Irma Rosenberg: Rising commodity prices

Speech by Ms Irma Rosenberg, First Deputy Governor of the Sveriges Riksbank, at SEB, Stockholm, 9 May 2008.

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A challenge for the central banks

What have we been able to read in the news in recent months? Let me give some examples.

Mining companies have begun prospecting for ore in many parts of Sweden, particularly in the Norrland region. Municipalities which have long experienced problems with emigration, such as Pajala, are now facing a more positive situation. Optimism has increased.

Increased trade barriers are being reported in some parts of the world. But this is not a question of what has been the usual case, where countries protect domestic industries by limiting certain exports. Instead they have introduced high charges to prevent exports of foods such as grain and rice.

We have also been able to read about demonstrations and food riots in poor countries such as Haiti, Cameroon and Burkina Faso. The UN food organisation FAO has also warned of social and political unrest in several countries.

Why am I taking up these examples? What have they got in common? Well, they are the result of one and the same phenomenon – that world market commodity prices have almost exploded in recent years. The high metal prices have made it profitable to search for ore and extract metals that earlier would have been left in the ground. High food prices have led to a reduction in purchasing power and social unrest in many areas. By limiting exports of foods and thereby keeping the supply in their own country many countries are hoping to be able to keep down domestic prices. The fact that this in turn risks pushing up world market prices even further and making the situation worse for some countries does not seem to carry any weight.

Commodity price rises of course have consequences for monetary policy. How will commodity prices develop, and what contagion effects will there be for other prices? These are questions that every central bank has to take into account when making decisions. It was also something we discussed at the Riksbank's most recent monetary policy meeting just over two weeks ago. I shall return to this shortly.

Why have commodity prices risen so much?

What is this sharp rise in commodity prices due to? As is often the case, it is difficult to point to any individual factor that will provide a complete explanation. Many factors have played a role. A product such as rice is, when one looks at it, rather different to a product such as oil. This would indicate that the driving forces have not been identical. But at the same time, the price increase has been so similar for so many different types of commodities that one can suspect there must be some common denominator.

Demand from emerging markets

One factor that has definitely been important is that emerging markets with a large population such as China and India have been increasingly integrated into the world economy. This was something that dampened inflation for a long period. Industrial nations were able to import cheap goods from emerging markets. At the same time, the increased international competition held back price rises on many domestic products. In this way the central banks were helped in keeping inflation at bay. For some central banks, including the Riksbank, the

problem was rather how to get inflation up to target level. But now there appears to have been a turnaround. The emerging markets' demand for energy and metals, but also food commodities, has grown and global inflation is beginning to be pushed up instead. This development is reinforced by some of these countries having price regulation that prevents the high world market prices from having an impact on the domestic market.

Supply effects and alternative use of agricultural products

But there are more explanations as to why prices have risen. Supply has not managed to keep up with demand. There were probably few who predicted the very rapid growth in the new economies. In addition there are natural rigidities regarding increasing supply. Quite simply, it takes time to progress from prospecting to mining. It is also possible to point to specific supply shocks. Poor harvests in many areas, such as Australia, have affected food prices. Here there is a possibility that climate effects have played a role. Political uncertainty in, for instance, Venezuela and Nigeria has had an effect on the oil price, to mention a couple of examples.

Food prices have also been pushed up as a result of alternative areas of use competing for the supply. Agricultural products are being used increasingly in the production of ethanol and other biofuels – and this development is also driven by the higher oil price.

Weak dollar, low interest rates and greater interest in commodities as an investment

Another factor that has certainly also been significant in the price rise is that the dollar has weakened. Commodities are usually priced in dollars and when the dollar depreciates commodities exporters want compensation. As demand has been strong, they have largely been able to do so, which has pushed up prices.

It is also possible that the low real interest rates have contributed to the rise in commodity prices. Commodities then appear to be a more interesting investment than interest-bearing assets. When the interest rate falls, it is also cheaper to keep stocks of commodities. However, it is doubtful whether the stocks have really increased recently.

