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**.

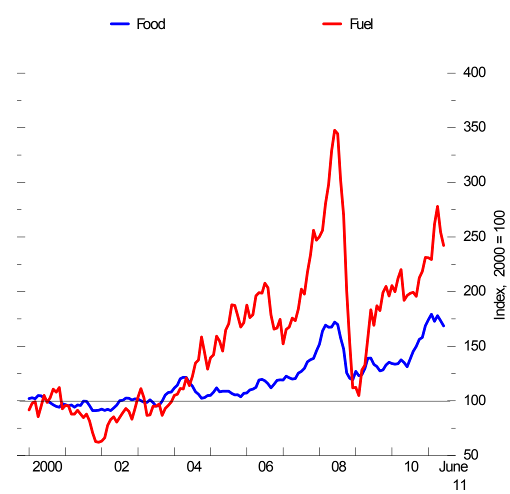
- **Commodity prices have larger effects on inflation in economies with high food shares and low monetary policy credibility—a number of emerging and developing economies share these characteristics.**

- **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.

PRESS POINTS FOR CHAPTER 4:

SEPARATED AT BIRTH? THE TWIN BUDGET AND TRADE BALANCES
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Prepared by Abdul Abiad (team leader), John Bluedorn, Jaime Guajardo, Michael Kumhof, and Daniel Leigh

Key Points

- **Fiscal policy has a key role to play in global demand rebalancing because it has a large and long-lasting effect on an economy's external balance. We find that cutting the budget deficit by 1 percent of GDP improves an economy's current account balance by over a half percent of GDP.**

- **The current account improves because imports fall with weaker domestic consumption and investment, and exports rise with the currency depreciation that tends to follow fiscal tightening.**

- **When the exchange rate is fixed and scope for monetary policy stimulus is constrained, the current account adjustment in response to fiscal consolidation is just as large but more painful. Economic activity contracts more and there is a sharper compression of domestic wages and prices.**

- **When economies tighten fiscal policies simultaneously, what matters for the current account is how much each economy consolidates *relative* to others. The current pattern of fiscal adjustment plans will contribute to a narrowing of euro area imbalances and emerging Asian trade surpluses, but a widening of the U.S. current account deficit.**

Fiscal adjustment will be one of the dominant forces shaping the global economy in coming years. To restore fiscal sustainability, many advanced economies need to reduce their budget deficit. Emerging and developing economies are tightening to rebuild fiscal policy room and in some cases to restrain overheating pressures.

What implications will these fiscal adjustments have for economies' external balances? In economies with twin budget and trade deficits, such as the United States and some economies of the euro area, policymakers may be hoping that fiscal consolidation will reduce both deficits. For economies such as China, Germany, and Japan, fiscal consolidation could further increase their existing trade surpluses. To try to shed light on these issues, this chapter analyzes fiscal policy changes in advanced economies over the past 30 years and conducts model simulations.

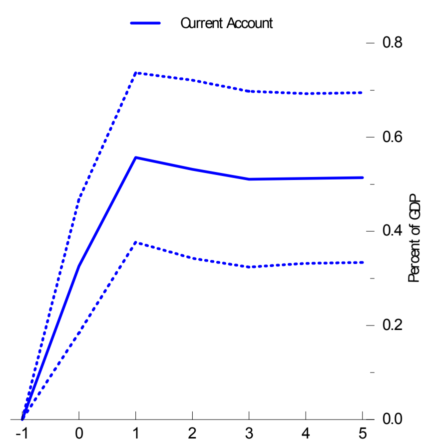
We find that fiscal policy has a substantial and long-lasting effect on the current account. A fiscal consolidation of 1 percent of GDP improves the current account by over a half percent of GDP within two years, with the improvement persisting into the medium term. The improvement in the current account comes not only through lower imports due to falling domestic demand, but also from an increase in exports arising from a weaker domestic currency.

If an economy's monetary policy is constrained, the current account adjustment is just as large but more painful. When policy rates cannot fall to offset the contractionary effects of fiscal consolidation, either because they are close to zero or because the exchange rate is fixed, there is a sharper contraction in domestic demand. The real exchange rate still depreciates, but it occurs through a greater compression of domestic wages and prices, a process sometimes called "internal devaluation." Overall, the current account still improves by about half a percent of GDP in response to a fiscal consolidation of 1 percent of GDP. These processes are relevant for the euro area economies, which are part of a currency union, and for economies with near zero interest rates, like the United States and Japan.

When many economies consolidate at the same time, what matters for the current account is how much consolidation an economy undertakes *relative* to others. This is because all economies cannot improve their current account balances at the same time. Some economies—including Australia, Canada, the United Kingdom, and some members of the euro area—are expected to undertake relatively large and permanent fiscal consolidation measures. For these economies, fiscal adjustment is expected to contribute positively to their external balances. Germany and emerging Asia are also consolidating, but by a lesser amount. This should contribute to a lowering of their external surpluses. Finally, the relatively small size of permanent fiscal consolidation measures currently envisioned for the United States suggests that they will contribute little to reducing the U.S. current account deficit.

Impact of a 1 Percent of GDP Fiscal Consolidation on the Current Account

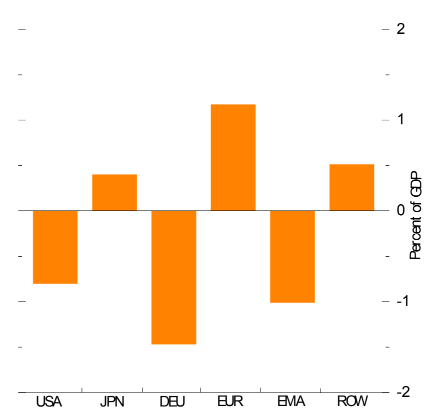
Fiscal policy has a large and long-lasting effect on external balances. A fiscal consolidation of 1 percent of GDP typically improves the current account by over a half percent of GDP within two years, and this improvement persists over the medium term.



Source: IMF staff calculations.
Note: X-axis units are years, where *t* = 0 denotes the year of consolidation. Dashed lines indicate the 90 percent confidence interval around the point estimate.

Long-Term Effect of Planned Fiscal Adjustment on the Current Account (2010 onward)

The differing magnitudes of fiscal adjustment plans across economies imply lower imbalances within the euro area, smaller external surpluses in emerging Asia, and a larger U.S. current account deficit.



Source: IMF staff calculations.
Note: DEU: Germany; EMA: emerging Asia; EUR: euro area excluding Germany; JPN: Japan; ROW: rest of the world; USA: United States.