Will the US dollar continue to plunge?
The trend, causes and outlook…

The downward trend of the US dollar over the last two years has fed various debates about worldwide macroeconomic imbalances. To date, the largest part of the depreciation has been absorbed by the euro, the yen and, to a lesser measure, although of even more concern to us, by the Canadian dollar. In order to be able to plot the changes in value of our currency, it is important to properly understand the trend the greenback will take for the next few years. For the moment, expectations with regard to the imminent tightening of monetary policy in the United States is giving the US currency some breathing space, but the factors that are driving it downward remain unchanged and suggest that in the longer run, the US dollar will continue to lose ground against the currencies of its trade partners.

Progress of the American dollar since 1995

In this article, we are endeavouring first to identify the main factors that have caused the recent depreciation of the US dollar. Second, we are contemplating the medium-term outlook for the greenback and its potential role in the process of adjusting numerous worldwide macroeconomic imbalances that have been observed for several years.

The worsening of the current accounts deficit

A survey by the National Association for Business Economics (NABE), conducted among its members in February 2004, shows that the decline in the US dollar over the past few years has been brought about by many factors. At the head of the list comes the pessimism of foreign investors with regard to the performance of assets written in greenbacks, the weakness of US interest rates and the “undeclared” relaxation of the American strong dollar policy. But what explains such a turnaround in the state of affairs? The answer to this question lies in large part in the progressive growth of the US current account deficit since the middle of the 90s and, specifically, the considerable increase in the inflow of foreign capital that has been needed to finance it.

Before going any further, a few definitions are needed. First, remember that the current account balance is one of the components of the balance of payments. The balance of payments stipulates that the sum of the current account balance, the capital and financial accounts balance and the reserves should be zero. For the United States, this means that the current account deficit must be compensated by a net inflow of foreign capital.

It is easy to show that the current account balance can be defined in two ways: 1) by the trade balance of the goods and services and net revenues and transfers by Americans on foreign assets, or 2) by the difference between domestic savings and investment. This means that we can see the growth of the current account deficit, first, as a function of the growing gap in the US trade deficit and, second, from the point of view of the insufficiency of savings in the United States. (See table next page.)

First, the trade balance…

In a space of less than ten years, the US current account deficit has more than tripled, mounting from 1.5% of GDP in 1995, or US$105B, to 5% of GDP in 2003, or US$553B. This sharp increase reflects mainly the marked growth of the United States trade deficit against its main trading partners during this same period. Japan and the euro-zone showed trade surpluses of US$121B and US$62B respectively in 2003. Now, those surpluses were only slightly higher than those of 1995. Therefore, it is important to underscore the boom of emerging Asian economies.
on the world economic scene over the same period. In particular, the deficit with China, which has risen from US$34B in 1995 to US$135B in 2003, alone represents a quarter of the US trade deficit.

How did a nation as productive as the United States come to balloon its trade deficits with its main partners? According to Brooks (2004), the answer to this question lies in the structural and cyclical divergences of the United States relative to its trading partners. For many, the considerable gap between the rate of growth of the US economy and that of the main large industrialized zones is held up as being greatly responsible for the deterioration of the American trade deficit. Since 1992, the growth of the US economy has surpassed that of the Euro zone and Japan by nearly 2% on average. This means that Americans imported proportionally more and exported proportionally less than the Europeans and the Japanese than would have been the case if growth had been equal.

The phenomenon is accentuated by the fact that the marginal propensity to consume is stronger in the United States than elsewhere in the world in general, which translates into an increase in imported goods. This effect can be easily illustrated by the size that the import ratio relative to GDP has assumed in comparison to the export ratio since the beginning of the 90s. As the following graph shows, the ratio of imports to GDP jumped from 11% to 14% between 1990 and today, while the export ratio, after a slight increase at the beginning of this period,
dropped back to its starting level, i.e. around 10%. At
nearly 5%, the gap between the two ratios has never been
as wide. This means that to be able to stabilize the trade
deficit at its current level, the increase in exports must be
at least 1.4 times faster than the increase in imports.

That imports of goods might increase by nearly 15%
compared to last year. In this context, it is hard to imagine
any improvement in the trade balance. At the expected
rate of imports, there would have to be an increase of 21%
in exports just to stabilize the deficit!

