INFOCUS

MACRO COMMENT

MAY 2021

Commodity prices and inflation in developed and emerging economies

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Many commentators expect inflation to increase after years of being below central banks' objectives. Rising commodity prices, from oil to agricultural goods, underpin these fears. In this edition of *Infocus*, GianLuigi Mandruzzato looks at the transmission of commodity price shocks to inflation in developed and emerging countries.

The rise in government bond yields since the beginning of the year is, for many observers, a sign of an imminent increase in inflation. After having declined gradually since the early 1980s, low inflation became entrenched after the Global Financial Crisis, but its reversal may now have begun. In support of this view, some emerging countries, such as Brazil, Russia, and Turkey have already seen inflation rise and their central banks have reacted by raising interest rates.

Factors behind the rise in inflation include the exceptional policy measures undertaken by central banks and governments to combat the Covid pandemic and the strong economic recovery that is underway (see Figure 1a) which has (as has been the case in recent years) been associated with rising commodity prices (see Figure 1b).

How important are commodity prices for consumer prices? With a few exceptions such as some energy goods and fresh food, raw materials are not sold directly to consumers. Rather, commodities are inputs into manufactured goods that are eventually purchased by households. However, other factors, including the costs of labour and capital and taxation are more important than raw materials in setting the final selling price.

The consumption of non-essential goods and services is higher in wealthier economies, reducing the importance of food and energy purchases in total consumption. This suggests that the impact of commodity price shocks on inflation declines with the level of income and should therefore lower in developed than in emerging economies.

To assess the impact of commodity price shocks on inflation, it is useful to start from the composition of consumer price indices (CPI) in emerging and developed economies.[1] The composition of the CPI baskets reflects consumers' expenditure, as measured by sample surveys among households and are updated annually.

The median weight of food in the 2021 CPI basket, based on 2020 consumption, is about seven percentage points higher in emerging than in developed economies (see Figure 2a).

1a. Global recovery underway

Source: IHS Markit, GSCI, Refinitiv and EFGAM calculations. Data as at 23 April 2021.

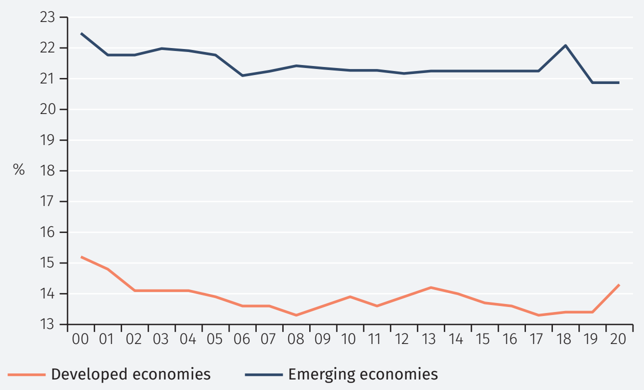
1b. Commodity price indices

Source: IHS Markit, GSCI, Refinitiv and EFGAM calculations. Data as at 23 April 2021.

The weight of groceries has fallen since 2000 by about 2 percentage points in both groups. The rebound of the weight of food purchases in the 2021 CPI in developed countries is due to the collapse of non-primary consumption following the restrictions imposed to contain the pandemic. Figure 2b shows that the weight of food expenditure in the CPI baskets is inversely correlated to the level of per capita income across both developed and emerging economies, supporting the view that increased per capita income explains the structural decline in the weight of food purchases in CPI baskets seen in the last two decades.

