

Soaring dollar could help Fed in fight against inflation

But the lofty greenback is making life harder for some U.S. trading partners.

By [David J. Lynch](#)

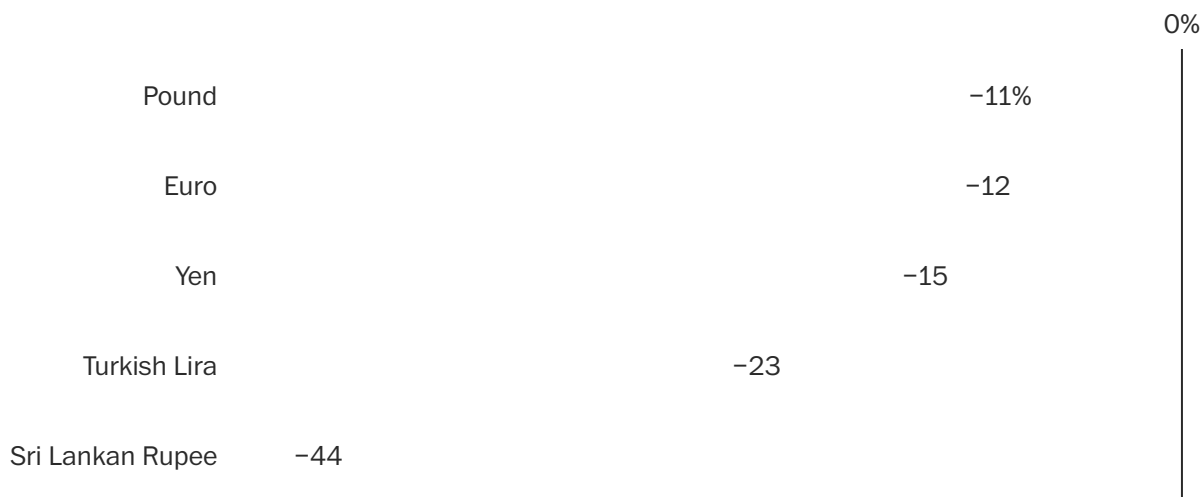
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The Federal Reserve's interest rate hikes have driven the U.S. dollar to its highest level in decades, treating American tourists to bargains in Europe and Asia, putting imported goods on sale here at home and squeezing the economies of several U.S. trading partners.

The dollar reached multi-decade highs this week against major currencies including the euro and Japanese yen and is almost certain to head higher still. With consumer prices rising by 9.1 percent over the past year — the fastest pace since 1981 — the Fed has signaled additional rate increases are coming, starting July 27.

Currencies that have significantly weakened against the U.S. dollar this year

Year-to-date percent change in value to U.S. dollar



Data as of June 12

Source: Bloomberg

THE WASHINGTON POST

The robust greenback is evidence that the Fed's anti-inflation campaign is starting to gain traction, even as prices overall continue ticking up. But it's a different story overseas, where currency weakness in Europe and the United Kingdom — the flip side of the dollar's strength — is making the fight against inflation even tougher.

As years of low inflation and low interest rates have given way to a more volatile era, currencies are trading in a wider arc. In particular, the war in Ukraine, which upended global food and fuel markets, has dealt more punishing blows to Europe and many developing countries than it has the United States, which helps explain the dollar's current shine.

"The dollar, euro, yen and yuan moved in relatively small ranges for a very long time. This is the first time in decades where everybody's down against the dollar," said Adam Posen, president of the Peterson Institute for International Economics.

The more muscular dollar is straining budgets for countries that are heavily dependent upon oil imports, which are priced in dollars, such as India, South Korea and Thailand. Several developing countries that need financial infusions to cover their debt payments, like Ecuador and Tunisia, also are hurting as the U.S. currency climbs.

The dollar's outperformance — up 13 percent this year in the DXY Index — reflects the strength of the U.S. recovery from the pandemic, which was faster than in Europe or Japan. And it shows that Federal Reserve officials, after misreading price signals for most of last year, have belatedly adjusted more quickly than their counterparts in Frankfurt and Tokyo.

This year, the Fed has raised rates twice by a total of 75 basis points and is expected to enact at least an additional three-quarters-of-a-point at its next meeting later this month. The European Central Bank is expected to raise rates for the first time in 11 years at its July 21 meeting and then only by a quarter-percentage point. The key European rate is expected to remain in negative territory until September even though inflation hit 8.6 percent in June.

In Japan, where inflation has long been subdued, the Bank of Japan last month opted to keep its main rate at a negative 0.1 percent.

"Central banks were caught unawares by the inflation surge and are now reacting at different speeds," said Marc Chandler, managing director of Bannockburn Global Forex. "The U.S. is carrying out its most aggressive tightening since 1980, while the Europeans and the Japanese haven't moved."

