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Focus on Economics

US dollar: between safe-haven currency and political uncertainty

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The US dollar lost significant value last year – not due to economic fundamentals but because of growing political uncertainty. While weak currencies can offer exporters short-term advantages, a further erosion of trust carries risks. Our simulations indicate that a further global dollar depreciation of 15 per cent would weigh on GDP growth in both the US and the euro area. At worst, GDP growth losses could range between 0.3 and 0.4 percentage points. It would also put the US at risk of a renewed sharp increase in inflation. Therefore, the US is unlikely to have an economic or political interest in a further rapid dollar depreciation. In contrast, theoretical estimates and models foresee the euro strengthening significantly against the US dollar over the medium term.

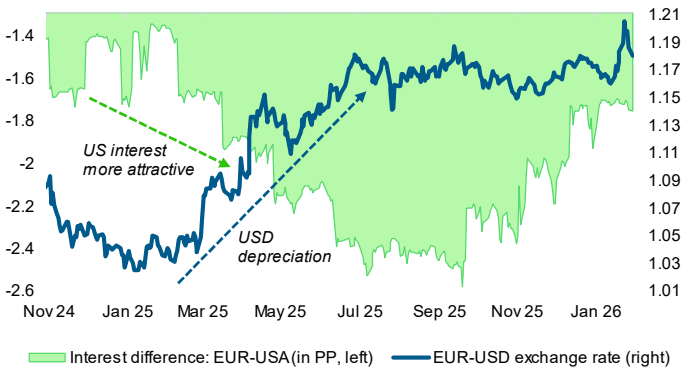
US Dollar hits a four-year low

The US dollar has been under notable depreciation pressure for more than a year now. Over the course of 2025, it lost nearly 13 per cent of its value against the euro and also showed notable weakness against a broader currency basket, exceeding typical cyclical fluctuations. This depreciation occurs in a period where the US economy is neither in a severe recession nor marked by exceptionally loose monetary policy. Traditional explanations like interest rate differentials have become less effective, as illustrated in Figure 1.[1] While the short-term interest rate differential between the euro area and the US rose sharply between January and September 2025, there was no corresponding shift into higher-yielding USD assets nor a related US dollar appreciation. Instead, the factor of uncertainty gained prominence. Increased uncertainty regarding US policies, along with likely better medium-term growth prospects in Europe, probably prompted investors to shift their portfolios away from US Treasury bonds and USD towards Europe. Consequently, the US dollar depreciated. With the onset of US rate cuts beginning in September 2025, the interest rate differential relative to the euro area narrowed. In this case, the appreciation at the margin is consistent with interest rate differential theory.

In financial markets, there is a growing perception that the US dollar carries a political risk premium.[2] Given the often erratic foreign policy of the Trump administration, culminating in the threat of annexing Greenland, this is not surprising. This risk premium is reflected not only in exchange rate volatility but also in a heightened flight to safe-haven assets like gold and silver, which saw significant rallies in recent months despite a sharp correction lately. At the same time, the US dollar index[3] (DXY) has declined markedly in value (see Figure 2).

Figure 1: USD/EUR exchange rate and interest differential

Interest differential in percentage points between the short-term reference interest rates of the euro area (€STR) and the US (SOFR); exchange rate in quantity notation.



Source: Bloomberg.

What exchange rates reflect

Exchange rates consolidate a wide range of economic information. In the *long run*, exchange rates reflect differences in productivity between two countries, which in turn determine the purchasing power of households in a country. In the *medium term*, interest rate differentials, inflation gaps, current account balances and the relative economic dynamics of two countries are relevant. Higher interest rates attract capital and support a currency, while higher inflation has a depreciating effect because the inflation-adjusted value of an investment declines. Persistent current account deficits can lead to depreciation if exporters from surplus countries convert their earnings back into their home currency. Besides these factors, exchange rates also reflect expectations. Financial markets react sensitively to political signals, uncertainty and trust in institutions. Where trust diminishes, risk premiums rise, including exchange rates.[4]

