What's Going on with the Dollar, and What Does it Mean?

By: Dan North, Chief Economist Euler Hermes North America

The value of the U.S. dollar has fallen quite a bit recently, after having risen steadily for the past two years. One of the main drivers of dollar fluctuations is Federal Reserve policy which can be seen in three phases in the chart below. During the financial crisis and the great recession, the Federal Reserve cut interest rates very aggressively, all the way to 0% in December of 2008. Investors, who then started looking for higher interest rates, bought the corresponding foreign currencies and sold the dollar, lowering its value. In addition, the Fed started quantitative easing (QE) programs which effectively drove more dollars into the financial system, increasing their supply and further lessening their value. Lower rates and more QE represented an "easy" or "accommodative" monetary policy.

However by 2013, the Fed made it clear that it was going to stop being quite so accommodative and was going to taper off its QE programs, and end them in October 2014 - effectively a move towards tighter monetary policy. At the same time, other central banks around the world started moving towards looser monetary policies. As a result, this divergence in policies drove the value of the dollar up. Furthermore, through 2015 it became clear that the Fed's next step towards a tighter monetary policy would be to start raising interest rates, further strengthening the dollar's rise.

Source: IHS, BEA, Euler Hermes

Then in early 2016, the Bank of Japan (BOJ) followed several other major central banks and set negative interest rates. This policy effectively made an even wider divergence between Fed policy and much of the rest of the world, lowering expectations that the Fed would raise rates because that would have widened the divergence even further. Expectations of Fed rate hikes then fell even more as the Fed became more dovish on the U.S. economy. When those rate hike expectations fell, so did the value of the dollar. Since January the dollar has fallen 6% as measured by the Broad (trade-weighted) dollar index. Compared to our two biggest trading partners, the U.S. dollar has fallen 12% against the Canadian dollar, and has fallen 6% against the Mexican peso. The U.S. dollar has also fallen 5% against the Euro and 10% against the Japanese Yen.

There are several implications of the dollar's drop in value, but typically there are offsetting effects that shift costs and benefits between different groups.

Dan North, Chief Economist for Euler Hermes North America, uses macroeconomic and quantitative analysis to help manage Euler Hermes' risk portfolio of more than $150 billion in annual trade transactions within the Americas region. After having predicted the 2008/2009 recession and its implications accurately, Dan was ranked 4th on Bloomberg's list of the 65 top economic forecasters in 2010.

For example a falling dollar:

- makes imports more expensive, which is bad for importers, but it also makes exports cheaper, which is good for exporters
- makes imports more expensive, which is bad for those who consume imports, but it’s good for businesses that compete against imported goods
- increases commodity prices, which is bad for commodity consumers, but is good for commodity producers
- increases inflationary pressures, which is good for wage earners, but is bad for wage payers

As long as the drop is not too rapid or caused by some sort of crisis, the shifting costs and benefits of a falling dollar tend to cushion any overall effects on the macroeconomy. But to be sure, individual industries might either suffer or benefit. As examples, two particular industries demonstrate very clearly the effect the value of the dollar.

Exports are particularly sensitive to the dollar. In the chart, note how the value of the dollar (plotted inversely so that as the blue line goes down it indicates a stronger dollar) is very closely tied to growth in exports (the green line). As the dollar started to strengthen more rapidly in 2014, the cost of U.S. exports rose, making them less competitive and reducing their sales. But since the beginning of 2016, as the dollar has weakened, exports have started to turn around.

Commodities that are dollar-denominated, such as oil (and most others) are also affected by the value of the dollar. If the dollar becomes more valuable, less of them are needed to buy a barrel of oil, which is another way of saying the price falls. And, of course, falling oil prices cause falling gasoline prices. Once again as the dollar started to strengthen in 2014, the price of oil and gasoline plummeted. But now that the dollar has reversed course, the price of a gallon of regular gasoline has risen from $1.72 in February to $2.24 in May - a 30% increase. Clearly rising gasoline prices will hurt consumers.

Source: IHS, Census, EIA, Federal Reserve, Euler Hermes

What this means for your business

Depending on your industry, a falling dollar can be a blessing or a curse. Exports, which have suffered under a stronger dollar, may now be seeing some relief, but importers will now have to face higher prices. Oil producers that have been decimated by the collapse in energy prices may also see some relief (although prices will have to rise more for longer to be a real boost). But gasoline consumers who have enjoyed such low prices since 2014, will now be taking a hit. Businesses which have exposure to imports or to consumers (who are already weak) face emerging risks, including non-payment. A trade credit insurance policy can help mitigate these kinds of risks.

What to watch for

Actions by central banks, particularly the Fed, the European Central Bank and the BOJ are critical in driving the value of the currency. The Fed’s next meeting ends on June 15th, and expectations are that they will not raise rates at that meeting. However, extra information from the meeting, including the statement, the forecasts, and the press conference will be carefully scrutinized to try to glean whether the Fed is going to hold rates low for longer than expected or move them up sooner than expected. Euler Hermes provides timely analyses on this and other subjects in our Weekly Export Risk Outlook (WERO), as well as monthly and quarterly analyses on the global macroeconomy and specific countries and industry sectors. Visit the Economic Research section of our website to learn more.