Forex Focus: Roughed Up By The Fed

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A DOW JONES NEWSWIRES COLUMN

LONDON (Dow Jones)--The dollar faces a rough time ahead.

How rough, depends on the Fed.

The simple issue is this: more quantitative easing in the U.S. means lower U.S. yields and a less attractive dollar as far as international investors are concerned.

Up until the last week or so, there were still some vestiges of hope that more quantitative easing, or QEII as it has been dubbed, could be avoided.

See how the dollar has been under pressure against euro in recent weeks:

http://www.dowjoneswebservices.com/chart/view/4645

Confirmation that quantitative easing was coming to an end would have been dollar-positive, helping the U.S. currency to resume the rally that seemed to be underway at one stage this summer.

But now, as more negative U.S. economic data stacks up and concern over the global recovery in general increases, QEII looks much more likely to reign.

The thing is, as the Wall Street Journal report pointed out this week, there is QEII and there is QEII Lite.

QEII would be very much like the heavy-handed exercise conducted in March 2009 when the Federal Reserve announced a $1.7 trillion bond buy-back program aimed at shocking financial markets back into life.

The program was partially effective, helping the U.S. economy out of recession and boosting the country's labor market.

However, the exercise was not enough.

U.S. growth is on the slide again and deflation, rather than inflation, appears to be the primary risk.

But, as the WSJ report pointed out, this time around the Fed may want to take a more sophisticated and gradual approach, in which the bond buy-backs would be more closely aligned to the pace of the recovery.

This would mean, of course, that the program is open-ended and could continue for some time as the Fed attempts to trigger inflationary pressures.

By easing market liquidity even further, the U.S. central bank should be able to kick-start the economy and avoid a double-dip recession.

For the dollar, though, there should be less downside to this approach.

QE II Lite should ensure that U.S. yields don't decline as far as they might have fallen under a dose of QEII proper.

Also, the exercise should help to increase the Fed's market credibility.

Not only would the central bank's more step-by-step approach, tied to the release of new U.S. economic data, boost market confidence but it also means that the Fed should be better-placed to exit quantitative easing more promptly if inflation pressures started to rise sooner than expected.

For the dollar, the best news would be that QE was being abandoned altogether. But, if the U.S. currency is going to have face more easing anyway, then it looks like QEII Lite rather than QEII as we knew it of old would be the lesser of the two evils.

The release of disappointing U.S. consumer confidence data late Tuesday has left sentiment towards the dollar flagging. By 0645 GMT Wednesday, the dollar had fallen to Y83.60 from Y83.89 late on Tuesday in New York, according to EBS.

The yen got some help from a stronger than expected Tankan survey from the Bank of Japan as well as a rise in the latest Chinese manufacturing purchasing managers' survey to a five-month high.

The euro was left floundering as investors remain nervous about the sovereign-debt crisis after Irish bond yields surged to a new record high on Tuesday.

However, it did find support from suggestions that the European Central Bank won't be extending its liquidity measures.

The single currency was up at $1.3622 from $1.3590 but down at Y113.78 from Y114.00.

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