Press Points for Chapter 3: *Is Inflation Back? Commodity Prices and Inflation*

World Economic Outlook, October 2008

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Key Points

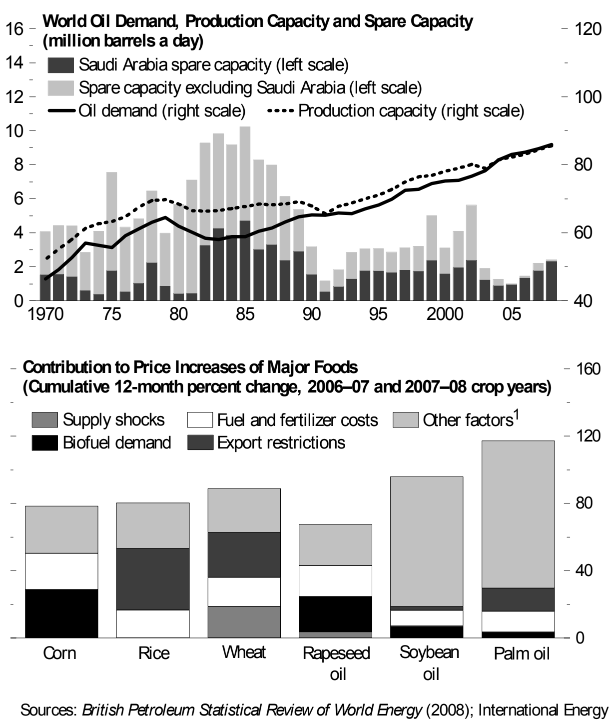
- **Despite some recent easing in commodity prices, many of the forces underlying the boom are still in place, and prices will likely remain at high levels by historical standards.**

- **While the situation is by no means uniform, inflation risks remain fairly high across a range of emerging and developing economies, reflecting continued pressures from the adjustment to high commodity prices and the danger of second-round effects on underlying inflation. In advanced economies elevated risks are diminishing rapidly, owing to the deflationary impact of the financial turmoil.**

- **In a number of emerging and developing economies further monetary policy tightening is important for containing inflationary pressures, especially where inflation is already high for other reasons, notably overheating, and where policy credibility is low.**

The world economy has experienced the broadest and most sustained commodity price boom since the early 1970s. The boom has largely been driven by the interaction of strong global growth, a lack of sector-specific spare capacity and low inventories from the onset of the boom, and slow supply responses. In addition, commodity-specific factors have contributed to the recent surge in food prices, including demand related to subsidy-induced biofuel production, supply disruptions for major crops, and trade restrictions. Finally, cross-commodity price linkages have played an important role, with rising energy prices spilling into food prices (see first figure). In contrast, the increasing role of commodities as alternative financial assets has had little discernible systematic impact on prices.

Recent Developments in Oil and Major Food Markets



Sources: *British Petroleum Statistical Review of World Energy* (2008); International Energy Agency; U.S. Department of Agriculture; U.S. Energy Information Administration; and IMF staff calculations.

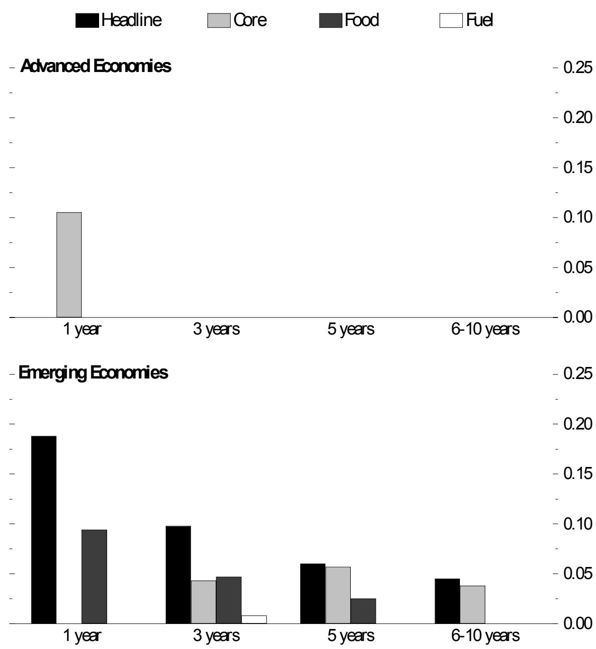
[1]Including spillovers and substitution effects.

Notwithstanding some recent easing in commodity prices, many of the forces underlying the boom are still in place. The recent price declines reflect prospects of slowing global growth in 2008–09, the resolution of weather-related supply constraints for key food crops this year, and increased oil supply. However, supply constraints and low inventories are likely to remain in place for some time, and the momentum of demand growth in large emerging economies remains robust. As a result, prices will likely remain at high levels by historical standards, with considerable scope for price volatility.

Barring a sharp drop in commodity prices, inflation risks will remain higher than in the recent past for some time, especially in a range of emerging and developing economies. The adjustment to the earlier commodity price surge is still in train in many emerging and developing economies, and the risks of second-round effects on underlying inflation are still present. The chapter's empirical findings suggest that the risks of second-round effects depend importantly on the ability of monetary policy to anchor expectations and the weight of commodities—especially food—in final expenditure. Emerging and developing economies score lower along these dimensions and are thus at greater risk of unanchoring expectations and unleashing second-round effects (see second figure). In addition, since the recent commodity-market-related shocks have been larger and more persistent than they were during the period used in the analysis, the actual inflationary consequences may yet surprise on the upside, unless the global slowdown intensifies.

Changes in Expected Inflation in Response to Changes in Actual Inflation[1]

(Expected inflation 1, 3, 5, and 6–10 years ahead; percentage point responses to a 1 percentage point change in actual inflation)



Sources: Consensus Forecasts; and IMF staff calculations.
[1]Based on statistically significant coefficients from panel regressions with fixed effects, using semiannual data since 2003. The measure of core inflation is net of food and fuel inflation.

In a number of countries, further monetary policy tightening will be important for containing inflation, especially where it is already high and where policy credibility is low. While headline inflation may start to come down in the wake of recent commodity price declines, underlying inflation pressures remain a concern, particularly where growth remains strong and where the monetary policy response has been constrained by exchange rate policies. Delays in responding to rising inflation can erode credibility, ultimately requiring more aggressive monetary policy responses to bring inflation down, at a higher cost in terms of output.