Dollar's retreat raises fear of collapse

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The huge Euro sign is seen in front of the headquarters of the European Central Bank in Germany.

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FRANKFURT: Finance ministers and central bankers have long fretted that at some point, the rest of the world would lose its willingness to finance the United States' proclivity to consume far more than it produces - and that a potentially disastrous free-fall in the dollar's value would result.

But for longer than most economists would have been willing to predict a decade ago, the world has been a willing partner in American excess - until a new and home-grown financial crisis this summer rattled confidence in the country, the world's largest economy.

On Thursday, the dollar briefly fell to another low against the euro of $1.3927, as a slow decline that has been under way for months picked up steam this past week.

"This is all pointing to a greatly increased risk of a fast unwinding of the U.S. current account deficit and a serious decline of the dollar," said Kenneth Rogoff, a former chief economist at the International Monetary Fund and an expert on exchange rates. "We could finally see the big kahuna hit."

In addition to increased nervousness about the pace of the dollar's decline, many currency analysts now also are willing to make an argument they would have avoided as recently as a few years ago: that the euro should bear the brunt of the dollar's decline.

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The euro, shared by 13 countries, once looked like a daring experiment. But it has gained credibility and euro-denominated financial assets are as good as their U.S. counterparts. With a slow economic overhaul under way in European capitals, and a fundamentally sound corporate structure, a weaker dollar justifiably means a stronger euro.

"The euro has earned what it has gotten," said Stephen Jen, global head of currency research at Morgan Stanley in London. "It is not simply rallying by default."

So long as Americans buy more than they earn from exports - and they did, creating a current account deficit of $850 billion last year - the rest of the world financed the binge by bringing dollars into the United States for investment in stocks, bonds, real estate or other assets, thereby preserving demand for the dollar.

The continued appetite for U.S. investments stemmed from a track record of strong economic growth and a financial system that has been remarkably resistant to shocks.

But the latest turmoil in mortgage markets has, in a single stroke, shaken faith in the resilience of American finance to a greater degree than even the bursting of the technology bubble in 2000 or the terror attacks of Sept. 11, 2001, analysts said. It has also raised prospect of a recession in the wider economy.

While most economists just a few months ago would have dismissed the prospect of a dollar collapse outright, they now are debating the possibility that something on par with the dollar debacle of the 1970s might just happen again.

When a currency collapses, the central bank can push up interest rates to attract needed investment, but strangle the economy in the process. Alternatively, it can let the currency fall and watch prices of imports - and eventually competing domestic goods - rise sharply.

Double-digit inflation resulted in the 1970s and only a global recession brought it to an end.

Today, the dollar's current weakness is being driven by uncertainty over how central banks will react to the turmoil in financial markets, unleashed by the collapse of the U.S. market for subprime mortgages given to borrowers with shaky credit histories.

The European Central Bank put off an interest rate increase it had planned for September, but is still inclined to tighten credit at least one more time by the end of this year. By contrast, the U. S. Federal Reserve has hinted at a rate cut at its meeting next Tuesday - a step that would diminish the appeal of dollar-denominated assets, almost certainly sending the dollar lower.

But across a horizon of 18 months to two years, investors are pondering how quickly the dollar will fall, a question to which there are no easy answers.

After a run of strong growth, the U.S. economy has lurched into a phase of slower expansion, and last Friday the most serious warning sign appeared - an outright deterioration in employment growth.

The data has coincided with profit warnings from major U.S. retailers like Wal-Mart Stores and Home Depot, suggesting that consumer spending, the backbone of the American economy for years, was ebbing. This step would logically follow the rapidly cooling housing market, since Americans have spent heavily with money borrowed against rising home values.

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