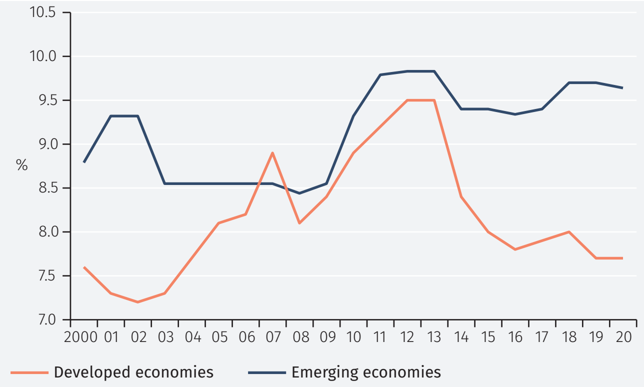
[1] The analysis considers data from 24 developed and 20 emerging economies. The group of developed economies includes: Australia, Austria, Belgium, Canada, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Japan, Latvia, Lithuania, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, UK, and US.. Emerging economies group includes: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Kazakhstan, Mexico, Poland, Russia, Saudi Arabia, South Africa, South Korea, Taiwan, Thailand, and Turkey.

2a. Food median weights in CPI baskets



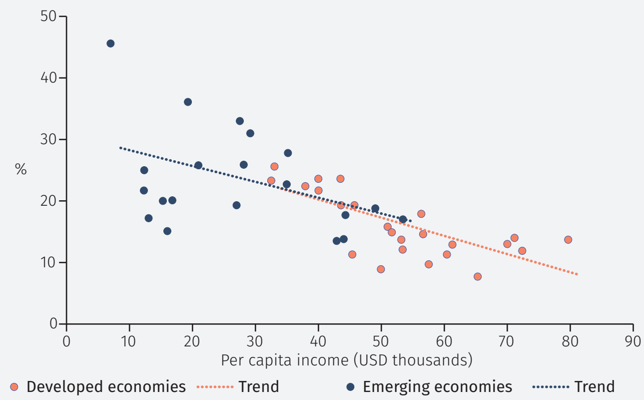
Source: OECD, World Bank, Refinitiv and EFGAM calculations. Data as at 23 April 2021.

3. Energy median weights in CPI baskets



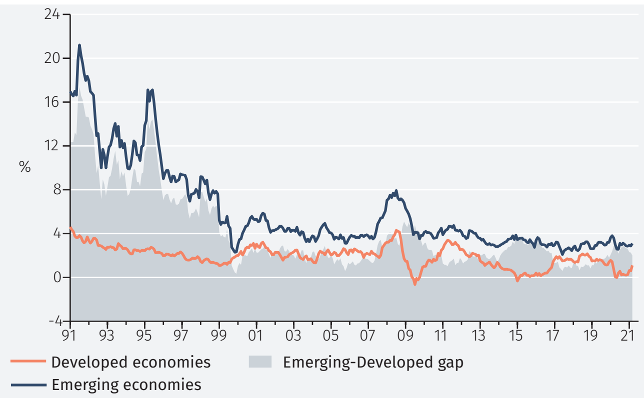
Source: OECD, World Bank, Refinitiv and EFGAM calculations. Data as at 23 April 2021.

2b. Income and food weight in CPI baskets



Source: OECD, World Bank, Refinitiv and EFGAM calculations. Data as at 23 April 2021.

4. Developed and Emerging economies' median inflation rates



Source: Refinitiv and EFGAM calculations. Data as at 23 April 2021.

The median weight of energy goods is about two percentage points higher in emerging than in developed countries (Figure 3). Its pattern in developed countries mirrors that of the oil price, which rose from 2000 to 2014 and then fell sharply. The gap with emerging countries has widened recently. This might reflect the fact that several emerging countries have taken advantage of low oil prices to reduce energy price subsidies.

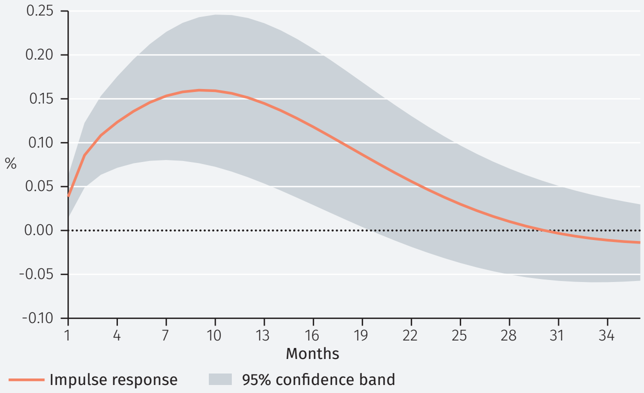
Looking at the median inflation rate in the two groups, there is little to support market concerns about a sharp rise in inflation (see Figure 4). In March 2021, median inflation was lower than the post-1999 average in both groups. After the great moderation of the 1990s, when an increasing number of countries emphasised price stability as the main objective of monetary policy, the decline in the median inflation rate has continued in developed and emerging market countries, albeit at a slower pace. In contrast, the convergence of inflation in emerging countries towards that in developed countries seems to have stopped: the gap between the two groups has been stable over the past two decades (see area in Figure 4).

