Global Focus: A strong dollar is in the world's interest

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- **Recent concern about growth and inflation prospects is largely related to commodity and food prices**
- **The USD – commodity price correlation is extremely strong historically and in recent years**
- **A stronger dollar would likely be associated with downward pressure on commodity-induced inflation globally**
- **The July-August 2008 USD strength and commodity price disinflation is a precedent and was accompanied by rapid reserves growth**

Commodity and food-price induced increases in inflation are viewed as a major threat to global growth (Figure 1). Most central banks in EM and (to a large degree) in G10 focus on headline CPI inflation as the policy target, so commodity/food price inflation in practise seems to threaten a global contractionary shock through the monetary policy response. Insofar as a relative price change (commodities versus non-commodities) is producing a global macroeconomic effect, one can argue that the outcome is an unambiguous negative for global welfare.

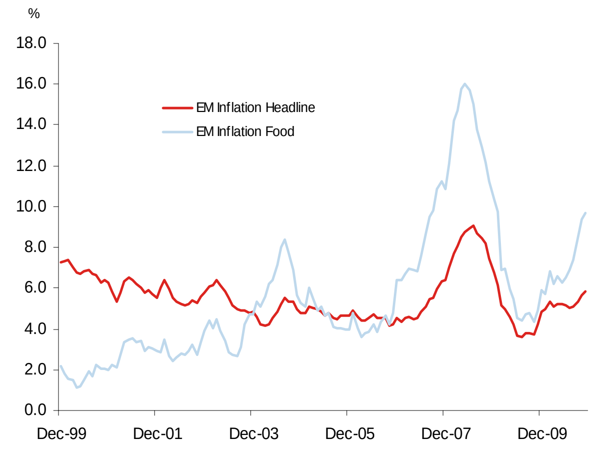
As a rule we do not editorialize. In some instances, however, the case for discussing what *should* happen is strong because of the attractiveness of the outcome. Even in the absence of a clear market mechanism to get from where we are now to the better outcome, it is useful to analyse why the outcome is so attractive, and whether it is attractive enough that some policymakers could be tempted to push the outcome, even if it is not the outcome that markets would produce in isolation.

The basic argument we make is that USD weakness is highly correlated with commodity price gains and USD strength is highly correlated with commodity price weakness. This is a relationship that is embedded in the data over long periods of time and which has not weakened in recent years (Figure 2). If anything, it appears to have strengthened. Moreover the volatility of commodity prices is a multiple of the volatility in currencies.

There is a legitimate question as to whether one should interpret this correlation as reflecting causation. We do not think it is likely that commodity prices have a strong regular causal impact on USD. In Figure 2, if anything, USD moves appear to lead commodity price moves. That most commodities are priced in USD also makes it more likely that the causal direction is at least partially from USD to commodity prices rather than the reverse.

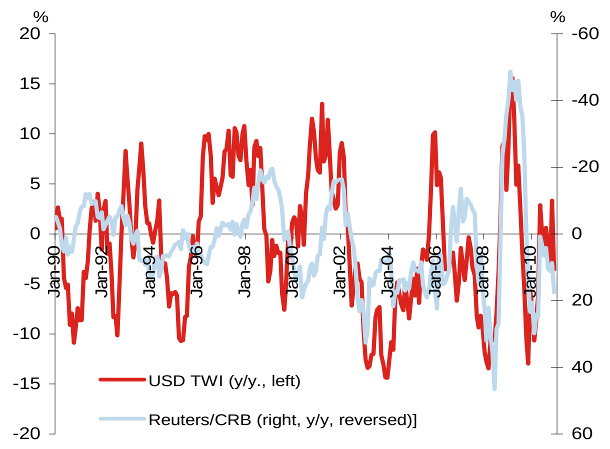
It is also possible that sometimes a correlation is just a correlation, with both commodities and currencies reflecting a third factor, e.g. risk appetite. What makes us think this is not the case is that indications on macro positioning show that long commodities appears to be the biggest position among macro investors.

Figure 1. Headline and food price inflation major issues



Source: Citi, CIRA

Figure 2. USD and commodity prices move together



Source:: Ecowin, Citi

The correlation between macro hedge fund returns (HFRXM) and commodities is as high now as in mid-2008, just prior to the run-up in the USD and the crash in commodities (Figure 3). In both periods, the market seemed long but now it seems longer. When we try and analyze positions in a multi-asset framework, long commodities again jumps out as the most significant position. Given this positioning, it might not take much of a shock to get commodity currencies heading downwards. So, even a modest amount of causality running from currencies to commodity prices could have a larger impact because of the positioning-induced vulnerability of commodity prices.

To be sure, we are not making a forecast. We are highlighting the observation that global policymakers have a real incentive to nudge commodity prices down, they have a means to do so that looks to be reliable based on the past (indirectly via currencies) and the market may be vulnerable given positioning.

The July-August 2008 precedent

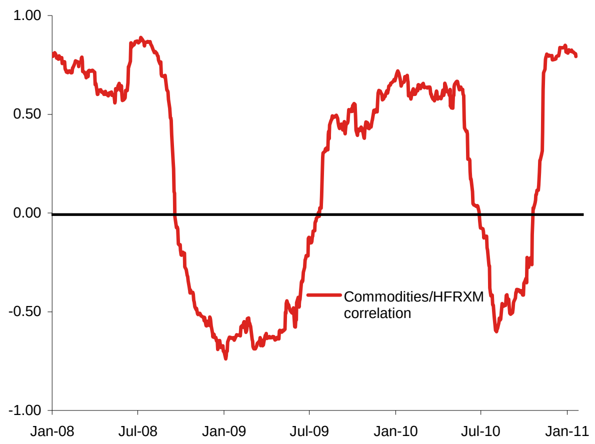
Our EM Economics colleagues estimate overall EM headline inflation to have peaked at 9.0% y/y in June 2008. EM food price inflation was 15.7% y/y. The equivalent November 2010 numbers were 5.8% and 9.0% y/y.