The links that may exist between interest rates and commodity prices imply that there may be a link between monetary policy and pricing in the commodities markets, in addition to the influence via demand in the economy. There are also analysts who say that the interest rate cuts made by the US central bank, the Federal Reserve, have contributed to the price rises.[1]

In recent years, portfolio investment in commodities appears to have become an increasingly common means of diversifying and spreading risks. The expected return on many other types of asset has declined and inflation has begun to rise in many areas. As this has occurred, real assets such as commodities have appeared to be a good and safe investment – a "safe haven". This has reinforced the price rises.

Demand from emerging markets – a more long-term driving force

There are a number of interacting explanations as to why commodity prices have risen so sharply. It is hardly possible to say exactly how important each of them has been. However, one can say with some certainty that the persistence of the different driving forces differs somewhat.

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[1] See, for instance, Feldstein, M. "Enough With the Interest Rate Cuts", the Wall Street Journal, 15 April, 2008 and Frankel, J. "The Effect of Monetary Policy on Real Commodity Prices", NBER Working Paper No. 12713, 2006.

What I mean more specifically is that demand for commodities from emerging markets may well have pushed up and may also continue to push up prices more persistently than the other explanatory factors. After all, the emerging economies are undergoing a structural transformation, which will probably be under way for a long time. This could mean that demand for commodities will remain high in the future. One force that could hold back demand is if the price regulation applied by some of these countries begins to be perceived as too costly and is therefore abolished. If this happens, world market prices will have a greater impact on the domestic market. If this happens, it should dampen demand. The other explanatory factors – the weak dollar, the low interest rate, the increased interest in commodities as a form of investment and to some extent also the supply side restrictions – are reasonably of a more short-term, or cyclical, nature.

In the shorter term, it is of course possible that commodity prices will slow down as a result of weaker international economic activity. But the emerging economies' demand for commodities will probably remain as an underlying, long-term driving force that pushes up inflation. It is perhaps this international pressure on commodity prices and the risk of contagion effects on other prices and on wages that will be the first major test for the low-inflation policy.

How should monetary policy react in general?

What consequences will this have for monetary policy? One thing it is important to remember is that the rising commodity prices are examples of changes in *relative prices*. A relative price is the price of a particular product or group of products in relation to other prices. What has happened in recent years could be described as a global increase in the relative price of energy and commodities, such as food, in relation to manufactured products.

Inflation is due to long-term monetary policy, not relative prices

Changes in relative prices play an important role for how resources are allocated in a market economy. An increase in a relative price is a signal that resources have become scarce in a particular area in relation to other areas. It is therefore often profitable to invest there. It is exactly this type of market mechanism that appears when interest in mining increases and optimism rises in the parts of Sweden suffering from depopulation. In a corresponding manner, high food prices provide an incentive to begin cultivating previously unused land around the world.

There is thus reason to believe that the higher relative price will in the long term increase the supply of commodities, which will then better match the demand for them. However, the adjustment may take time. It remains to be seen whether supply will increase sufficiently to keep an even pace with world market demand. It is therefore difficult to predict how long relative commodity prices will continue rising.

But what is fundamental from a monetary policy perspective is that changes in relative prices do not in themselves constitute inflation. Inflation refers to general price levels, or the average of all prices, rising over time. The general price level is measured with some broader measure of prices, such as the consumer price index, CPI.

Monetary policy cannot and should not counteract changes in relative prices. But what central banks can govern in the long term is the way inflation develops. A change in relative prices can occur when there is low inflation as the price increases on the goods that become relatively more expensive are compensated for by low price increases or even falling prices on other goods. The same relative price change can occur with high inflation, when all prices rise rapidly but some more than others. But if commodity prices soar, this means that companies' costs will rise and inflation will be pushed up. For a central bank with an inflation target the task is then to use monetary policy to avoid secondary effects on wages and other prices and to counteract a rise in inflation expectations. If prices rise more quickly abroad

then a credible monetary policy should also lead to a stronger domestic currency, which contributes to limiting the impact on domestic prices. Managing price increases in a long-term perspective is actually a question of making well-balanced interest rate decisions at each individual monetary policy meeting.

