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The Fed's Dilemma

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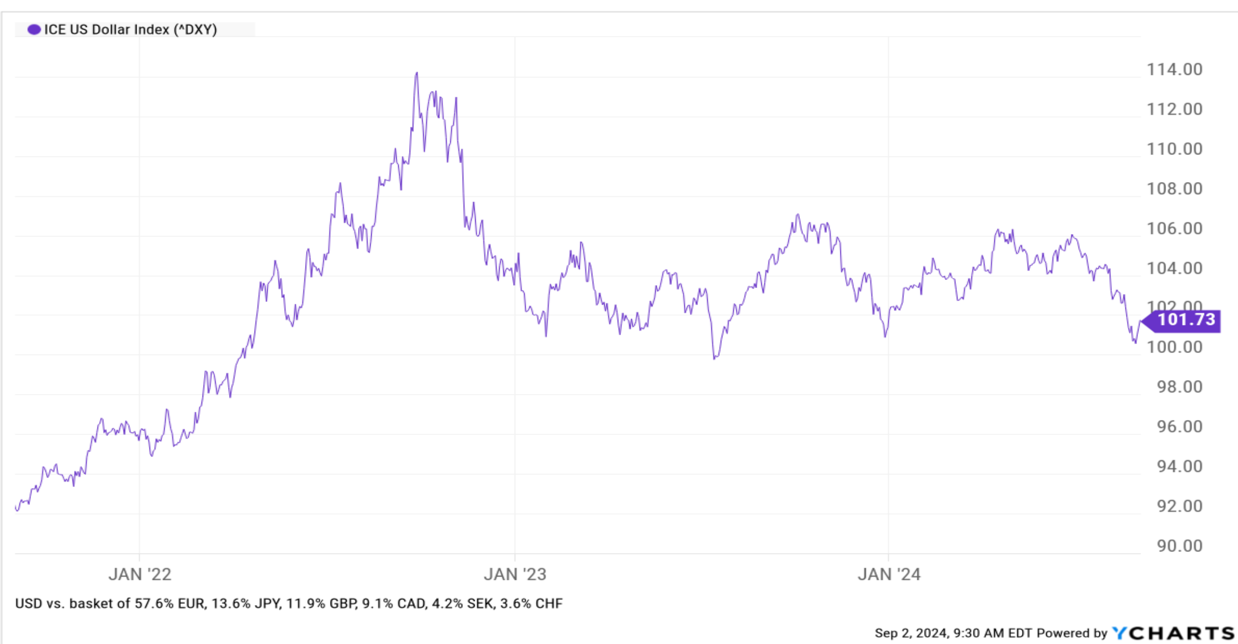
Inflation expectations have subsided during the last two years. In July 2024, the US consumer price index was 2.9% compared to the prior year. According to the Federal Reserve Bank of New York's Survey of Consumer Expectations which is based on 1300 households, consumers expect the inflation rate to remain at 3.0% during the next 12 months. The same survey showed inflation expectations at 6.2% and 3.5% for July 2022 and July 2023, respectively.

Now that inflation appears to be under control, the Federal Reserve is turning attention to its other major policy objective which is maximum employment. Their policy tool for increasing employment is a lower fed funds rate. According to the Federal Open Market Committee (FOMC), the median forecast of its members for the fed funds rate is 1.0% lower at 4.1% by the end of 2025 and another 1.0% decline to 3.1% by the end of 2026. It is widely expected that the Fed will lower the fed funds target at the next scheduled meeting on September 17-18. However, the Fed may be constrained in lowering interest rates in the future as it must consider the impact on currency exchange rates.



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From July 1 to August 30, the ICE US Dollar Index declined by 3.9%. The index measures the value of the US dollar relative to a basket of six trade-weighted currencies consisting of the euro, the Japanese yen, British pound, Canadian dollar, Swedish krona, and Swiss franc. The decline was attributed to anticipation of a fed funds rate reduction.

For many decades, the US dollar was widely used for international trade settlement and provided a stable reserve currency. As a result, the Eurodollar market became huge. The term “Eurodollar” is a misnomer as it refers to any dollar-denominated deposit held outside the United States which are not subject to controls by the Federal Reserve. Reliable estimates are scarce, but in 2016, Nedbank in South Africa with the assistance of the Bank of International Settlements, estimated the size of the Eurodollar market at $13.8 trillion, or about 56% of the US banking sector.

The key assumption of many financial market participants, including the FOMC, is that the international order of things hasn’t changed much. The upcoming BRICS Summit in Kasan, Russia on October 22-24 will challenge that assumption. Viktoria Panova, Head of the BRICS Presidency Council said this about the October conference:

> There are active efforts underway to create a financial payment mechanism that would make cooperation between BRICs countries easier, maintaining their sovereign trade and economic exchanges. The issue tops the agenda because every member of the group sees it as important.

Financial sanctions are one of the reasons most cited for the development of an alternative international payment system. Providing additional motivation for countries to implement alternative means for trade and financial settlements, on August 23, the US Treasury announced additional sanctions against nearly 400 individuals and entities both in Russia and outside its borders.

As the BRICS countries implement their international trade settlement system that will use local currencies and gold, there will be a decline in demand for US dollars. Typically, when a country’s currency declines too rapidly, their central bank will raise interest rates to avoid capital flight. If the Fed continues to lower interest rates while there is less demand for US dollars, a decline in the US dollar relative to other currencies and gold is inevitable.

If you have any questions or comments, please contact me.

Sincerely,
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