Global Food and Oil Crisis: Its Impact on Domestic Inflation and Monetary Policy Implications

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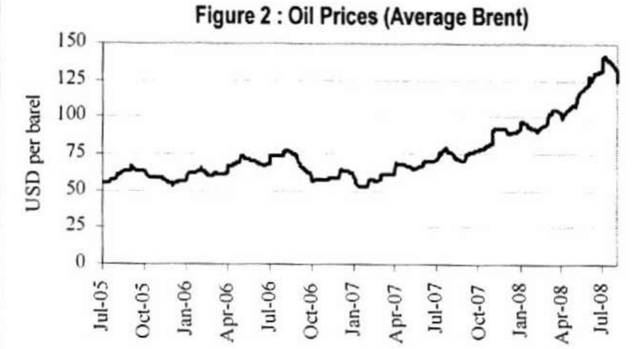
Abstract

The sharp increases in food prices coupled with oil price hikes have resulted in a global turbulence posing risks to macroeconomic stability in many countries, particularly in emerging and developing countries. These macroeconomic impacts include adverse effects on terms of trade and balance of payments, fiscal performances, and especially on inflation. Both developed and developing / emerging countries have experienced a substantial acceleration in inflation during the recent past, particularly since the latter part of 2007. The long run inflation is essentially caused by demand pressures in the economy, which are primarily driven by excessive monetary expansion and hence curbing long run inflation entirely relies on the containment of money growth and also improvements in productivity. However, when inflation is driven by supply side and external shocks, different policy prescriptions may be deemed as appropriate. Sri Lanka was one of the worst hit countries by the surge in international food and oil prices during the recent past. Although demand pressures fuelled by past monetary expansion have contributed to inflation, the recent movements in inflation in Sri Lanka are largely explained by supply side and external factors. Against high inflation, the Central Bank of Sri Lanka adopted a tight monetary policy stance during past few years to contain demand driven component of inflation and also to prevent second round impacts of supply side and external shocks. This article examines the impact of twin shocks, i. e., food price shock and oil price shock on inflation in global and Sri Lankan context and elaborates various policy prescriptions, particularly in view of monetary policy implications.

Global Food and Oil Crisis

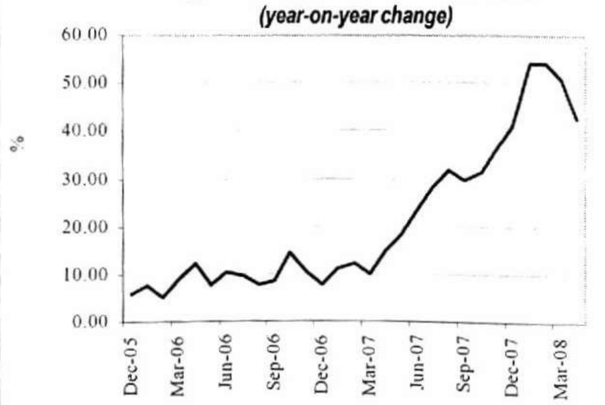
A phenomenal increase in food prices was observed recently, particularly during the latter part of 2007, causing severe threats to economies and imbalances in many macroeconomic variables in many countries. Since the start of 2006, the average world price for rice has risen by 217%, wheat by 136%, maize by 125% and soybeans by 107%. By January 2008, the Global Food Price Index compiled by the Food and Agricultural Organisation (FAO) reached the peak of 200 index point recording an increase of 54% on a year-on-year basis (Figure 1). The increase was only 11.2% at end January 2007 (FAO, 2008).

Figure 2 : Oil Prices (Average Brent)



Source : Reuters

Figure 1 : FAO Global Food Price Index (year-on-year change)



Source : Food and Agricultural Organisation

Several factors have contributed to this rise in food prices. They are poor harvests in various parts of the world, increasing bio-fuel usage and transformation of cultivable land for producing energy-related crops due to increase in global oil prices, lowering food reserves, changes in preferences to invest in food commodities by some countries particularly the USA, and growing consumer demand, particularly in Asia. At the same time, oil prices in international markets rose substantially during the recent times (Figure 2). During 2005-2007, average Brent oil prices increased by 60% while the increase was nearly 130% during the period, end 2005 to July 2008 (Reuters, 2008).

