IIF Global Macro Views

Central Banks in the Long Winter of Dollar Strength

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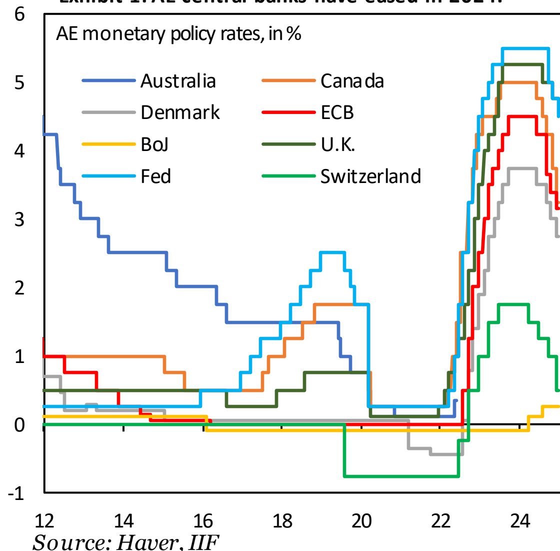
- In general, central banks in advanced economies have shifted toward easing, with differing paces driven by local conditions.
- Central banks in emerging markets are increasingly influenced by Fed actions, as global financial conditions tighten.
- Forward-looking inflation dynamics, shaped by sticky core components and potential tariff impacts, are key to the outlook.
- The strengthening dollar continues to pose challenges to most countries, especially net exporters.
- Geopolitical and fiscal shifts are poised to play a significant role in shaping monetary responses globally.

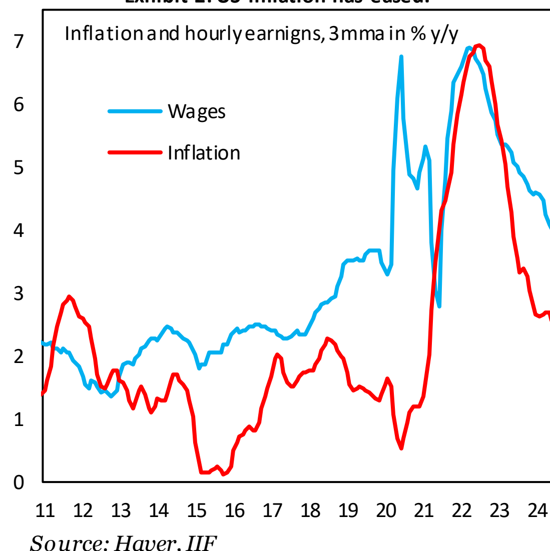
As 2024 concludes, central banks worldwide are recalibrating their policies in response to evolving economic conditions, shifting inflation dynamics, and geopolitical developments. This ***Global Macro Views*** delves into the actions taken by major advanced and emerging market central banks, the forward-looking drivers of monetary policy in 2025, and the nuanced impact of a strengthening U.S. dollar. With the Federal Reserve (Fed), European Central Bank (ECB), and Bank of Japan (BoJ) moving either in distinct directions or at different paces, their decisions underscore the challenges of synchronizing monetary strategies in a fragmented global economy. The Fed's recent rate cuts aim to a finer balance between domestic growth with inflation targets, while the ECB's monetary easing seems more directed to counter persistently sluggish economic performance in key Eurozone economies even if inflationary pressures are not completely gone. Conversely, the BoJ's cautious approach to a future rate hike reflects its focus on achieving sustainable inflation amid domestic and external uncertainties. At the same time, the strengthening U.S. dollar continues to exert pressure on emerging markets, increasing the burden of dollar-denominated debts and influencing capital flows, further complicating their monetary policy frameworks. Adding to these dynamics, the incoming Trump administration's proposed trade and immigration policies and fiscal expansion are poised to reshape global economic relationships, presenting both challenges and opportunities for central banks.

Exhibit 1: AE central banks have eased in 2024.



Source: Haver, IIF

Exhibit 2: US inflation has eased.



Source: Haver, IIF

In 2024, global central banks navigated the challenge of balancing growth and inflation in a global economy marked by uneven recoveries and persistent geopolitical uncertainties (Exhibit 1). At its December 17–18 meeting, the Federal Reserve delivered a 25-basis-point rate cut, bringing the federal funds target range to 4.25%–4.50%. This marked the third consecutive cut in the second half of the year, following cuts of 50-basis-point in September and 25-basis-point in November, totaling 100 basis points of easing for 2024. Inflation has slowed to 2.8% by November, down from over 4% in early 2023, while the unemployment rate edged up to 4.2%, reflecting a gradual cooling in labor market conditions (Exhibit 2). These developments provided the Fed with space to fine-tune policy to support growth while avoiding excessive accommodation.

