Forex Focus: Dollar Bulls Smile As Washington Grits Teeth

By Nicholas Hastings
A DOW JONES NEWSWIRES COLUMN

LONDON (Dow Jones)--The interest rate rise China is contemplating won't be welcomed in the U.S. but it will be welcomed by dollar bulls.

As far as Washington is concerned, Beijing's likely decision to step on the monetary brake even harder means two things: a slower recovery in the global economy and a reduced chance of a higher yuan.

Neither of these will be helpful for the U.S. economy.

A slower global recovery is the last thing the U.S. wants as it struggles to keep its own economy from faltering.

Even the recent announcement by the U.S. Federal Reserve of an additional $600 billion of quantitative easing hasn't been enough to boost market confidence in the U.S. recovery.

Fed officials have spent much of this week reassuring investors that if bond purchases of more than $600 billion are needed, the Fed stands ready to step in.

President of the Federal Reserve Bank of Chicago Charles Evans, told the Wall Street Journal: "I would continue to want to apply accommodative monetary policy until I had some confidence that the situation was changing."

A slowdown in the global economy makes it less likely that the U.S. situation will change and more likely that the Fed, as Evans suggested, may have to be even more generous on the QE front.

Meanwhile, increased speculation over a Chinese rate increase means that Beijing will be less inclined to allow a more rapid appreciation of the yuan. In recent weeks, the People's Bank of China has allowed the yuan to rise to its highest level in 17 years but the prospects of further sharp gains are now likely to fade.

This will be bad news for U.S. manufacturers, who will have been hoping that further yuan gains would translate into more competitive U.S. exports.

For China, the need to tighten policy has become imperative.

Repeated attempts at reducing borrowing by raising bank reserves has had limited impact, with the country's data last week showing inflation rocketing to 4.4% from 3.6%.

With much of the inflation increase coming from food prices, this poses a serious problems for China's rulers.

Not only is there the risk of political unrest but the high inflation level could promote more speculative investments by Chinese savers, who are receiving negative real returns on their deposits.

Prime Minister Wen Jiabao and his cabinet has even warned that price controls on key products could be introduced to address the problem if needs be.

While U.S. officials might be gritting their teeth at the prospect of slower growth in China, dollar bulls are probably smiling.

As the prospects for global growth are downgraded in line with China, investor appetite for global risk is likely to subside, reducing interest in higher-risk and commodity currencies, such as the Australian and Canadian dollars, and working in favor of safe-haven ones, such as the U.S. currency.

The reduced chances of accelerated yuan appreciation will also be dollar positive as the U.S. currency generally benefits when the PBOC starts keeping a stricter curb on Chinese currency moves.

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