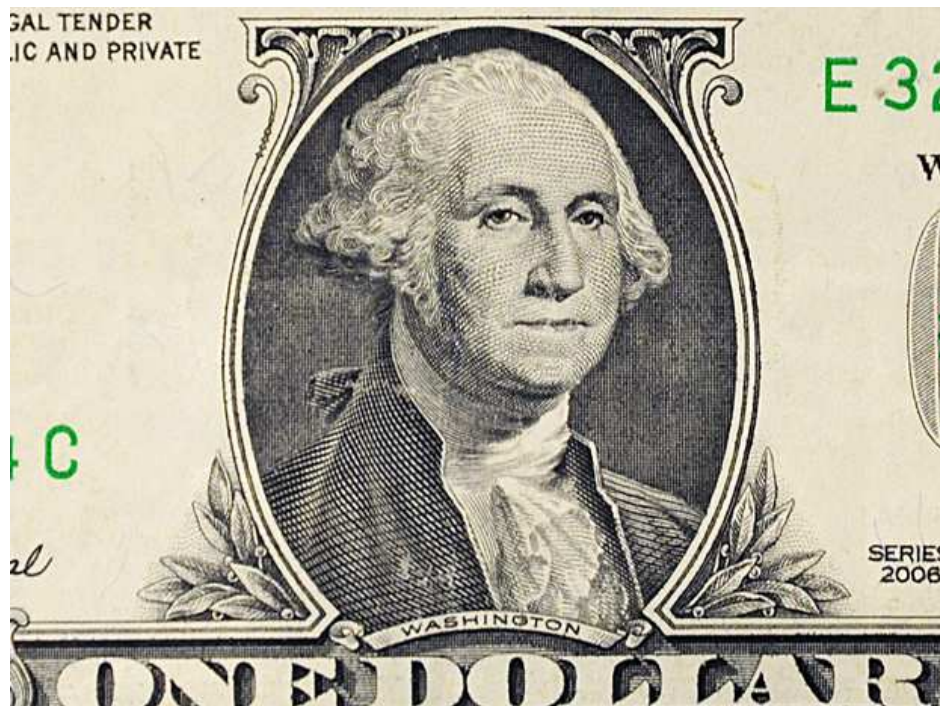


Financial Post

Economy

ECONOMY

The U.S. dollar's vanishing act



Tim Shufelt May 6, 2011 – 5:16 PM ET

It is almost becoming an affront to the legacy of George Washington to have to grace the lowly greenback.

While the currency managed to claw back some ground amid turmoil on global markets this week, it remains on the verge of sinking below a pair of important thresholds. The first is the 2008 record low.

But perhaps an even greater indictment of the U.S. dollar is its depreciation against the euro, a currency that's one sovereign default away from an existential crisis. At US\$1.50, the euro will have climbed all the way back from last year's plunge.

The downward trend is quickly lowering confidence in the currency among the major creditors of the United States.

"I think you'll see a lot of turnover once we cross those thresholds," said Mark Calabria, director of financial regulation studies at the Cato Institute in Washington, D.C. "And I think we're going to cross those thresholds."

Of the forces guiding the greenback, almost all of them promise further weakness. About the only mitigating factor is the sheer economic power of the United States, which remains the world's safe haven of choice, effectively putting a limit on the dollar's losses.

"Absolutely, there is a floor under the dollar, but we're not there yet," Mr. Calabria said. And nobody knows quite where that floor sits.

Against a basket of currencies, the dollar has lost almost 18% since last June and more than 10% since December, raising the concern that panic selling has already set into foreign exchange trade. The U.S. dollar index fell to 72.933 on April 29, nearing the all-time low of 71.329 set during the financial crisis in 2008.

"The rout of the U.S. dollar has begun in earnest," Dennis Gartman, a trader and editor of the Suffolk, Va.-based Gartman Letter, wrote in a recent commentary, noting the dollar's fall against virtually every major currency in the world.

"This may carry farther than any of us dream of or, worse, have nightmares of," he said.