Despite the December rate cut, the Fed's forward guidance has struck a cautious tone. Chair Powell highlighted uncertainties tied to potential fiscal policy shifts under the incoming Trump administration and external risks such as trade policy changes. The Fed's guidance tempered market expectations for additional aggressive cuts in 2025, despite earlier assumptions of a more

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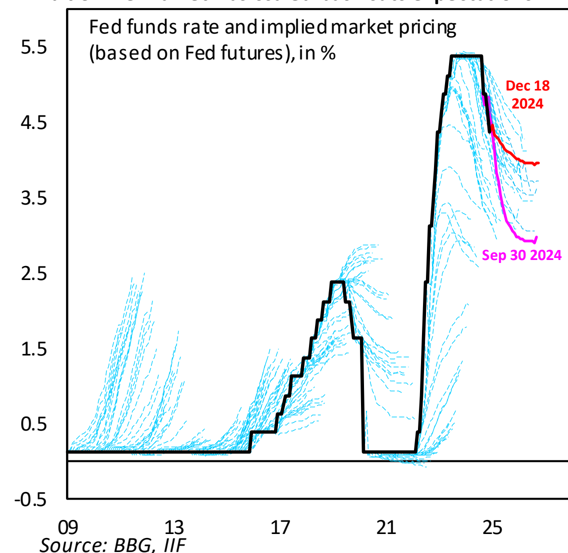
pronounced easing cycle (Exhibit 3). In response, U.S. Treasury yields adjusted higher, with the 10-year yield rising from mid-year lows around 3.6% to approximately 4.5% by mid-December, as investors recalibrated their views on the likely trajectory of monetary policy.

On December 12, the European Central Bank implemented its third consecutive rate cut of 2024, lowering the deposit rate by 25 basis points to 3.00%. Persistently sluggish growth and some remaining inflationary pressures are central to the ECB's concerns. Core inflation held at 2.7%, driven by high service-sector costs (especially prices of eating out, hospitality, and health services), while Germany's industrial production contracted again in October, adding to the 16.3% trend decline since the peak in December 2017—an ominous sign that a key engine of growth for Europe is broken. ECB President Lagarde reiterated the need for sustained policy accommodation to address structural economic weaknesses and cautioned against prematurely tightening conditions. European politics have added uncertainty to the mix with hung parliaments in Germany and France, which also cast a shadow over fiscal policy prospects and complicates the monetary scenario, despite relatively better economic performances in Spain and, to a smaller extent, Italy.

The Bank of England maintained its policy rate at 4.75% during today's meeting, following a 25-basis-point reduction on November 7. UK inflation rose to 2.6% year-on-year in November, up from 2.3% in October, driven by higher transport and entertainment costs as well as increased taxes on tobacco products. Wage growth accelerated to 5.2% in the three months through October compared to the same period last year—the first acceleration since August 2023—highlighting persistent underlying inflationary pressures. The BoE has remained cautious, balancing the need to address above-target inflation with signs of economic stagnation, including a 0.1% GDP contraction in October.

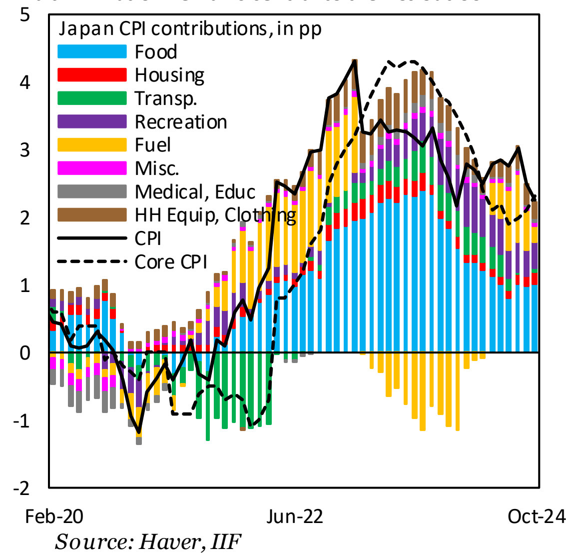
The Bank of Japan is expected to take a more deliberate approach, with its next significant policy move (a tightening) likely in early 2025. While the BoJ chose to maintain its policy rate at 0.25% today, this decision reflects a continued focus on evaluating the realization of its economic projections and gathering further data, particularly concerning SME wage dynamics ahead of the 2025 Shunto wage negotiations. The BoJ remains attentive to yen depreciation risks, but with speculative short positions shrinking and the yen stabilizing around 150 per dollar, immediate intervention was deemed unnecessary. We believe that Governor Ueda's strategy is to prioritize building confidence in the sustainability of inflation exceeding the 2% target before committing to additional rate hikes (Exhibit 4). Given these conditions, we anticipate a rate hike at the January 2025 MPM, coinciding with greater clarity on domestic wage trends and U.S. policies under the Trump administration.

