Inflation and emerging markets force U.S. hand on dollar

Sun Apr 13, 2008 4:12pm EDT

By Glenn Somerville and Emily Kaiser

WASHINGTON (Reuters) - U.S. officials, worried on inflation even as the economy weakens, took the rare step on the weekend of toughening their talk on the downtrodden dollar in the hope that they won't have to back it up with action.

European leaders had been pushing for months for U.S. Treasury Secretary Henry Paulson to step up his defense of the dollar as the euro soared to an all-time high, making euro zone exporters uncomfortable.

In the end, the strongest push came from an unlikely source -- emerging markets, where rising costs for food and fuel are contributing to a distressing bout of global inflation.

For U.S. policy-makers, there is little maneuvering room to contain prices as the Federal Reserve has its sights firmly set on averting a serious recession. That means the U.S. central bank is locked in a monetary easing mode instead of the tightening stance that would be the normal inflation cure.

On Friday, finance leaders from the Group of Seven -- the United States, Canada, Britain, Germany, Italy, France and Japan -- issued their sternest warning in seven years that volatile currency markets threatened financial and economic stability.

Sources told Reuters the debate on the currency language shift was heated. By signing on, Paulson effectively strengthened the United States boilerplate backing of a strong dollar -- something the U.S. Treasury had not done for years.

"If you never change the communique language, it would be pretty meaningless .... It reflects developments in the markets," Paulson told reporters after G7 officials met.

Eswar Prasad, economics professor at Cornell University and a former official at the International Monetary Fund, said Paulson and his colleagues hope talk will preclude action.

"A tough statement is a way of costlessly trying to show a coordinated front," he said. "They all recognize that if it comes to action it is going to be a lot tougher," referring to the possibility officials could decide to intervene in markets to try to give a lift to the dollar, which has fallen 6 percent against a basket of currencies since the start of the year.

However, Prasad said he was highly skeptical that talk would be sufficient, adding, "The market might end up calling their bluff" and forcing intervention.

EMERGING INFLATION

China and other emerging markets had been a global inflation buffer for a decade, taking advantage of large pools of low-wage workers to churn out inexpensive consumer goods. However, higher food costs at home and leaner times in consumer markets overseas, which may have diminished any willingness to let their currencies rise in value, suggests the buffer is shrinking.

"Americans had assumed that emerging markets could take on some of the burden of the (currency) adjustment, but the emerging markets are now being hit with this double whammy," Prasad said. "The countries that could make a material difference by making currencies appreciate are the ones relying on export demand."

What that has meant in practice, particularly in China's case, is that a cheapening dollar has fueled a steep appreciation in the euro -- much to Europe's annoyance.

"The increased volatility in foreign exchange markets ... points to the risk of exchange rate overshooting," European Monetary Affairs Commissioner Joaquin Almunia told global finance chiefs at a meeting of the International Monetary Fund on Saturday. "The euro's real effective exchange rate is approaching a level where it would clearly no longer be in line with economic fundamentals."

Paulson's standard rhetoric that "a strong dollar is in the U.S. interest" has rung increasingly hollow in the face of a relentless drop in the currency's value.

DARK SIDE OF DOLLAR PEG

Further complicating matters, some Middle East oil producers price their products in U.S. dollars, so the inflationary impact of costlier energy is amplified throughout the global economy as the dollar weakens.

Bank of France Governor Christian Noyer singled out one more issue by noting that emerging market countries that link their currencies to the dollar were increasing facing an inflation struggle as their currencies weakened.

"They ... have a monetary policy which is not adapted to their situation," he said.

Chinese Vice Finance Minister Li Yong on Sunday noted emerging markets were facing mounting price pressures posed by the combined impact of unfavorable food and currency trends, curbing their former deflationary power.

"As global food and energy prices soar, factor prices of labor and land resources increase, many developing countries -- (and) the emerging countries in particular -- will encounter huge pressures of inflation, economic overheating and asset bubbles," he warned.

Amid worry over how deep and long-lasting a U.S. downturn will be, G7 officials advise they are trying to bring stability to currency markets -- critically distinguishing from any perceived bid to set targets for a specific currency.

In practice, though, it means that officials are looking for an end to the dollar's long skid, and that challenge will be taken up quickly when trading resumes this week.

(Reporting by Emily Kaiser and Glenn Somerville)