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The dollar is weak against a clutch of currencies that share many of its flaws

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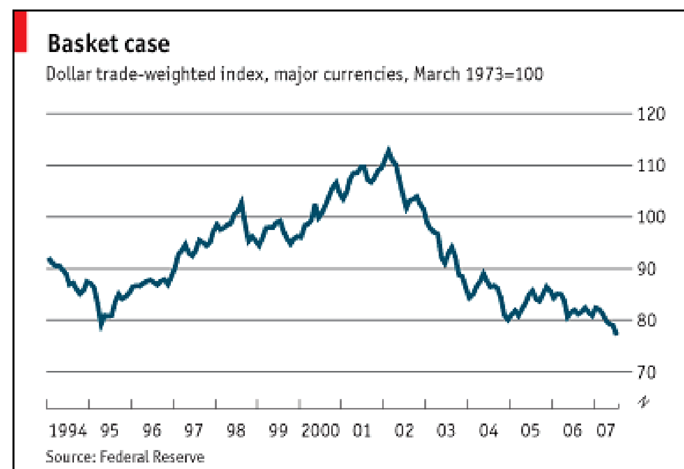
LONDON is never a cheap destination, but American visitors to Britain's capital this summer will find their wallets emptying a little faster than usual. A dollar now buys less British currency than it has for a generation. On July 23rd, the greenback slumped to $2.06 against the pound, its weakest level since 1981. Paris is scarcely cheaper for transatlantic tourists: this week the dollar sagged to €1.38, its lowest rate since the euro's launch in 1999.

The greenback has never been further out of favour on currency markets. The Federal Reserve tracks the dollar's value against a weighted basket of seven currencies that are commonly traded beyond their respective borders. This index, regarded as a good gauge of financial-market sentiment about the dollar, has fallen to an all-time low (see chart).



What lies behind the latest bout of dollar weakness? Part of the slump is cyclical, reflecting America's weak economy. GDP growth this year is expected to be lower in America than in the euro area, Britain, Australia and Canada, according to *The Economist*'s monthly poll of forecasters.

The origins of weak growth are a particular worry. Just as the trouble in America's housing market is a drag on the economy, the turmoil in the subprime-mortgage market weighs on the currency. Analysts at Goldman Sachs believe that lower overseas demand for corporate debt has put downward pressure on the dollar. The disquiet about mortgage credit in America, they suggest, may even have chipped away a little at the dollar's standing as a reserve currency.

High oil prices haven't helped either. Paul Robinson, a currency strategist at Barclays Capital, reckons that the dollar is the worst performing major currency during periods of rising oil prices. This might be because America uses more oil for each unit of output than other rich countries, so the higher cost of fuel hits growth—and thus

the dollar—harder. American consumers are especially vulnerable, because low fuel taxes leave a thinner cushion between the cost of crude and retail prices. The spending of petrodollars also helps the dollar less than the euro, because oil-producing countries tend to import more from Europe than America.

So a steep oil price, a weak economy and an anxious credit market have all weakened the dollar. But America's growth prospects are not so poor and the subprime-mortgage market not so woeful—at least, not yet—that they can fully explain the dollar's recent sickliness.

Stephen Jen, currency economist at Morgan Stanley, suggests there might be more powerful forces driving the dollar down. A common fear is that Asia's central banks will diversify out of their large holdings of American debt. Mr Jen argues, however, that the biggest dollar diversifiers have been pension, insurance and mutual funds in America. These funds control assets worth $20.7 trillion, more than four times the size of the world's official currency reserves.

American mutual funds have gradually increased their overseas allocation of equities since 2003 from 15% to 22.5% of assets, says Mr Jen. If this portfolio shift mirrors the behaviour of all pension, insurance and mutual fund managers, it would imply an outflow from dollar assets of $1.16 trillion since 2003. That sum is not far short of China's entire hoard of official reserves.

Mr Jen argues that these capital outflows need not be a sign that asset managers are gloomy about prospects for either the dollar or the American economy. Rather they might reflect an underlying decline in provincialism, as investors gradually come to appreciate the dangers of relying excessively on home-country assets. A similar thing is happening, he says, in Japan where households are greedily buying overseas assets. If the dollar has suffered most, it is only because American institutions are the biggest pioneers of financial globalisation.

Yet wariness about the dollar may be part of the motivation to diversify. A regular survey by Merrill Lynch shows that global fund managers have been consistently negative about the dollar's prospects for the past five years. For most of that period, the same asset managers have expressed a wish to reduce the weight of American assets in their portfolios, though that urge was strongest three years ago. It is hard to disentangle diversification from desertion since each feeds on the other.

Don't deficits matter?

On the surface, the latest episode of dollar frailty seems to validate concerns about America's persistent current-account deficit and the associated build-up of overseas debt. Many economists welcome a weaker dollar which, by making America's imports dearer and its exports cheaper, helps narrow the country's external deficit. Indeed, the trade gap in the first five months of this year was smaller than in the same period in 2006.

But a closer look suggests that currency markets, rightly or wrongly, are blithe about trade imbalances. Some of the countries whose currencies have gained most at the dollar's expense, like Britain, Australia and New Zealand, have large external deficits and debts too. Australia's current-account shortfall has been more persistent than America's and, as a result, its net overseas debt last year was 60% of its GDP, compared with 19% for America. New Zealand's debt ratio is larger still at 90% of GDP. Meanwhile the currency of the world's largest creditor nation, Japan, continues to languish—even against the dollar.

If anxiety about global imbalances is not driving currency markets, perhaps the dollar might rally once America's economy is back on its feet. It has, after all, fallen a long way already: on the Fed's broad trade-weighted index, the greenback is down 22% since its peak in 2002. According to the purchasing-power parities calculated by the OECD, the dollar is undervalued by 15% against the euro, 18% against the Australian dollar and 21% against the pound. Such divergences from fair value might not prove sustainable, particularly for the countries that have external financing gaps of their own to fill.

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