The principles are simple…

So how should a policymaker reason at each monetary policy meeting when rising commodity prices are pushing up inflation? Describing what should be done in principle is fairly simple. Given the monetary policy system we currently have in Sweden, it involves trying to find a path for the policy rate that ensures inflation is reasonably close to the target while the real economy is in balance. This is how one should reason regardless of what shocks affect the economy. In this sense an upswing in commodity prices is nothing special.

…but their practical implementation is difficult

However, the practical implementation of the principles is far from simple. This is partly because it is no simple task to capture in the forecast all of the effects that rising commodity prices might have on the economy. It is also because monetary policy works with a lag. Rapid price impulses cannot be immediately counteracted. A further complication is that the effects on inflation and the real economy move in different directions. Inflation rises while the real economy, for instance, production and employment, slows down. It is not self-evident how these effects should be weighed against one another, but this is something that must be achieved in monetary policy.

The commodity price rises in recent years have caused inflation to rise in many countries. At the same time, growth in production and employment is slowing down. The slowdown is partly due to weaker international economic activity in the wake of the financial market turmoil and the downswing in the United States. But it is probably also partly due to the upturn in commodity prices. For example, higher commodity and food prices function roughly in the same way as a tax increase for households and dampen domestic demand. Price rises on energy and commodities also mean that companies' costs increase. This also tends to dampen production and growth.

In such a situation it is important to try to find a policy that is sufficiently tight to prevent inflationary impulses gaining a lasting grip. This is necessary to ensure that they do not spread to inflation expectations, wages and other prices. At the same time, the policy must be sufficiently loose to avoid unnecessary negative effects on production and employment. It is a difficult balancing act. To manage this in a way that provides a good growth in the economy that is sustainable in the long term requires that the credibility of the inflation target remains intact. This is the premise for formulating monetary policy.

If the expectations of inflation are pushed up and remain above the inflation target, there is a risk that they will become a self-fulfilling prophecy. And dealing with high and fluctuating inflation rates is often a very difficult and expensive process – for individual households and the economy as a whole. The oil price shocks in the 1970s are examples of how external inflationary impulses were allowed to gain a firm foothold and spread throughout the economy at the same time as economic activity was weak. The cost of dealing with this adjustment was high, not least because our competitiveness was undermined.

The consequences for Swedish monetary policy right now

What do the rising commodity prices mean for the interest rate decision we made a couple of weeks ago? What will it entail for future monetary policy if these price rises continue? Well, it is of course largely the balancing act I recently described. We Executive Board members must currently take into account in our deliberations the forces pulling the economy in

different directions. In Sweden economic activity is still fairly strong, but there are signs of a slowdown. We are also seeing weaker international developments and financial turmoil. In contrast, inflation and inflation expectations remain high. One can thus say that commodity prices are in a way in both scales of the balance. They are to some extent both behind the slowdown in economic activity and behind the high inflation and inflation expectations.

The way my Executive Board colleagues and I weighed together the various factors at the most recent monetary policy meeting resulted in our holding the repo rate unchanged at 4.25 per cent. We are also currently assuming that the interest rate will need to be held at this level in 2008 to manage the inflation target a couple of years ahead. Of course, commodity prices were important in our assessments. So let me therefore conclude by describing how I myself reasoned in connection with the interest rate decision.

Rising prices

All in all, inflation has largely developed in line with the forecast in the February Monetary Policy Report. The consumer price index, CPI, increased by 3.4 per cent in March. This is an inflation rate well in excess of the target of 2 per cent. A large part of the upturn in the CPI – close to one percentage point – is linked to an increase in mortgage interest expenditure for home-owners and thus to the interest rate increases made by the Riksbank over the past two years.