So, this means that the situation remains very difficult to
resolve. Due to the rigidity of international trade contracts,
improvement in the foreign trade sector after a currency
depreciation can take time to appear. In the jargon of
economists, this phenomenon is referred to as the “J
curve.” The 13% drop the greenback has experienced
since the beginning of 2002 should start to bear fruit.
Judging from the significant growth in the “Exports”
component, the ISM Index of the US manufacturing
sector over the last six months, exports of goods may
undergo their best growth of the last decade. Unfortunately,
for the reasons mentioned above, the expected increase
in exports will not be reflected by an equivalent reduction
in the current account deficit. Despite the reduced
purchasing power of Americans, consistent domestic
demand will result in imports continuing to grow at a
sustained pace. In fact, our growth forecasts for US
domestic demand over the next few quarters indicates

... and second, savings and investment

The major stake behind the growth of the US current
account deficit lies in financing it. To understand it properly,
it is necessary to introduce the notions of savings and
investment. Savings refers to all revenue shares not
allocated to the consumption of nondurable goods
(purchases of durable goods most often being considered
investments). In a balanced situation, national savings
(savings in the private sector plus government savings)
should equal national investment, the one serving to
finance the other. Note that private sector savings is the
sum of the savings of consumers and businesses. In an
open economy, imbalances in the current account, or the
difference between national savings and national
investment, allow allocation of surplus savings for
investment where they are likely to prove more produc-
tive.

Generally, emerging countries provide higher yields on
capital. However, the collective values in most
industrialized countries, such as political stability, effi-
cient market economies, solid financial systems and
education systems that make it possible to train highly
qualified workers, result in investors being more confi-
dent that these countries will provide risk-return
relationships that are among the best.

Beyond these factors, several developments attest to the
expansion of investment opportunities in the United States
between 1996 and 2003. The yield on capital invested in
the United States benefited from the rapid spread of
technological innovations. The productivity of workers in
the US advanced by nearly 3% per year. At the same time, the value of American stocks rose nearly 80% compared to a 64% increase for the European markets and a decline of near 30% for the Japanese stock market. The upward trending bond market was also favourable for the US dollar. The weakness of inflation allowed interest rates to decrease. So, it is no surprise that the United States enjoyed a strong inflow of foreign capital over the period. This contributed to putting upward pressure on the greenback and financing the US current account deficit.

For a few years now, we have seen that national savings in the United States is lower than investments. Between 1993 and December 2000, the considerable efforts of the Clinton administration to clean up the public finances led to an increase in public savings. At the same time, however, household and corporate savings were diminishing, essentially reflecting the wealth effect tied to the rise of stock prices and expectations of higher future revenues caused by the improvement in production potential. This state of affairs reversed recently. On the one hand, the negative wealth effect linked to the bursting of the technology bubble pushed households to increase their savings rate while businesses, faced with an overcapacity in production and the weakness of stock prices, had to clean up their financial balance sheets. On the other hand, the very expansionist US fiscal policy drove public federal finances from a record surplus of US$237B for fiscal 2000 to a deficit of US$374B for 2003, or +2.4% of GDP to -3.4% of GDP respectively. Conversely, Japan, the Euro zone and the greater part of the world maintain a rate of savings to GDP higher than that of their investments.

**How low can the dollar go?**

Usually, when there is a large imbalance in the current account balance, a relative price adjustment occurs to correct the situation. This might be an increase in interest rates to make US securities more attractive, an increase in foreign prices to raise the cost of imports or, conversely, a reduction of US prices to make US exports more competitive, or a correction in the exchange rate. Each of these adjustment mechanisms occurs naturally and all lead to the financing or resorption of the imbalance in the current account balance.

In a study by the United States Federal Reserve, C. Freund (2000) tries to demonstrate that, over the last few decades, industrialized countries faced with large current account deficits have had to make major macroeconomic adjustments that, often, led to recession. It concludes that a turnaround generally takes place when the current account deficit reaches about 5% of GDP, is related to a deceleration in revenue growth and to a considerable decrease in value of the currency over a period of at least three years.

However, these conclusions are difficult to apply to the US economy, which seems better able to more easily sustain a current account deficit that is large in proportion to its GDP. Given that the greenback is used as the reserve standard in most international transactions (more than two-thirds of the US dollar bills in circulation are outside the United States) and that more and more countries are using an exchange rate pegged to the US dollar, the demand for it grows continually. That said, since only the United States issues greenbacks, the only way for foreign interests to obtain them is to finance the US current account by a proportional increase in the financial account. So, financing US debt is as vital for the United States as it is for foreign interests.

