Economic INSIGHT

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Dollar Strength Could Aid in Inflation Battle but Limit Export Growth

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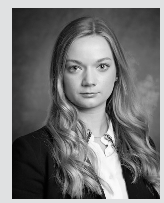

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For decades, the Federal Reserve (Fed) has pursued a policy pathway to achieve and sustain a strong dollar in the global financial markets. And now, with inflation at a four-decade high, the U.S. central bank has reaffirmed that goal – at least indirectly – by raising rates to tamp down inflation and restore price stability. Unfortunately, however, as products become more expensive overseas against a strong dollar, some countries are being deterred from engaging in trade with the U.S. – or at least are limiting transactions – intensifying near-term downward pressure on domestic growth.

As the Fed continues along a more aggressive pathway to stem inflation, where higher capital and broader based borrowing costs may reduce domestic demand and demand-side price pressure, a rapidly appreciating U.S. dollar is also causing complications in international currency markets.

A RACE TO THE BOTTOM

Typically, currency wars occur on the way down. Meaning as economic activity slows, countries often compete for what economists term a "comparative advantage" by driving domestic currencies lower. As the relative value of a country's currency declines, its exports become relatively cheaper. As a country's exports become more affordable compared to others, overseas demand would presumably rise, spurring an influx of capital, further investment and additional production in domestic industries. All of which would, according to economic theory, result in improved output and growth levels, at least in the near term.

Competitive devaluation tactics have been deployed many times throughout history – and in the not so distant past. They were used, for example, during the Great Depression with some countries permanently abandoning the gold standard. In the early 2000s, China was accused by the U.S. and other Western countries of employing devaluation measures that forcibly depressed its currency in order to boost exports and, some would argue, gain a greater role in the international monetary system. More recently, in the aftermath of the Great Recession – the financial crisis of 2007-2008 – the tables were turned. This time Brazil openly complained that the U.S. and other *"wealthier nations"*

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of the West were engaged in competitive devaluation, deliberately undermining the strength of their respective domestic currencies in order to jumpstart lackluster economic activity. In fact, according to reports, it was this latter occurrence that popularized the phrase "*currency war*."

Today, however, the Fed appears engaged in what has been termed a "*reverse currency war*." As opposed to targeting higher growth, the goal of a reverse currency war is to stem an upward trajectory of prices by strengthening the value of the country's domestic currency. After all, if a weaker domestic currency makes imports relatively more expensive and exports relatively cheaper, a stronger domestic currency presumably does the exact opposite. The appreciating value of a domestic currency makes imports relatively cheaper and exports relatively more expensive, boosting domestic buyers' purchasing power, at least in the international market. This allows domestic consumers by default to import deflation, or at least disinflation to the domestic market.[1]

When asked about the rising value of the dollar last month at the *"International Roles of the U.S. Dollar,"* a research conference sponsored by the Fed Board in Washington, DC, Fed Chairman Jerome Powell reiterated the benefits and longer-term stability gained from a strong dollar policy. *"The dollar's international role holds multiple benefits. For the United States, it lowers transaction fees and borrowing costs for U.S. households, businesses, and the government,"* said Powell. *"Its ubiquity helps contain uncertainty and, relatedly, the cost of hedging for domestic households and businesses. For foreign economies, the wide use of the dollar allows borrowers to have access to a broad pool of lenders and investors, which reduces their funding and transaction costs."*

A DOLLAR FOR YOUR EURO?