Finally, a simple model was used to assess the interaction between the business cycle, commodity prices, and inflation in developed and emerging countries.[2] The observation of how the model variables respond to a standard shock highlights several interesting results (see Figures 5a-f overleaf):

1. Business cycle improvements and commodity price increases are followed by higher inflation in developed and emerging countries. The impact of shocks to the business cycle and agricultural prices is more persistent than that of energy price shocks.

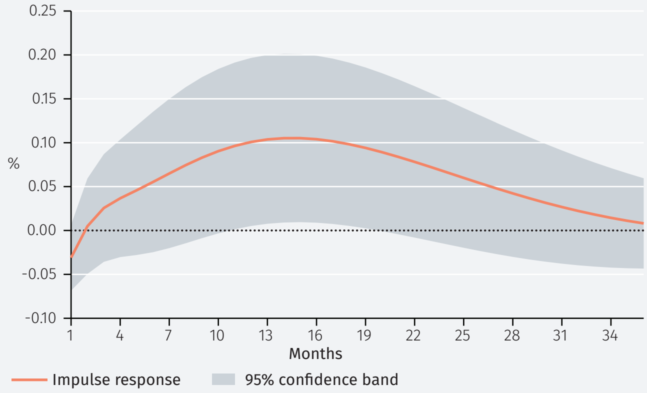
[2] A monthly VAR model with two lags was used. The variables are: the global composite PMI index, the 12-month percentage change in the GSCI indices of energy and agricultural commodity prices, and the median 12-month headline inflation rate for developed and emerging countries. The sample runs from January 1999 to December 2020. The variables are stationary in the sample period and the analysis is carried out in levels. The correlation matrix of the model variables suggests that shocks to activity should come first, followed by that on energy and agricultural commodity prices, and, finally, developed and emerging markets inflation.

5a. Developed economies' inflation response to PMI



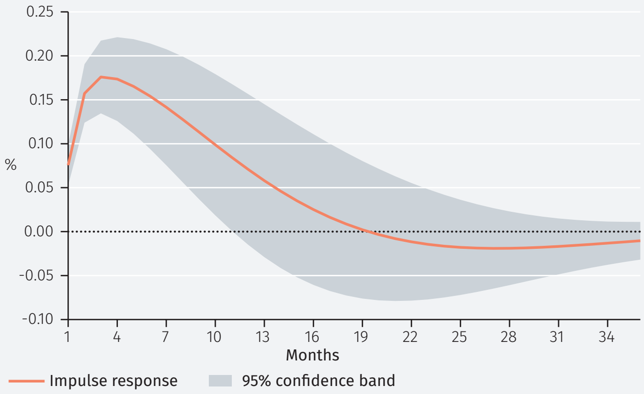
Source: EFGAM calculations. Data as at 23 April 2021.

5b. Emerging economies' inflation response to PMI



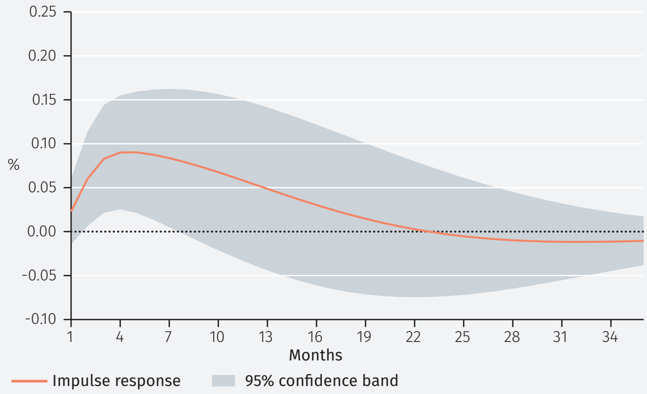
Source: EFGAM calculations. Data as at 23 April 2021.

