Surging Commodity Prices Linked To Declining US Dollar

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NEW YORK (Dow Jones)--As policymakers cautiously monitor rising price pressures, an increasing number of analysts are pinpointing a weak dollar as a force that is accelerating commodity-linked inflation.

By some economists' calculations, dollar weakness has contributed upwards of 50% to price inflation on key consumer goods such as rice, grain, wheat and oil.

For years, analysts have tracked the tight correlation between the value of the dollar and commodity prices. But a recent confluence of interrelated factors--including a historically weak greenback, ultra-loose monetary policy in the U.S., and social unrest in countries like Egypt that some observers have linked to soaring prices on everyday staples such as wheat and rice--has refocused attention on the strong relationship between commodities and the U.S. currency.

"At the most abstract level you'd expect there to be a causal connection between changes in the dollar and international commodity prices, as most are invoiced and priced in dollars," said Steve Hanke, a professor of applied economics at The Johns Hopkins University and a senior fellow at the libertarian Cato Institute. Hanke's research has mapped the impact of the euro/dollar exchange rate on commodities.

Europe, China and other economies are being buffeted by surging headline inflation, attributed mainly to food and energy. With unemployment still high and wages constrained, most economists argue that the rise in prices is the equivalent of a broad tax hike during a time when few can afford it.

As the world's premier reserve currency, the dollar is utilized in most trade and financial transactions. Many commodities are priced in dollars, which means when the dollar loses value as it has over most of the last decade, major goods become more expensive for consumers.

The Federal Reserve tracks the value of the dollar using a broad index containing a basket of major currencies. Historical data shows that within the last decade, the index fell from a February 2002 high of 129.68 to an April 2008 low of 95.55--shedding more than a quarter of its value.

Hanke posits that had the euro/dollar exchange rate remained at about 89 cents--its level in late 2001--commodity prices would now be substantially cheaper. According to his calculations, the dollar's persistent weakness may have contributed between 51% to more than double of the prices of key goods such as wheat, oats, cattle and crude oil.

Commodity price changes are often stripped out of many headline inflation calculations, as they are notoriously volatile and can be influenced by unpredictable factors like weather, economic and geopolitical uncertainty. But many analysts think the correlation between the dollar and commodities is unambiguous.

"What you find is that commodity prices are more volatile than currencies???more than one-to-one with the dollar," said Steven Englander, head of G10 strategy at Citigroup in New York, who recently wrote a research note boldly stating that a stronger dollar is in the world's best interest.

Noting that global inflation accelerates when the dollar is weak, "what you observe is that global inflationary pressures tend to become much more acute when you have a weak dollar driving commodity prices," Englander said.

As a result, food and energy price inflation tends to consume a sizeable portion of personal budgets, especially in developing economies where incomes are relatively meager and resources scarce. While the circumstances vary widely, analysts say surging inflation can trigger socio-political instability. In Egypt, anti-government protests were initially sparked by soaring prices in wheat, which is one of the country's major goods.

A growing consensus is forming around the view that lax U.S. monetary policies are playing a major role in feeding what some consider a commodities bubble. This critique has clearly stung the Federal Reserve, whose controversial $600 billion monetary stimulus has led governments around the world to fret about its spillover effects on inflation and currencies.

Although Fed Chairman Ben Bernanke last week dismissed the idea that low borrowing costs and easy money policies are to blame for higher commodity prices, market observers beg to differ.

"On the one hand, the Fed is not responsible for all the evils in the world," said Axel Merk, president and chief investment officer of Merk Investments and a sharp critic of the U.S.'s fiscal and monetary policies. "But on the other hand, the policies of the Fed and Asian central banks have contributed to food inflation. Bernanke has increased stakes with his monetary policy."

Some argue that the Fed's quantitative easing is providing a perverse incentive for investors to borrow dollars cheaply, and feeding speculative buying of commodities. This is putting upward pressure on food and energy, analysts said.

"I think its part of the reason that [quantitative easing], which was viewed as a dollar negative, had such a bad reception globally," Citibank's Englander said. "There's a consciousness that a weak dollar exacerbates these tensions...it's a contributing factor."

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