Since the start of the COVID-19 pandemic, the value of the U.S. dollar as measured by the National Broad U.S. Dollar Index has increased 10%, gaining 9% alone since the Fed first initiated rate hikes in March with what is now considered a relatively benign increase of *"just"* 25 basis points. Against the euro and the pound, the dollar continues to gain ground amid an international economic slowdown, energy crisis, and as market participants grow increasingly skeptical, central bankers overseas will be able to keep up with U.S. interest rate hikes. The euro hit parity with the U.S. dollar for the first time in 20 years on Wednesday, and on Thursday the pound fell to $1.1824 against the U.S. dollar, its lowest level since March 2020. In other words, on virtually all fronts, the strength of the U.S. dollar in foreign exchange markets is increasingly apparent. Such an upward

[1]And of course, independent of current inflationary pressures, a stronger currency also allows U.S. policy makers to maintain a leadership role in international financial markets, as other nations seek higher levels of control, particularly China with the renminbi gaining reserve currency status in 2017.

GLOSSARY

CPI: Consumer Price Index

FOMC: Federal Open Market Committee

GDP: Gross Domestic Product

PCE: Personal Consumption Expenditures

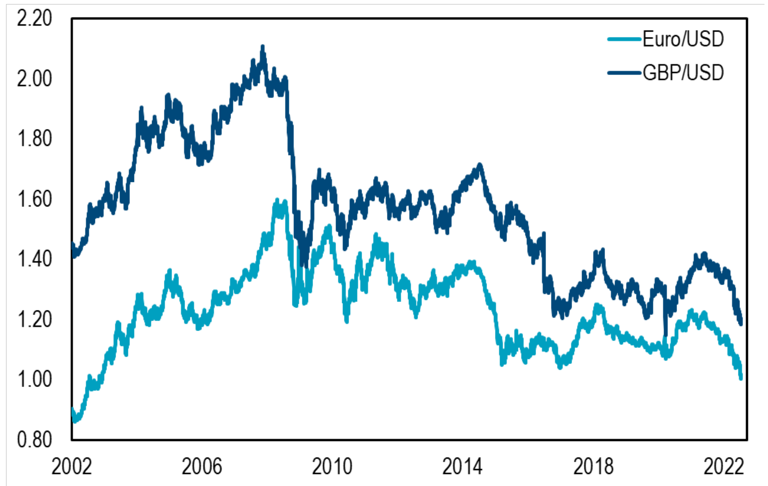
PPI: Producer Price Index

YoY: Year over Year

ECB: European Central Bank

SEP: Summary of Economic Projections

QT: Quantitative Tightening



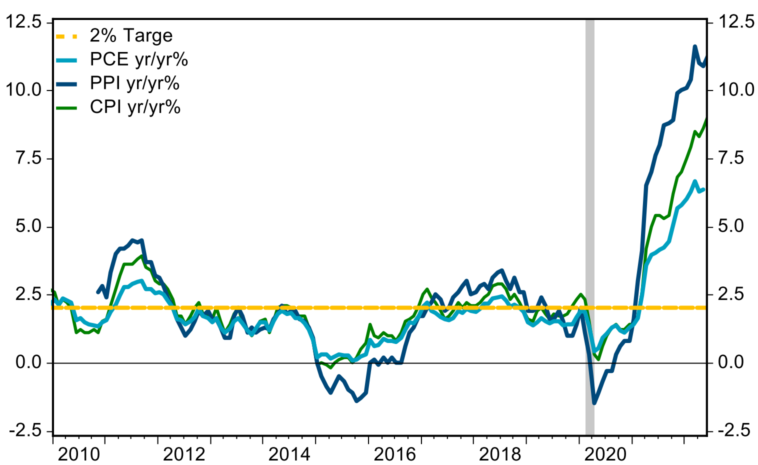
Source: Bloomberg

trajectory, is furthermore likely to continue, at least as long as the Fed maintains its pathway to a more restrictive policy, and global economic uncertainty and weakness continues to push risk-adverse capital flows – and investors – into U.S. dollar assets perceived as a safe haven.