Exhibit 3: The market has scaled back cuts expectations.



Source: BBG, IIF

Exhibit 4: Inflation remains central to the BoJ outlook.



Source: Haver, IIF

Other advanced economy central banks have also recalibrated their policies in response to their respective domestic dynamics. The Bank of Canada reduced its policy rate by 50 basis points to 3.25% in December, citing weaker economic growth and labor market softening as key factors for providing additional accommodation. The Reserve Bank of Australia opted to hold its cash rate steady at 4.35%, signaling a pause to assess the lagged effects of prior tightening amid persistent services inflation. The Swedish Riksbank, responding to weakening domestic demand and improving inflation, cut its policy rate by 25 basis points in May, August, and September, followed by a 50 bps reduction in November, bringing it to 2.75%. The central bank signaled further easing remains possible if disinflation trends persist. Meanwhile, the Swiss National Bank delivered a surprise 50 basis point rate cut to 0.50% in December, underscoring global economic pressures and the need to ensure Swiss inflation remains anchored as external uncertainties persist.

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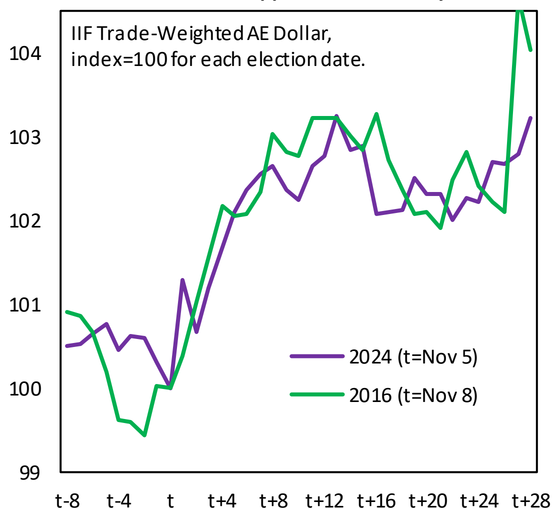
Emerging market central banks broadly reflected the easing narrative of their advanced economy counterparts. In Latin America, inflation moderation allowed for continued rate cuts. Going against the grain, Brazil's central bank delivered a 100-basis-point rate hike on December 9, bringing the Selic rate to 12.25%, following 25-basis-point and 50-basis-point hikes in the two prior policy meetings. The move reflected a response to persistent inflationary pressures and the need to re-anchor inflation expectations in the context of fiscal challenges and external risks. However, recent indications suggest a dovish shift, with expectations for stabilization in the Selic rate as inflationary pressures moderate. Further specifics on Brazil's policy outlook and its macroeconomic backdrop are available in an accompanying note published by our LatAm team.

Elsewhere in the region, Banco de México delivered its third consecutive 25-basis-point rate cut today, lowering its policy rate to 10.00%, as inflationary pressures eased and real activity softened. In Colombia, the central bank is expected to accelerate its easing pace with a 50-basis-point cut tomorrow, bringing the policy rate to 9.25%. This reflects confidence in the ongoing disinflation process, although fiscal risks and external imbalances may temper the pace of future cuts. Similarly, Chile continued its easing cycle, with a 25-basis-point cut on December 17 lowering the policy rate to 5.00%. The Central Bank of Chile's move aligned with the global pattern of easing but remained calibrated to address lingering inflationary pressures from services and energy.