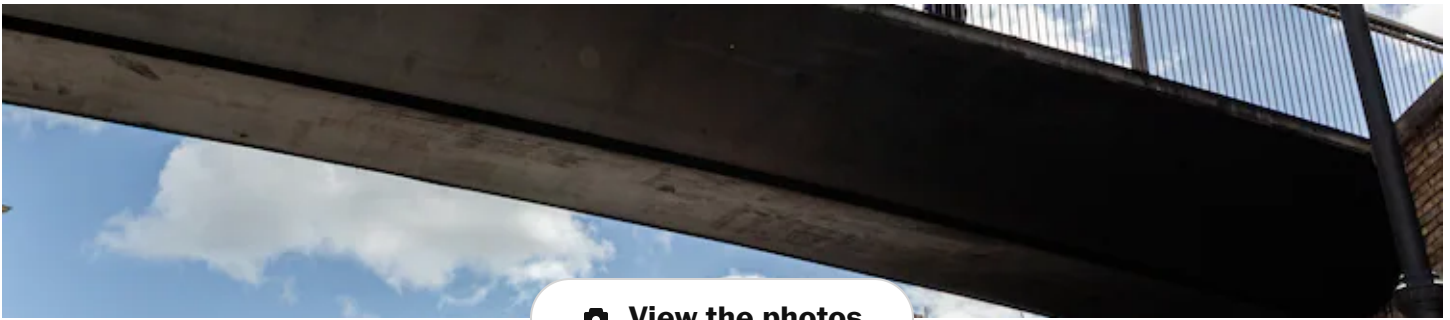
Still, the stronger dollar isn't all good news for the United States.

American products are becoming more expensive for customers overseas, whose currencies are losing value against the dollar. That hurts major exporters like Boeing, the world's largest commercial aircraft maker. And giant U.S. corporations are seeing their overseas earnings shrink when they are converted into dollars, further eroding support for sinking stock values.

Microsoft last month lowered its forecast for the current quarter, saying the strong dollar would reduce its expected earnings by around \$250 million.

In April, the software giant was among the first major corporations to warn of the dollar's strength. Executives told investors the dollar's climb during the first three months of the year had cost it about \$225 million in profit.

In general, U.S. companies derive about 30 percent of their total earnings from overseas operations, according to Morgan Stanley. The earnings hit to U.S.-based multinationals from the rising dollar could cause them to reduce spending in other areas, thus contributing to the economic slowdown that the Fed is trying to arrange.



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Some central banks are trying to keep pace with the Fed. On Wednesday, the Bank of Canada surprised markets by raising its key lending rate by a full percentage point to 2.5 percent, and signaled plans for further increases. The Reserve Bank of New Zealand also set its policy rate at the same level, the highest in more than six years. Those moves came one day after South Korea's central bank lifted rates by half-a-percentage-point, its largest move since 1999.

The financial fallout is especially challenging for European policymakers. The weaker euro is making inflation worse by raising the cost of goods imported from elsewhere.

Any benefit that German exports get from the weaker currency is being overwhelmed by rising energy costs due to the loss of inexpensive Russian supplies.

Germany this month reported its first trade deficit in 30 years as Russia's limits on natural gas shipments to Europe, sparked by the diplomatic showdown over Ukraine, made German goods more expensive, and China's economic slowdown cut into demand.

Elsewhere, the stress may be even more severe.

On Wednesday, the International Monetary Fund said it had reached a staff-level agreement with Pakistan on a \$1.2 billion bailout designed to help the government cope with a dire economic situation but which will, in return, require officials to cut energy subsidies — even though inflation is running at 20 percent.

The global lending agency is also negotiating with other debt-ridden countries like Tunisia, where economic troubles could bleed into social unrest.

According to the Organization for Economic Co-Operation and Development, the 38-nation developed-country group in Paris, the dollar is now overvalued by the most in 30 years.

The currency's performance is defying worries voiced earlier this year that the Biden administration's aggressive use of financial sanctions to punish Russia for invading Ukraine would encourage other countries to reduce their reliance upon the dollar.

Instead the dollar remains by far the most widely held global currency, accounting for almost 59 percent of total central bank reserves, according to the International Monetary Fund.

The soaring dollar in recent months also has contributed to falling prices for imported goods.

On Friday, the Labor Department reported that the price of imports, excluding fuel, dropped in June by 0.5 percent, the second consecutive monthly decline. Over the past year, prices of non-fuel imports rose by 4.6 percent, roughly half of the overall increase in consumer prices.

"The strong dollar is helping curb inflationary pressures," said Rhea Thomas, senior economist with Wilmington Trust.

Past episodes of major currency misalignments have triggered outbreaks of protectionism in the United States, as blue-collar workers rebelled against the loss of jobs to overseas competition, or central bank intervention to reset the value of the dollar, euro or yen.

In a 1985 meeting at the Plaza Hotel in New York, the United States, Japan, Germany, France and the United Kingdom agreed to coordinate moves to weaken the dollar to make American products more competitive in global markets.

When the euro was struggling to establish itself in 2000, central banks in the United States, Europe and Japan agreed to intervene to boost the value of the new currency after it had lost almost one-third of its original value.

This time, no such intervention is likely. On Tuesday, after meeting with top Japanese officials, Treasury Secretary Janet L. Yellen swatted away talk of joint action.

"Our view is that countries like Japan, the United States, the [Group of 7 nations], should have market-determined exchange rates, and only in rare and exceptional circumstances is intervention warranted," Yellen said, adding that she had not discussed any such plans with Japan's government.

Central banks are more focused on ensuring those who need dollars can obtain them rather than worrying about their cost, said Chandler of Bannockburn Global Forex.

The Fed has standing arrangements to swap dollars for foreign currencies with its counterparts in Canada, the U.K., Europe, Japan and Switzerland. At the start of the pandemic in March 2020, the Fed extended those arrangements to nine other central banks, including those in Brazil, Mexico and South Korea to ensure that markets could operate normally despite the sudden stop in economic activity.

"The politics of the dollar have really changed since the 1980s and 1990s when there was active intervention," said economist Steven Kamin, former director of the Fed's division of international finance. "Central banks recognize what's really moving currencies are these substantial economic forces."

Jeff Stein in Bali, Indonesia, contributed to this report