Economic Commentary

QNB Economics
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Has the USD depreciation gone too far in 2025?

The "US dollar is King," as the saying goes. Few times in history has this being more true than in recent years, after the greenback appreciated by more than 50% over 15 years against a basket of major currencies, from the aftermath of the Global Financial Crisis and Euro Debt Crisis in 2008-2011 to Trump's second inauguration in 2025.

This came on the back of an enduring primacy of US financial markets as the world embraced the "there is no alternative" (TINA) narrative. Faced with structurally low yields, weaker liquidity, and higher risks in other advanced and emerging economies, international investor continue to channel flows into US Treasuries and equities, benefiting from the unrivalled depth, safety, and innovation of US markets. Such persistent demand for dollar-denominated assets, underpinned by the unique institutional and geopolitical advantages of the US, has driven strong capital inflows that, in turn, supported a marked appreciation of the US currency. The USD's strength reflected not only cyclical dynamics but also the entrenched structural role of the US as the world's default financial safe haven.

However, the strong engine of the USD started facing significant headwinds in 2025, as the USD idex (DXY) collapsed by more than 10% year to date (YTD).

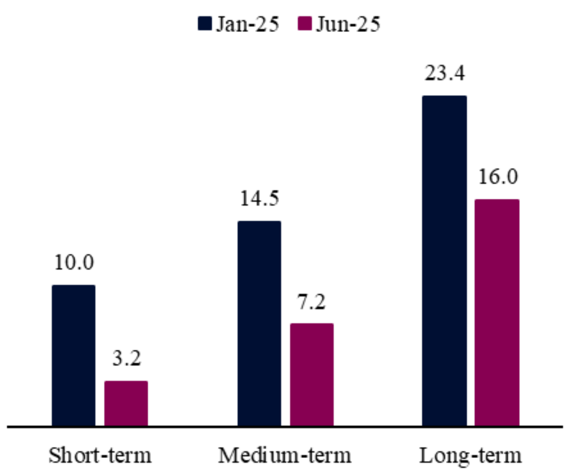
USD index (DXY)
(DXY index points, 2025 YTD)

Sources: Bloomberg, QNB analysis

Importantly, the DXY depreciation amounted to the sharpest intra-year movement for the US currency since 1973, when then President Richard Nixon engineered the USD de-pegging from gold and a significant currency devaluation. The recent DXY depreciation was also broad based, including all major currencies within the DXY basket, i.e., the Euro (EUR), the Japanese Yen (JPY), the Pound Sterling (GBP), the Canadian Dollar (CAD), the Swedish Krona (SEK), and the Swiss Franc (CHF).

An assessment of the USD suggests that, while in fact there has been a significant FX adjustment so far this year, there is more room for further USD depreciation, particularly over the long-term.

USD "overvaluation" and adjustment
(USD REER vs 5yr, 10yr, and 20yr average in %)



Sources: Haver, BIS, QNB analysis

A common way to look at currency "valuations" is to analyse trade-weighted, inflation-adjusted exchange rates, i.e., the real effective exchange rates (REER), and compare it to their averages or historical norms across different time frames. These REER metrics are more robust than traditional FX rates as they capture changes in trade patterns between countries as well as economic imbalances in the form of inflation and inflation differentials. The REER picture for mid- 2025 suggests that the USD is indeed still significantly overvalued when compared to all major time frames. Importantly, while the short-term adjustment places the USD cyclically close to "fair" value, longer-term references still point to sizable overvaluation.

In our view, this "overvaluation," alongside both cyclical and structural factors, creates an environment where USD selling pressure is likely to predominate.

On the cyclical side, the so-called US exceptionalism is set to moderate significantly, as both growth and interest rate differentials versus other advanced economies converge. The US-Euro area GDP growth differential, which favoured the US by an annual average of 220 basis points (bps) over the last few years, is set to narrow to 70 bps over 2025-2027. This is set to be driven by net negative fiscal and migration policies in the US as well as more positive fiscal policies in the Euro area. Moreover, while the European Central Bank is likely to have concluded its monetary policy easing programme or to be very close to doing so, the US Federal Reserve is still expected to deliver significant rate cuts throughout the rest of 2025 and 2026. The real rate gap between US rates and Euro area rates are set to narrow from 170 bps currently to nil by late 2026. Taken together, thiss should strengthen the EUR against the USD, driving the DXY further down – the EUR counts for 57.6% of the DXY basket.

On the structural side, the Trump administration seems to be keen to engineer a major adjustment of the economy, favouring narrower current account deficits and the re-shoring of critical manufacturing activities. In order for this to happen, a significant amount of surpluses from key trading partners of the US need to shrink, diminishing the availability of cross-border flows entering the US and supporting its currency. Importantly, this structural re-balancing of global capital allocations may trigger a significant wave of capital outflows from the US. The US is currently a large net debtor to the rest of the world, with a net international investment position (NIIP) that is negative by USD 24.6 trillion. Even a moderate correction of this large imbalance would demand further capital outflows from the US in a multi-year process, causing additional USD selling pressure.

All in all, there is no indication that the USD depreciation has gone too far this year, even if the initial movement in H1 was particularly sharp. The USD remains "overvalued" across different time-frames and both cyclical and structural factors point to an environment dominated by further selling pressure for the greenback.

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