It must also be remembered that the United States’ debt is written almost exclusively in US dollars. If the value plummets, it automatically implies that the amount of US debt expressed in foreign currency loses value. As a result, foreign holders of US debt might be tempted to buy back US securities in order to stabilize the value of their
The major currencies were hit the hardest

The benchmark: The Plaza Accord

This drop of the US dollar, while very orderly, is difficult to compare to the planned depreciation that took place after the Plaza Accord of September 22, 1985. Nonetheless, the situation appears to be quite the same on many
points. After four years under the Reagan administration, the United States was heavily in debt, the current account deficit had reached alarming proportions, interest rates were high and moving upward and the US dollar was strongly overvalued.

The meeting of the group of finance ministers and central bank governors of the 5 world economic powers, the G5 (the United States, Germany, France, the United Kingdom and Japan) was intended to control trade balances and American protectionism, promote world economic growth by fostering domestic demand in Japan and Germany and reduce the debt service of the United States. To achieve this, it was decided that a planned depreciation of the US dollar was desirable and that exchange rate policies should play a role in the adjustment process.

Based on the Fed’s major currencies index, the effective US dollar underwent a depreciation of 40% in a little under 3 years, or between March 1985 and May 1988. In fact, no one knows where the dollar might have depreciated to if not for the Louvre Accord of February 21, 1987. At that time, it was decided that the planned fall of the dollar should end. All of the G5 were of the opinion that currency prices were in line with the bases of the economy.

Today, things are somewhat different. It is true that when the current account deficit is combined with the budgetary deficit (nearly 10% of GDP compared to 8% during the Reagan era), the situation seems even more alarming. Nonetheless, there is basically nothing resembling a concrete agreement among nations to devalue the American currency. At the G7 summit (the G5 plus Italy and Canada) in Boca Raton, Florida, in March 2004, no mention was made of a plan to depreciate the US dollar. The United States instead stated that a strong dollar remained in the national interest. In fact, only a short phrase in the official press release mentioned that excessive volatility and chaotic fluctuations of the exchange rates were undesirable for economic growth.

This does not mean, however, that the fall of the dollar will continue chaotically. Due to the weakness of their domestic demand since the beginning of the century, the economic growth of several large industrialized zones has been mainly focussed on the foreign trade sector. Thus, they remain largely dependent on developments in the American and Chinese economies. Consequently, most of them look unfavourably on any marked appreciation of their currencies. This leaves little room for a rapid and pronounced depreciation of the greenback.

All things being equal, from an historical point of view, there would have to be an additional depreciation of the effective US dollar of at least 10% to enable a correction of the US current account deficit. As the following graph shows, the marked depreciation that took place after the Plaza Accord in 1985 only had an effect when the level of the effective US dollar approached its long-term average. Today, the drop in the greenback has not succeeded in slowing down the growth of the deficit. So, the problem is not so much the sudden weakness of the American dollar but rather that, at its current level, its value is still too high. If correcting the current account deficit must necessarily take place via a depreciation of the greenback, the greenback’s long-term trend will remain to the downside. Between now and then, however, many factors will work against this.

The evolution of the “big players” since the beginning of the year

As we mentioned earlier, the depreciation of the greenback has reflected mainly on the Canadian dollar, the euro and the yen. For them alone, the increases of 45% for the euro and 20% for the loonie and the yen between February 2002 and February 2004 represent 100% of the depreciation of the US dollar for the period. Undeniably, the scope of the combined US budgetary and trade

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*Sources: Federal Reserve and Desjardins, Economic Studies*
deficits will continue to have a negative effect on the greenback for the next few years, but beyond the effect of its downward trend, many local factors linked to the Canadian and overseas economies will continue to favour an appreciation of their currencies.

To properly characterize the greenback’s recent change in value, it is important to understand the recent developments in the currencies of the United States’ main trade partners. Up to now, our most recent forecast scenario (Quarterly Financial Forecasts, Spring 2004) is quite close to the mark. After the gradual decline of the effective dollar from its cyclical high, it was predicted that the expectations on short-term interest rates would favour the American currency until the end of 2004.

Here is a short overview of the recent developments in the Canadian, Euroland and Japanese markets, and their effects on the direction of the greenback.