The surge in oil prices was due to both demand and supply side factors. On the demand side, the increase in oil prices was driven by the buoyant economic performance in many developed and emerging countries, particularly in Asia. World crude oil demand grew at an average rate of 1.8% per year from 1994 to 2006, while the rate was as high as 3.4% during 2003-2004. The transportation sector is the largest energy consumption sector, and has contributed largely to the rapid growth in demand in recent decades. At the same time, an important contributor to price increases has been the slow down in oil supply growth, which has continued since oil production surpassed new discoveries in 1980. Besides demand boost and supply concerns, many other issues such as labour strikes, hurricane threats to oil platforms, fires and terrorist threats at refineries, and other geo-political tensions have also had some effect on oil prices.

[1] *Views expressed in this paper are those of the author and do not necessarily represent the views of the Central Bank of Sri Lanka.*

Impact of Twin Shocks

Higher food and oil prices have serious macroeconomic impacts across countries, including adverse effects on terms of trade and balance of payments, fiscal positions, and mainly on inflation.

Table 1
Inflation in Selected Economies

%

Period End	USA	UK	ECB	Canada	Australia	Korea	Malaysia	Thailand	India	Pakistan	Sri Lanka
Dec-05	3.4	1.9	2.2	2.2	2.4	2.7	3.3	5.8	3.9	8.5	7.4
Jun-06	4.3	2.5	2.5	2.5	4.0	2.6	3.9	5.9	5.2	7.7	10.6
Dec-06	2.5	3.0	1.9	1.6	3.3	2.1	3.1	3.5	5.6	8.9	13.5
Jun-07	2.7	2.4	1.9	2.2	2.1	2.5	1.4	1.9	4.3	7.0	13.5
Dec-07	4.1	2.1	3.2	2.4	3.0	3.7	2.5	3.2	3.8	8.7	18.8
Jun-08	5.0	3.8	4.0	3.1	4.5	5.5	7.7	8.9	11.6	21.5	28.2

Source: Web sites of respective Central Banks

The adverse impact of twin shocks could worsen the trade account, current account, balance of payments, reserves and finally pressurise the exchange rate. As per the International Monetary Fund's (IMF) estimates, because oil imports are 2.5 and 2 times larger than food imports for low-income countries and middle income countries respectively, the oil price increase has a larger balance of payments impact than that of the food price. Accordingly, oil price rise would severely weaken the external position of 81 countries, while the food price increase would have a severe negative effect for 16 countries, and the combined price increases for 72 countries (IMF, 2008). However, it was also observed that a number of countries that have negative oil price shocks could be compensated by gains from the food price increase as it gives better incentive to enhance production levels.

Spikes in food and oil prices have tempted fiscal authorities to take actions in view of creating safety nets for most vulnerable groups. These actions mainly include increasing salaries and wages, reducing taxes and tariffs, providing subsides and expanding transfers, etc. According to the IMF, roughly half of the countries surveyed by them reports a net increase in fiscal cost stemming from remedial and safety measures, with a median annualised increase of 0.6% of gross domestic product (GDP) during the period 2007-08. Also, for about one-fifth of the countries, the fiscal costs exceed 1% of GDP and the largest increases were driven by expansions in oil price subsidies (IMF, 2008).

Both developed and developing/emerging countries have experienced a substantial acceleration of inflation during the recent period, particularly since the latter part of 2007 (Table 2) [2]. According to the IMF, in some of these countries, inflationary impact of rising food and oil prices were amplified by continuing demand pressures (IMF, 2008). In most of the countries, particularly low income countries, inflation was mainly driven by high prices of staples, mainly due to surge in prices of imported essential food items. At the same time, inflation accelerations were mainly associated with substantial adjustments in energy prices.

