Is the dollar finally following the fundamentals?

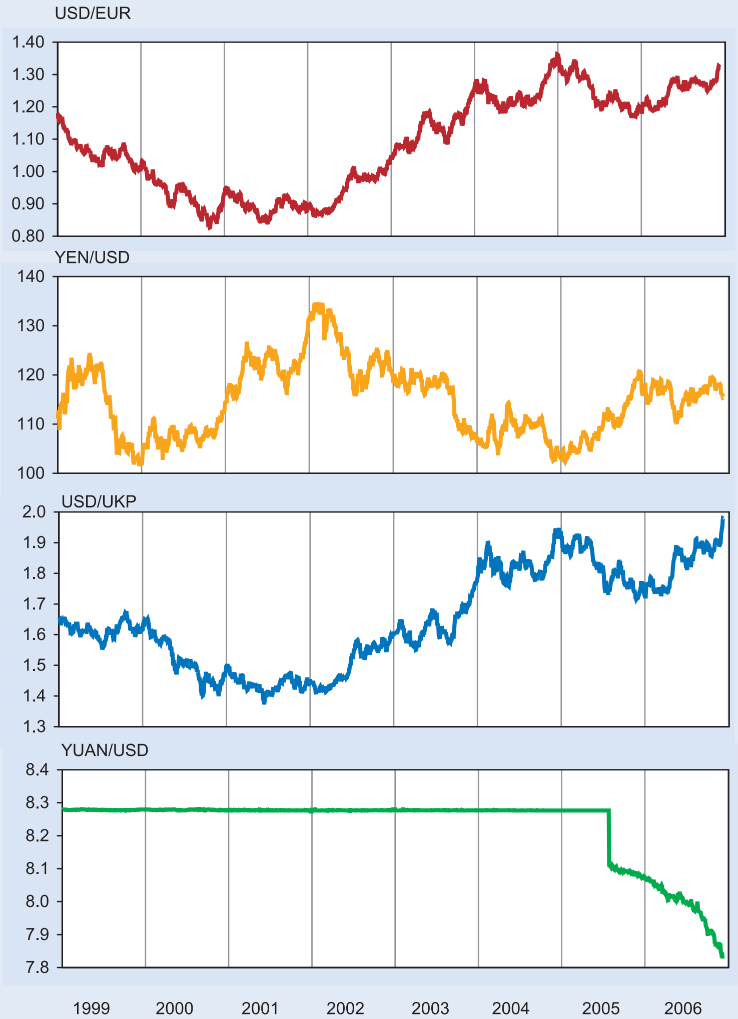
The huge twin deficits of the United States – in the federal budget and the current account of the balance of payments – have fed expectations for some time now of a substantial decline in the exchange rate of the dollar in line with a general readjustment in the currency markets.

Also, a gloomy outlook on the US economy initiated by the housing bust, on the one hand, and surprisingly strong economies in the EU and in Asia, on the other, means interest rate movements in opposite directions: The US Federal Reserve last raised interest rates five months ago and if the economy gets bad enough, the Fed may start to cut interest rates. At the same time, the European Central Bank is continuing its step-up in key rates and the Bank of Japan is also considering a long-postponed move to raise interest rates again. Sooner or later the dollar had to fall. And so it has.

Against the euro, the dollar had been dropping, little by little, for more than a month before it broke through 1,30 on November 28th, going on to hit a 20-month low. Against the pound, on November 28th, the greenback was at its weakest in two years. It also slipped against the yen and against the yuan, politically the most sensitive exchange rate these days.

The Chinese yuan has picked up the pace over the past few months, rising at an annual rate of almost 7 percent against the US dollar since September – four times as fast as over the previous 14 months since it broke its link with the dollar. This has prompted expectations that the yuan could approach parity with the Hong Kong dollar, its traditionally stronger neighbour, by the end of the year.

Exchange Rate of the US Dollar



Source: US Federal Reserve Board.