

The dollar

Further to fall

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A new year is likely to bring a new low for the dollar

THE dollar ended the year as it began: heading downhill. It hit a new low against the euro, below \$1.36, on December 28th. Against the yen, it was steadier: ¥103, slightly stronger than in late November. The yen has risen by less than the euro because, although the Bank of Japan has not intervened in the foreign-exchange markets since March, the bank looks more likely to act than the European Central Bank. Japan's finance minister, Sadakazu Tanigaki, gave warning this week that his country's authorities would monitor foreign-exchange markets over the New Year holiday. In contrast, Gerrit Zalm, the Dutch finance minister, suggested that the euro's rise so far was acceptable.

Since early 2002 the dollar has lost 37% against the euro and 24% against the yen. But it has shed only 16% against the Federal Reserve's broad basket of currencies, because many Asian currencies are pegged or closely tied to the greenback.

The cause of the dollar's decline is hardly a mystery: private investors are less eager to finance America's huge current-account deficit. The deficit widened slightly in the third quarter of 2004, to a record \$165 billion, or 5.6% of GDP. If the deficit remains so big, America's foreign debt burden and hence its debt-service payments will increase sharply.

So far, America's mounting foreign liabilities have not harmed its economy because the rise in its debt in recent years has been offset by lower interest rates. As a result, America still enjoys a net inflow of foreign investment income despite being the world's biggest debtor. But, as interest rates rise, refinancing America's debt will become more costly. Goldman Sachs forecasts that net foreign investment income is likely to shift to a sizeable deficit during 2005, growing thereafter. The investment bank estimates that, if America's current-account deficit remains steady as a share of GDP and interest rates average 5% in future, net foreign debt-service payments will reach 4% of GDP by 2020—a significant drag on American living standards.

By most measures the dollar is already undervalued, but experience suggests that it will need to fall further still to cut the deficit to a sustainable level, say 2-3% of GDP. Capital Economics, a London research firm, forecasts that the dollar will fall to \$1.40 against the euro and to ¥90 by the end of 2005. But it expects the dollar to recover against the British pound to \$1.82 from \$1.93 today, as British interest rates are cut in the wake of falling house prices.