Dollar will probably continue to weaken

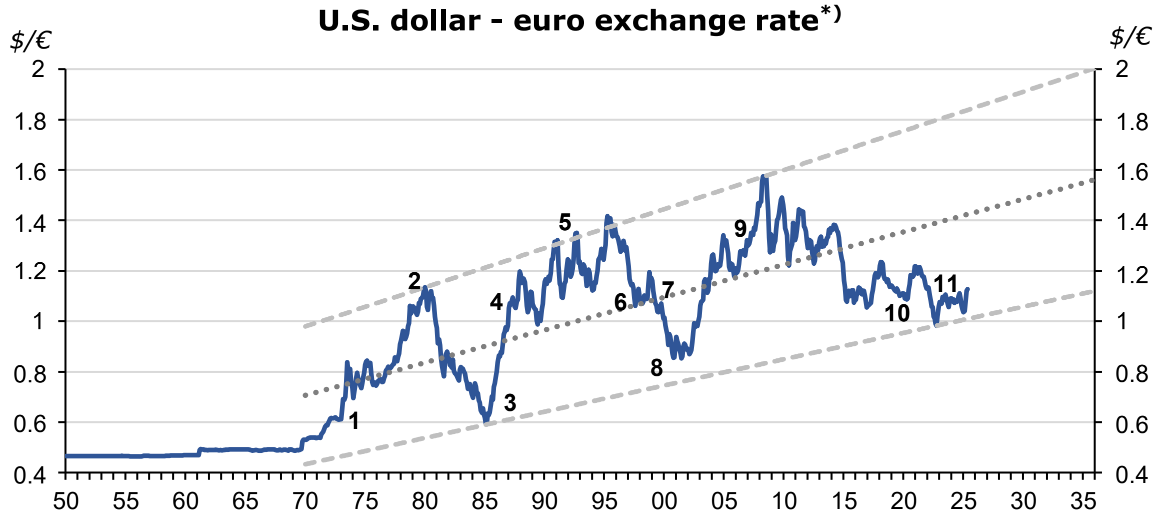
Mainz, June 5, 2025 | *Dieter Wermuth*

Since April 2, when Donald Trump launched his trade war against the rest of the world, the price of the euro has increased from $1.08 to $1.14 – at the beginning of the year it had been even lower: $1.03. In the past two months the yield of benchmark 10-year US Treasuries has moved up by almost 30 basis points, the equivalent of a 2% loss of market value. As to equities, America's two most important stock indices, the S&P 500 and the Dow Jones are presently trading about 3 and 6% below the highs they had reached in the early months of the year while European indices such as the EuroStoxx 50 or the DAX are still close to their historic highs. In relative terms, US assets are not so attractive anymore. Is this a new trend or just a normal correction?

As asset managers know, news of a demise of US capital markets has usually been premature, often just reflecting analysts' wishful thinking. For many years American politicians were able to pursue massive expansionary and growth-boosting fiscal and monetary policies without being punished by market participants. The US has long benefited from the "extraordinary privilege" that came with being the issuer of the main reserve currency, to the envy of European, Japanese, British and, lately, Chinese competitors.

So what does all this mean for the exchange rate between euro and dollar? Our graph which covers the past 75 years (no less!) shows that large swings have been normal since the end of the Bretton Woods fixed-rate system in the early seventies. One obvious conclusion is that all forecasts, as produced by the IMF, the OECD or the German economic institutes, predicting more or less stable exchange rates have invariably been wrong. Hedging foreign currency exposures is vital in all deals involving non-domestic goods, services and financial assets.

U.S. dollar - euro exchange rate*)



*) monthly averages, until 1998 U.S.dollar-DM exchange rate x 1.95583 DM/euro; last value: May 2025
1) until Mar 1973 Bretton Woods system; Mar 1973 Germany lets the DM float against the U.S. dollar; autumn 1973 first oil crisis – 2) 1979/80 second oil crisis – 3) Sep 1985 Plaza Accord – 4) Feb 1987 Louvre Accord – 5) 1992/93 EMS crisis – 6) 1997/98 Asia crisis – 7) Jan 1999 launch of the euro – 8) Mar 2000 the dotcom bubble bursts – 9) Aug 2007 the beginning of the Great Financial Crisis – 10) Mar 2020 the beginning of the covid-19 pandemic – 11) Feb 2022 Russian invasion of Ukraine
sources: Bundesbank, ECB; own calculations, design & research: Uwe Richter

If I draw a line through the lows of the exchange rate since 1970, and another one through the highs I get a cone whose mean is at 1.42 dollars per euro today (1.84 plus 1.00, divided by 2). Over time, the dollar has lost ground against the Deutsche Mark and its successor, the euro (1 euro = 1.96 DM). But over the past 13 years the dollar has appreciated a lot, not smoothly but in large swings. Since 2008 the dollar has been king and the euro occasionally looked as if it might become a weak currency, a poor relation so to speak.

Are FX markets changing direction once again? The graph may suggest that it is overdue, but I also know that I am on highly speculative territory. Even so, if the currency cone stands for a fairly reliable range that defines the upper and lower bound of the exchange rate, I would not be surprised if the euro reached 1.6 dollars by the early thirties – and 1.85 at the peak.

The main reason for the euro's long-term appreciation is the relatively low inflation in Germany and, after January 1999, in the euro area. Over the past 50 years, European consumer prices rose at an average annual rate of 2.5% while the US equivalent was at 3.8%. That the euro is presently hugely undervalued vis-à-vis the dollar can be inferred from various statistics which are generally considered to be important determinants of the exchange rate. They suggest that the supply of dollars will probably be larger than the demand for dollars – and that the euro is about to appreciate further:

1. In the coming years, the euro area's balance on current account will continue to show a surplus of about 3% of GDP, a result of relatively slow economic growth in Europe and the large (real) depreciation of the exchange rate, whereas the US is expected to run an annual current account deficit in the order of 3% of its GDP – this translates into a strong, almost structural demand for euros and an equally large supply of dollars.
2. Compared to America's, the euro area's fiscal policies are almost restrictive – the US (central) government floods markets with rising amounts of debt (Treasuries). Since covid-19, ie, since 2020, budget deficits have averaged no less than 8.5% of GDP. During that time euro area government deficits were "only" 4% of GDP. Despite the coming massive and expensive military build-up, European government deficits will remain much smaller than those of the US – on FX markets, the supply of euro denominated government debt will rise at a much slower rate than dollar debt.
3. Both developments have so far not hurt the dollar's external value by much. Because America's capital markets were – and are – not only very liquid but were also mostly fairly cheap compared to expected returns, the demand for dollar assets had exceeded supply for many years. The US capital market and the dollar's role as the main reserve currency had been the all-important determinants of dollar strength.

For at least two reasons this is changing now: in the wake of the new trade war US inflation is about to accelerate (less competition, rising import prices), while the euro area will be hit by deflationary effects. The ECB will therefore be able to continue cutting policy rates this year and next whereas the Fed has signaled that it is in no hurry to do likewise. This situation affects the outlook for bond markets – Europe's will do better. Reason number two: the average price-earnings ratios of US equities remain considerably higher than Europe's – they are more expensive, even on the basis of expected, rather than actual corporate earnings.

An alignment is long-overdue and probably already under way, witness the significant outperformance of euro area stocks in recent months.

Since the election of Donal Trump winds are blowing from another direction on FX markets.

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