Dollar Turn Ahead Will Pose New Challenges

By Gabriel de Kock

It's not news, the dollar has been weak. As recently as July 15, the euro traded above $1.60 in global currency markets, the all-time high since the creation of the single currency on January 1, 1999. In mid-March, the dollar was worth less than one Swiss franc (also a record) and less than 96 yen, a 12-year low.

Taking a longer and broader view, the latest dollar swoon is just another leg in a six-year slump. Since early 2002, the dollar has lost nearly 30% of its value against a broad trade-weighted basket of currencies, falling to its lowest level since the move to free-floating exchange rates in early 1970s. Nearly one-quarter of this decline has occurred since July 2007, when the US sub-prime meltdown morphed into a global financial crisis.

There is no one-size-fits-all explanation for the past six years' dollar slide. In 2002 and 2003, global investors fretted about the US twin deficits: a federal government deficit at 3.5% of gross domestic product and an external deficit that peaked at about 9% of ex-US world savings. International money managers feared that they had put too many of their financial eggs in the US basket. The dollar had to fall to convince them to continue investing in US assets.

Since the eruption of the global financial crisis last summer, however, currency trends have closely followed shifting economic growth prospects. As financial shocks, steep oil and food price increases and the deepening housing slump threatened to push the US economy into recession, the Fed moved forcefully, cutting the federal funds rate by 325 basis points. Market interest rates on dollar-denominated fixed income securities fell sharply undercutting investors' demand for dollars.

Now, the tide has turned, but not because our economic prospects have brightened. Instead, the euro area, the United Kingdom and Japan are on the brink of, if not already in, recession. While Fed policy easing and tax rebates have kept the US economy afloat, inflation and budget constraints limited the freedom of policymakers abroad. As a result, their consumers and businesses have borne the brunt of rising food and energy bills, weakening housing, tightening credit, and deteriorating competitiveness.

The turn in relative economic fortunes already has shifted interest rates in the dollar's favor. But there is much more to come, as markets face the possibility of rate cuts in Europe and the UK and start to anticipate the Fed raising US rates from unusually low levels as the economy gradually heals.

Dollar weakness has played an important role cushioning the US economic downturn over the past year. It has allowed US firms to gain a foothold in foreign markets, boosting exports and production. And it has prompted Americans to spend their tourism dollars stateside. In dollars, the nightly rate at that charming little hotel in Florence has doubled since early 2002.

A weak dollar also has posed challenges for US businesses and consumers. Firms that source aboard have seen their costs rise sharply. But, contrary to popular perceptions, dollar weakness can only explain a small fraction of the past five years' steep rise in oil prices.

In the coming year, US exporters will face stiffer competition abroad as the dollar gains ground. Unfortunately, those who source in China and most emerging Asian economies will not see significant cost reductions. Those currencies remain undervalued and likely will rise against the dollar.

Gabriel S. de Kock is Executive Director of Foreign Exchange Strategy for JPMorgan Chase Bank, NA.

For local information, please contact Margie Florentin, JPMorgan Chase at 303.244.3140.

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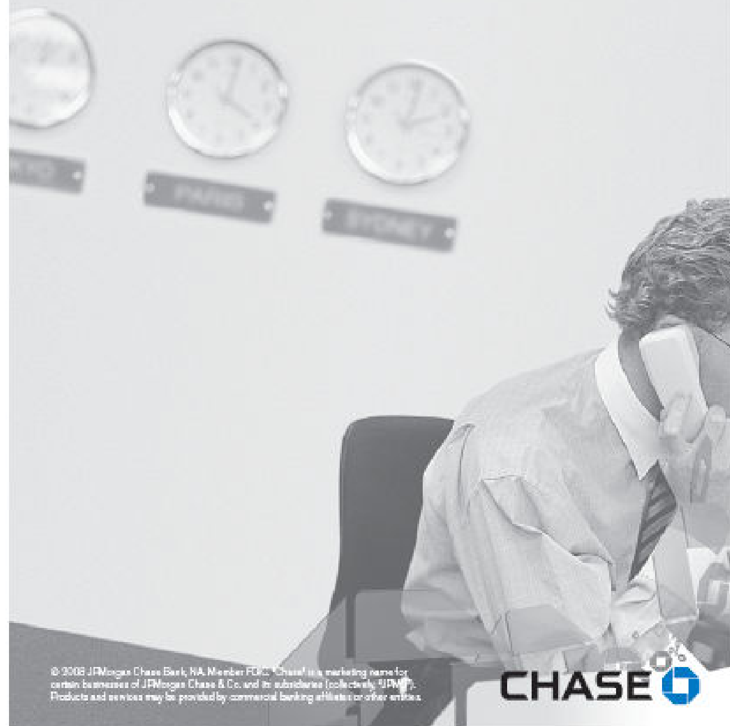

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