More importantly, increase in prices have serious impact on poverty levels of people as food and oil price increases undoubtedly affect the vulnerable - low income groups in a society. Although rising both food and oil prices have adverse effects on poverty; the main concern is high cost of food, especially for the urban poor. The main reason is that the share of household expenditure on food is higher than that of oil-related products and services, particularly in emerging and developing economies. According to estimates, 1 billion very poor people, who sustain themselves on one US dollar or less a day, are tremendously hit as price increases have doubled the cost of their food. Therefore, the impact, particularly the impact of food price increase for poor is very high and painful.

Facing the Shock

Price increases due to demand pressures, which accelerated as a result of increase in money availability, need to be addressed through monetary policies. Since, the long - run inflation is a monetary phenomenon, cubing inflation is entirely rely on containing money growth and also increasing productivity. However, when inflation is driven by supply side shocks and external turbulences, different policy prescriptions may be deemed appropriate.

In most cases, subsides and transfers are considered as most appropriate way of tackling price increases due to supply and external shocks. However, the strategy to protect the domestic prices using subsidies, transfers and price controls is inevitably creates further problems. For example, if governments use inflationary - banking sector financing to subsidise selected food items, it would ultimately raise the overall price level. On the other hand, if the required resources are raised from non-bank sector, it would crowd-out investments and affect the future economic growth. The important fact is that the largest beneficiaries of subsidies are the high-income brackets who consume more, but not the poorest segments. At the same time, price controls may create a food shortage within the country while export bans will maintain the domestic prices lower in the short-run, but it will not encourage production. The most appropriate policy in a long-term perspective would be to pass the shock to domestic prices, except for any directed subsidies or transfers.

At the same time, monetary accommodation should be removed and monetary policy may be tightened despite the increase in prices is due to supply side and external factors. The following extracts justify the monetary tightening or non-relaxation of monetary policy stances in such a context:

> *"At the same time, **monetary policy should be sufficiently tight** to prevent the first-round effects of higher food and fuel prices on inflation from spilling over to higher prices of other goods and services (second-round effects; as higher inflationary expectations may trigger a wage-price spiral). This is particularly important for countries where inflation has already been rising because of overly expansionary macroeconomic policies." (IMF, 2008)*

> *"In addition to the market adjustment of fuel prices, should a central bank continue with tight monetary policy when a country has been hit by a severe external shock? Or in the alternative, should a central bank not relax monetary policy to permit the economy to get into a higher growth path? ..... The external shock in the form of higher fuel prices raise the overall costs in the economy. Higher costs make production uncompetitive and cause the economy to move to a lower output level. The resultant economic recession and high unemployment would increase the welfare costs to a significant level. But, the way out for an economy in such a situation is not through monetary policy, but through real adjustments such as improvement in productivity and moving into less energy intensive production*

methods. This real adjustment, though somewhat painful and difficult, has to be made by an economy in its own long term interest....

What would happen if central banks relax monetary policy when a country is hit by a negative output shock arising from an increase in fuel prices? First of all, it causes the economy to postpone the required real adjustment, because the monetary policy incentive acts as a temporary veil placing businesses in a false sense of complacency. The more disastrous outcomes yet to happen in the future as a result of low productivity and high costs would be temporarily hidden from the vision of all. As a result, the long term sustainability of economies concerned would be at stake. Second, the relaxed monetary policy would cause to build inflationary pressures by increasing the nominal aggregate demand over and above the already constrained aggregate output. Consequently, the long term inflation that is set in the economy would worsen the position of businesses by raising the other costs as well. Hence, ***monetary incentives are not the solution to negative real shocks in an economy****"(Wijewardena, 2008)*

The basic premise of the above two statements are straight forward: When country is facing negative external shock, monetary policy should be tightened enough and there should be a real adjustment with a long term interest. At the same time, some policy makers agree on tracking the core inflation, which is called underlying inflation freed from noise or undue price volatility rather than merely looking at headline inflation. They argue that core inflation is easily understood by the people and it provides some greater signal about persistent movements in inflation than headline inflation and therefore it is extremely valuable for the conduct of monetary policy.

