Opinion **Markets Insight**

A turning point for the dollar is coming

The short- and long-term prospects of the currency are at odds

BARRY EICHENGREEN

In the medium term, the dollar is likely to give back any short-term gains, and then some © Reuters

Barry Eichengreen 12 HOURS AGO

The writer is professor of economics at the University of California, Berkeley

There is now a conventional narrative in the markets about the short- and medium-term prospects of the dollar.

In the short run the dollar will continue to strengthen, as an unprecedented confluence of domestic and foreign forces push it up. Foreign exchange traders are focused on Donald Trump imposing tariffs on his return to the White House. His latest blast on his social media channel Truth Social suggests plans for tariffs of 25 per cent on imports from Canada and Mexico, and an extra 10 per cent on China.

These new taxes will shift spending by American consumers away from now more expensive foreign goods. Given record low unemployment and the limited capacity of US manufacturing to expand production, something will have to give. Namely, the dollar will have to appreciate to shift some of that spending back towards imports, which are in more elastic supply.

Moreover, extending Trump's tax cuts enacted in his first administration as

Republicans in Congress aspire to do, and then adding yet more tax cuts on tips, social security payments and who knows what else will only goose US spending still further. Given that American households disproportionately consume domestically produced goods, this will worsen the incipient excess demand for US products.

It will require yet more dollar appreciation to shift a portion of that spending towards foreign supplies.

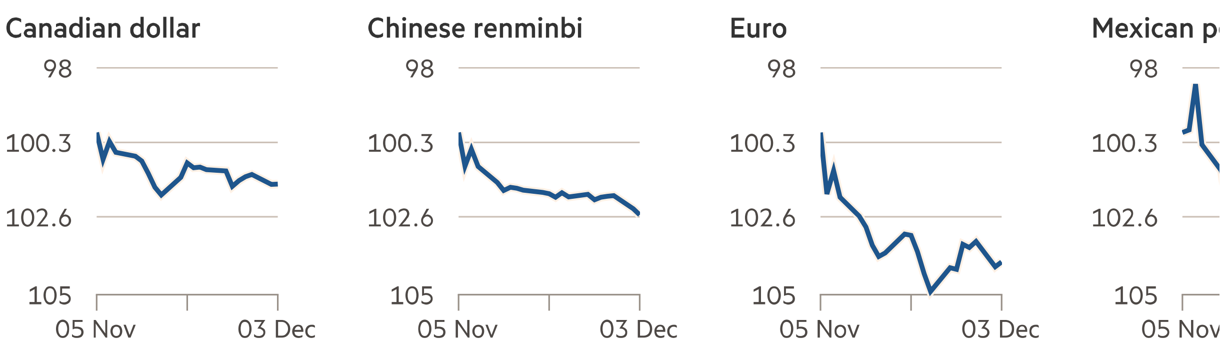
Treasury secretary designate Scott Bessent may be a balanced budget man, and his crack team of cost cutters — Elon Musk and Vivek Ramaswamy — have high ambitions. But if recent decades have taught us one thing, it is that cutting taxes is easier than cutting spending. The dollar's behaviour is a clear signal that investors expect the budget deficit to widen.

Central banks of course will do nothing to moderate the dollar's rise — on the contrary. Tariffs pushing up US import prices will be inflationary. Even if a one-time increase in tariff rates leads only to a one-time increase in prices, the Federal Reserve has learned that households dislike one-time increases in prices as much as ongoing inflation.

Having been taught this chastening lesson, the central bank will react more strongly to the next burst of inflation than it did in 2021-22. There will be tension with the new administration, no doubt, with Trump and Bessent both being Fed critics. But Jay Powell and colleagues are unlikely to be deterred.

The dollar has continued to strengthen since Trump's re-election

Currencies rebased against the dollar



FINANCIAL TIMES

Source: LSEG

The European Central Bank and the People's Bank of China, meanwhile, will be quite happy to see their currencies fall. The European economy is in dire straits, and Europe lacks the political will to lend it fiscal support. The ECB, not for the first time, is the only game in town. A euro at parity against the dollar is now clearly on the cards.

Meanwhile, the good standing at home of the Chinese government of Xi Jinping rests on its ability to hit, or at least come within hailing distance of, its growth targets. With Trump clamping down on not just US-China trade but also on Chinese products assembled and routed through countries such as Malaysia and Vietnam, the blow to Chinese growth will be considerable.

To be sure, a sharply lower renminbi would dent Chinese consumer confidence and elicit aggressive action by an angry American president. But a renminbi that falls by a limited amount, say by 10 per cent against the dollar, thereby boosting Chinese exports to other markets, might be just what Xi would want.

In the medium term, however, the dollar is likely to give back these short-term gains, and then some. Tariffs and tax policy aside, the strength of the dollar has rested on the strength of the US economy, which has consistently outperformed Europe and other parts of the world. Tariffs on imported inputs, which will impart a negative supply shock to US manufacturing, are incompatible with that strength.

Moreover, the higher interest rates adopted by the Fed to damp down inflation will not be investment friendly. Neither will eliminating the investment subsidies and tax credits of the Chips Act, the Inflation Reduction Act and other Biden-era initiatives. None of this will be good for growth.

Above all, we know that economic policy uncertainty has a strong negative effect on investment. And Trump is an uncertainty machine.

At some point, foreign exchange traders will cotton on to this fact. Clearly, then, the short- and longer-term prospects of the dollar are at odds. The key to successful investing and forecasting is identifying the turning point. If only I — and the markets — could offer more guidance on that.