Political Risk and Commodity Currencies

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ABSTRACT

We examine the impact of political risk on the relationship dynamics between commodity and currency returns in commodity-exporting countries. We find that the typically positive contemporaneous relationship between commodity and currency returns disappears when political risk increases. This finding is in line with the rare disasters model of Farhi and Gabaix (2016), with the negative effect of political risk being transmitted to foreign exchange rates indirectly by affecting the relationship between the foreign exchange and commodity returns. The results hold for various measures of political risk. The documented effect on the commodity-currency pricing relationship is driven by political risk, not economic uncertainty, and not by appreciation of the US dollar during periods of heightened political risk. The documented effect is stronger for countries with high political risk. The implication is that commodity currencies do not benefit from commodity price increases during periods of heightened political risk.

Keywords: commodity currency, political risk, rare disaster risk, geopolitical risk, foreign exchange rate, commodity return

JEL classifications: F31; F51; G13; G14

THIS VERSION: 1 December 2024

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