FOREX FOCUS: Inflating The Dollar Is The New Currency Game

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LONDON (Dow Jones)--Inflating the dollar looks like the name of the new currency game.

Global inflation may still be fairly subdued but concern over consumer prices is becoming an issue with U.S. yields back up at levels last seen seven months ago, gold and copper prices at record highs and Chinese domestic demand still going from strength to strength.

Yet with deflation still looming in Japan, a patchy recovery becoming even more uneven in the euro zone and the U.K.'s recovery already showing signs of faltering, only the U.S. might be in a position to respond.

Fears of U.S. inflation have emerged gradually over the last few weeks as first the U.S. Federal Reserve injected a second tranche of quantitative easing, and then the Obama administration introduced more fiscal easing by agreeing to extend tax cuts and unemployment benefits that should have expired at the end of the year.

For the moment, U.S. inflation has remained subdued, with the core year-on-year measure estimated last month at only 0.8%. But with economic data, including industrial production, retail sales and consumer confidence, all coming in stronger than expected, upward pressure on U.S. consumer prices is likely to grow.

Meanwhile, a reluctance by China to slow down its economic growth, despite much stronger-than-anticipated price pressures there, makes it likely that global inflation fears will rise.

Commodity prices in general have continued to rally strongly, with demand for gold, copper and even silver suggesting that investors are now reaching out for inflation hedges.

The rise in U.S. Treasury yields, with the 10-year note now offering a return last available back in May, shows that financial markets are also starting to factor in higher U.S. interest rates even though U.S. monetary policy remains at record easy levels.

For the dollar, this can only be good news, especially given the inability of other major central banks to respond to price pressures even if they wanted to.

In the case of the Bank of Japan, the focus remains very much on the risk of deflation as the country's economy continues to show a limited response to repeated efforts at fiscal stimuli.

In the euro zone, strong growth in Germany will certainly keep the hawks on edge but as economic data for the currency bloc as a whole continues to show, the European Central Bank's hands are tied.

The latest purchasing managers' indexes Thursday showed even greater divergence between the core and peripheral economies of the euro zone as the latter struggle under austerity packages aimed at reducing their debts.

For the ECB, this means stalemate, with rates unlikely to be moved for at least another year or so.

For the Bank of England, the picture isn't any prettier.

Data this week confirmed just what many had feared: U.K. inflation pressures are proving much more stubborn than expected. However, with growth starting to slow as the coalition government's massive spending cuts start to bite, there will hardly be room for the central bank to respond.

Forecasters suggest that it may well be 2012 before the Bank of England is confident enough in the recovery to start tightening policy again.

So, for dollar bulls, inflation fears will provide just the excuse they need to stick with the greenback as currency trading gets underway again in earnest in the new year. Because, of course, for the last week or two investors have decided that high U.S. yields are a good reason to buy its currency.

Bloomberg	TNI FRX POV
Reuters	USD/DJ
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