COULD TRUMP DRIVE DOWN THE DOLLAR?

On 20 January 2025, Donald Trump once again became President of the United States. With a ‘clear mandate’, the Republican intends to harness his victory by addressing his favourite issues. His return to the Oval Office comes at a time when the dollar is witnessing one of the biggest rallies in history. The real effective exchange rate of the greenback is now at a comparable level to the one which led to the Plaza Accord of 1985, and its appreciation has a high likelihood of continuing. This trend is likely to frustrate the new President, who is keen to denounce weak currencies as penalising US industry. At the same time, the dollar’s status as reserve currency is essential to the strength of the US economy, which suggests (a contradiction between protecting this position and seeking a depreciation. If the US economy ends up underperforming, such a depreciation could become a reality. Considering an agreement along these lines, similar to the Plaza, seems unrealistic given the complexity of aligning interests.

THE RETURN

20 January 2025 marks Donald Trump’s return to the White House. Elected by a comfortable margin on 5 November, the former President begins his final four-year term. To say that this event will usher in a new era in international economic relations is an understatement. Conflicting relationships, uncertainty and unpredictability are the central characteristics of this new world. On the domestic front, the first economic implication of Trump’s victory, under the (admittedly tight) control of Congress, is the heightened risk of inflation, in stark contrast to his first election’s macroeconomic environment. For US counterparties, the two sensitive issues are the potential tightening of global financial conditions, caused by potentially resurging inflation and rising long-term interest rates, and possible prohibitive tariffs. In addition, the valuation of the US dollar relative to other currencies is one area of focus, or, more likely, of tension. Although this issue is not being discussed much outside the United States now, it is one of Trump and his team’s favourite economic topics.

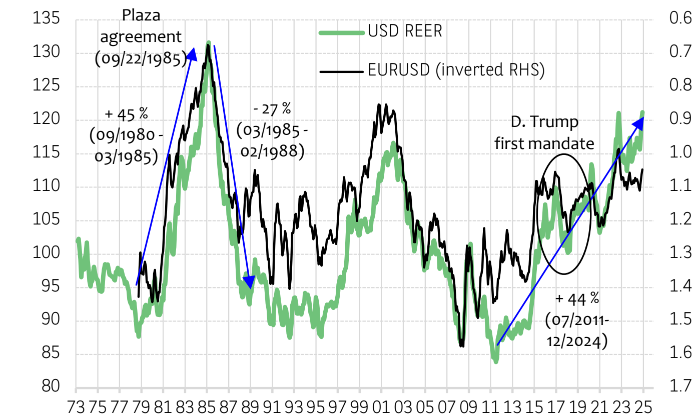
STRONG DOLLAR, WEAK DOLLAR: TWO IRRECONCILABLE SIDES OF THE SAME COIN

Donald Trump’s position on the greenback is somewhat ambivalent and contradictory, straddled between maintaining its dominance and wanting to see it depreciate to boost the competitiveness of US exports. The upward impact on the dollar of the tariff increases that he plans to implement is a good example of the internal contradictions of his economic agenda.

The ‘exorbitant privilege’ of the US dollar is a key factor underpinning the country’s power. It has been maintained despite the decline in the greenback’s share of total world foreign exchange reserves (from over 70% at the start of the 21st century to less than 60% today). At his hearing before the Senate, Scott Bessent, the Treasury Secretary chosen by the President-elect, reiterated the new administration’s attachment to the US dollar’s status as a reserve currency. Trump is also not particularly keen on this background thrum of ‘de-dollarisation’. This appeared in December 2024 in explicit threats to the BRICS, which he wants to block from accessing the US domestic market (notably with 100% customs tariffs) if they try to turn away from the greenback.

However, Trump also believes that the United States has a ‘currency problem’ undermining the price competitiveness of its industry (his Vice-President, J.D. Vance, also believes that the strength of the dollar is unwarranted and that this has contributed to the country’s de-industrialisation). This is why a weaker dollar is seemingly desirable to him.

UNITED STATES: LONG-TERM PERSPECTIVE OF THE USD REAL EFFECTIVE EXCHANGE RATE (BROAD INDEX) AND THE EURUSD



CHART

SOURCE: FED, MACROBOND, BNP PARIBAS

However, this would not come without negative repercussions on its attractiveness. In this realm, the targets of the 45th and now 47th President of the United States include his trade competitors, as well as those within the country. For example, Trump has warned China and Japan against further appreciation of the USDCNY and USDJPY. However, seeing these developments as the result of manipulation does not seem relevant given the structure, with the exception of the Chinese case, of the floating exchange rates of US partners. Trump has also pointed the finger of blame for the strong dollar at his domestic institutional partners. In 2019, against the backdrop of a trade war with China, he referred to Jerome Powell as an ‘enemy’ of the United States, a position that he could repeat in 2025 in view of our scenario of extended monetary *status quo*.

