

The declining dollar

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An important development over the last year is that the dollar has been declining in the market almost continuously even though the economy looks to be one of the swifter movers among the developed nations. It is hence surprising that the dollar continues to weaken against the euro and the effects have been perceptible on other currencies too which have tended to strengthen against the dollar. This is serious as several countries' exports growth has been affected especially where they compete against the USA.

When Mr Donald Trump took over as President it was expected that the dollar would strengthen especially since he had spoken of providing a major boost to the economy through tax cuts and higher spending on infrastructure. Also with the economic parameters looking up with the Federal Reserve on the path to increase interest rates it was largely expected that capital flows would revert to the shores thus keeping the dollar strong. In fact higher rates in the USA should ideally be making the dollar stronger considering that it is widely expected that there would be at least two more hikes this year. But this has not worked out.

Some of the factors that are working in favour of the euro against the dollar are:

1. The Euro region is expected to gain momentum in the coming year; and with the unwinding of the QE programme countries like Germany and France expected to do better. This will be followed by interest rate hikes by the ECB which is viewed positively for the euro. There is hence more clarity here compared with USA where the picture is perceived as being ambivalent.
2. The Election victories of Mr Emmanuel Macron of France and Ms Angela Merkel of Germany have also helped support the euro.
3. Some of the stiff trade policies spoken of by the US President have not yet been implemented which has made the market less sure of strong policies coming from the USA. The slow delivery of promises by the Trump administration has hence hurt the dollar
4. The US treasury Secretary Mr Steven Mnuchin has gone on record at the WEF stating that the US was happy with a weaker dollar as it would help their exports. This has been interpreted to mean that it would be kept down consciously which is driving the dollar down further.

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5. While Ms Janet Yellen was considered to be an inflation-fighter, the stance of the new Fed Chairman Mr Jerome Powell is still being assessed by the market.
6. The worries of a shutdown earlier in January contributed to the weakness of the dollar as this was taken to be reflective of the strength of the government in the political sphere.
7. Central banks have also been moving towards non-dollar holdings of forex reserves which have added to dollar pessimism.

The decline of the dollar vis-à-vis the euro

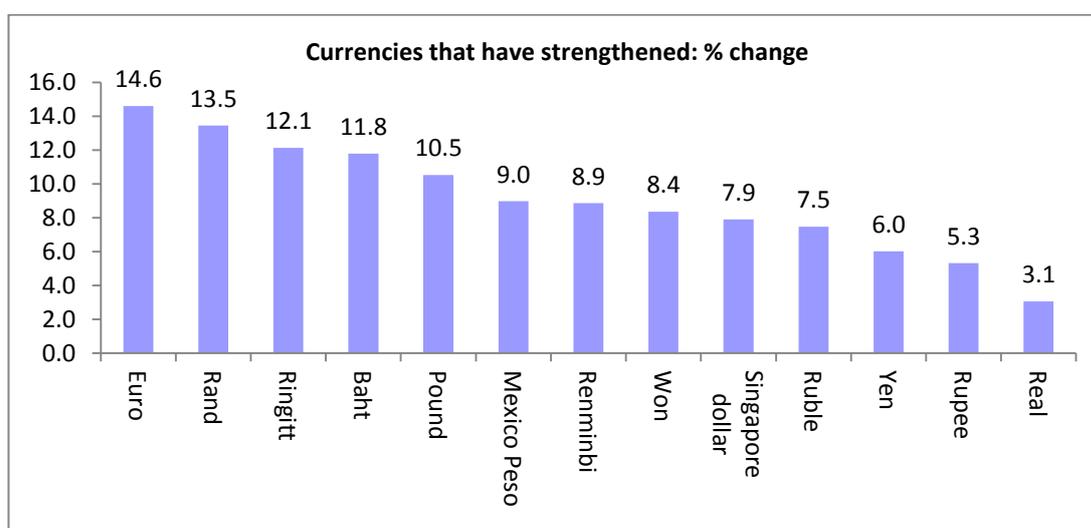
The table below provides information on some of the comparable parameters for the two regions.

% 2017	USA	Euro
GDP (2018)	2.7	2.4
Inflation	2.1	1.5
Unemployment	4.1	8.7
CAD	-2.4	3.2
Budget deficit	-3.5	-1.2
10-year yield	2.87	0.76

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- USA is expected to do better than the euro region in 2018 which should ideally be making the dollar stronger. However, as mentioned earlier, perceptions are more positive for the euro in future.
- The CAD is high for USA compared with a surplus for the euro region.
- Fiscal spending has limits in the USA given the high deficit level which could be holding back the government from spending more.

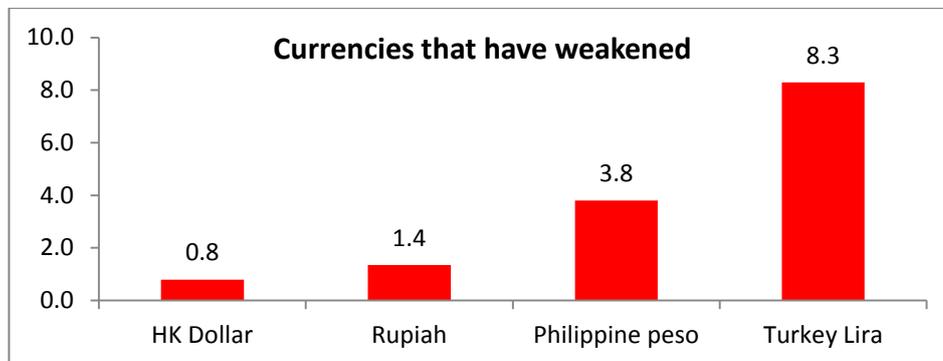
How have currencies moved?

Those that have gained: Feb (15 days) 2018 over January December 2016



The euro has gained by almost 15% over the 13-months period. The appreciation in rupee by 5.3% is hence more at the lower end as currencies like rand, ringgit, baht, renminbi, peso, won, Singapore dollar, yen and ruble have strengthened by higher rates.

Those that weakened during this period



Concluding remarks

The dollar could continue to remain weak against the euro in 2018 unless there is significant change in the dynamics. However, a similar rate of depreciation is not expected this time. A lot will depend on how the economy fares and the speed with which the euro area grows. From the Indian point of view, this external force would continue to work towards keeping the rupee strong. The foreign investment flows will hold the clue as the CAD would continue to be stable at the 2-2.5% level, with the trade deficit being driven by the developments in the oil sector.

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