"When headline inflation has an important transitory component, a focus on core measures can help avoid monetary policy mistakes. If the monetary authorities react to headline inflation numbers, they run the risk of responding to merely temporary fluctuations in inflation. We can think about this danger by considering a supply shock that causes the relative price of energy to increase sharply, as in fact has happened over the past three years. Let us suppose that we start out with both headline and core inflation at acceptably low levels.

First, let's consider a supply shock that temporarily raises the price of energy by a large amount. In this case headline inflation will rise well above its underlying trend as the price of energy rises but will soon fall well below its underlying trend as the price of energy falls back to its initial level. On average, inflation will remain unchanged without any monetary policy action. But a tightening of monetary policy in reaction to the rise in headline inflation would lead to a decline in employment and inflation; and because of the long lags between monetary policy actions and changes in economic activity, that decline would occur sometime down the road, when inflation would more likely be at or below its underlying trend. The outcome of such a policy would be a more pronounced fall in inflation with a decline in employment. Such a policy would be bad indeed because it would increase volatility in inflation and employment, which is the opposite of what a central bank should be trying to achieve as it seeks to promote price stability and maximum sustainable employment.

But what if a supply shock leads to a permanent shift in the relative price of energy? Indeed, almost all commentators characterise the current oil price shock that way, in part because they see the rise of new economic powers like China as adding to the demand for energy in the foreseeable future. Although in that case the rise in relative energy prices is not reversed, the rate of change in energy prices does not persist: Headline inflation will rise with the increase in energy prices, but once energy prices reach their permanently high level, headline inflation will revert to its underlying trend rate. Thus, as long as the permanent change in relative energy prices does not lead to a change in the underlying trend rate of inflation—a crucial assumption—then headline inflation will come back down again....

Monetary policy clearly can do little about the first-round effects of a permanent rise in energy prices, which include both its direct impact on the energy component of overall consumer prices and the pass-through of higher energy costs into prices of non-energy goods and services. ***But policy does have a critical role to play in determining the second-round effects associated with changes in the underlying trend rate of inflation****. Such second-round effects are likely to be quite limited as long as the rise in the relative price of energy does not lead to a rise in long-run inflation expectations, as has largely been the case in the recent period. However, the stability of expectations rests on the central bank's strong long-term commitment to provide a nominal anchor. With such a commitment firmly established, monetary policy then does not need to respond as much to the temporary rise in headline inflation to stabilize inflation over the longer run. Under these circumstances, if monetary policy is tightened appreciably in the face of a surge in headline inflation, the policy would likely be excessively tight and lead to an unnecessary decline in employment (Mishkin, 2007).*

Responses of Various Parties

The responses by the general public to the increase in prices have been aggressive in nature, particularly in low income countries. In countries that affected largely by price rises, particularly in Asia and Africa, protests and riots were seen in late 2007 and early 2008 over the unavailability of basic food staples.

Governments have responded mainly through fiscal policies. As mentioned above, most of the governments have introduced measures including reduction of taxes and tariffs imposed on fuel and food commodities, increase of subsidies, expansion of transfer programs, and increase of public-sector wages. Also, several countries adopted various policies including export restrictions and export taxes focused on key food commodities such as rice and cereals. For example, to ensure the food security for domestic populations and to combat dramatic price inflation, major rice exporters, such as China, Brazil, India, Indonesia, Vietnam, Cambodia and Egypt, have imposed strict export bans on rice. At the same time, some countries including Argentina, Ukraine, Russia, and Serbia have either imposed high tariffs or blocked the export of wheat and other foodstuffs.

At the same time, authorities who are responsible for monetary policies have taken steps to mitigate or hedge mainly against the second round impact of undue price increases. Most of the countries have taken actions to tighten monetary policy in view of rising demand pressures, which already had elevated levels of inflation before the recent acceleration of international food and oil prices (e.g., Ghana, Egypt, Pakistan, and Sri Lanka). However, the sharp increase in food and oil prices has raised headline inflation and it has become the major and increasing concern despite the tightened monetary policy. Most of the monetary authorities were concerned about not allowing the first-round effects of higher food and oil prices on inflation to spill over to higher prices of other goods and services, which is called second-round effects.

