Exchanges at Goldman Sachs

Breaking Down the Dollar's Rise

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Allison Nathan: Global currencies, from the British pound and the Japanese yen to the Chinese yuan are plunging. At the same time, the US dollar is surging to new highs. So, what's behind the volatility in the currency markets? And how much higher can the dollar go?

Kamakshya Trivedi: "Under our central scenario, we think even from current strong levels, the dollar can appreciate further. We have another couple of percent dollar appreciation baked into our forecasts for the next few months. But in a more hawkish scenario where US inflation is more entrenched, the Fed needs to move further and keep rates higher for longer than envisioned. I think you could see another five to 7% appreciation on the broad dollar in that sort of hawkish scenario.

Allison Nathan: I'm Allison Nathan and this is Exchanges at Goldman Sachs.

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Allison Nathan: To help explain the implications of these moves on the global economy, I'm sitting down with my colleague in Goldman Sachs Research, Kamakshya Trivedi, Head of Global Foreign Exchange, Interest Rights, and Emerging Markets Strategy Research. Kamakshya, welcome back to the program.

Kamakshya Trivedi: Thanks, Allison, pleasure to be here.

Allison Nathan: So, it's been a pretty crazy time in the currency markets, Kamakshya. There is so much to talk about. I can't wait for this conversation.

So, let's start with what's happening in the UK where you're based. The pound took an absolute beating last week on the back of the new government's tax plan. And it even came within spitting distance of parity with the US dollar. Although, this weakness in the pound has reversed somewhat on the Bank of England's announcement to buy back UK sovereign bonds or gilts. So, where does the pound go from here?

Kamakshya Trivedi: Look, I think that there's no question that amongst the broader dollar surge higher, there were some pound-specific elements that caused the weakness in the past week. We've seen, as you mentioned, a relatively large unfunded and untargeted fiscal expansion announced by the government. And in response to that, financial markets are demanding a higher risk premium to buy those government bonds that the UK government is going to have to issue.

At a very simple level, that issuance can cheapen in two ways. Either those bonds can become cheaper. Or the currency can become cheaper to incentivize foreign investors to hold UK bonds. I think what we've seen in the past week is that there is limited tolerance from policymakers to allow government bonds or gilts to cheapen. And so, the revealed preference here, to some extent, is that the pound may have to fall further.

As you mentioned, it's bounced a bit. I think that reflects some stabilization in the volatility. It also probably represents some closing out of positions, given that it is quarter end. It's also helped that we've seen some degree of fiscal stability from the UK government, in particular with regards to the top rate of income tax. But we will have to see more on that front as well when we have the final statement on the budget and the budget projections. But we think without much more forceful action from the Bank of England, the pressure on the pound is likely to reemerge.

Allison Nathan: So, you mentioned that this is actually, largely, a dollar story. We have seen the dollar strengthen substantially across many currencies in the recent period. So, talk to us a little bit about what's driving that dollar strength, and if you expect it to continue.

Kamakshya Trivedi: So, what you are seeing in taking a step back is that the US economy looks to be somewhat overheated. Inflation is high and growth is pretty resilient. And in the face of that, the US Federal Reserve is hiking rates in a single-minded fashion, hefty increments of 75 basis points each time. And it's very hard for other countries to match this combination of solid growth and large Fed hikes. And that is primarily what is supporting the dollar against all kinds of developed marketing and emerging market currencies.

You have seen some hikes in other parts of the world as well. Inflation is, to some extent, a global problem. But it is this single-minded focus on inflation. The Fed just appears to be less constrained than other central banks in terms of moving policy tighter.

The ECB, for example, has started moving policy higher. But they also need to worry about financial fragmentation risk, whether the new political transition in Italy creates sovereign spreads to widen. Places like China, they need to concern themselves with the domestic soft growth backdrop.

So, the Fed appears to be unconstrained. They're moving fast. That's supporting the dollar against, pretty much, most currencies across the world.

And under our central scenario, we think even from current strong levels, the dollar can appreciate further. We have another couple of percent dollar appreciation baked into our forecasts for the next few months. But in a more hawkish scenario where US inflation is more entrenched, the Fed needs to move further and keep rates higher for longer than envisioned, I think you could see another 5 to 7 percent appreciation on the broad dollar in that sort of hawkish scenario.

Allison Nathan: And what are the implications of that? Ultimately, as we're sitting here in the US having cheaper imports strikes me as a good thing.

Kamakshya Trivedi: Yes. A stronger currency is typically part of a tighter financial conditions mix. So, what that means is it makes it harder for exporters. And as you mentioned, it makes the local prices of imported good lower. And so, normally, there is a trade-off. You get a little bit of benefit on the inflation side. But then there's a little bit of a cost on the growth side.