In Central and Eastern Europe (CEE), the deceleration of inflation has been uneven, prompting varied responses from policymakers. Poland's central bank has maintained its policy interest rate at 5.75% since October 2023, while Romania's central bank has cut its policy rate twice in July and August, leaving it at 6.5% since then. The Czech National Bank held its key rate unchanged at 4.00% at its December 19 meeting, pausing its easing cycle as inflation showed signs of persistence and underlying price pressures remained elevated. Meanwhile, the National Bank of Hungary has adopted a more cautious stance since September when it lowered its key policy rate to 6.50%. When considering broader regional dynamics, however, the inclusion of Turkey and Russia underscores clearer divergences in policy stances. The Central Bank of Russia has maintained its key interest rate at 21% since a 200 basis point increase in October 2024, marking a continuation of its aggressive tightening cycle in response to inflationary pressures and a weakening ruble. We expect a further 100 bps hike to 22% at the December 20 meeting. In Turkey, the Central Bank (CBRT) has kept its benchmark one-week repo rate steady at 50% since March 2024 following significant rate hikes earlier in the year. While inflation has gradually declined, with November figures at 47.1% compared to 48.6% in October, the Turkish economy has entered a technical recession after two consecutive quarters of contraction. The CBRT has signaled the possibility of gradual rate cuts starting at its December 26 meeting, contingent on developments such as the outcome from minimum wage negotiations which will have significant impact on inflation expectations. (For more details on Turkey, see our recent post-trip notes.)

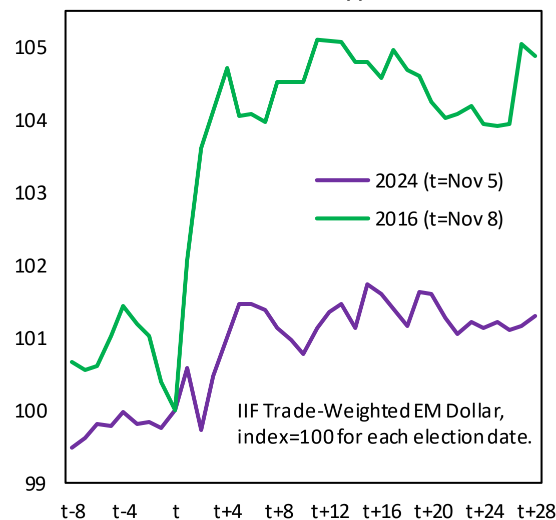
While several Eastern European central banks may return to an easing cycle in 2025 depending on either fiscal consolidation taking shape or additional signs of disinflation, broader challenges persist. Currencies such as the Hungarian forint continue to underperform despite improving inflation dynamics, partly due to lingering political and fiscal risks. This complexity in monetary policy trajectories reflects both domestic pressures and the broader geopolitical and economic realities facing the region..

Exhibit 5. The AE dollar has appreciated similarly to 2016...



Source: Haver, IIF

Exhibit 6. ... while the EM dollar has appreciated less.



Source: Haver, IIF

The recent wave of rate cuts across emerging markets reflects not only improving inflation profiles but also proactive efforts by central banks to stimulate growth and insulate their economies from global uncertainties heading into 2025. These cuts are designed to mitigate the effects of softening global demand and support domestic economies as fiscal tightening and external risks

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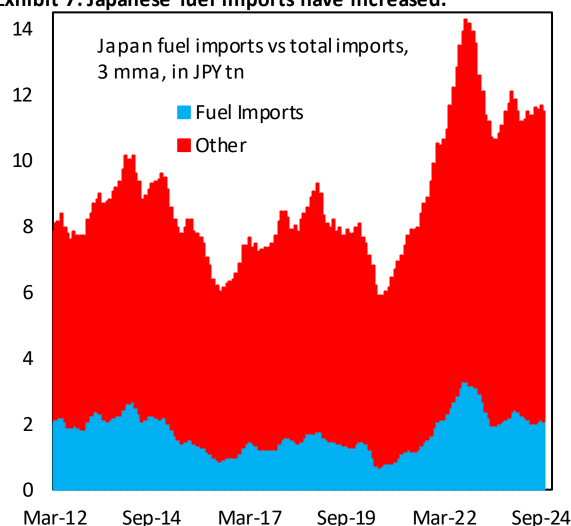
weigh on growth prospects. However, the influence of Federal Reserve decisions remains significant, often shaping the policy space available to EM central banks. The Fed's rate cuts in 2024 helped alleviate some pressures on capital flows and provided room for EM central banks to lower rates, but risks remain. A stronger U.S. dollar, driven by resilient U.S. growth or shifts in global risk sentiment, could exacerbate the burden of dollar-denominated debt in EM economies and contribute to inflationary pressures through higher import costs. For central banks in EMs, navigating this balance will remain a central challenge as they contend with the dual pressures of domestic priorities and global monetary dynamics in 2025.

