N° 2009 – 08

April

THE DOLLAR IN THE TURMOIL

Agnès Bénassy-Quéré, Sophie Béreau & Valérie Mignon

NON-TECHNICAL SUMMARY

It is often argued that long-lasting global imbalances have been one major cause of the international financial crisis that started in 2007 and has developed since then throughout 2008-2009. Whatever the origins of those imbalances—wrong microeconomic incentives, failed supervision, lax monetary policy in the United States, excess savings in China,. . .— the fact is that net foreign assets or debts cannot build up continuously without some correction. This basic idea triggered intense research prior to the crisis. Most economists were suggesting that large exchange-rate adjustments, and more specifically, a substantial depreciation of the dollar, would be necessary to bring balances of payments back to sustainable paths, although some of the adjustment would take the form of valuation effects rather than current-account adjustments.

From end-2007 to the end of 2008, the financial crisis had an ambiguous effect on the US dollar, which first depreciated before recovering higher its pre-crisis level. Several factors can explain these erratic changes, including the evolution of interest-rate differentials, massive sales of foreign assets by US institutional investors, the fall in the USD share of international bond emissions, or the fall in the price of oil.

The dollar appreciation observed from end-2007 to the end of 2008 means that US foreign assets were devalued once converted into dollars. Simultaneously, asset prices were heavily affected by the crisis worldwide. In this paper, we show that the crisis so far has not triggered the long-awaited re-balancing of the US balance of payments. This suggests that the dollar would need to depreciate even more than what was thought before the crisis.

We evaluate the impact of the crisis on the real equilibrium exchange rate of the US dollar. We find that, between end-2007 and end-2008, the US net foreign asset position fell by 15 to 24 percent of GDP. Consistently, the equilibrium effective exchange rate of the dollar depreciated by 2.8 to 72%, depending on the methodology and horizon. Looking forward, the dollar may temporarily appreciate if the US economy recovers more quickly than other economies. However, global-imbalance determinants of the dollar point to a weak dollar in the medium-to-long run, although a fall in sovereign-bond prices may help the US net foreign asset position to improve when the crisis is over and interest rates start to rise again.

*J.E.L. Classification***:** F31, C23

Keywords : Equilibrium exchange rate, US dollar, global imbalances, crisis, valuation effects