But right now, given that it's inflation that is primarily above target, that's the main focus of policymakers. And what that means is that the downside growth effects are somewhat second order. And so, the fact that there is an inflation benefit from that stronger dollar is going to be the main thing that policymakers in the US are going to be concerned about.

This is very much a case of what we've seen a few times historically where a stronger dollar, from the US perspective, is our currency, but your problem for a lot of the other parts of the world.

Allison Nathan: Well, talk to us about the problems that this could be causing for other economies.

Kamakshya Trivedi: So, just like it benefits US inflation, it's complicating the trade-off that a lot of countries face. Because they have a somewhat unhelpful dilemma. Either they accept much faster deprecating currency. Or they need to move rates up fast enough to either keep pace with the Fed, or even outpace the Fed, which may not be appropriate for their local economic conditions, either because the domestic economy is not as strong as the US. Or because underlying inflationary pressures are not as strong as the US. And so, you're faced with this very unpalatable trade-off in a lot of economies about just how much you can tighten. And whether there are any other tools you can use to stem the degree of the currency depreciation. Because it just ends up fueling your own inflation pressures.

One of those tools is FX intervention. And we have seen some examples of that. It creates some real severe problems in emerging markets, which have dollar denominated debt. And I think those are the more severe group of problems that we may come back to talking about.

Allison Nathan: So, as we're talking about FX intervention, it would be interesting to hear how common is that? We are seeing, obviously, a lot of economies begin to do that. But it's pretty rare.

Kamakshya Trivedi: FX intervention is pretty rare amongst developed economies these days. I think that it's more common amongst emerging markets who typically have used outright currency interventions to manage the volatility in their currencies. It's, I would say, pretty common amongst emerging markets, but rare amongst developed markets.

Allison Nathan: But, we've seen the Bank of Japan intervening now. Other central banks. Correct? Do you think we'll see more of that?

Kamakshya Trivedi: It wouldn't surprise me. You're right. We've seen the Bank of Japan intervene. We've seen the policymakers in China guide towards slower pace of depreciation of the yuan. You've seen a number of emerging markets central banks intervene, all the way from Chile to the Czech Republic to India.

And so, I think that currency intervention is one way of trying to make that trade-off that I was describing between tightening policy and accepting a weaker currency to improve the terms of that trade-off. So, it wouldn't surprise me if we saw more of that.

I think that one of the challenges, however, for a lot of this is whether it will work. And what you've seen is that these interventions can slow the pace of the depreciation of the currencies. But they're not going to change the direction of travel until the underlying fundamental macro and policy drivers change.

To go back to the example of Japan that you mentioned, the big reason why the Japanese yen is depreciation is that even as the Fed hikes, the Bank of Japan has a policy of yield curve control. They are keeping yields capped and not moving policy tighter. That means that the interest rate gap between the US and Japan keeps widening, keeps pushing towards a weaker currency.

If this was really a deep problem, the Bank of Japan needs to shift its policy stance. We don't expect them to do that. And so, the pressure on the currency to weaken is just going to keep reemerging, even if intervention slows the pace.

So in a nutshell, a number of the moves that we've seen in these currency crosses with respect to the dollar have been extreme, but they're explainable based on the macro and policy differences.

Allison Nathan: Right. And we don't expect them to tighten their stance because they don't have the inflation problem that we have in the US and other parts of the world. And it's just not appropriate for their economy.

Kamakshya Trivedi: Exactly. I would say that even one step further is the case of China. There as well you have no inflation problem. And actually, growth is pretty weak. So, not only are they keeping policy on hold or fixed, like Japan, they've actually been easing policy to support their economy.

And so, once again, the gap between China, which is easing policy, and the US, which is tightening policy, keeps growing. It's no surprise then that the Chinese yuan depreciates versus the US dollar. I think they recognize that. I think there's a discomfort with the speed at which that is happening. And what that volatility means for both financial market participants and businesses and households. But I think there is a recognition that until the underlying inflation and policy dynamics don't change, the direction of travel here is still going to be for a weaker Chinese yuan or a weaker yen and a stronger dollar.

Allison Nathan: That said, if all of these central banks outside of the Fed, the non-US central banks, are struggling with this issue, is there a chance that we could see more of a coordinated action of some kind that could help bring out a better result for them?

Kamakshya Trivedi: It's been done before. The most common example is the Plaza Accord of the mid 1980s when a number of central banks got together, including the US, to strengthen the yen and weaken the dollar. I think it's unlikely at the current juncture to a large extent because it's not in the US's interest to participate in such a move.

If you go back in terms of the backdrop to the Plaza Accord, that came after many years of dollar strength and a number of quite a big increase in protectionist sentiment in the US on account of that dollar strength. We are not at that point yet.

And on the other side, as we were discussing earlier, if the weaker yen was really an issue, the Bank of Japan could change its own policy mix to a more currency-supportive direction.