As per the IMF, many countries have allowed the pass-through of the first-round effects of food and fuel price increases. At the same time, although monetary policies were already tight, most countries further tightened monetary policies in order to prevent the second round impact of one-off price. Accordingly, in many countries, monetary policy has responded to the risks of food and oil price inflation (Table 2).

However, Sri Lanka was one of the worst hit countries by the surge in international food and oil prices during the recent past. Higher international food and oil prices have put upward pressures on the cost of living, both directly and through their potential impact on nonfood prices. Hence, the recent movement in inflation in Sri Lanka is largely explained by supply side and external factors. Reflecting the impact of these, Sri Lanka's inflation as measured by the Colombo Consumers' Price Index (CCPI, 2002 = 100) increased substantially, particularly during the latter part of 2007 and first half in 2008. Accordingly, inflation as measured by the year-on-year change in the CCPI increased from 13.5% by end 2006 to 18.8% by end 2007 and further to 28.2% by June 2008. At the same time, annual average inflation also increased from 10% to 15.8% during end periods of 2006-2007 and further to 21% by June 2008.

Some would think why only Sri Lanka hit worst by such price increase and why not others in the world and the region. Obviously, as mentioned earlier, most of the advanced and developing/emerging countries severely hit by price increases and the impact were felt at different magnitudes. The pass-through of international prices to domestic prices in different countries varies depending on several factors and the impact on Sri Lanka's inflation was higher due to several reasons.

First, although food has relatively small share in consumer baskets in developed countries, it is relatively high in many developing/emerging countries. For example, the weight of food in the consumption basket is 17% in Canada, 16% in the Euro zone, and 11% in the UK where as 57%in Ethiopia, 48% in Vietnam and 31% in China. According to the IMF estimates, on average, food accounts for a share of 37% in non – OECD[3] countries. In Sri Lanka, food has a weight of 47% in the revised CCPI (Figure 3).

Table 2
Policy Interest Rates in Selected Economies*

Per cent

Period End	USA	UK	ECB	Canada	Australia	Korea	Malaysia	Thailand	India	Pakistan	Sri Lanka**
Policy Interest Rates											
Dec-04	2.25	4.75	2.00	2.50	5.25	3.25	2.70	2.00	4.75	7.50	7.50
Dec-05	4.25	4.50	2.25	3.25	5.50	3.75	3.00	4.00	6.25	9.00	8.75
Jun-06	5.25	4.50	2.75	4.25	5.75	4.25	3.50	5.00	6.75	9.00	9.00
Dec-06	5.25	5.00	3.50	4.25	6.25	4.50	3.50	5.00	7.25	9.50	10.00
Jun-07	5.25	5.50	4.00	4.25	6.25	4.50	3.50	3.50	7.75	9.50	10.50
Dec-07	4.25	5.50	4.00	4.25	6.75	5.00	3.50	3.25	7.75	10.00	10.50
Jun-08	2.00	5.00	4.25	3.00	7.25	5.00	3.50	3.25	8.50	12.00	10.50

*US and many other countries lowered interest rates in 2008 in view of slowing down of economies due to global financial turbulence.
**Sri Lanka has broadly relied on monetary tightening through reserve money control

Source: Web sites of respective Central Banks.

