Soaring Commodity Prices Point Toward Dollar Devaluation

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The astonishing rally of commodity prices during the past 12 months has taken most analysts, economists and investors by surprise. Rather than a dramatic change in the relationship between supply and demand for the underlying commodity, surging commodity prices have been driven by the devaluation of the preeminent marker of international commodity values -- the U.S. dollar. In the months ahead, the dollar's devaluation will increasingly register against other major currencies. Rapidly deteriorating U.S. economic fundamentals, questionable policy at the Federal Reserve, increasing political instability and extreme global geopolitical instability may trigger significant foreign capital flight from the United States.

Brief History of Commodity Prices

In late 2005, the Commodity Research Bureau's broad commodity price index, known as the C.R.B. Index, quietly surpassed record high levels set in the early 1980s. By the third week of May 2006, the C.R.B. Index gained another 12 percent. Behind this year's rise in the C.R.B. Index have been unprecedented price rallies of individual commodities. In the first five months of 2006, crude oil prices have increased by a mere 14 percent followed by gains in corn and wheat of about 10 percent. Price gains for other commodities have far outpaced the gains of oil and grains.

Zinc prices have doubled in the past five months, copper prices are up 80 percent, silver has risen by 60 percent and palladium, tin, gold, aluminum and platinum have gained 50 percent, 40 percent, 39 percent, 36 percent and 35 percent, respectively. Prices for other commodities including lead, iron and scrap iron have followed a similar path this year. While these commodities have vastly varied uses from industrial to food production, they all have one common feature -- they are denominated and traded internationally in U.S. dollars.

It is a dubious notion that global economic growth has suddenly reached a point where worldwide demand has overwhelmingly and simultaneously outstripped worldwide supply of all these commodities. In 2005, real global economic growth slowed to about 3.2 percent from nearly four percent in 2004. Slower global economic growth was led by slower real economic growth in the United States, which decelerated to 3.5 percent in 2005 from 4.2 percent in 2004. Global demand for commodities was actually declining, as prices for these commodities began to gallop higher in 2005.

Falling Commodity Value of the Dollar

While U.S. and global real economic growth accelerated in the first quarter of 2006, this acceleration was hardly sufficient to be behind the further rise of commodity prices in the first five months of this year. Rather than demand pushing the value of commodities higher in the past 18 months, it has been the dollar's devaluation against commodities that has pushed commodity prices to record highs. In other words, it is not zinc, copper and silver prices that are gaining; it is the value of the dollar that is declining against these commodities.

The devaluation of the dollar against the world's major commodities is being driven by the exceptional growth in the world's supply of dollars during the past two years. Growth in the world's supply of dollars has come from two primary sources: rising international oil prices and the very large and growing U.S. trade deficit.

Rising international oil prices during the past two years have dramatically increased global demand for and supply of dollars, which are used to buy crude oil. These dollars end up in the hands of the world's crude oil producers, who have invested some of this windfall in U.S. Treasury, agency and corporate bonds. Similarly, the U.S. trade deficit has lavished dollars on many countries that produce exports bound for the United States during the past two years. Again, most of this windfall has been invested in U.S. Treasury, agency and corporate bonds.

To get an idea of the magnitude of growth in the world's supply of dollars during the past two years, one must calculate the dollar value of rising crude oil prices and add to this the size of the U.S. trade deficit. In 2004, global demand for crude oil grew by about four percent. Higher oil prices, which advanced by 34 percent, and demand for oil combined to increase the world's dollar supply by about $330 billion. In 2005, international crude oil prices gained another 35 percent and global demand for oil grew by only 1.6 percent. Nonetheless, the world's supply of dollars increased by a further $460 billion.

The U.S. trade deficit was $666 billion in 2004 and $782 billion in 2005. Thus, in 2004 the world's supply of dollars grew by over $1 trillion, which was overshadowed in 2005 when the supply of dollars grew by a further $1.2 trillion. Adjusting these figures downward for double counting the portion of the U.S. trade deficit linked to crude oil imports still leaves the average annual growth of the world's supply of dollars in excess of $1 trillion per year in 2004 and 2005. According to data from the U.S. Treasury, foreigners invested about $900 billion in U.S. securities in both 2004 and 2005. At the end of 2005, foreigners held about $4 trillion worth of U.S. debt securities and about $2 trillion worth of U.S. equities.

Of course, the world's supply of dollars has also been pushed higher during the past two years by rising prices of other dollar-denominated commodities such as zinc, copper silver, palladium, and tin, among others. Although most of the increase in the world's supply of dollars since 2004 has been reabsorbed into U.S. bonds and equities, as much as $600 billion remains outside of U.S. asset markets. Some of this money has undoubtedly found its way into the asset markets of other countries. Most of it, however, has been parked in alternative investments such as commodities. Rather than a bubble in commodity prices, as at least one prominent economist has asserted, recent commodity price action is indicative of a growing bubble in the world's supply of dollars.

