adopting the Euro in 2005, a strong GBP can aid in a better bargain for the GBP/Euro for UK.

Since the days of the Bretton Woods agreement, the USD has been truly an international currency and playing its role to perfection by also being a vehicle currency in most of the transactions. Are we moving towards one monetary era towards a new leader? The single currency Euro may in the long term replace the USD. In the event of the UK adopting the Euro, the Euro's shall be strengthened further and its stability shall be enhanced. Euro has always appreciated against the USD every December from the past 4-5 years, but this year's appreciation is there to stay. The ECB may not change its interest rates in the near future. Many European manufactures do not want a strong Euro as it makes the US manufactures more competitive in both the US and European markets.

The US economy has shown signs of recovery in the later part of third quarter and current quarter of this year. Inspite of the improved economic conditions in the USA (with improved economic indicators), there are probabilities that the USD may remain in its current state or depreciate further to an extent of 10-15% against the major global currencies. This southbound journey of the USD may last through 2004 and early 2005. The term "Hysteresis" can be aptly applied to the situation. Are the exchange rates and

the USD particularly in Hysteresis? I think we shall witness a scenario wherein regional single currencies shall be formed which will eventually culminate into a single world currency. But that is too far to be envisioned, for the time being, *ceteris paribus* the USD will adhere to the laws of hysteresis and the Euro may take the reigns of international/vehicle currency. The central banks of many countries have redistributed their forex reserves by shifting from the USD to Euro (the exact percentage is yet to be ascertained).

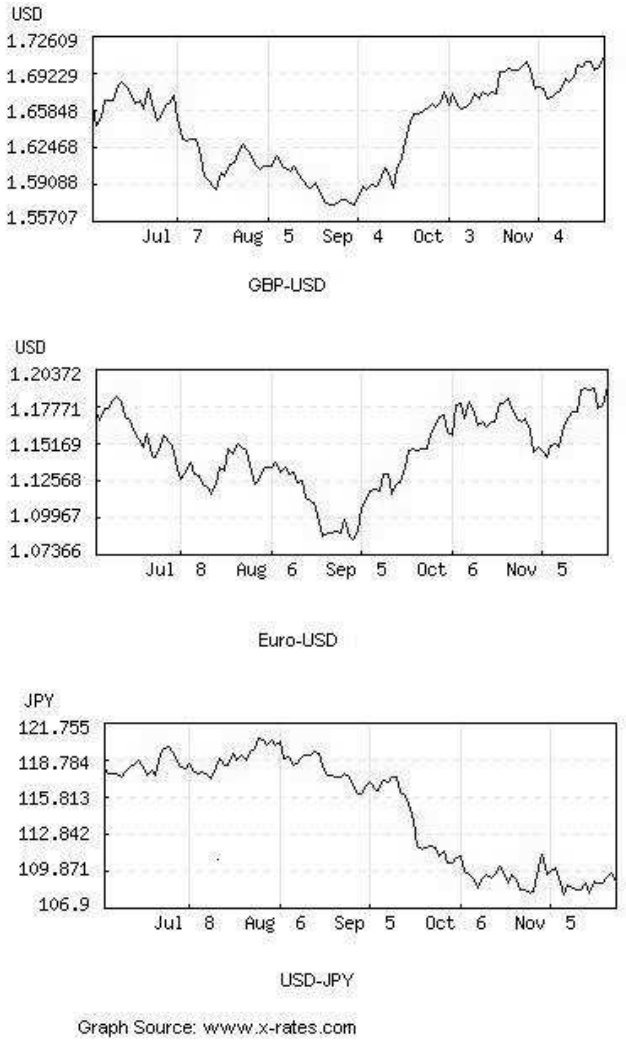

Figure – USD versus major currencies 120 day data