QNB Economics
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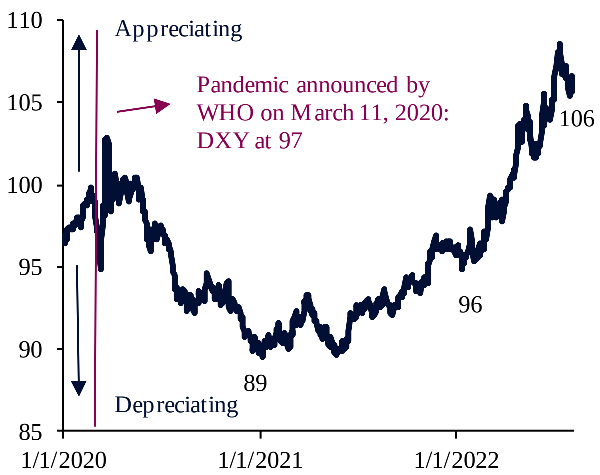
# Unpacking the strong USD

As the saying goes, the "USD is King." This seems to be a particularly valid statement in recent months, as the greenback has appreciated against major currencies to levels not seen in almost two decades. Importantly, the move has been sharp and volatile, especially since the US economy re-opened from the pandemic.

In fact, the USD index (DXY), a traditional benchmark that measures the value of the USD against a weighted basket of six major currencies, has appreciated by more than 10% from pre-pandemic levels, more than 10% year-to-date and more than 19% from the post-pandemic bottom in early 2021.

**USD index**
(DXY index points)

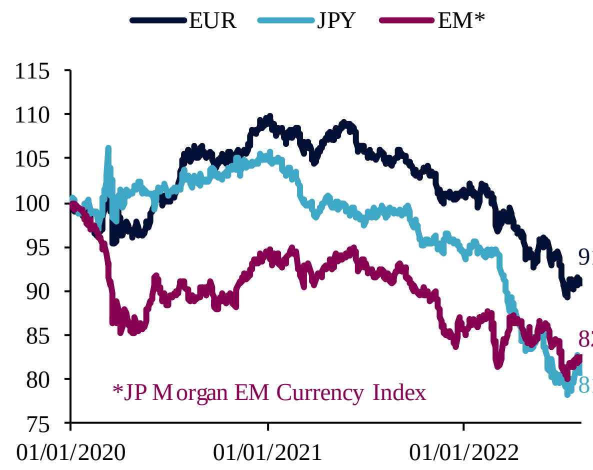



Sources: Bloomberg, QNB analysis

This appreciation was broad-based, encompassing all major currencies, including the Euro (EUR), Japanese Yen (JPY) and most major emerging market (EM) currencies.

However, the move did not happen in a straight line. At the beginning of the pandemic, the USD was supported by significant "safe-haven" demand from global investors. However, shortly after this, in a matter of weeks, the USD depreciated against major currencies for around six months. This took place between May 2020 and January 2021, when the US provided faster and bigger policy stimulus than other economies. But the move more than fully reversed thereafter, leading to a deeper appreciation of the USD. This included a 17% peak to trough against the EUR, 24% against the JPY and 13% against EM currencies. This piece dives into the main drivers behind such reversal towards a stronger USD in FX markets. In our view, three main factors led to the recent USD appreciation.

**Changes in key currencies against the USD**
(normalized, January 1st 2020 = 100)




Sources: Bloomberg, QNB analysis

First, growth differentials favoured the US vis-à-vis most other countries. With a GDP growth of 2.5% since the pre-pandemic levels in Q4 2019, the US presented a much stronger economic performance than other advanced economies. During the same period, GDP growth was 1.5% in the Euro area and -0.6% in Japan. Similarly, growth differentials between the US and EM narrowed significantly, pointing to a weaker EM relative performance. Faster relative growth in the US tends to favour domestic investments, attracting capital from overseas. This supports the USD.

Second, expected real interest rates, which adjust the medium-term interest rate by forward-looking inflation metrics, have also moved in a direction that favoured the USD. This is not only due to the aggressive policy stance of the US Federal Reserve (Fed) but also due to the fact that mid-term US inflation expectations moderated in recent months. In contrast, inflation expectations have been increasing in the Euro area and Japan, where central banks are much more constrained in terms of how aggressive they can be in fighting inflation, due to weaker economies and higher debt levels. Real interest rate differentials are a major driver of capital flows, as investors seek to allocate their resources in assets with high, risk-adjusted real yields. Hence, the backdrop has been negative for the EUR and JPY versus the USD.

Third, the USD has also benefitted from a profusion of high and rising political, geopolitical as well as other tail risks that are threatening global economic conditions and the outlook. This makes investor and consumer sentiment vulnerable to negative news. Last but not least, the USD functions as a "safe-haven" instrument that was again substantiated by geopolitical turbulence in Europe and Asia.

All in all, the USD is strong on the back of a robust US relative economic performance, a more aggressive Fed and geopolitical tensions in both Europe and Asia. While the magnitude of the FX moves were sizable, we are unlikely to see momentum driving USD much higher over the next few months. Indeed, we still expect the USD to remain elevated for a while. Other advanced economies are likely to continue to be in a more fragile position in terms of growth, inflation control and geopolitical risks.

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