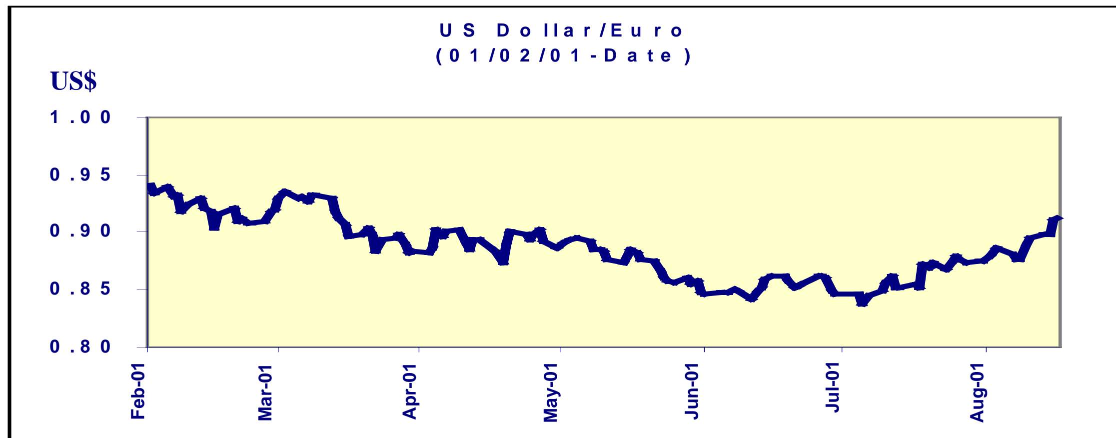
AIB Group Treasury
Economic Services Unit

US Dollar, Overdue Correction or Collapse



The US dollar has finally succumbed to the pressures of a marked slowdown in the US economy, falling sharply against the euro, sterling and yen over the last 2-3 weeks. Despite persistently weak data, the dollar's trade weighted index had appreciated steadily for the first six months of the year. This appreciation was based on the belief that aggressive Fed action on monetary policy would see the US economy rebound in the second half of the year. However, while there are some signs of a stabilisation, recent data are showing no signs of a pick-up in activity. Manufacturing continues to be the primary drag but the slowdown has spread to other support industries.

Furthermore, consumer spending, the main contributor to growth so far this year, is slipping as consumers react to a deterioration in labour market conditions and a weak stock market. The only area of the economy that is showing any real strength is the housing sector. Initial estimates put the GDP growth rate for the second quarter at just 0.7%. This is expected to be revised downwards in subsequent releases and the economy may even register a negative growth rate for the period. As well as economic numbers, August's downbeat Beige Book and the latest IMF report have also damaged sentiment.

Pronounced and prolonged weakness in the economy is expected to result in the Federal Reserve reducing interest rates by a further 0.25% at its meeting on 21 August. If this is the case, official interest rates will have been reduced by a full 3.0% since the beginning of the year. If forthcoming data do not show some signs of a pick-up in activity there is a risk of a further reduction at the Fed's October meeting. Up until recently the dollar was unhurt by poor US economic releases. Instead, it rallied as each weak number increased the chances of yet another rate reduction. However, there has been a distinct change in sentiment over recent weeks with even positive numbers failing to provide any real boost.

As well as the dearth of a swift economic recovery, the dollar is also suffering from suggestions that the US administration is not overly happy with its "strong dollar" policy. Compounding problems for US manufacturers, the strength of the currency has also reduced the effectiveness of US monetary policy in this cycle. While the Treasury has persistently backed the policy, comments from President George Bush suggest some solidarity with export groups. US Treasury Secretary Paul O'Neill's failure to use the word "strong" in recent comments has also raised some concerns about the administrations commitment. However, given the size of its current account deficit, any sudden and sharp drop in the currency would hardly be in the economy's best interests.

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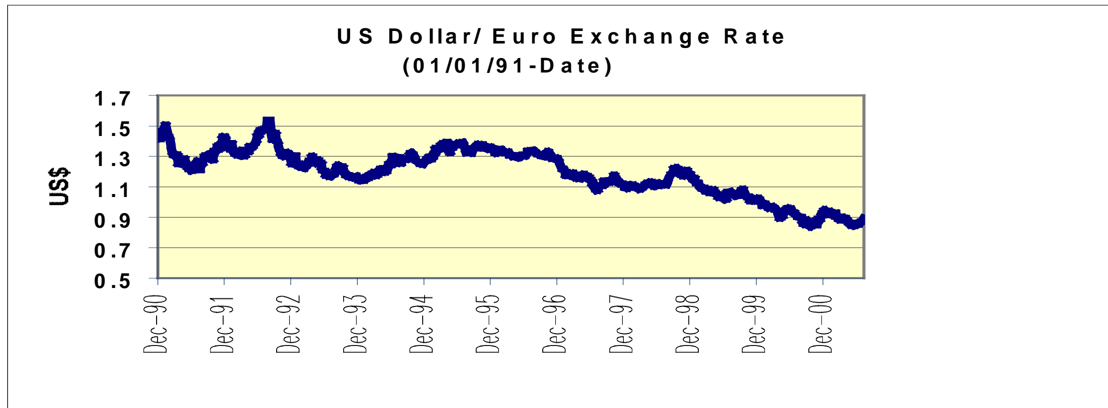
Given the weakness in the US economy a correction in the dollar was inevitable and lingering doubts about the health of the US economy have left it vulnerable to further falls before the year-end. However, although the dollar has weakened there is no real sea-change in sentiment towards the euro. In the context of its absolute value the current bout of dollar weakness is minimal. On a trade weighted basis it is still up 3.5% since the beginning of the year.



If the US economy remains sluggish or was to weaken further the dollar's correction would undoubtedly be deeper, with a breach of $0.95 within the euro's reach at that stage. Indeed, if forthcoming data go the euro's way, this level could be tested over the next week or so. However, a move to parity would necessitate recessionary conditions in the US. There are significant risks attached to the outlook for the US economy but outright recession seems unlikely. Taken together, the easing of monetary and fiscal policy in the US is large by historical standards and should stimulate growth over time. There are already tentative signs that the economy has bottomed. Jobless claims, as measured on a four week moving average basis, have fallen steadily over the last two months and the decline in non-farm payrolls has moderated. Consumer spending has slowed but not stopped, the housing market remains strong and July's NAPM index showed a pick-up in orders.

There is potential for significant volatility and uncertainty in fx markets in the weeks ahead. As market sentiment ebbs and flows on the back of data from the US and Europe, the trading range that we have seen over the last month could easily be repeated. Recently markets have been focusing on the US. However, the eurozone is not immune to the slowing global economy and to some extent the euro is only ahead by default with thin summer trading only exaggerating its gains. A refocusing on E-12 numbers could leave the euro vulnerable to a retrenchment. With leading eurozone economies in decline, eurozone Q2 GDP (due 13 September) may be only barely positive. This deceleration in activity and the improvement in the eurozone inflation position has heightened speculation that the ECB will cut interest rates when it returns from it's summer break. A failure to ease policy will have negative implications for the euro.

Geraldine Concagh
August 17, 2001

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