Going deeper on USD appreciation effects, the dollar's continued appreciation—rising 6% in trade-weighted terms in 2024—has redefined global monetary dynamics, with distinct regional impacts. Against advanced economy currencies, the appreciation mirrored the magnitude of the first Trump administration in 2016, exacerbating trade competitiveness issues for exporters (Exhibit 5). However, the dollar's gains against emerging market currencies were more subdued compared to 2016 (Exhibit 6). This relative resilience in EM financial conditions reflects stronger economic fundamentals and market expectations that the Trump administration may adopt a more transactional and pragmatic approach to trade policy, reducing fears of abrupt disruptions. For the United States, the dollar's strength has been a stabilizing force, easing inflationary pressures by lowering import costs and allowing the Federal Reserve to implement a gradual pace of monetary easing. However, this domestic benefit has come at a global cost.

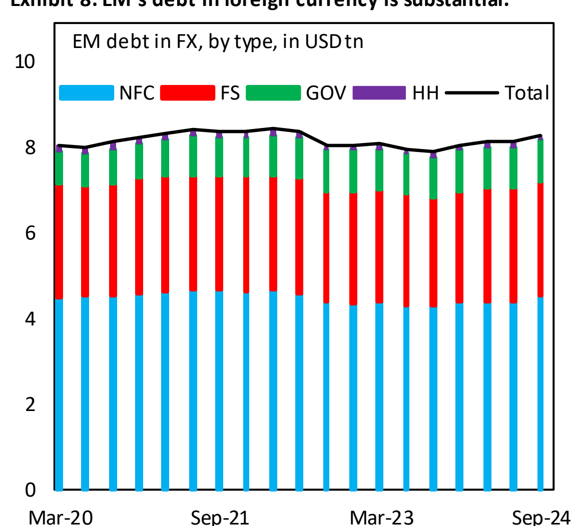
For advanced economies, the stronger dollar has exacerbated trade competitiveness issues, particularly for export-heavy regions like the eurozone and Japan. In Europe, a stronger dollar has worsened trade deficits and placed further strain on Germany's industrial sector, which recorded a 6% drop in auto exports to North America year-on-year. In Japan, the BoJ's exit from Yield Curve Control was necessitated in part by the inflationary spillovers of a weakened yen—a direct result of the stronger dollar. Imported energy costs surged, pushing Japan's trade deficit to its widest since 2022, highlighting how the dollar amplifies external vulnerabilities for economies reliant on commodity imports (Exhibit 7).

Exhibit 7. Japanese fuel imports have increased.



Source: Haver, IIF

Exhibit 8. EM's debt in foreign currency is substantial.



Source: IIF Debt Monitor.

In emerging markets, dollar strength has underscored structural fragilities tied to external debt and financial flows. Global EM FX-denominated debt now stands at $8.3 trillion, and higher U.S. yields have increased the burden of servicing this debt. This has forced EM central banks to prioritize currency stability, even at the expense of domestic growth. For example, Mexico's Banxico adopted a cautious monetary stance, limiting rate cuts to anchor inflation as the peso faced renewed volatility. In Brazil, external funding costs surged, constraining the Central Bank's ability to accelerate rate easing.

Looking ahead, we argue that the Trump administration's expected infrastructure spending, tax cuts to corporations, re-affirmation of the 2017 personal income tax cuts, trade tariffs, and tighter immigration rules—all pointing to higher interest rates—would reinforce the dollar's strength. Optimism with respect to better business conditions would have the same effect. Extra boost to the USD would amplify capital outflows from EMs, intensify global financial tightening, and limit policy flexibility for central banks outside the United States and push the USD further up. For advanced economies, the focus will increasingly turn to currency stabilization tools, such as FX interventions or enhanced forward guidance, as policymakers attempt to mitigate the economic drag of a dollar-dominated system. In a dollar-centric world, central banks face an increasingly delicate balancing act: addressing domestic inflation and growth priorities while managing the global spillovers of U.S. monetary dominance. For emerging markets, the risks of capital flight, inflationary shocks, and fiscal constraints will require innovative policy strategies in 2025 to navigate the challenges posed by a persistently strong dollar.

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