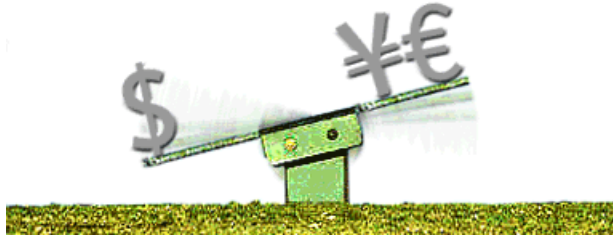


How far can it fall?

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After losing one-tenth of its value during 2002, the American dollar has fallen to its lowest point against the euro since 1999. Will it continue its retreat?



IS THE party finally over? For years, currency experts have been confidently—and largely mistakenly—forecasting the decline of the dollar. They were able to marshal an impressive array of evidence in support of their arguments. It was, they said, overvalued on any historical measure. America could not continue to absorb the large capital inflows which had propped up the greenback for so long. The euro, after its creation in January 1999, would soon challenge the dollar's reserve-currency status. More recently, America's burgeoning current-account deficit alarmed economists, who saw no alternative to a precipitous collapse of the dollar.

Yet the dollar—or, more accurately, the people who buy and sell currencies—remained impervious to economic forecasts. The world's most important currency continued to be its most sought-after. The euro endured what to many Europeans was a humiliating decline in its international value almost from its inception. Neither the American recession in 2001 nor the huge and growing current-account deficit (about 5% of GDP) seemed to discourage people from holding dollars. And then, in the closing months of last year, the dollar finally started to weaken. By the end of the year, the dollar had lost 10% of its value as measured against a trade-weighted basket of currencies. The first few days of 2003 have seen it slip further against the euro and the yen.

Will the slide continue—and if it does, what will it mean for the global economy? Only a brave forecaster would try to predict with any confidence where the dollar will be in six months' time. Of course, currency economists make such forecasts all the time—but that's their job and they are frequently mistaken. The factors which affect the value of one currency in relation to another are numerous and complex, and often confusingly contradictory. It is not simply a question of working out what foreign-exchange speculators think. Most currency trading is not speculative: it is the consequence of economic decisions taken by largely rational actors. Any shift in a currency's value is driven by the cumulative impact of those millions of rational decisions.

The source of the great dollar surge in the late 1990s was easy to spot. The booming American economy offered enormously attractive rates of return on investment: as a consequence, large amounts of investment capital flooded into the country. Even when boom turned to bust, America still looked to be a better home for capital than many other, even more lacklustre economies. In 2001 and 2002, for instance, Europe's economic performance was disappointingly sluggish, and the prospects for 2003 look little better. Emerging-market economies have lost their allure for most investors, especially after the collapse of the Argentine economy.

As the most important reserve currency, the dollar is also seen as a haven in times of global political uncertainty. Even after the terrorist attacks on New York and Washington—putting America, for the first time, at the heart of the security threat—it was to the dollar that nervous investors first fled. More recently, gold has recovered some of its attractiveness as a haven, reaching its highest level in six years this month. But the yellow metal is still worth only a fraction of its long-term historical value.

The prospect of war with Iraq, and the continuing threat from international terrorism, have made investors more nervous about the future. Yet the tide now seems to be turning against the dollar. This suggests that, for the time being at least, factors other than risk-aversion are more powerful in determining currency flows. One of the most important is the recognition that American investment returns are likely to be significantly worse than in the recent past for at least the next year or two. It doesn't need investors to start shifting capital out of America to weaken the dollar—lower inflows would be enough.

Some of the dollar's weakness is also likely to be self-fulfilling. As investors become convinced that the American currency will depreciate, they will seek an alternative home for their funds. That will, in turn, put further downward pressure on the dollar.



But is the decline such a bad thing, for the American economy or the rest of the world? Few American exporters will weep as the greenback sinks: the strong dollar has made it difficult for them to compete in world markets in recent years. Nor will tears be shed among manufacturers who have been desperately trying to fight off competition from cheap imports. Those countries whose currencies are linked, loosely or tightly, to the dollar will breathe a sigh of relief as well—Hong Kong and Brazil are among those economies that have suffered as the dollar has soared. Argentina's currency peg was stretched to breaking point—and beyond—partly because of the American currency's strength.

Those countries that compete for business in America, or with American exporters, though, will not relish the impact of the dollar's decline. The rise in the value of the euro might boost morale at the European Central Bank in Frankfurt, but it will not bring much comfort to Germany's export-driven corporate sector. East Asian economies such as Singapore, still reeling from the collapse of the high-tech boom, have no reason to welcome a devalued dollar.

Paul O'Neill, the treasury secretary fired by President George Bush at the beginning of December, was known for his belief in the benefits of a strong dollar. Such conviction is the refuge of old-fashioned politicians who associate national pride with a strong currency. Mr O'Neill was accused of trying to talk up the dollar, and consequently blamed for its persistent strength. His successor, John Snow, is, as yet, innocent of such uncomplicated views. In reality, of course, politicians have almost no power to influence currency movements except in the very short term. They are reduced to watching when currencies overshoot—as they almost always do—on the way up, and on the way down.