US interest rate policies leading to major shifts in global currency markets

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The rapid rise in inflation, which is pushing the US Federal Reserve to lift interest rates, is causing shifts within the global financial system reflected in the sharp rise of the dollar against other major currencies.

With inflation in the US running at more than 8 percent, the Fed is expected to lift its base interest rate by 0.5 percentage points at its meeting next month with further rises to come later in the year.

When the COVID-19 pandemic began in 2020, the major central banks cut interest rates in unison to historic lows to support financial markets, sending stock prices to record highs. But now divergences have opened because not all of them want to proceed as rapidly as the Fed with interest rate increases.

This has led to a rapid rise in the US dollar which, according to the *Financial Times* (FT)"is ripping through markets as investors bet most central banks will lag behind the pace of rises" by the Fed.

Consequently, the dollar index, which measures its strength against a basket of other currencies including the euro, the yen and the pound, hit a 20-year high yesterday.

The euro is down to a five-year low against the dollar and could fall even further. In trading this week, it fell even further than in March 2020 when markets were in turmoil at the start of the pandemic.

While the European Central Bank (ECB) has indicated it is moving to tighten monetary policy, it is not expected to shift as rapidly as the Fed. This is because of the impact of the Ukraine war on the euro zone economy with fears that moves to impose a complete embargo on Russian energy supplies will have a recessionary impact.

The ECB must also tread very carefully lest a too rapid tightening of monetary policy causes major problems for the highly indebted southern European economies, especially Italy, and leads to a return of the sovereign debt crisis of 2012.

Last week, the British pound fell to its lowest level against the dollar since late 2020. While the Bank of England (BoE) has begun to raise interest rates, the developing contraction of the British economy is giving rise to expectations the rises will not be as large as the Fed.

Retail spending is down, with sales falling 7.9 percent in March compared to the previous month, consumer confidence is plunging, reaching a near all-time low and there are indications of a decline in business activity.

According to Chris Williamson, the chief business economist at S&P Global: "Orders received by manufacturers have almost stalled, driven by an increasing loss of exports, and growth of services has slumped to among the weakest since the lockdowns of early 2021."

This has given rise to the expectation that the BoE will not raise its bank rate by 0.5 percent points when it meets next month, leading to a fall in the value of the pound.

The widest divergence in currency values is between the dollar and the Japanese yen. The Japanese currency has dropped to a 20-year low against the dollar with further falls likely. Yesterday the Bank of Japan made clear it is not moving away from its low interest rate regime and will continue to intervene to keep bond yields close to zero.

The yen, normally regarded as a safe haven in times of economic turmoil, has fallen 12 percent so far this year and is ranked the worst performer out of 41 currencies tracked by the *Wall Street Journal* (WSJ)—worse than even the Russian ruble and the Turkish lira.

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Reporting on the yen's slide earlier this week, the WSJ noted that "if the yen were a smaller currency, its slide might have less importance to financial markets. But the yen is key to global finance, ranking as the third-most-traded currency in the world."

The slide will have a significant effect on the $22 trillion US Treasury market where Japanese financial institutions are the largest foreign purchasers of US government debt.

But the capacity of Japanese finance capital to buy US debt, under conditions where the US is moving to sell off some of the financial assets it has purchased as part of its monetary tightening policy, is under strain.

When buying debt, purchasers take out hedges against currency movements to protect the value of their trades. But the currency movements have become so large that the cost of hedging means the additional return an investor would obtain from holding US rather than Japanese bonds has almost disappeared.

Earlier this month, Japanese finance minister Shunichi Suzuki warned of damage to the economy because of the falling yen. "Stability is important and sharp currency moves are undesirable," he said.

While a weak yen had its merits, the demerits were "greater under the current situation where crude oil and raw material costs are surging globally" making these items more expensive.

China is also being adversely affected, amid a battle within the government, reported on by the FT, over how to deal with the effects of the crisis in the property market on the economy and the financial system.

A group led by Vice Premier Liu He is pushing for a loosening of the credit restrictions that have hit Evergrande and other large property developers. One government adviser, who shares Liu's views, has warned that continuing problems "may cause bad debts to spike and the entire financial sector to go under."

But this is being opposed by another faction in the cabinet which says that claims of a financial collapse are overblown, and the clamp down must continue.

These problems are being exacerbated by the US interest rate rises which have seen the renminbi depreciate. If China does loosen credit and monetary policy this fall, this could accelerate and lead to a movement of capital out of the country.

So-called emerging and developing countries are also being hit. The International Monetary Fund's latest *Global Financial Stability Report* noted that a quarter of the countries that had issued hard currency debt had liabilities trading at distressed levels.

The higher interest rate regime being enacted by the Fed is leading to significant movements on Wall Street. Earlier this week, the Dow fell by 800 points with the S&P 500 index dropping by 2.8 percent to bring its fall for the year to 12 percent.

The decline in the tech-heavy NASDAQ index has been even sharper. It has lost 20 percent for the year and is now down to its lowest level since the end of 2020, wiping out all the gains for 2021.

Rising interest rates and the expectation of further increases is the main factor. This is because in the orgy of speculation that has been fuelled by the Fed's financial support, the "valuation" of high-tech companies is not based on their actual profits—many of them are making a loss—but on the "expectation" of future earnings.

The "expected" flow of future earnings—in effect a gamble that the company will take off—are discounted at the prevailing rate of interest with a higher rate leading to a decline in the expected value of the company.

And in a warning of the developments in the real economy, yesterday it was announced that the US economy had unexpectedly contracted at an annualised rate of 1.4 percent in the first quarter of this year. That trend is set to continue if interest rate rises start to hit the housing market.

So far, the Fed's rises have been small and even the planned rises are not great by historical standards. But the fact that even these small rises are leading to major problems is a further indication of the inherent instability in the US and global financial system.

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