Impact on Domestic Inflation

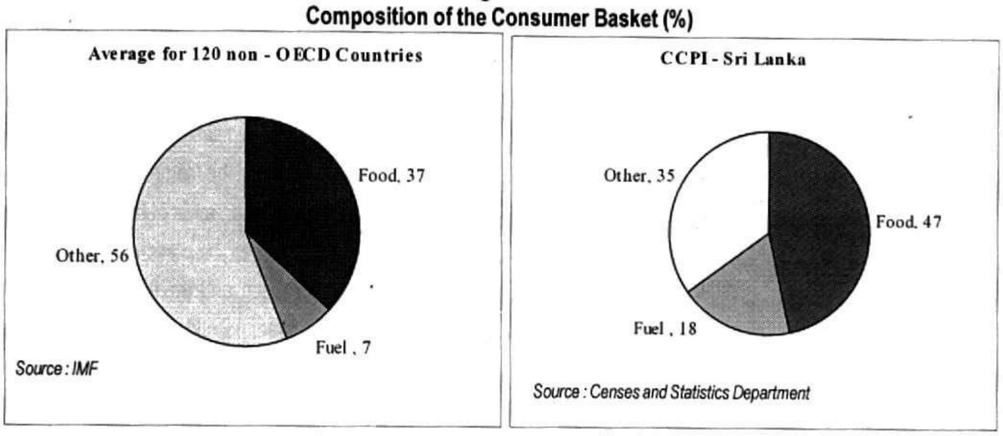
There was some pressure to increase in inflation since 2004 mainly due to demand pressures driven by the monetary accommodation prior to that period. However, foreseeing the emanating inflationary pressures, the Central Bank of Sri Lanka (CBSL) began to tighten monetary policy since late 2004, mainly using instruments such as policy interest rates and open market operations supported by some prudential measures and moral suasion (Box 1). These measures were instrumental in curbing demand-driven inflationary pressures and results were witnessed as headline inflation was coming down during the first half of 2007 and core inflation remaining at single digit levels throughout in 2006 and 2007 due to the lagged effect of tight monetary policy.

Box 1

Policy Measures taken by the Central Bank of Sri Lanka to curtail Inflation

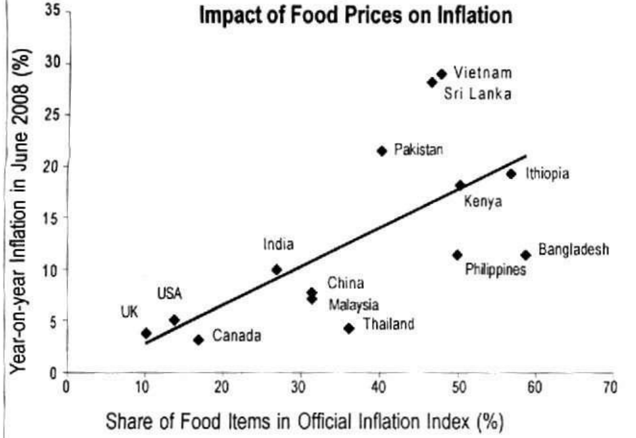
- *Policy interest rates of the Central Bank, which were raised by 300 basis points during the period 2004- 2006, were further raised by 50 basis points in 2007.*
- *More stringent reserve money targets were determined for 2007 and 2008 and targets for 2008 were revised downwards twice in 2008. Point targets of reserve money were changed to quarterly average targets.*
- *More emphasis was placed on conducting Open Market Operations aggressively, while imposing certain limits on the provision of the Reverse repurchase facility by the Central Bank (since November 2007, access by both commercial banks and primary dealers of the Reverse repurchase facility was limited to 3 times per month per institution. It was allowed access beyond this limit at a penal interest rate of 19%. However, limits on access were enhanced to 10 times and Statutory Reserve Ratio on domestic rupee deposits was lowered from 10.00% to 9.25% in October 2008 to provide additional liquidity to the market in order to avoid undue liquidity constraints)*
- *Margin requirement on Letters of Credit for the import of several categories of vehicles, luxury items and non-essential items on Documents on Acceptance (DA) terms were imposed.*
- *Several prudential measures were also introduced to contain high credit expansion:*
    - *A general provisioning requirement of 1% was imposed on all performing advances of commercial banks*
    - *When computing capital adequacy risk weights, in respect of loans secured by primary mortgages over residential properties were increased from 50% t 55%*
- *Moral suasion was used to discourage undue credit expansion.*

Figure 3
Composition of the Consumer Basket (%)



When the share of food is substantially high in the consumer basket, the first-round contribution of direct food inflation to total inflation is significant (Figure 4). At the same time, food prices could also increase headline inflation indirectly by raising nonfood prices. It was clearly observed that the impact of food inflation was significantly high in Sri Lanka, particularly in 2008.

