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# G10 – Reverse currency wars less than meets the eye

- **Disinflation driven by a strong USD is likely to be reversed over time; so is poor-quality disinflation**
- **Global benefits from a weak USD probably outweigh the US benefit from a strong USD**
- **Some two-way risk could be introduced by jawboning, given the one-sidedness of positions**

**Steve Englander**
+1 212 667 0564
Steve.Englander@sc.com
Head, Global G10 FX Research and North America Macro Strategy
Standard Chartered Bank NY Branch

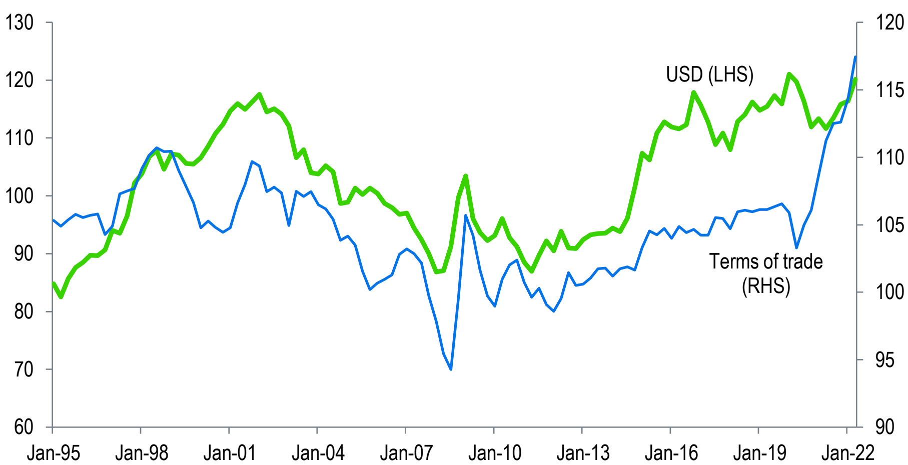
## Transitory disinflation yet again

It is hard to argue against the thesis that a strong currency leads to lower import prices and lower inflation. However, we see these disinflationary gains as low-quality, dare we say 'transitory'. On the whole, we are probably getting a modest disinflationary impulse from the strong USD as there is a broad correlation between the USD and US terms of trade (Figure 1), but it is not enough to make a material difference in how we perceive inflation. Core goods price inflation, which would reflect USD strength the most, was clearly the driver of core inflation, despite the USD rising about 15% since early 2021 (Figure 2).

Big USD dollar cycles come maybe twice every quarter-century, but reflect very unusual conditions that are unlikely to persist long-term even if there is nothing obvious on the horizon to disperse them (Figure 3). When USD strength reverses, so will the disinflation contribution of the exchange rate. Arguably, choosing somewhat lower inflation now at the cost of somewhat higher inflation in the future seems reasonable. But it may not seem that way in a year or two when the Fed is struggling to see where inflation plateaus amid structural changes that may make returning to pre-2020 inflation levels difficult.

The policy takeaway is that if a weaker USD becomes desirable, the lost disinflation from USD strength is a second-order consideration. There are other hurdles before a weak USD policy becomes feasible; inflation risk is towards the bottom of the list.

**Figure 1: Terms of trade and USD move broadly together**
*Index (Fed broad USD, LHS); index (terms of trade, RHS)*




Source: Macrobond, Standard Chartered Research

*The disinflationary benefits of a strong USD will likely be given back*

## Hard to win long-term victory in reverse currency wars

With inflation the dominant economic policy issue now, many would argue that any contribution to lowering it is welcome. The counterargument is that lower imported goods inflation that artificially reduces core inflation may mask an even bigger core domestic inflation problem. We suspect that the those who see an extended period of disinflationary benefits from a strong dollar expect the strength to persist. Having experienced several such episodes of USD strength, when the forces in play seemed long-lasting but reversed sharply, we are much less optimistic that USD strength will remain anywhere near current levels long-term.

Improved terms of trade provide real purchasing power gains for US consumers. Moreover, supply constraints abroad mean that foreign producers cannot take advantage of competitive exchange rates to ramp up US market share. Paradoxically, the Fed may be ambivalent on these gains. Enhanced purchasing power that spills over into demand for domestic goods may be delaying the impact of monetary tightening on activity. We suspect that the lower gasoline price is enabling consumers to maintain demand and that the stronger dollar may be having a similar impact, although it is much easier to gauge the impact of gasoline prices.