But will the Fed's strong dollar policy work to cool inflationary pressures? Or will a stronger dollar simply crowd out foreign buyers, exacerbating already limited domestic activity? Like most answers in economics, it depends. Historically, a strengthening of the dollar has worked to curb inflation, but by how much varies on a myriad of factors. Earlier periods of dollar strength, as some reports have shown, have had only a marginal impact of less than half a percentage point of price reduction on the pass-through effect, or the degree to which changes in the exchange rate impact domestic price pressures. Although, with inflation markedly elevated in today's environment and given the vast majority of price pressures are stemming from food, energy, and other commodity costs as a result of lingering supply-side disruptions, the pass-through rate could be significantly larger. And of course, with inflation at the highest level in four decades, tempering domestic price pressures – even somewhat – would offer a welcome reprieve to U.S. consumers already reeling from years of elevated costs.

On the other hand, while U.S. consumers appreciate any improvement in their dwindling purchasing power, U.S. companies that rely on overseas demand are already suffering disproportionately. Again, recall, a stronger U.S. dollar makes U.S.-made goods relatively more expensive for foreign buyers. As a result, domestic producers become relatively less competitive in the international market, resulting in reduced sales and revenues. Large U.S. companies such as Salesforce Inc. and Costco Wholesale Corporation have already voiced concerns about the rapidly rising value of the U.S. dollar in recent company reports. Industry analysts have also warned of the potential *"massive headwind"* to U.S. companies' profits with an expected *"significantly negative"* impact on international revenues.

In fact, according to the latest report from the U.S. Census Bureau, with the rising value of the U.S. dollar favoring import growth at the expense of export activity, the U.S. trade deficit narrowed $20.6 billion in April, the most on record in dollar terms, to $87.1 billion in April, and narrowed an additional 1.3% to $85.5 billion in May, the lowest level of the year. Declining trade activity alone shaved off more than 3% from headline GDP January to March. Excluding trade, headline growth rose 1.6% at the start of the year as opposed to the headline read of a 1.6% *decline*.



Sources: BEA, BLS/Haver

Meanwhile, despite the appreciating value of the U.S. dollar, the latest read on inflation showed costs continue to rise. According to the June CPI report, consumer prices rose 1.3% and 9.1% over the past 12 months, the highest in more than 40 years.

Similarly, the latest PPI report showed a 1.1% increase in June and an 11.3% rise year-over-year, the fastest annual pace in three months. Additionally, the PCE, the Fed's preferred inflation rate, rose 6.3% in May, more than three times the Fed's 2% target.

WHAT'S A FED TO DO?

Central banks around the world are taking a more direct approach to currency control. This year, the Swiss National Bank, for example, has allowed its currency to strengthen to a three-year high and has openly said it would consider selling foreign currency if the country's domestic currency, the Swiss franc, *"weakened excessively."* Officials of the European Central Bank (ECB) have also issued warnings of a *"too weak"* euro, warning a significant decline in the region's currency could *"undermine"* the ECB's authority – and ability – to institute price-stability.

For the Fed, while U.S. central bankers seek to uphold stability in the greenback, consensus suggests strength in the currency is a result of broader monetary policy action as opposed to a direct target of policy implementation. In other words, the U.S. central bank appears to be taking a more controlled stance, emphasizing traditional policy metrics, such as raising rates and drawing down the balance sheet, rather than specifically targeting exchange rates to battle inflation. The Fed has already launched a series of rate increases, taking the upper bound of the federal funds target range from 1.00% to 1.75% as of June with apparent intentions, according to the latest Summary of Economic Projections (SEP), to hike rates to 3.50% or higher by year-end. Additionally, the Fed has initiated a drawdown of its balance sheet, known as Quantitative Tightening, ramping up monthly reductions to $95 billion by September.

Of course, despite a massive run-up in the dollar index, the upward trajectory is unlikely to continue ad infinitum. In fact, with the implied yield of the December 2023 fed funds futures contract now below the December 2022 yield, as reported by *Bloomberg*, the end of the dollar's rally may be approaching. In the meantime, the debate over international exchange rate policy – and market dominance – continues, particularly as the use of cryptocurrencies expands and the broader digital world evolves.

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