



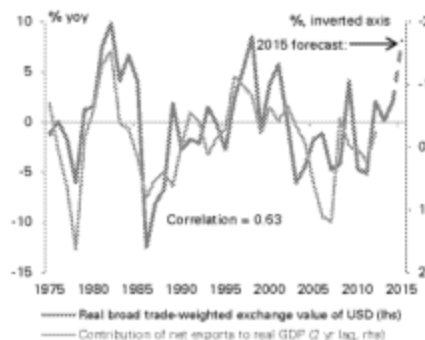
Whither the dollar? The bigger issue for the economy and the financial markets is the dollar. To be sure, the Fed is worried about its recent appreciation, which has been the fifth fastest on record. It has been eclipsed only by the moves in 1981-1982, 1984-1985, 1997 and 2008-2009. In the case of the two 1980s episodes, high real interest rates, which were induced by tight monetary policy, were the root cause of dollar appreciation. In 1997, the surge was due to the abandonment of fixed currencies in the Asian bloc. The most recent previous period of dollar strength occurred during the global financial crisis, which resulted in a massive flight to safety into US Treasury securities. The current period is different: The US economy is arguably the healthiest of the major industrialized economies, and the Fed is still expected to raise interest rates this year. Other central banks such as the BOJ and ECB are at different stages of the business cycle and are both pursuing expansionary monetary policies designed to weaken their exchange rates.

In order to gauge the implications of the strengthening dollar for monetary policy, we simulated a one-time, 14% shock to the trade-weighted dollar (the current move from last summer) in the Federal Reserve Board's macroeconomic model of the US economy, often just referred to as FRB/US. All else being equal, the simulated shock causes real GDP growth to decrease by about -0.5 percentage points (or 50 basis points) and -0.8 percentage points, respectively, one and two years after the shock occurs. This is also broadly consistent with what we found when we estimated the impact of the change in the dollar on the contribution of net exports in the GDP accounts. As we illustrate in the accompanying chart, changes in the trade-weighted dollar tend to impact net exports with a lag of approximately two years. When the dollar strengthens, net exports tend to weaken as US manufacturers' prices become less competitive in the global marketplace and imported goods become relatively cheaper. In the process, domestic production and employment suffers. The opposite is the case when the dollar weakens. Hence, a stronger dollar can effectively act as a monetary tightening. This is partly why the Fed recently "shallowed out" its trajectory for interest rates over the next few years; the other reason being the Fed's lower estimate of the NAIRU.

At the same time, the strengthening dollar will weigh on US inflation: Domestic producers will be forced to keep their prices as internationally competitive as possible as the cost of imported goods declines. We can see in the nearby chart that when the dollar rises, import prices decline, and when import prices fall, consumer goods prices tend to weaken. According to our FRB/US simulations, the recent dollar appreciation could subtract a tenth or more off of core consumer prices over the next couple of years. This may not seem like much, but core inflation has been running significantly below the Fed's 2% target for the past three years. For inflation to rise toward that level, either dollar strength will have to reverse, or services prices will have to rise further, thereby offsetting the former. Given our expectation of a further significant decline in the unemployment rate, services prices, which are dominated by the cost of labor, should increase further, effectively negating dollar strength. Services prices account for roughly 75% of core CPI inflation compared to just 25% for goods.

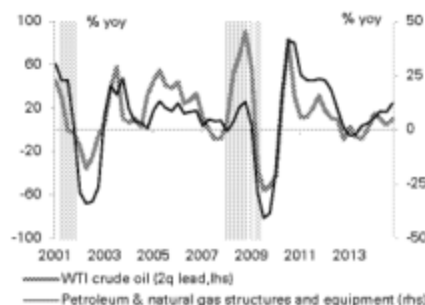
Don't forget oil prices. An important caveat to the above analysis is that the appreciation of the dollar has been accompanied by a collapse in oil prices to below \$50 per barrel, which has been a significant stimulant to US households and non-energy related businesses. We estimate that the decline in energy prices has lifted US household cash flow by approximately \$140 billion. Another way to see this positive effect is to look at real earnings: Over the past 12 months, real earnings are up 2.4%, the largest increase since October 2009. Last quarter, inflation-adjusted consumer spending rose at a robust 4.2% annualize rate — matching its best quarter of the business cycle — and while recent nominal spending figures for the current quarter have been disappointing, we believe this is mainly due more to weather and the seasonal

Figure 5: Dollar strength will weigh on net exports for the foreseeable future



Source: FRB, BEA, Deutsche Bank Research

Figure 6: The collapse in oil prices points to a sharp pullback in energy capex



Source: EIA/WSJ, BEA, Haver Analytics, Deutsche Bank Research

Figure 7: Import prices are likely to weaken further in the months ahead



Source: FRB, BLS, Haver Analytics, Deutsche Bank Research