PRESS POINTS FOR CHAPTER 3:
TARGET WHAT YOU CAN HIT: COMMODITY PRICE SWINGS AND MONETARY POLICY
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Key Points

- **Economies with credible central banks and economic slack can afford to look through high headline inflation caused by commodity prices.**

- **Food price shocks can have particularly large second-round effects in economies with less credible central banks and excess demand pressures; this argues for a more active policy response in these economies.**

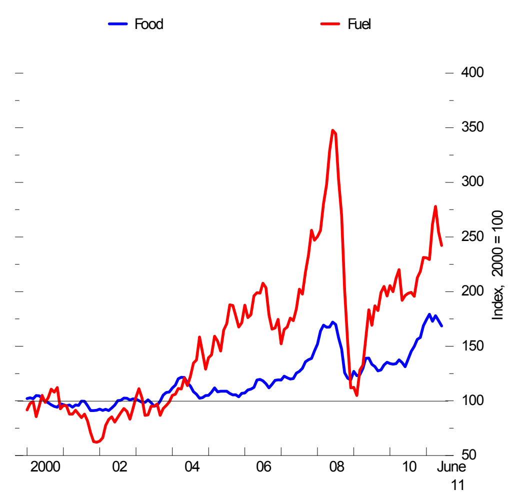
- **Commodity prices have larger effects on inflation in economies with high food shares and low monetary policy credibility—a number of emerging and developing economies share these characteristics.**

- **Commodity price swings can make it hard to meet a headline inflation target. Trying to hit the headline target can undermine central bank credibility and destabilize economies.**

- **Targeting underlying inflation, which can be measured in different ways, helps build credibility and, thus, achieve superior economic outcomes. It is better to target what you can hit.**

Figure 3.1. World Commodity Prices, 2000–11
(In real terms, as deflated by U.S. consumer price index)

Food and fuel prices have risen dramatically since 2000. Food and fuel prices peaked in 2008 at levels 80 percent and 250 percent above the levels in 2000. Current prices are 80 percent and 175 percent above 2000 levels, and there are concerns that structural forces will push prices higher over coming years.



Sources: Haver Analytics; and IMF staff calculations.

This chapter examines the inflationary effects of commodity price movements and the appropriate monetary policy response. Recent world commodity prices have been volatile (see figure). We find that commodity price movements have stronger and longer-lasting effects on inflation in economies with high shares of food in the consumption basket and in economies with less firmly anchored inflation expectations. A number of emerging and developing economies share these characteristics.

Underlying inflation is a measure that reflects the changes in inflation that are likely to be sustained over the medium term. Such a measure is resilient to temporary commodity price shocks. One possible measure—which excludes food and fuel prices—is core inflation. A forecast of headline inflation can also used. The best measure, however, will vary between countries.

In responding to commodity price shocks, the measure of inflation used to define a central bank's target matters because of its effect on the central bank's credibility. In economies with low initial monetary policy credibility and high food shares in the consumption basket, focusing on underlying inflation rather than headline inflation, makes it easier to build credibility. The reason is that it is harder to hit headline inflation targets than underlying inflation targets when commodity prices are volatile. Higher credibility, in turn, leads to better anchored inflation expectations and lower levels of both output and headline inflation volatility.

The chapter's main policy message is "target what you can hit." Since shocks to commodity prices are typically hard to predict and often not sustained, central banks seeking to establish credibility are generally better off communicating their policy objectives in terms of underlying inflation rather than headline inflation. While targeting headline inflation can lower the volatility of headline inflation, it can only do so at the cost of significantly higher volatility in economic activity. The desirability of doing so depends on the relative importance attached to stabilizing food and commodities prices relative to output and employment.

Economies with credible central banks and economic slack can afford to look through high headline inflation caused by commodity prices. In economies where the central bank's credibility is strong—as reflected in well-anchored inflation expectations—and where there is substantial economic slack, monetary policy can remain accommodative even if headline inflation is higher due to food price shocks. A number of major advanced and some emerging economies face these circumstances today.

In economies with demand pressures and inflation above target, a food price shock is likely to have particularly large second-round effects. This argues for a more active policy response than in other economies, while being mindful of external demand developments. The loss of credibility from an inflation increase is more severe the greater is the initial gap between actual inflation and the target. A number of emerging and developing countries continue to face these pressures even today.