Figure 4
Impact of Food Prices on Inflation



Second, the share of imported items is also high in many developing countries. If a country imports a larger share of its food consumption, compared to its domestic production, the pass-though is usually high unless government tariffs are not adjusted downwards. The impact could be much higher depending on exchange rate impact, tariff structure and magnitude of government subsidies/transfers. It was observed that the impact of imported inflation was gradually rising in Sri Lanka in recent times, particularly in 2008 (Figure 5 & 6).

Third, removal of fuel subsidies had a substantial impact on inflation during the recent past. Sri Lanka's inflation has been suppressed to a certain extent in the past through subsidised fuel prices. Since those prices have been adjusted in line with international market prices, a one-off increase in inflation appeared.

Sri Lanka was one of the first developing countries to adjust the fuel prices according to world oil prices (Table 3) while removing subsides in order to ease burden on the government fiscal operations and thereby future inflation and also to dampen the demand for oil. Hence, a significant fraction of Sri Lanka's inflation was further driven by the one-off adjustments in fuel prices particularly during the second half of 2007 and first half of 2008 in view of substantial increase in international oil prices (Figure 7).

Figure 6
Movements in Domestic and Imported Inflation (Year on Year change)

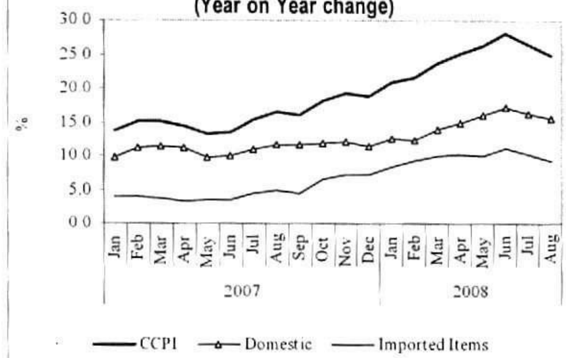


Table 3
Price Revision of Petroleum Products in Sri Lanka : 2006-2008 (Rs. per litre)

Date	Petrol (90 Octane)	Auto Diesel	Kerosene
15 /04/06	88.00	58.00	38.50
10/06/06	93.00	61.00	43.50
01/08/06	96.00	64.00	45.50
04/09/06	101.00	67.00	48.00
27/09/2006	99.00	64.50	-
05/10/06	97.00	62.00	-
25/10/2006	92.00	60.00	-
05/01/2007	97.00	-	-
30/03/2007	104.00	-	-
19/04/2007	-	63.00	50.00
28/04/2007	105.00	65.00	
12/05/2007	106.00	67.00	51.00
30/6/2007	111.00	71.00	67.00
29/07/2007	117.00	75.00	68.00
14/01/2008	127.00	80.00	70.00
25/05/2008	157.00	110.00	80.00