## Supply chain restoration

*Once supply chains are restored, foreign competition should gear up*

When the global supply chain and trading system is behaving normally, the stronger dollar induces supply from abroad as producers become more competitive. Once global supply becomes more responsive to price signals, substitution of foreign production for domestic could become a material drag on growth, leading to subsequent USD weakness.

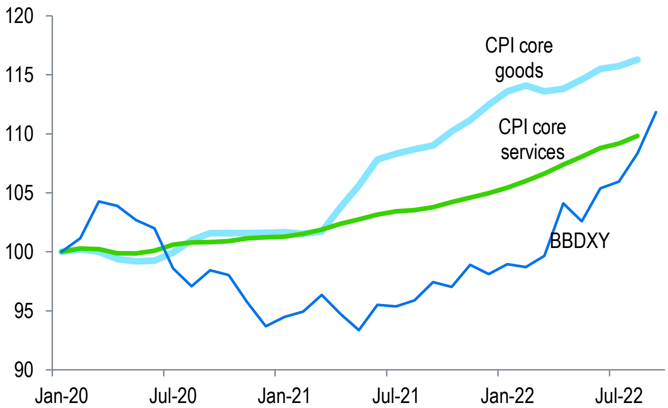
At present, the European supply response is limited by energy availability and China's by zero-Covid. In H2-2020, the US economy faced supply constraints, China had largely reopened and USD-CNH was trending steadily lower. As European energy supply chains loosen, the EUR is similarly likely to bounce back. None of this is imminent, but the timing of inflation payback is not guaranteed to be optimal.

*The Fed largely controls domestic demand and prices*

In precise terms, the Fed can target domestic demand and domestic inflation through its rates policy. The USD and commodity prices are at least partially determined globally and should not be seen as independent targets.

**Figure 2: Core goods led inflation, despite USD strength**

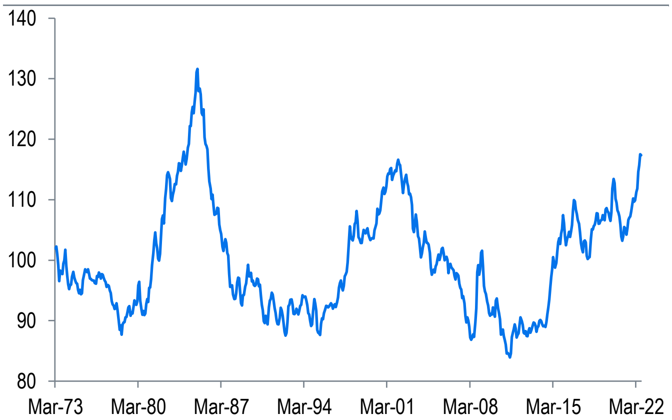
*Index, Jan 2020=100*




Source: Macrobond, Standard Chartered Research

**Figure 3: USD spikes typically reverse**

*Index, real effective USD*




Source: Macrobond, Standard Chartered Research

## Should the US/world want a weaker dollar? Can they have it?

***Financial market transmission of US financial conditions increasingly a global negative***

USD strength looks increasingly negative globally. From a financial market perspective, added credit risk premia, potential debt servicing issues and risks of diminished liquidity add to risks of financial market disruption. The role of US rates in driving global rates makes it hard for foreign financial markets to insulate themselves from US rates pressure, especially in a period of weak activity.

By contrast, we do not see the strong USD as more than a very modest positive from the point of view of macro stabilisation. As a consequence, we do not see that the US would lose much if the USD fell. We agree with the Biden administration that the strong USD is an indication of the relative strength of the US economy, but do not think the US economy would be much the worse or stabilisation of the US economy much harder if the USD were weaker.

***Long USD positioning suggests that modest intervention would be effective, initially***

Given the official silence on the USD thus far, a round or two of verbal intervention is likely to have some impact as market participants realise that policy makers are not indifferent to USD strength. Intervention would probably be similarly effective the first couple of times but be increasingly futile over time unless growth or rate fundamentals changed. Nevertheless, taking advantage of the limited low-hanging intervention fruit may be worthwhile, provided that expectations are realistic.

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Document approved by
**Suki Cooper**
Precious Metals Analyst

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