FOREX FOCUS: Inflation Dilemma For Dollar Fans

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LONDON (Dow Jones)--Inflation alarms are going off all over the world, creating a big dilemma for dollar fans.

Support for the greenback is starting to wane as the U.S. is one of the few countries not suffering from an inflation problem.

The argument runs that low inflation in the U.S. means low U.S. interest rates and a less attractive dollar.

As it is, the Federal Reserve is still debating the need for further quantitative easing while many central banks elsewhere in the world are looking at the options for tightening monetary policy.

China, Australia, India and other Asian countries have already been hiking interest rates for months, with South Korea and Thailand announcing their latest moves last week.

But now the trend is becoming more global.

Brazil is on the verge of responding to rising inflation with higher interest rates and Poland has just done so. After this week's data in the U.K. and the euro zone, both the Bank of England and the European Central Bank are also under pressure to consider raising rates later this year.

In most cases, the swift response to higher inflation isn't surprising. Strong recoveries from the global financial crisis have brought their own problems in the form of overheating.

Rallies in commodity markets and a rise in food prices have made price pressures worse.

However, there are now signs that inflation fears may be overdone.

Local press reports in China suggest that new data will show inflation fell back to 4.6% in December from 5.1% in November. The Bank of England has long maintained that price pressures in the U.K. will eventually decline, especially if growth subsides in the months to come, and even the arch-hawk, Axel Weber, who will probably take over from Jean-Claude Trichet as president of the ECB later this year, concedes that euro-zone inflation will peak in March and then fall back.

Also, those recent strong rallies in commodity and gold prices are showing the early stages of topping out.

If that is the case, the current rash of rate hikes, and rate-hike expectations, may also start to subside and dollar support should start to recover.

Note the dollar has been fixed at its lowest-ever level against the Chinese yuan and the dollar trade-weighted index that measures its level against the currencies of its main trading partners is at the lower end of its recent seven-week trading range.

See how the dollar index has fallen in recent weeks:
http://www.dowjoneswebservices.com/chart/view/5300

While the former is probably more of a diplomatic nicety associated with Chinese President Hu Jintao's visit to Washington this week, the latter will need more negative momentum to extend its decline.

So, as they wait for either more evidence that the Fed is about to start reversing its easy monetary policy or evidence that rate-rise expectations elsewhere in the world are subsiding, investors are left with the quandary of whether to support the inflation-free dollar or not.

Bloomberg	TNI FRX POV
Reuters	USD/DJ
Thomson	P/1066 or P/1074

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