Loose monetary policy will continue into the foreseeable future and skepticism abounds that the U.S. government will resolve its fiscal mess, about which the ratings agency Standard & Poor's has already sent an unmistakable warning.

The official line at the Federal Reserve and the Treasury is that the United States supports a strong dollar policy, a claim widely regarded as insincere.

"There's a fair amount of evidence to the contrary," Mr. Calabria said. "I do think there is a determined effort to try to spur exports via a weaker dollar."

Federal officials at least appear comfortable with a depressed currency, making it even more unlikely that the Fed will support the dollar with a rate hike any time soon.

The European Central Bank, on the other hand, has signalled its concern with price stability and reinforced expectations of rate hikes this summer, fuelling the euro's rally.

Since last June, the euro has gained 25% on the U.S. dollar, even while the sovereign debt crisis continues to unfold and still threatens to envelop Spain.

"I can't see why the euro can continue to strengthen in that environment. It seems very strange to me," said Paul Dales, senior U.S. economist with Capital Economics.

"I know in five years time, there's going to be a U.S. dollar in the current form, backed by a political union and a very important economy. I couldn't really say the same for Europe."

One possible explanation lies in the apparent commitment of European authorities to keep the monetary union intact and protect the finances of the eurozone's peripheral countries.

"That's a huge vote of reassurance," said Camilla Sutton, chief currency strategist for Scotia Capital. The strength of the eurozone's core, combined with U.S. dollar weakness, has brought the euro back from the brink, she explained.

"Even a Greek debt restructuring is unlikely to throw the euro back to parity," she said.

Despite its flaws, the euro is emerging as an alternative reserve currency, while most agree that the U.S. dollar still has room to fall.

"I still think we'll have a lower U.S. dollar by year end than we do today against most currencies, including (the loonie)," Ms. Sutton said, predicting the Canadian dollar will make a run at US\$1.10, and its previous high, this year.

Periods of U.S. dollar strength, like the one that began at the end of this week, are likely to be temporary pauses until the next catalyst sends the dollar ever lower, Ms. Sutton said.

That amounts to a slow, steady deterioration of value for the U.S. currency. A complete collapse, of course, would take a far more drastic incitement, one that China has the power to set in motion.

With almost US\$1-trillion in U.S. dollar-denominated foreign exchange reserves, Chinese officials are undoubtedly grinding their teeth over their devaluing assets. Were China to implement a large-scale selloff, the results for the U.S. dollar could be catastrophic.

"The big danger is that at some point, overseas holders of U.S. assets will get a bit fed up and will start to cash in for fear they'll just lose value," Mr. Dales said.

Such a move would be self-defeating, however, as it would only further devalue China's assets, Mr. Dales said.

The more likely scenario is that China bites the bullet and slowly diversifies its holdings with alternative currencies while allowing its U.S. treasuries to mature.

Much else has to happen before the greenback's reign comes to an end.

Almost 2/3 of global central bank reserves are denominated in U.S. dollars, a figure that has barely changed over the last year-and-a-half.

"Just the footprint of the U.S. in the world economy will guarantee it will continue to have a very large role," Mr. Calabria said.

And as ever, the United States is the inheritor of the world's safe haven flows.

"The U.S. capital markets — the biggest, deepest markets in the world, the biggest bond market — are what a safe haven needs," Ms. Sutton said. "There's really nobody who can compete with that."

Posted in: [Economy](#) Tags: [Cato Institute In Washington](#), [Euro](#), [Greenback](#), [U.S. Dollar](#)

MORE FROM TIM SHUFELT »



Soaring crude prices putting squeeze on U.S. GDP

What will the economy look like if the Conservatives win full power?

Central banker blames politicians for Europe's crisis

Is 1st half gain 2nd half pain?

©

Harper challenged on corporate tax cuts in debate

© 2011 National Post, a division of Postmedia Network Inc. All rights reserved. Unauthorized distribution, transmission or republication strictly prohibited.

↵