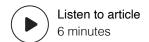
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The Dollar's Rise Shouldn't Hold Back the Fed

COMMENTARY By Eswar Prasad Oct. 20, 2022 3:00 am ET





A world without a single dominant currency would not necessarily be an improvement, writes Eswar Prasad. Eva Hambach/AFP via Getty Images About the author: **Eswar Prasad** is a professor at Cornell University, senior fellow at Brookings, and author of The Future of Money.

Federal Reserve Chair Jerome
Powell and his colleagues are
taking fire from all sides. On one
flank, they're facing criticism for not

hiking interest rates early and boldly enough to tamp down inflation. And those worried the Fed is engineering a recession are attacking them from the other.

Now there is incoming fire from abroad as well. The Fed's rate increases have boosted the dollar's exchange rate versus virtually all other currencies. In the process, the Fed has raised funding costs for the many foreign countries and corporations who borrow in dollars. A U.N. agency recently chided the Fed for damaging the economic prospects of developing countries and even called for a reversal of recent rate increases. At last week's IMF-World Bank meetings in Washington, policy makers from around the world seemed united in assigning

blame to the Fed for adding to their economic woes. U.S. officials were alone in their support of the Fed.

The U.S. economy is the largest in the world. Its financial markets dwarf those of other countries. And the dollar remains the preeminent global currency. Hence, the Fed's actions touch every corner of the world. Surely it has a responsibility to consider the consequences of its decisions for the rest of the world's people, doesn't it? That proposition is plausible but misguided. Were the Fed to try to take the entire world economy under its mandate, it could cause even more damage to the one central bank trusted worldwide.

The Fed is tightening monetary policy more aggressively than other major central banks. And U.S. growth prospects, while weakening, look better than those of most other major economies. Small wonder the dollar has strengthened sharply across the board.

The dollar is special. A majority of cross-border trade is denominated and settled in dollars. It is the preferred currency for issuing debt in international markets. And it dominates global central banks' foreign exchange reserve portfolios. The dollar therefore has outsize influence in world financial markets. Extensive research has shown that the dollar's fluctuations affect emerging market economies, often for worse.

The U.S. is hardly an island. What happens in the rest of the world affects its economy and the Fed <u>accounts for that</u> in its policy making. But should the Fed explicitly consider the direct effects of a stronger dollar or high U.S. interest rates on other countries when setting rates?

The Fed's statutory mandates are to keep prices stable and to ensure maximum sustainable employment. The Fed should focus on those two goals, with the priority now being to corral inflation at home. That is challenging and painful enough as it is. Loosening monetary policy in the interest of slowing the dollar's rise would be self-defeating. Persistently high inflation would cause still more pain in the U.S. and abroad. Moreover, the Fed is under constant pressure to expand its basket of mandates. Adding yet another fuzzy objective would only hurt the Fed's credibility and effectiveness.

The dollar's rise has fueled <u>chatter about another Plaza Accord</u>, an agreement brokered by the U.S. and other major economies in 1985 to limit the dollar's appreciation. This is ill-advised. Exchange rates largely reflect market forces including policies and growth prospects of the U.S. and other countries; controlling exchange rates directly should not be any central bank's main objective.

Gripes about the dollar's status allowing the U.S. to inflict damage on other countries are escalating. Perhaps other countries should right their own ships and wean themselves off unsavory dollar dominance. Which raises the question of why that supremacy perseveres despite all the knocks the U.S. economy has taken in recent decades.

In international finance, everything is relative. In addition to its financial dominance, U.S. economic dynamism and the strengths of its institutional framework remain unrivaled. Potential rivals have fallen by the wayside. The euro zone is wracked by centrifugal political forces that threaten to pull it apart. Japan is beset by long-standing economic malaise made worse by a rapidly aging population, while the U.K. keeps shooting itself in the foot. China is burdened by a fragile financial sector and an authoritarian regime whose disdain for the rule of law hardly inspires the trust of international investors.

New research attributes the recent modest decline in the dollar's share of global reserves to the small but collectively significant rise of smaller reserve currencies such as the Canadian and Australian dollars and the Swiss franc. Meanwhile, the gap between the dollar and its larger rivals has widened, cementing the dollar's dominance. It is still *the* currency investors everywhere turn to at times of economic and financial turmoil.

A world without a single dominant currency would not necessarily be an improvement. Foreign investors need abundant safe assets in a trusted currency that they can invest in and sell easily when needed. In the absence of one, they would be far more likely to panic when troubles arise. Without a credible central bank that can engineer massive infusions of money to meet worldwide demand at critical times, bad situations might become worse.

Rather than complaining, other countries should reduce their reliance on the dollar and earn the trust of foreign investors by adopting better policies and improving their institutions. For now, they should cheer the Fed on for doing what is necessary to rein in inflation and avoid even more tightening and global economic pain down the road.

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