

Forex Focus: Dollar Joins The Competitive Devaluations?

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LONDON (Dow Jones)--"Anything you can do, we can do better."

This seems to be the message from the U.S. Federal Reserve to other major central banks as they all battle to keep their currencies from rising and choking off their already-feeble economic recoveries.

In this post-recessionary world, it is one thing to enjoy the fruits of recovery and the end of deflation.

However, it is another thing to suffer at the hands of a strong currency that will bring an end to export growth before domestic demand recovers.

This is precisely the problem facing most major economies--and their central banks.

Japan has already explicitly acknowledged its problem, instructing its central bank to wade into the markets and stop the yen from rising with direct intervention for the first time in six years.

The Bank of Japan continues to hover over the market, with Prime Minister Naoto Kan issuing periodic warnings that there is certainly more intervention to come if the yen starts heading higher again.

Japan has only followed in the footsteps of Switzerland, which has been battling to keep its currency from rising too far for well over a year.

See how the dollar has fared against the yen since the Bank of Japan intervened:

<http://www.dowjoneswebsites.com/chart/view/4619>

Elsewhere in the developed world, the pressures are the same but the currency management method has probably been a bit more subtle.

The euro zone has long made it clear that a strong euro wouldn't be popular, especially given the continued threat of a sovereign debt default among the region's peripheral debtors. On Wednesday, for example, the cost of insuring Irish debt rose to a new record high despite the country's recent success in raising more funds.

Also, with the recent strength in core euro-zone economies showing signs of fading very fast, investor interest in the euro has been looking at the best patchy.

A similar, if not worse, fate has faced the pound as the U.K. prepares to undergo the most draconian cuts to public spending in decades. With bank lending still on the decline and house prices on the slide, the Bank of England has admitted that talk of more quantitative easing is on the rise.

With the prospects for the yen, the euro and the pound all starting to crumble, it is hardly surprising that the Fed has now run to the defense of the dollar to keep it weak as well.

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As the Fed watches the U.S. economy continue to stumble along, with inflation pressures now subsiding to such a level that deflation has become a new concern, it isn't surprising that the central bank issued a stark warning after its latest policy meeting this week that further monetary easing is still on the cards.

In fact, by also hinting that a double-dip recession is probably not so likely, despite the weakness of the U.S. economy, the Fed appears to be keeping risk sentiment alive.

In that case, the dollar should find itself falling out of favor not only because of the risk of increased more quantitative easing but also because of a likely flow of funds out of the traditional safe havens, such as the U.S. currency, and back into riskier currencies, such as the euro.

This was already evident in the dollar's weak post-FOMC performance Wednesday.

The Fed's statement will likely ensure that support for the dollar remains undermined until either U.S. growth and inflation show more established signs of recovery or the FOMC meets again in November and lowers speculation about more quantitative easing.

On Thursday, the gloom injected by the threat of more QE continued to hang over the dollar. Sentiment towards the U.S. currency wasn't helped by the latest warning by Chinese premier Wen Jiabao that Beijing has no intention of letting the yuan rise too rapidly. The U.S. has been putting pressure on China to allow its currency to rise in value and make Chinese exports less competitive.

In the meantime, Japan's intervention policy will come under the spotlight when Japan Prime Minister Naoto Kan visits Washington Thursday. The Bank of Japan has kept out of the market since last week's exercise but is expected to return if the dollar continues fall much further under Y85.

By 0645 GMT, the euro had risen to \$1.3406 from \$1.3394 late on Wednesday in New York, according to EBS. The euro was also up at Y113.39 from Y113.22 while the dollar was a little higher at Y84.58 from Y84.54.

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