Dollar Devaluation Against Other Currencies

Although large by itself, the dollar bubble that is driving the value of the dollar lower versus commodities is dwarfed by the dollar bubble that is parked in U.S. debt securities. In 2005, this bubble kept long-term U.S. interest rates exceptionally low. The excess supply of trade and petro-dollars pushed higher all dollar-denominated bond prices, including prices for risky junk and emerging market bonds. Interestingly, the powerful surge in commodity prices in 2006 has been accompanied by an equally powerful decline in the prices for all dollar-denominated bonds, pushing bond yields steeply higher.

As U.S. bond yields have risen, the value of the dollar against both the yen and the euro has declined, signaling that foreign capital flight from the U.S. may have already begun. The dollar has depreciated by about eight percent against the euro and about five percent against the yen between January 1 and May 22, 2006. The sale of dollar-denominated bonds by foreigners is shifting the global dollar bubble back into the U.S. money supply. This added liquidity undoubtedly helped to propel U.S. economic growth higher in the first quarter of 2006. It has also added to already growing inflationary pressures in the United States.

As historically benign investment risk in the U.S. begins to rapidly increase during the next several months, foreign capital flight could intensify dramatically, prompting the dollar's devaluation against other major currencies. Weakening economic fundamentals, missteps by the

U.S. Federal Reserve, increasing political instability and extreme global geopolitical instability are factors that could easily push investment risk in the United States to extraordinary heights sending foreign investors toward the exit.

Rising energy prices are finally beginning to push U.S. inflation indicators broadly higher. As summer begins, energy demand in the United States will increase, driving crude oil and fuel prices much higher. This will fan the inflation fire in the United States. At the same time, rising prices will begin to dampen the growth of both private consumption and investment, slowing U.S. economic growth. Although not seen in the U.S. since the early 1970s, stagflation could make a strong comeback bid in the months ahead.

The last episode of stagflation in the United States was the result of the 1973-1974 Arab oil embargo, which produced a prolonged increase in international crude oil prices. The reappearance of stagflation could accelerate foreign capital flight from the United States. How the U.S. Federal Reserve responds to the unusual combination of rising inflation and slowing economic growth could further accelerate foreign capital flight. With inflation already rising and U.S. economic growth far above sustainable levels in the first quarter of this year, one can easily argue that the Fed has been too timid in tightening monetary policy during the past several months.

This timidity can be blamed on two factors: the change in the chairmanship at the Fed and the approach of U.S. mid-term elections. The Fed's new chairman, Ben Bernanke, was appointed by President George W. Bush. Bernanke has undoubtedly come under some amount of political pressure to delay further tightening of monetary policy until after the November 7 elections in order to avoid a U.S. economic slowdown. The Fed's failure to act decisively in the face of rising inflation could damage the credibility of the U.S. monetary system, turning capital flight into a flood.

The flood of foreign capital from the United States could be further attenuated by political instability. Public opinion polls indicate that popular support for President Bush has fallen to about 30 percent. Popular support for Vice President Dick Cheney is below 25 percent. The exceedingly weak popular support for the president and vice president raises questions about the legitimacy of the entire Bush administration. This erosion of legitimacy has encouraged public rebuke of several administration officials including Secretary of Defense Donald Rumsfeld.

The erosion of the Bush administration's legitimacy has also undermined popular support for

Bush's Republican Party, producing a widening rift between the president and Republican Party representatives in the U.S. Congress. This rift is already causing Bush's important legislative initiatives to founder. With public support for the Republican Party dropping as a result of Bush administration policies, a revolt against the president by his own party may emerge. Alternatively, the Republican Party could be trounced by the Democrats in the upcoming elections, leaving Democrats in control of at least one house of Congress and Bush languishing as a lame duck president.

Yet another factor that could produce a torrent of foreign capital flight from the United States is extreme global geopolitical instability. Historically, geopolitical instability has usually prompted a flight to the safe haven of the U.S. dollar. Geopolitical instability, however, has rarely been of such global proportion and so elevated. The Bush administration is simultaneously applying pressure on two very strong adversaries, Iran and North Korea. Military action against either of these countries will have profound long-term negative global economic and geopolitical consequences. Even the threat of military action or the imposition of economic sanctions against Iran or North Korea would have similar negative consequences.

The growing bubble in the world's supply of dollars also undermines the safe haven value of the dollar. This is precisely why prices for precious metals are at record highs. The dollar is like any other commodity -- print too many dollars and their value will inevitably decline. The decline in the dollar's value has already appeared against commodities. It will also become increasingly apparent against other major currencies in the months ahead.

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