The Canadian economy is turning around

Faced with the faltering of the Canadian economy over the last three quarters, the Bank of Canada responded with three successive rate reductions of 25 basis points each in January, February and April 2004. This reduced the gap in key rates between Canada and the United States from 175 to 100 basis points, which at the same time reduced the attractiveness of Canadian short-term financial securities. From a high of nearly US$0.79 (its highest level of the last 10 years) on January 9, the loonie has pulled back nearly 4 cents US in the space of a few weeks to settle at US$0.75, the level it stayed close to on average for the following two months. After a slight rebound at the end of March, the currency depreciated again, falling below the US$0.72 threshold for the first time since September 2003.

More recently, things have improved considerably for our economy; so much so that there is no doubt that the period of easing in Canadian monetary policy is at an end. However, even though retail sales and real salaries are heralding a recovery in domestic demand, our economy’s growth remains well below its potential. Additionally, despite the recent rise in the annual variation of the CPI, inflationary pressures remain contained, which leaves the Bank of Canada a good margin of leeway to establish its monetary policy. But, we should not expect to see the Bank raise its key rates before the fall of 2004. Conversely, the strong growth signals coming from the US production and leading indicator indices, together with the improvement in employment and the end of disinflation, suggest that the US Federal Reserve’s (Fed) cycle of monetary tightening will precede the Bank of Canada’s by a few months.

The current price of the Canadian currency reflects to a great extent the market expectations regarding the difference between Canadian and American short-term interest rates. However, since the Bank of Canada has to stay on the sidelines until the fall, it is the influencing factors of the US money market that will have the most effect on our currency. In particular, if job creation in the United States continues to be sustained and inflation accelerates, the Fed could speed up tightening its monetary policy or proceed with more aggressive hikes. So, the loonie might find itself depreciating momentarily over the summer.

The European Central Bank (ECB) remains cautious

In the Euro zone, things seem to be a little more complicated. If the popular saying “strong economy, strong currency” is generally true, the weakness of the
Euroland economy over the last few years is hard put to explain the marked increase the euro has experienced against the greenback between February 2002 and February 2004. Remember that during this short period, the euro went from a low of US$0.88 to nearly US$1.29—a gain of more than 45%. Of course, after the greenback, the euro is the most common international trade currency. The portion of foreign reserves held in euros increased from 12.7% to 18.7% from 1999 to 2002. But it is clear that the euro’s appreciation over the last two years is mainly the result of the weakness of the greenback.

Just like the Canadian currency, the euro experienced a low recently. It even fell below the US$1.20 mark at the end of April. Apart from the optimism of foreign investors with regard to the US economy, the period has been accompanied by market expectations favouring an imminent rate reduction by the ECB. However, things did not go as the market had hoped. In spite of weak inflation (the annual variation of the CPI was 1.6% in March and April), the ECB maintained its usual passivity and preferred to opt for the status quo for the twelfth consecutive month in June 2004.

In the short run, the ECB will remain cautious. It is true that the improvement in global demand seems to have counteracted the bad effects of the euro’s appreciation on the zone’s exports. The growth of the Euroland economy is slowly picking up speed. But, we should not expect to see the ECB tighten its monetary policy quickly. On the one hand, even though the annual variation of inflation rose from 2% to 2.5% in May, this is due essentially to underlying effects related to the hike in energy prices relative to last year. On the other hand, the internal economy of the euro zone remains relatively weak. Particularly, in the face of the deteriorating job market, hikes in energy prices and structural rigidities, the confidence of economic actors is not improving.

The Bank of Japan’s foreign exchange interventions limited the plunge of the greenback against the yen

After an initial plunge of about 10% in 2002, the greenback stabilized around 118 yen/US$, on average, throughout the first 8 months of 2003. Following that, US currency slumped downward again, depreciating to a cyclical low of 104 yen/US$, its lowest level since 2000. With the improvement in outlook for economic growth in Japan, things could have been worse. The Bank of Japan’s massive foreign exchange interventions limited the appreciation of the yen.

In order to maintain the yen at a competitive level, foreign exchange operations by the Bank of Japan totalled close to 20 trillion yen in 2003, or nearly US$190 billion at the current exchange rate. Worse yet, the Bank increased its interventions at the beginning of the year, pushing its purchases of US securities up by more than 10 trillion yen over the first 3 months of 2004 alone, or US$95 billion. It must be noted that without the possibility of further easing monetary policy (interest rates are already at zero), foreign exchange interventions remain the only tool available to the Bank of Japan to slow down the yen’s rise in value.