We emphasize the July-August 2008 episode because the Lehman Bankruptcy did not occur till mid-September. The S&P had weakened in May and June but had rebounded a few percent points in July and August. The USD rebound and the commodity price decline occurred much earlier in this period, commencing right at the beginning of July – if anything both paused in the second half of August. So we do not see this as reflecting the forces that were in play in late Q3 and early Q4.

Global reserves went up sharply as well in July and August 2008. When we correct for valuation effects, the pace of reserves accumulation was much stronger than in the Spring despite the rebound in the USD that would have mitigated the need to accumulate reserves (Figure 4). In 2006-2009 there were very few episodes of global reserves rising sharply when the USD was rising either against the EUR or on a trade-weighted basis. This anomaly in the summer of 2008 does not constitute proof that reserve managers had taken advantage of market vulnerability, but it is consistent with that possibility, and possibly even suggestive that some USD buying did occur. In mid-2008 global reserves were about USD7500bn.

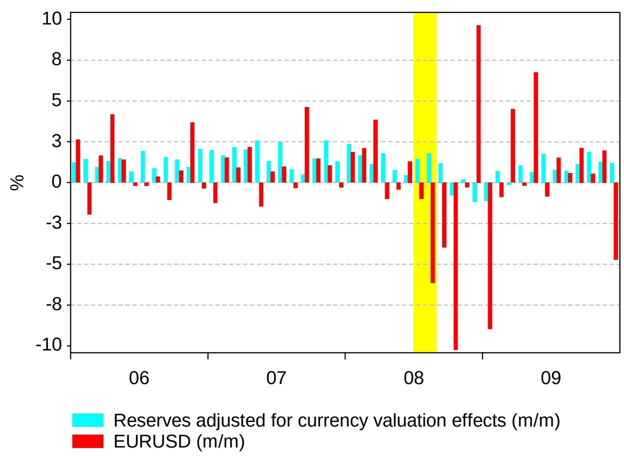
We can make the very rough assumption that all of the July-August 2008 reserves accumulation represented the cost of the pushing EURUSD from 1.5755 at the end of June to 1.4672 at the end of August, in which case the 'cost' of the 3% reserves increase would have been about USD 225bn. In fact while reserve managers may not have been enthusiastic about accumulating more reserves, the true 'cost' would be the ultimate capital gain or loss from this accumulation. Even if you make a strong assumption that the USD will be 25% weaker at the end of the day, the USD55bn cost would does not seem that onerous if the alternative is social disruption or significant permanently foregone production.

Figure 3. Hedge funds appear long commodities



Source: Ecowin, Citi

Figure 4. Unusual reserves growth in mid-2008



Source:: Ecowin, Citi

Market Commentary

What are the alternatives policy choices and how much do they cost?

The IMF estimates non-G7 GDP to be about USD 30trn in current dollars. By their categorization, GDP of developing and emerging economies is about USD 20trn. It is very unclear what the Phillips curve trade-off is in EM, but 1% of these totals is USD 200-300bn, so the cost of conventional contractionary policy adds up quickly.

The other obvious alternative is to allow the local currency to appreciate. The cost is the lost competitiveness. The competitiveness cost will tend to be lower if there is a broad set of countries appreciating together and higher for appreciating countries if only a limited set of countries appreciate. Getting agreement on a coordinated currency appreciation is complex and may be difficult even if a broad set of countries stand to gain from lower commodity prices. Moreover, the inflation problem is concentrated in a narrow set of CPI categories – currency appreciation will affect imported goods in local currency but not necessarily in USD terms.

The final alternative is simply to sell commodities directly. If the market is long, it will certainly be caught at a vulnerable point. However, commodity price intervention has never been done by consumers of commodities who are naturally short already, despite stockpiles. The currency intervention route is better established and the results less certain than through commodities.

Who would gain and who would lose? The winners would be all G10 and EM countries with low core and high headline inflation that is driven by commodity prices. Asian exporters would face a joint appreciation with the USD against non-dollar bloc currencies, but the competitiveness effects would be mitigated by the joint move. European and UK policymakers would probably be pleased as well both because of competitiveness effects and the easing of inflation pressures.

To be sure, a strong USD may be associated with somewhat weaker export performance, complaints from exporters and policymakers that the ball is being kicked in the wrong direction, and worse that foreign officials are engaged in currency manipulation. Similarly, despite their complaints about the strength of their currencies, officials in commodity exporting G10 countries may find that there are worse things than strong economies and improving terms of trade. US policymakers may decide that political and economic stability abroad is worth temporarily lost competitiveness.

Conclusion

If the world's inflation problem is primarily derived from rising commodity and food prices, it is very likely that a stronger USD will help mitigate this inflation quickly and efficiently. There is a well established relationship between USD strength and weaker commodity prices. The problem is that there does not appear to be a market driver for USD strength. However, during a similar high commodity price episode in mid-2008, we saw some evidence of high reserves growth, which is unusual when the private sector is buying dollars. Moreover, then as now, market macro investor positions appeared to be long commodities. While it would be unusual for reserve managers to buy USD for inflation stabilization reasons, as a quick solution to a major problem it may be more effective than most.

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