5c. Developed economies' inflation response to energy prices



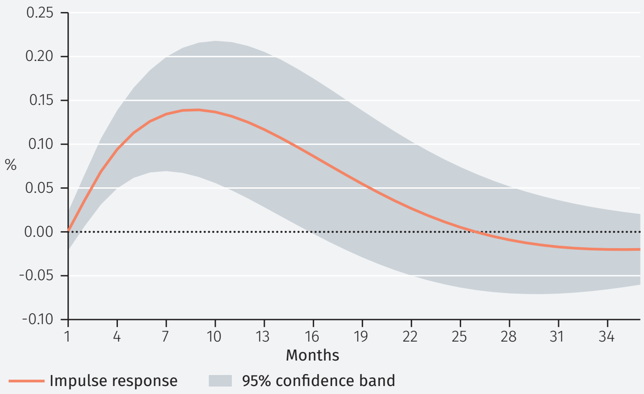
Source: EFGAM calculations. Data as at 23 April 2021.

5d. Emerging economies' inflation response to energy prices



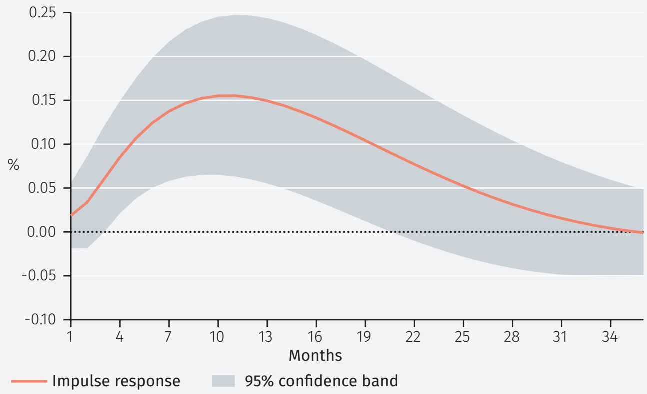
Source: EFGAM calculations. Data as at 23 April 2021.

5e. Developed economies' response to agricultural prices



Source: EFGAM calculations. Data as at 23 April 2021.

5f. Emerging economies' inflation response to agricultural prices



Source: EFGAM calculations. Data as at 23 April 2021.

2. The response of inflation to a shock on agricultural prices is similar in the two groups, but it is stronger in developed than emerging economies after a shock on activity and energy prices. Furthermore, in emerging economies, the estimated impact of a shock to economic activity is barely significant. One explanation of this counterintuitive result is that emerging market currencies tend to appreciate when the global business cycle improves, thereby dampening the inflation response to activity shocks.

3. The energy price shock is transmitted faster than the agricultural goods price shock. The peak impact is reached after 2 months in developed countries and after 4 months in emerging countries for an energy price shock and after 8 months and 10 months, respectively, for an agricultural price shock.

4. At the peak, the transmission of an energy price shock is about twice as high in developed as in emerging countries. In contrast, the response after an agricultural prices shock is similar in the two country groups. These results may be surprising considering the higher weight of these goods in CPI baskets in emerging than in developed countries. However, in several emerging countries commodity-related prices are centrally managed to preserve household purchasing power - commodity price shocks are absorbed into public accounts.

5. Considering the size of the three shocks recorded from December 2020 to April 2021, the expected impact on median inflation in developed and emerging countries is moderate. If the three shocks reached their maximum impact at the same time, median inflation would increase by 1.1 percentage points in developed countries and by 0.7 percentage points in emerging markets.

Conclusion

To conclude, these results support the view that despite the strengthening economy and large increases in energy and agricultural commodity prices, their impact on inflation in the coming months will be contained and will be largely absorbed within a few months.

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