Since then, publication of the national accounts for the first quarter of 2004 has added elements in favour or sustained economic growth in Japan. In spite of the persistence of deflation, consumer spending increased strongly for the second consecutive quarter. This suggests that the economy’s progress will not be focussed exclusively on the foreign trade sector over the next few quarters. This reawakening of Japan’s domestic economy enabled monetary authorities to reduce foreign exchange interventions to nil in April and May.
The factors driving down the US dollar remain unchanged...

Due to the continuing current account and budgetary deficits, the downward trend of the US dollar will persist for the next few years.

In Canada, the stabilization of the difference between short-term interest rates will give way to longer term influencing factors such as the rise in the prices of raw materials and the better report card on the health of Canadian public finances (compared to the US government’s). This will allow the loonie to resume an upward trend and likely return to around US$0.78 between now and the end of 2005.

In the Euro zone, the currency has already made up a good part of the ground it lost against the greenback over the last few weeks. The expected rate reductions have been sidelined and the markets are now waiting for advance signals of the cycle of monetary tightening by the ECB. The continuing improvement of economic growth between now and the end of 2004 and the strengthening of the economy in 2005 will result in the ECB having no other choice but to get in stride with the Fed, although probably not before the end of the year. Between now and then, the euro will have ups and downs before returning upward beginning in mid-2005.

China holds part of the solution...

However, it is unlikely that the loonie and the euro will experience as pronounced an appreciation as over the last two years. We believe that an additional depreciation of the US dollar will involve a further rebalancing of Asian currencies apart from the yen.

As we noted earlier, over the last few years, Asian central banks have purchased large quantities of US Treasury securities in order to preserve their currencies at a competitive level against the greenback. The idea is that by keeping the US dollar strong, Asian exports are less costly for Americans—but also for the Chinese. Remember that since 1997, the yuan has been pegged to the US dollar at 8.27 yuan/US$ (see economic outlook of January 23, 2004, on China). So, the efforts of Asian central banks to support the greenback also preserve China’s buying power. That said, over the last few years, this country has experienced phenomenal economic growth—a veritable windfall for the economies of the rest of Asia. In Japan, among others, the annual variation of exports to China was close to 35%, on average, throughout 2003. The share of total exports from Japan to China has risen from 3% in 1995 to 13% at the end of 2003.

With economic growth above 9%, massive net inflows in direct foreign investments and large trade surpluses with the most industrialized countries, it appears more and more evident that the Chinese currency is undervalued. The recent plunge of the US dollar, which only supports the necessity for a realignment of the currency, is encouraging the flow of capital to China. The marked accumulation of reserves in US dollars is clear evidence of an imbalance. To counteract the emergence of inflation that could arise from the currency’s lack of flexibility, our base scenario anticipates a re-evaluation of the yuan of at least 10%, probably around the middle of 2005, followed by matching to a basket of currencies.

A revaluation of the yuan would enable China to wipe out part of the trade deficit

In such a case, the need to intervene to maintain the other Asian currencies at a weak level against the US dollar (and, consequently, against the yuan) will be less pressing. This will allow an additional depreciation of the American currency. Note that the “Asia” bloc of the Fed’s effective US dollar index accounts for nearly 30% of the total index.
Conclusion

We feel that the greatest part of the depreciation of the US dollar is behind us. However, the scope of the US budgetary and current account deficits should result in, to the extent to which the tightening of monetary policies in the Euro zone and Canada are synchronized with that of the United States, US currency returning to the downward trend it has been experiencing since February 2002. Nonetheless, the euro and the loonie should not experience as sizeable an appreciation as over the last two years, as their current levels are already very high. The depreciation of the US dollar will instead be against Asian currencies, excluding Japan. A 10% re-evaluation of the Chinese yuan, followed by matching to a basket of currencies would be a good place to start.

All in all, the health record of the US economy and the role of the US dollar as the reserve currency in international transactions mean that the United States can support a higher current account deficit. As a result, we do not anticipate a marked depreciation of the greenback over the next few years. In our opinion, an additional decrease of 10% in the US dollar, and then a period of stabilization over the next three years, are to be expected. However, due to the growth differential between the United States and the overseas economies, the current account deficit will remain close to 4.5% of GDP until the end of 2005—a level which is easily sustainable for the US economy.

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