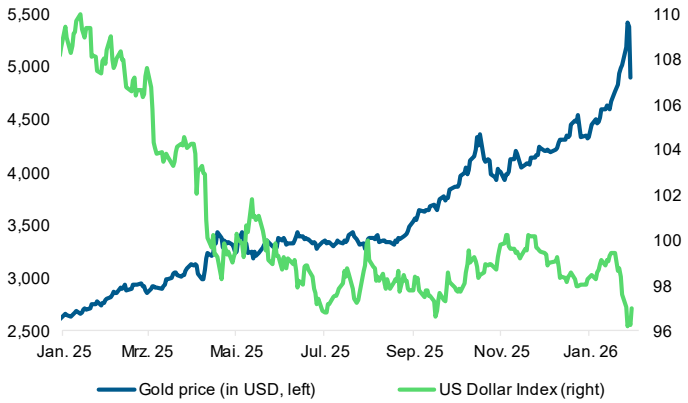
History: the US dollar as safe-haven currency

The US dollar has long established itself as the dominant crisis and safe-haven currency. In times of increasing global uncertainty – whether geopolitical, economic or fiscal – investors tend to shift capital more for safety and liquidity reasons rather than for returns. The US dollar benefits from

several structural advantages: it is freely convertible worldwide, backed by the deepest and most liquid bond markets (notably US Treasury securities) and symbolises legal and contractual security highly valued by market participants. Central banks hold a significant portion of their foreign exchange reserves in US dollar-denominated assets and international trade and financial contracts are heavily dollar-denominated. This preference for safety and liquidity consistently leads to increased demand for US dollar assets during periods of stress, which tends to push the US Dollar Index higher over extended periods. Even in US-originated crises, such as the global financial crisis of 2008/2009, demand for US dollar liquidity surged because US Treasury bonds and short-term dollar credit markets were perceived as particularly safe. This role of the dollar as a global "safe haven" is a core aspect of what economists refer to as the international reserve currency or "exorbitant privilege." The real benefit to the US lies in its ability to maintain lower interest rates than would be possible without this additional foreign demand for US dollar assets.

Figure 2: The gap is widening: US dollar vs. gold

Development of the gold price (in USD) and US dollar index since January 2025.



Source: Bloomberg.

Desired Dollar weakness?

The ongoing US debate also addresses whether a weaker US dollar could be an economic policy objective.[5] US President Donald Trump expressed satisfaction with the ongoing weakness of the US dollar, stating that he finds the current value of the dollar "great" and that "the dollar is doing well".[6] Formally, exchange rates in market-based systems result from supply and demand. In practice, however, states can exert significant influence through monetary policy, fiscal policy and communication. What is new is not the existence of these avenues of influence but their overt politicisation. When political actors explicitly set exchange rate targets, they change expectations. Markets begin to price in political motives. The exchange rate thus becomes an instrument of geopolitics. The argument behind advocating for a weaker dollar is that a depreciation improves price competitiveness and thereby promotes growth and employment. Economics describes this as the *Marshall-Lerner* effect: a depreciation improves the trade balance if the demand from exporters and importers is sufficiently elastic with respect to price changes.

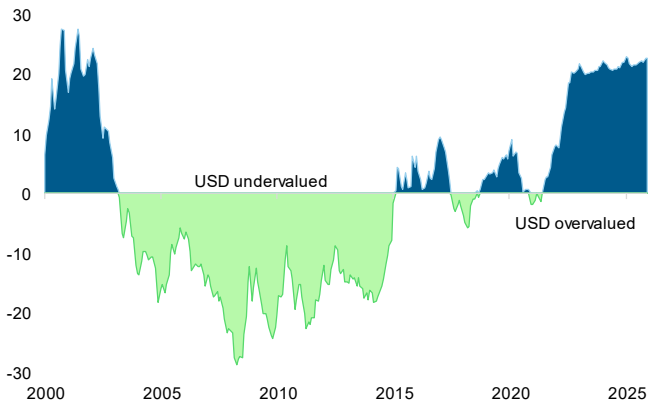
A look into the textbook: Purchasing Power Parity (PPP)

Purchasing power parity describes the exchange rate at which the prices of a representative basket of goods are equal in both currency areas. Given the inflation differential in favour of the euro area, PPP theory suggests a further euro appreciation in the *medium term*, as this represents the necessary price adjustment to the real loss of purchasing power of the US dollar. However, it is empirically well documented that exchange rates can deviate significantly from this equilibrium level over extended periods. Moreover, purchasing power parity is only one of several approaches to explaining exchange rate movements.