THE DOLLAR IS SMILING

Recent developments in the dollar are not moving in the direction of the competitive weakening sought by Trump. The pre-election period already saw a sharp rise in the Bloomberg Dollar Spot Index, closely correlated with the increased likelihood of a Trump victory. The US currency is also being supported by factors that go beyond expectations about future economic policy. The dynamism of US growth, both cyclical and structural, relative to a less positive situation in the Eurozone, Japan and even China, is helping to support the dollar in real effective exchange rate (REER) terms.

The interest rate and monetary policy differentials are also in its favour. The greenback is benefiting as well from its status as a safe haven currency and from the increased demand resulting from current geopolitical tensions and the major economic uncertainties surrounding the implementation of Trump's economic programme. The dollar's appreciation is not a recent phenomenon either, as it is part of a longer-term trend that has been underway since the post-GFC recovery, and which has taken the dollar's REER to levels not seen since the mid-1980s and the signing of the Plaza Accord (*see chart*).

STRENGTHENING EXPECTED, BUT REVERSAL STILL POSSIBLE

The dollar's general uptrend is set to continue, mainly as a result of the Federal Reserve's monetary *status quo* that we anticipate, and the resulting widening of US interest rate spread vis-à-vis the rest of the world. According to our forecasts, the dollar's appreciation will come mainly from the interest rate channel rather than the terms-of-trade channel, even though the latter is also favourable to the greenback. We have seen how sensitive the dollar can be to announcements about Trump's tariff policy (the possibility of targeted hikes, limited and/or postponed, for example, causes it to fall back instantly).

While it seems highly likely that the dollar will continue to appreciate, at least in the short term, a reversal cannot be ruled out. With its high level already pricing many favourable expectations, its further upside potential may not be as great as all that, and any disappointment could trigger a correction. Furthermore, as mentioned above, the dynamism of the US economy is one of the factors behind the dollar's current strength. However, Trump's tariff policy as well as his environmental policy will negatively affect US growth and attractiveness, which should in turn weigh on the currency. And while Trump's economic policy seems clear given the announcements made during the campaign, we still know nothing about what will actually be implemented, or when or how. This uncertainty is detrimental to the rest of the world and, by extension, to US growth. So perhaps it's not so much a question of whether the dollar will weaken, but when.

PLAZA 2.0?

The parallel was suggested above: in terms of REER, the dollar has returned to a similar level to the one which led to the Plaza Accord signed on 22nd September 1985. The seeds of the dollar's depreciation were already there, but this agreement certainly also played a role. Faced with a widening US trade deficit, the aim was to counter the dollar's strength against the yen and deutschmark through combined and concerted action by the G5 countries (France, Germany, the United States, the United Kingdom and Japan) on interest rates and foreign exchange markets. In 1987, the United States did not want to see the dollar weaken any further and a second agreement was reached, the Louvre Accord (symmetrical to the Plaza Accord) to halt the fall in the dollar and stabilise exchange rates.

Given the current strength of the dollar and the size of the US trade deficit, the idea of a new Plaza-type agreement seems understandable at first glance. An orchestrated depreciation of the dollar might also make sense from the perspective of global financial stability. It would ease financing conditions for numerous emerging countries. Europeans, Chinese and Americans might also have an interest to reach a 'deal', as Trump enjoys them (for example, no tariff hikes in exchange for a concerted fall in the dollar), and thus avoid the greater damage caused by tariff hikes and the risk of a trade war. For the United States, such an agreement would also have the advantage of avoiding the negative combination of 'higher inflation/higher interest rates/less growth' resulting from tariff hikes.

However, it is also in the interest of the Eurozone and China for their currencies to be relatively weak, as this is a factor supporting growth. Japan's difficulties following the Plaza Accord are a reminder of how important exports are as a growth engine. For the Eurozone, the rise in imported inflation could embarrass the European Central Bank (ECB) somewhat. However, it is more likely that disinflationary pressures will prevail, enabling the ECB to continue its gradual easing of monetary policy. For China, imported inflation is rather a good thing, given the existing deflationary pressures. However, we know too that China is monitoring closely the situation, keeping a close eye on any capital outflows that might be triggered by an overly weak yuan, which would further weaken the economy. It is also controlling the depreciation of the yuan against the dollar in order to retain some leeway in order to allow its currency to depreciate further in response to the tariff hikes targeting it. China also has a trump card, as it could push up its currency against the dollar by reducing its purchases of Treasuries, or even by actively selling them. This would be a potential retaliatory weapon, which the United States probably has no desire to test, given the scale of its financing requirements.

In addition, the size of the foreign exchange and capital markets and their dominant role in determining the exchange rate make them difficult if not impossible to manipulate, even jointly, conversely to 1985 and 1987. Nevertheless, in view of today's context of heightened geopolitical and geo-economic tensions, it seems illusory and unrealistic for current stakeholders, who are far greater in number today than in 1985, with such different interests to reach a consensus.

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