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What Explains the Dollar’s Doldrums?

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By Michael Heise

The weakness of the dollar against the euro defies textbook wisdom. Understanding why is the latest challenge for economists and policy makers trying to form expectations about what comes next. The key is to look for an answer in the right place.

Since December 2016, the euro has risen to $1.23 from $1.05. Under the circumstances one would expect the currency pair to have moved in the opposite direction. Monetary tightening in the U.S., in combination with fiscal loosening, would push up the dollar. The European Central Bank's commitment to a zero interest rate at least until 2019 should depress the value of the euro. These diverging trends have widened the spread on two-year bond yields in a way that implies a stronger dollar. So where is the currency revaluation?

Most analysts are looking to the U.S. for an answer. Trump administration officials have recently suggested they would welcome a weaker dollar, but more is at work here than simply talking the dollar down. The greenback has been weakening relative to the euro for more than a year. Something else is going on.

Some factors still point to a weaker dollar, despite the monetary-policy trends. One is that the dollar has been overvalued in recent years. On a purchasing-power-parity basis, one euro should probably be worth $1.30.

The dollar devaluation may also reflect America's large current-account deficit, which translates into a deteriorating net foreign asset position. As the U.S. imports large volumes of goods and services, it sends dollars overseas to pay for them. But it appears that this large supply of dollars is not being met by demand. Some central banks, notably the People's Bank of China, may actually be replenishing their euro reserves, which they reduced during the eurozone debt crisis that began in 2010. There has been a moderate increase in the euro share of international reserves since last year.

These factors don't necessarily mean the current dollar weakness will last, however. While there are some plausible arguments to explain the dollar's current weakness, there are equally good reasons to expect the greenback to regain strength. Besides the currency impact of rising interest rates and expansionary fiscal policy, the Trump administration's new tax reform is encouraging a repatriation of foreign profits that U.S. companies have hoarded abroad. It may trigger additional inflows of foreign direct investment into the U.S. Both factors will increase demand for dollars.

And the U.S. may be the wrong place to look for an explanation anyway. Fundamental determinants like purchasing-power parity and trade balances have little predictive value for short-term exchange-rate movements. The last two dollar revaluations, in 1995-2001 and 2011-16, showed that rising trade balances often coincide with a strong currency, at least for the dollar.

So instead we need to look to Europe for an explanation of recent dollar-euro movements. The relative weakness of the dollar recently reflects Europe's surprisingly good economic performance. While currency markets had priced in steady and solid growth in the U.S., where the economy has been expanding for a considerable time, investors seem to have been surprised by the strong pickup in eurozone growth over the past year.

The key question for forecasting the dollar is this: How long will the perception of relative eurozone strength last? In Europe, there is probably a little too much optimism. A firmer euro will dampen exports and inflation while European governments are rightly using the economic upswing to consolidate their budgets. The aggregate eurozone fiscal deficit will be below 1% of GDP in 2018.

In the U.S., meanwhile, a weaker dollar helps exporters and attracts foreign direct investment. Therefore, U.S. growth may well surprise on the upside, especially as fiscal policy is providing an (unnecessary) boost, with the deficit likely to hit 5% of GDP this year. The U.S. expansion, entering its 10th year, may not be losing steam but rather accelerating into a late-cycle boom. If so, the dollar will start regaining ground relative to the euro.

It looks unlikely that some careful hints from eurozone central bankers at a somewhat less expansionary monetary policy will continue to outweigh the hard facts about a strong U.S. economy. The Fed will continue walking the talk by raising interest rates and downsizing its balance sheet. The ECB will do nothing of that sort in the foreseeable future. Today's strong euro may prove merely a passing fad.

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