I think more individual or one-directional intervention is possible. But a coordinated intervention that includes the US, I don't think the stars are aligned for that yet. If we see many more years of dollar strength, perhaps then. And if you see a sort of US inflation start to come lower, then perhaps the domestic US politics, but also the overall conjuncture might change for there thing a bigger alignment of interests. But right now, I don't think so.

Allison Nathan: So, if you talk about this dollar strength, are there any currencies that have been able to withstand it and have held up better?

Kamakshya Trivedi: Yeah, paradoxically, you wouldn't think it, but actually, a couple of emerging market currencies are still stronger relative to the dollar, year to date. To give a couple of examples, both the Brazilian real and the Mexican peso have held their own against the dollar. That's unusual because typically these are highly risky, higher yielding currencies that you tend to have a larger sensitivity to risks that have been playing out in the world.

But I think the key reason for that is that they started their rate hike cycles much earlier. And have been going, again, at a very rapid clip that either matches or outpaces the Fed. So, Brazil, for example, started hiking rates all the way back in March 2021. And has kept going. And got rates close to 14 percent. Mexico started later but has been matching the Fed. Has rates now close to 10 percent.

So, I think the lesson of that is that it is possible to have some degree of currency stability. But for that, you need to be able to keep up or even outpace the rate hikes that the US is delivering.

The fact that these two countries have done it, I think, also partly reflects their own historical experience with inflation. When inflation first hit their shores, there was none of this transitory versus non-transitory debates there. They have a history of high inflation. They know how problematic it can be. They were very quick to start moving rates higher and slamming on the monetary brakes, if you like. And that, in turn, has stood them in good stead.

It has to be said, as well, they are somewhat further removed from the growth slow down in China or some of the gas related problems that Europe is facing. And I think that has also helped, aside from the fact that they've brought their nominal and real interest rates up.

Allison Nathan: So, do you think that the challenges that some of these emerging markets are going to face by the strong dollar could actually generate a crisis of some sort in the emerging market economies?

Kamakshya Trivedi: Allison, I think in some of the more vulnerable pockets of emerging markets, there is already a debt crisis. This is the group of emerging markets where there is substantial amount of dollar-denominated debt. Exchange rates have typically been a bit more pegged. And you have limited reserves. They typically form what you would call the frontier economies.

But for this group of economies, either some of them have already deflated, like Sri Lanka. Or a number of them are already engaged with the IMF to try and either negotiate programs or extend programs to get funding, given their roll over needs and limited dollar reserves. Places like Ghana, Pakistan fall into that group.

I think there is a group of vulnerable emerging markets. And I think that's the place you need to look for the real debt problems that are beginning to take place. And in many of them, to be honest, when you look at their sovereign credit spreads, are priced at extremely distressed levels as well.

Allison Nathan: So, if the Fed is committed to tackling inflation now and is, therefore, likely to continue to outpace other central banks in terms of the rate hikes as we've been discussing, what do you think could end the dollar boom?

Kamakshya Trivedi: I think there are a few things that need to happen for the dollar boom to end. Obviously, partly you need to see convincing evidence that inflation in the US is peaking, because that will allow the Fed to pivot back towards smaller steps and, ultimately also, to pause this hiking cycle. I think that's one important thing that you need to see on the US side.

But currencies, at the end of the day, are a relative game. You also need to see better news elsewhere. You need to see growth in Asia, and China in particular, pick up more convincingly so that policies there actually start moving in a currency supportive direction rather than the other way around. And likewise, we are expecting a pretty tough winter across Europe. Our economists forecast a recession in the euro area. In the UK, as well, we need to get to the other side of that and start seeing a recovery in these economies as well.

If you get that sort of better growth impulse in the rest of the world, even as the Fed starts to slow down its hiking cycle or it ultimately pulls it, I think that's the confluence of circumstances that you need for the dollar to start to peak and move lower.

Allison Nathan: So, when do we reasonably expect that all could happen?

Kamakshya Trivedi: I think the conditions are not in place yet. I think you could imagine a situation where sometime time in 2023, China starts to move away from its Zero COVID policies. Our economists expect that to come some time in the second quarter of the year.

Likewise, we expect the euro area recession to be over some time in 2023. And probably, even before that, we would get a sense of how bad the winter is. And therefore, how much demand destruction needs to take place in order for Europe to get through the winter.

If around the same time we get some convincing signs that US inflation has finally peaked, I think one can envision a scenario where the dollar starts to turn. But we are not there yet.

Allison Nathan: Kamakshya, thank you so much for taking the time to speak with us during what I know is a very busy time for you.

Kamakshya Trivedi: Thank you, Allison.

Allison Nathan: Thanks for joining us for another episode of Exchanges at Goldman Sachs. If you enjoyed this show, we hope you follow on your platform of choice and tune in next week for another episode. Make sure to share and leave a comment on Apple Podcasts, Spotify, Stitcher, Google, or wherever you listen to your podcasts.

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