Source: Ceylon Petroleum Corporation

Figure 5
Impact of Domestic and Import Components to CCPI

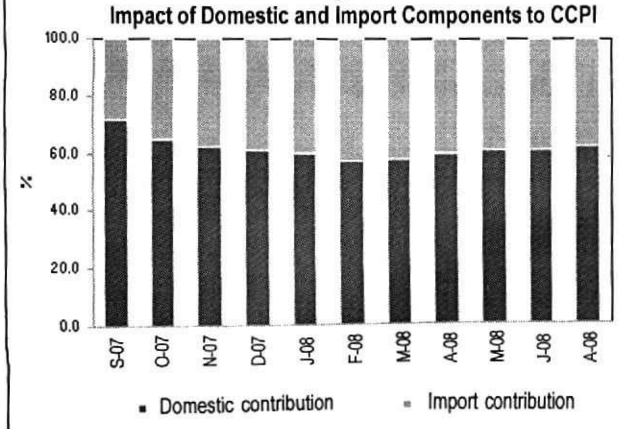
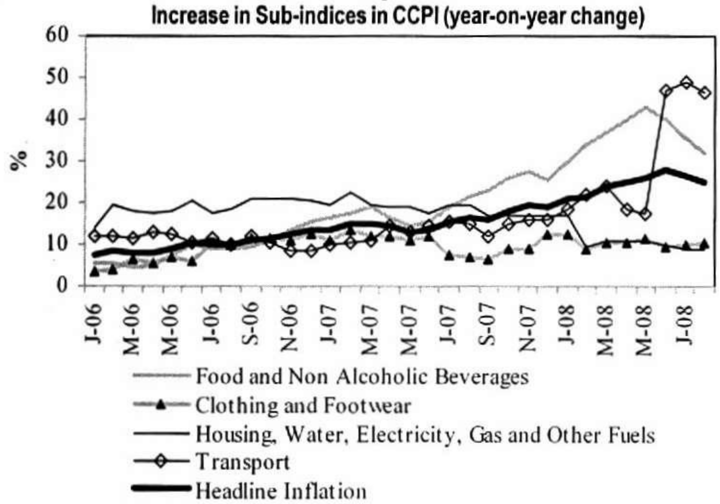


Figure 7

Increase in Sub-indices in CCPI (year-on-year change)



Source : Census and Statistics Department

Hence, Sri Lanka's inflation reflected the true impact of the external shock, unlike the inflation in many other countries where the inflation is partially suppressed through direct subsidies and price controls.

A recent study of the IMF examined the causes of inflation in Sri Lanka and used statistical analysis to investigate the magnitude of external shocks on Sri Lanka's inflation. An official statement released by the IMF on this study confirmed that the impact of monetary and fiscal expansion on inflation would be lower than 16% captured by the study and that the impact of food and energy prices could be much higher as food and energy prices rose sharply and monetary and fiscal policies were tightened further since July 2007 (IMF, 2008).

Policy Responses by Sri Lankan Authorities and Conclusion

The strategies followed by Sri Lanka were mainly passing the shock to domestic prices without direct subsidies, focusing to increase the agricultural production and ensure food security, reducing import tariff[4] aiming to protect vulnerable groups and providing directed subsidies. Accordingly, by advocating the policy of passing-off the food and fuel price shock to domestic prices, except for any direct subsidies, authorities have shown that their intention is to pursue the most appropriate policy in a long-term perspective CBSL also continued with more tighter monetary policy stance in order to curb inflation through reducing the expansion in money and credit and containing inflation expectations and to provide a clear signal to the economy on its intention on taming inflation. As such, the CBSL was particular to implement more stringent reserve money targets for 2008, and by monitoring developments in money and credit aggregates and other macroeconomic variables, the CBSL revised targets in order to contain the second round impact of food and oil price increases. At the same time, the CBSL and the other government authorities articulate the need for improving productivity to tame long run inflation, which can be considered a real adjustment to face negative shocks. Such actions would contribute to lower the long-term inflation in a sustainable manner.

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Footnotes

[2] *Many countries were facing their highest recorded inflation figures by mid 2008. Accordingly, inflation in Pakistan*

- *highest in 30 years, Singapore*
- *highest in 25 years, US*
- *highest in 17 years, EU*
- *highest in 16 years, UK*
- *highest in 16 years, India*
- *highest in 13 years, Japan*
- *highest in 10 years, and Australia*
- *highest in 7 years.*

[3] *OECD is a groups 30 member countries committed to democracy and the market economy. Members are Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak republic, Spain, Sweden, Switzerland, Turkey, United Kingdom, and United States.*

[4] *In August 2007, Sri Lankan government introduced a single specific customs duty on ten selected food items instead of surcharge on imports, Value Added Tax, Social Responsibility Levy, Cess, Port and Airport Development Levy and other charges applicable them to ease the pressures on prices and provide a relief for vulnerable groups.*

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