



Most Central Banks Have No Choice But to Remain Hawkish

Few have the scope to loosen policy if economic conditions worsen.

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Commodity prices have surged since Russia invaded Ukraine. As a result, headline inflation¹ in most countries will likely rise rapidly over the next few months. Given that global headline inflation was already elevated before the invasion, this puts central banks under considerable pressure to act.



Nikolaj Schmidt
Chief International Economist

So, they should just accelerate the pace of monetary tightening, right? For the most part, this logic makes sense—however, the impact of rising commodity prices complicates the picture. For an energy importer, a surge in the oil price tends to be a deflationary shock. Although headline inflation rises upon impact, the sudden rise in import prices is a negative terms of trade shock that drains income from the economy. Over time, this income drain produces a pronounced growth deceleration, which takes pressure off the labor market and slows wage growth. Given that wage pressure is the nucleus of core inflation,² tightening policy while wage growth is slowing might not be such a good idea after all.

As well as being restricted by prevailing economic conditions, central banks are constrained by the credibility of their institutional frameworks and their dependence on global capital flows. In other words, we should expect a central bank's response to surging commodity prices to depend on whether it operates in a developed market (DM) or emerging market (EM) country and whether that country is a commodity importer or a commodity exporter.

Not All Central Banks Can Act Freely

DM countries tend to respond differently to external shocks than EM countries. Typically, DMs have well-established and credible institutional frameworks, usually including an independent central bank. With greater institutional resiliency comes a stronger anchoring

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¹ Headline inflation is the raw inflation figure reported through the Consumer Price Index. It includes volatile elements such as food and energy prices, and is not seasonally-adjusted.

² Core inflation is the change in the cost of goods and services reported through the Consumer Price Index, stripped of volatile elements such as food and energy prices.

“...for commodity importers, a sharp rise in commodity prices is a negative terms of trade shock....”

of inflation expectations. This provides the central bank with policy autonomy: The central bank can “look through” shocks to headline inflation without undue concerns about de-anchoring inflation expectations and without fears of destabilizing capital outflows.

EM countries usually have young institutional frameworks that have yet to prove their resistance to political pressure. For the populations of these economies, low and stable inflation is not something that can be taken for granted. Consequently, as adverse external shocks hit, the populations have learned from painful experience to try to preserve purchasing power by obtaining U.S. dollars. Therefore, as inflationary shocks wash up on the shores of emerging markets, EM central banks are usually forced to hike interest rates to prevent painful

surges in inflation expectations and associated disruptive capital outflows. The ability to look through headline inflation shocks is virtually absent as there is little policy autonomy.

Regarding capital flows, for commodity importers, a sharp rise in commodity prices is a negative terms of trade shock that drains income from the economy and slows activity. Headline inflation may initially increase, but, over time, slowing activity would reduce inflationary pressures.

For commodity exporters, a rise in commodity prices should be a positive terms of trade shock that brings an income windfall. Higher incomes would increase consumers’ purchasing power, which raises economic activity. Activity likely gains further as surging commodity prices should prompt a capital expenditure (capex) expansion

How We Expect Central Banks to Act

(Fig. 1) Location and dependence on capital flows is key

	Commodity Exporter	Commodity Importer
Developed Markets	<p>U.S., Australia, Norway, Canada.</p> <ul style="list-style-type: none"> Headline inflation: Up. Positive terms of trade shock = a positive income shock = good for activity = “Core inflationary.” Mon. Pol.: Unequivocally hawkish impulse. 	<p>Euro Area, Japan, UK, Sweden, New Zealand, Switzerland.</p> <ul style="list-style-type: none"> Headline inflation: Up. Negative terms of trade shock = a negative income shock = bad for activity = “Core deflationary.” Mon. Pol.: Dovish impulse. Policymakers may descend into academic discussion about whether shock contaminates inflation expectations (especially if economy operates at full capacity): (A) It does because expectations are 99% about oil anyway and (B) After a few months, economy struggles, and debate is irrelevant.
	<p>Latin America, South Africa, Middle East, Indonesia, Malaysia.</p> <ul style="list-style-type: none"> Headline inflation: Up. Positive terms of trade shock = a positive income shock = good for activity = “Core inflationary.” Mon. Pol.: Hawkish impulse. Some policy autonomy restored when capital flows chase commodity prices (i.e., not forced to hike interest rates). 	<p>China, India, Manufacturing Asia (South Korea, Thailand, Taiwan, etc.), Central and Eastern Europe, Turkey.</p> <ul style="list-style-type: none"> Headline inflation: Up. Negative terms of trade shock = a negative income shock = bad for activity = “Core deflationary.” Mon. Pol.: Hawkish impulse. No policy autonomy when capital flows chase commodity prices.
Emerging Markets		

As of March 25, 2022.

Mon. Pol. = Monetary Policy.

‘Hawkish’ means favoring tighter monetary policy; ‘Dovish’ means favoring looser monetary policy.

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“...investors might want to favor long positions in commodity-producing DMs....”

in the extractive industries. As such, for commodity exporters, inflationary pressures typically rise in response to rising commodity prices as both headline inflation surges and as a higher level of economic activity leads to additional wage pressures.

How We Expect Central Banks to Act

When we put all this together, we can see that a surge in commodity prices will likely result in higher headline inflation and a positive term of trade shock for a commodity-exporting DM country. The income windfall will likely drive activity and push core inflation up, resulting in an unequivocally hawkish response from the central bank.

Rising commodity prices will likely also lead to a positive in terms of trade shock for an EM commodity exporter. As with the DM commodity exporter, the income windfall will likely fuel activity and push core inflation higher. I expect the central bank's impulse will be hawkish and will benefit from the restoration of some policy autonomy if capital flows chase the rise in commodity prices.

For a commodity-importing EM country, a rise in commodity prices will likely lead to higher headline inflation and a negative in terms of trade shock. The associated fall in income will likely depress activity, which, over time, will likely weigh on core inflation. The prospect of capital outflows likely means that the central bank will adopt a hawkish stance despite the projected slowdown in economic activity. In other words, the absence of policy autonomy will likely effectively force the central bank to adopt a more hawkish policy stance than it would ideally like to.

Finally, for the commodity-importing DM country, the surge in commodity prices likely results in higher headline inflation and the negative terms of trade shock erodes purchasing power, which, over time, reduces activity and puts downward pressure on core inflation. In this instance, however, the relatively high degree of autonomy enjoyed by the central bank should enable it to adopt a slightly more dovish stance than its commodity-importing EM counterpart.

Commodity-Producing DM Currencies Look Strong

These divergent policy responses have a few straightforward implications for fixed income investors: Across the currency complex, investors might want to favor long positions in commodity-producing DMs such as Australia, Norway, and Canada. Commodity-importing EMs and DMs such as Korea, the eurozone, the UK and central Europe are unlikely to benefit from rising inflation. Interestingly, with a relatively neutral oil trade balance, the U.S. dollar is approximately in the middle of the pack.

When it comes to interest rates trades, we believe investors should look for bond markets to underperform and for yield curves to flatten more in the commodity-producing DMs versus their commodity-importing counterparts.

As with any analysis, initial conditions matter. Most countries enter the current inflationary period with economies that need tighter financial conditions. Apart from the European Central Bank, commodity-importing DM central banks do not have space for a meaningful dovish shift. In practice, this means that while marginal decisions might favor the dovish option, I expect that the overall policy direction will not change until there is a significant impact on economic activity.

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