However, the upturn is also due to the rapidly rising commodity prices in the world market. This became clear in autumn 2007 in particular. CPI inflation then rose by just over 1.5 percentage points in just a few months. The primary reason was higher commodity prices. When such rapid price impulses from abroad have an effect on inflation, monetary policy is unable to counteract them immediately. Moreover, it may be very difficult, if at all possible, to predict this type of fluctuation. This is why one cannot expect to avoid effects on inflation like those we have seen recently.

A balancing act

Now, as I have said, both we and other central banks have to manage the balancing act I described. The Riksbank’s statutory target is price stability, and we must conduct monetary policy so that inflation attains the target of 2 per cent within a couple of years. If we manage this, we can also try to influence cyclical fluctuations in, for instance, production and employment. As I said, this sounds simple but we now have to manage the fact that the commodity price rises are on the one hand pushing up inflation and on the other hand dampening growth. A tight monetary policy could contribute to dampening inflation. At the same time, it would restrain real activity in the economy in a situation when economic activity is slowing down.

The decision is not made easier by the fact that it is difficult to capture and predict all of the effects of an increase in commodity prices on the economy and – not least – how persistent the price impulses will be. If it is a question of temporary effects on inflation, these need not be counteracted by monetary policy.

Sometimes one hears the argument that the Riksbank should not try to counteract price increases that are impossible to stop. One such example is the rising world market price for oil. But even prices we have little possibility to affect, other than to the extent that the exchange rate is affected by monetary policy, are included in the basket of goods that measures consumer prices. This is of course because they affect households’ purchasing power. A price impulse can gain a foothold and have long-lasting effects on inflation regardless of where it originates. And the central bank must parry long-lasting effects, whether the impulses come from wages, food prices, oil or something else.

The outlook is far from certain…

In the forecast we published just over two weeks ago we assume that the rapid commodity price rises are partly temporary and that they will subside in the future. We are also expecting the krona to be strong. This will contribute to inflation falling. But of course this is uncertain, not least for the reasons I took up earlier this morning. If the international price impulses were to become stronger and longer lasting than expected, inflation would of course be higher. But as I see it, it is not impossible that the international price rises will instead be lower than expected. This would push down inflation more quickly. One possible reason for this would be if international economic activity slows down more quickly than anticipated. We have highlighted these risks in earlier reports.

A further factor, which in my opinion contributes to the uncertainty in the assessment, is the increased interest in portfolio investment in commodities. If the expectations of future return on such investments alter, it could contribute to a more sudden slowdown. And this would gradually affect consumer price inflation.

It is also possible that such an effect – that capital is withdrawn and invested in other assets – has contributed to the price of wheat falling more rapidly recently. With regard to movements in the commodity markets since the previous forecast, prices have moved in slightly different directions. Pricing in different forward markets currently gives a slightly divided picture of what direction prices will take. The oil price has risen more than expected and forward rates imply that it may remain at a higher level. At the same time, the world market price for certain foods and metals has fallen in recent weeks, for instance, the price of wheat, meat and aluminium. However, the price of some other foods, such as rice, has risen recently.

…but we must nevertheless take a stance

But regardless of whether the international price impulses are temporary or more lasting, they must not be allowed to push up inflation permanently! In my opinion, the risk of this has increased in that inflation expectations have risen during the autumn. According to Prospera's survey in April, however, expectations have fallen slightly. The National Institute of Economic Research's Consumer Tendency Survey also indicates that households' inflation expectations have been adjusted downwards since the February report.

But expectations are still a little too high, particularly in the longer term. And this was one reason why I voted to hold the repo rate unchanged at 4.25 per cent at our most recent meeting. Other important factors behind my stance were that, according to our forecast, inflation will overshoot the target for a good while to come, at the same time as growth remains fairly robust. Weighing together these factors also indicated that the interest rate may need to remain at its current level for some time to come. But at our meeting I also emphasised the risks of a weaker outcome in the long run, particularly as a result of the financial turmoil and the slackening in international growth. For me these factors weighed slightly heavier than the risks of a higher inflation rate in the future. I therefore did not rule out the possibility that the interest rate may need to be cut later in the forecast period.