Figure 3 illustrates the fair USD/EUR valuation based on the Purchasing Power Parity. Between 2003 and 2014, the US dollar was slightly undervalued, mainly due to relative differences in growth and interest rates; Europe and other regions experienced stronger growth. Additionally, US interest rates remained comparatively low, while current account deficits and high US imports weakened the US dollar. Since 2021, the US dollar has been significantly overvalued relative to its PPP fundamental, driven by higher US interest rates, capital inflows into US dollar assets and its role as the global reserve currency. The COVID-19 pandemic amplified this effect through rapid monetary tightening and relative US economic strength. The current dollar weakness could therefore be interpreted less as a structural trend break and more as a gradual return to its fair value. Nevertheless, the USD overvaluation in 2025 has hardly declined as the long-term equilibrium has shifted upwards recently due to higher US inflation compared to the euro area. The market-driven dollar weakness only compensates for this new gap but does not reduce the overall overvaluation.

Figure 3: Long-term fair USD/EUR exchange rate by purchasing power parity

Deviations from fair value based on purchasing power parity in per cent. Higher values indicate USD-overvaluation against the euro (based on US inflation).



Source: Bloomberg, OECD.

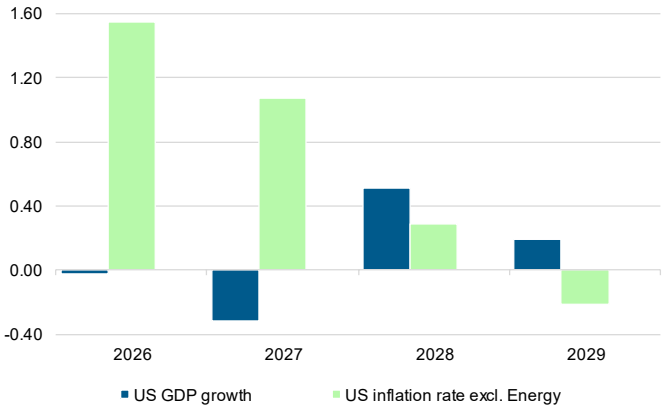
Effect of further global US dollar depreciation

Let's assume a scenario in which the US dollar depreciates by a further 15 per cent in 2026 compared to the base scenario against a broad basket of currencies (as it did in 2025) and remains at that level for two years. Simulations using the Oxford Economics model suggest that such a global dollar weakness would have noticeable effects on growth and inflation.

For the **US**, a weaker nominal exchange rate would strengthen price competitiveness against many trading partners; however, the effect would be limited. As the US economy is deeply embedded in global value chains, a weak US dollar simultaneously raises the cost of imported intermediate goods. Consequently, inflationary pressures intensify, burdening real wages and household purchasing power. The simulation shows that the US inflation rate (excluding energy) could rise by up to 1.55 percentage points above the baseline (see Figure 4). This inflation surge would affect an economy that has only recently experienced an exceptionally strong price shock. Accordingly, households are expected to be sensitive to purchasing power losses, while businesses face rising costs and uncertain demand. From a monetary policy perspective, a significant trade-off emerges. The Federal Reserve would have to balance stabilising inflation with supporting growth and employment. Assuming an independent Fed committed to its price stability mandate, the scenario implies a more restrictive monetary policy stance. Rising interest rates would counteract inflationary effects but at the same time dampen investment, lending and consumption. The exchange rate channel thus ultimately acts contrarily: depreciation generates inflationary pressure, prompting monetary policy responses that slow growth. Compared to the baseline forecast, GDP growth in 2027 would be roughly 0.3 percentage points lower.

Figure 4: effect of a further global 15% USD depreciation on the US economy

Deviations from the Oxford base forecast in percentage points, year-over-year rates.

