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INTELLECTUAL AMMUNITION

Emerging Markets, Emerging Dollar Inflation

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US inflation shows up first in the developing world, and then it comes home to roost.

One of the Fed's arguments in maintaining that its aggressive easing campaign isn't posing significant risk of an inflationary blowback is that while the US dollar is considerably weaker, decline of the exchange rate hasn't been strongly correlated with rising inflation in recent decades. That would be a difficult case to make right now in many countries, especially those in the developing world, that are being forced to take measures aimed at quelling the local inflation resulting from their ties to a depreciating dollar. Why? Because inflationary impacts of monetary policy that take a long time to be felt in the sophisticated US economy feed through developing countries' economies more rapidly, because those economies have shorter average contract lengths and less mature pricing structures.

Probably most striking has been the shift in Chinese currency policy. After years battling US politicians who (wrong-headedly) claimed that the yuan's dollar peg amounted to an unfair export advantage, Chinese authorities have initiated a steady appreciation of the currency versus the dollar because, as the central bank governor recently put it, a stronger currency "helps to rein in inflation." The move higher in China's consumer price index, which a year ago was running at less than 2% year over year, is now close to 6%. So far this year, the yuan has strengthened by more than 3% against the dollar, but the yuan price of gold is up some 40% since early last year.

Update to strategic view

US MACRO: Statistical inflation is already rising somewhat in the US since the Fed started aggressively easing at the onset of the credit crisis. But it is becoming severe, and in some cases politically destabilizing, in developing countries with currencies linked to the dollar. This is a taste of higher inflation levels ahead for the US, unless the Fed reverses its headlong rush to cut rates to near-zero.

US DOLLAR: While some developing countries are taking steps to manage their currencies to mitigate imported dollar inflation, the European Central Bank is giving no signs that it intends to weaken the euro. Until it does, on a trade-weighted basis, we expect the present dollar weakness to continue.

[see Investment Strategy Dashboard]

In the Middle East and Southeast Asia, a number of economies facing these pressures are putting similar policies in place, and others are expected soon to follow suit. Vietnam, with a 12-month inflation rate of more than 15%, is instituting a steadily more aggressive currency appreciation strategy. On a 4-week annualized basis, the dong is now strengthening against the dollar at a rate topping 7%. A month ago, the rate was only 1%. Indonesia, with an inflation rate of more than 7%, has allowed the rupiah to strengthen nearly 3% since January. Singapore, with inflation approaching 7%, up

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from about 0.2% a year ago, has put its dollar on a course that has seen it strengthen by about 5% since late last year.

Among some Persian Gulf states, the inflationary price of pegging to the dollar is becoming increasingly difficult to bear. So far, only Kuwait has abandoned its dollar peg, but others are considering it. In the United Arab Emirates, rising inflation sparked riots in Dubai late last year. Saudi Arabia, which has maintained a steady peg to the dollar, has seen its cost of living rise 7% the past year, versus a 12-month rate of 3% a year ago.

There is some confusion in identifying the source of the inflation uptrend, with some analysts pointing to rising prices of oil and other commodities, as if this were an exogenous factor unrelated to monetary conditions. While it's true that real demand has played some role in the commodity price run-up, with global growth now widely seen as likely to cool significantly, it's unlikely that it remains a major factor continuing to push prices higher. For dollar-denominated commodities, it’s the weakening of the unit of account -- that is, the dollar itself -- that accounts for much of the rising price trend. And for economies that closely tie their domestic currencies to the dollar, the weakness of the currency magnifies the impact of rising commodity prices.

BOTTOM LINE: While the most significant inflationary consequences of a depreciating dollar are being witnessed first in non-US venues closely tied to the dollar, the US economy is highly unlikely to escape unscathed. As it is, US inflation is already seeing a shift to higher levels -- with core CPI at 2.5% year over year, and headline at 4.4%. The inflationary consequence of dollar weakness now being seen globally offers strong support for the proposition that at some point the Fed-engineered erosion of dollar purchasing power will inevitably hit home, and in a big way. While some developing countries are taking steps to manage their currencies to mitigate imported dollar inflation, the European Central Bank is giving no signs that it intends to weaken the euro. Until it does, on a trade-weighted basis, we expect the present dollar weakness to continue.