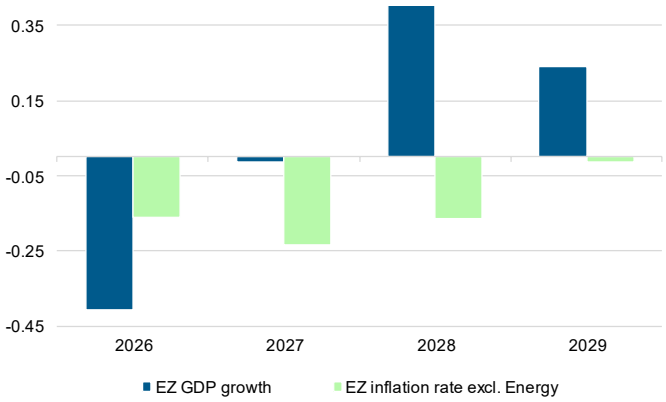


Source: Own calculations based on the Oxford Economics Model. As of February 2026.

For the **euro area**, a further strengthening euro would also pose risks. European exports would lose competitiveness against the US, weakening the economy. In the simulation, annual real GDP growth would decline by up to 0.4 percentage points at its peak, despite European consumers and businesses benefiting in the short term from lower import prices (see Figure 5). Energy prices, in particular, could become cheaper. As a result, inflation (excluding energy) would fall below the European Central Bank's target. Renewed ECB rate cuts would likely follow to curb the appreciation and stabilise demand.

Figure 5: effect of a further global 15% USD depreciation on the euro area

Deviations from the Oxford base forecast in percentage points, year-over-year rates



Source: Own calculations based on the Oxford Economics Model. As of February 2026.

In summary, the simulation shows that a further global depreciation of the US dollar, which primarily reflects a changed assessment of the political situation in the US, would significantly burden both the US and the euro area, although the model results carry some uncertainty. The dollar weakness particularly impacts inflation in the US, which could make households especially sensitive following the 2022 inflation shock. At the same time, the US Federal Reserve faces the challenge of adjusting monetary policy without further burdening the economy. Even if our simulation results are only directionally accurate, it is unlikely to be in the US's economic or political interest to allow the dollar to depreciate significantly further, despite theoretical estimates suggesting *long-term* exchange rates between 1.30 and 1.40 USD/EUR. Beyond a certain point, a too strong and rapid depreciation would outweigh the negative effects on growth and inflation.

Conclusion

The current pressure on the US dollar may signal a gradual loss of its global role. In the current environment, exchange rates are less a technical price and more a political signal. They reflect not only economic conditions and monetary policy but also institutional trust and geopolitical expectations. However, increasing politicisation of the exchange rate carries systemic risks. If the US dollar comes under growing pressure due to a loss of political trust, the US could face imported inflation. At the same time, an excessively strong euro burdens the international competitiveness of European industry, potentially leading to real production losses and an accelerated deindustrialisation in the worst case.

Disclaimer

The simulation results presented from the Oxford Economics model should be understood as conditional scenarios and do not represent precise forecasts. Since economic models only partially capture political reactions and non-linear market effects (such as sudden losses of confidence), the values for GDP growth and inflation rates should be interpreted as indicative guidelines.

[1] Among the causes for this are the increasingly negative net balance of trade of the US and the changed structure of US assets held by foreign investors. Moreover, the US dollar generates relatively high returns compared with other G10 currencies, which is why it is used less as a financing currency in carry trades. The US dollar: Not a traditional safe haven | CEPR..

[2] Pástor, Ľ., and Veronesi, P. (2013): Political uncertainty and risk premia, Journal of Financial Economics, 110(3), 520–545.

[3] The DXY measures the external value of the US dollar against a basket of major trading partner currencies, with the euro accounting for approximately 57%, followed by the yen, pound, Canadian dollar, Swedish krona, and Swiss franc. A rising DXY indicates a broader appreciation of the US dollar, while a falling DXY signals a depreciation.

[4] Krugman, P. R., Obstfeld, M. and Melitz, M. J. (2022). International Economics: Theory and Policy. Pearson Series in Economics.

[5] The Wall Street Journal (2026): A Weaker Dollar Has Always Been Part of Trump's Plan, 29 Jan. 2026.

[6] Reuters (2026): Trump says value of the dollar is 'great', currency hits 4-year low, 28 Jan. 2026.