

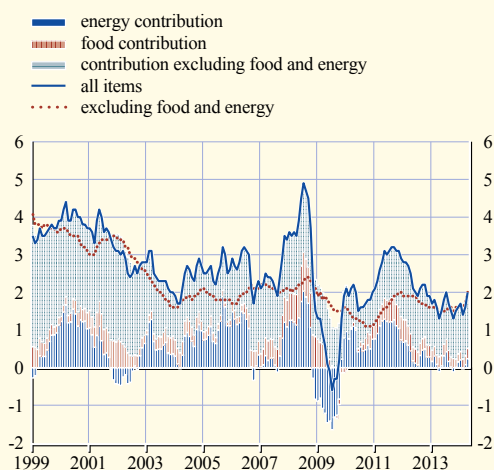
Box 2

COMMODITY PRICE DEVELOPMENTS AND THEIR IMPLICATIONS FOR GLOBAL INFLATION

The decline in global inflation in recent years is largely explained by a drop in the contribution of energy and food prices. OECD headline inflation declined from a high of 3.2% in the summer of 2011 to a low of 1.4% in February 2014, before increasing slightly again (see Chart A). Over four-fifths of this decline is attributed to reduced contributions from the food and energy components. This box discusses the drivers of this reduction in the contributions of energy and food prices to inflation, assesses the outlook for commodity prices on the basis of recent developments and discusses the implications for global inflation.

Chart A Contribution of energy and food prices to OECD inflation

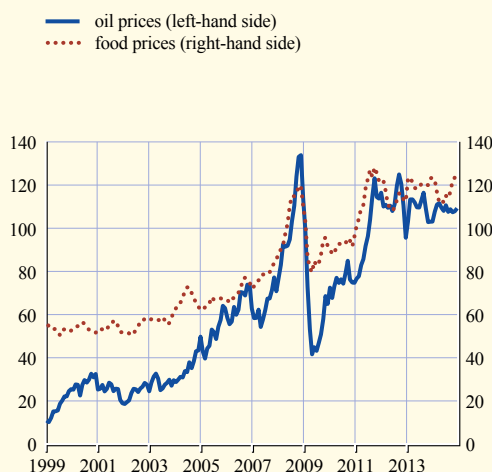
(annual percentage changes; percentage points)



Sources: OECD and ECB staff calculations.
Notes: Monthly data; the latest observation is for April 2014. The calculation of the contributions is based on ECB staff calculations.

Chart B Oil and food prices

(USD per barrel; index: 2010=100)



Source: IMF.
Note: Monthly data; the latest observation is for May 2014.

Factors behind the recent stability in commodity prices

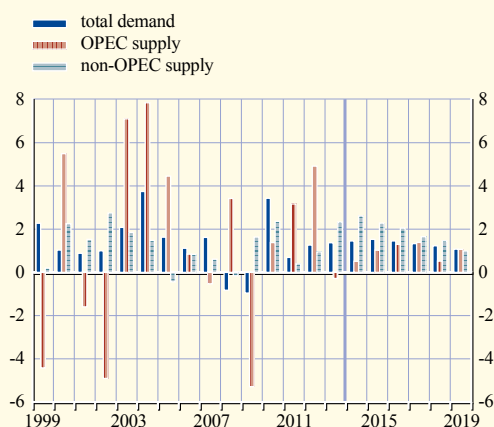
From 1999 onwards there was a broad-based increase in international oil and food prices, which was interrupted by the 2008 financial crisis (see Chart B).¹ The upward trend observed in oil and food prices is largely explained by increasing demand for commodities owing to strong economic growth in emerging economies, in particular China. Combined with somewhat lagging supply, the steep rise in demand for commodities pushed up oil and food prices sharply. This upward trend in commodity prices was reflected in the almost constantly high contribution of energy and food prices to OECD inflation, averaging 1 percentage point over the period 1999-2008 (see Chart A).

In stark contrast to this upward trend, oil and food prices have been broadly stable since 2011 (see Chart B). This reflects changes on both the supply and the demand side. With regard to the supply side, the high levels of oil and food prices have encouraged investment, which has led to an increase in the production of these commodities and, in turn, to better-supplied commodity markets. This is particularly notable in the case of the oil market, where technical innovations combined with high oil prices triggered the shale oil revolution in North America, thereby boosting non-OPEC oil production (see Chart C). As far as food prices are concerned, owing to good weather conditions, among other things, there was an excess supply of cereals, for example, as supply rose strongly in the aftermath of severe weather-related shortages in 2012, leading to higher prices and boosting production. As regards the demand side, while the acceleration of growth in emerging economies was the main driver behind the steep rises in oil and food

¹ For the energy contribution, the focus is on oil prices, as these constitute the largest component of energy inflation and are also most subject to price changes.

Chart C Demand and supply developments and projections in the oil market

(annual percentage changes)



Source: International Energy Agency (IEA).
 Notes: The values from 2014 refer to IEA projections (based on the June Medium-Term Oil Market Report). As projections on OPEC production are not available, the projections for OPEC refer to OPEC crude capacity.

Chart D Commodity price changes and real GDP growth in emerging market economies

(annual percentage changes)



Sources: Haver Analytics and IMF.
 Note: The commodity price index contains all primary commodities.

prices over the period 1999-2008, growth in these economies has since slowed (see Chart D). Although the level of oil demand continues to be high, growth in the demand for commodities is moderating. To sum up, since 2011 slowing growth in demand together with favourable supply developments have prevented oil and food prices from increasing at similar rates to those observed from 2003. Instead, notwithstanding some short-run volatility, oil and food prices have remained broadly stable. Taking into account the transmission lag to inflation, these commodity price changes have caused the contribution of oil and food prices to global inflation to decline since 2013, reaching 0.4 percentage point on average since 2013, compared with 1 percentage point in the preceding decade.

The outlook for oil and food prices

Turning to the outlook for commodity prices, the recent supply and demand-side developments suggest that, compared with the period in which demand-related tightness continuously pushed prices upwards, a better-supplied commodity market can be expected.

In the case of oil prices, the International Energy Agency (IEA) expects the oil market to remain well balanced over the next five years, as growth in oil supply is projected to surpass growth in oil demand (see Chart C). On average, according to the IEA's projections, oil demand will grow at 1.3 million barrels per day (mb/d) each year compared with an average projected growth in oil supply capacity of 1.5 mb/d each year. On the demand side, growth in oil demand is expected to remain relatively steady, in part because the growth in demand from China is expected to decline (China's contribution to global oil demand growth is expected to drop to 30% over the next five years, as compared with 60% over the previous six years). On the supply side, non-OPEC production related to the exploration of shale oil resources is expected to provide most of the growth in oil production capacity over the next few years. In addition, production capacity in OPEC countries is projected to expand owing to investment.

However, risks to the oil price outlook exist. The main such risk relates to potential oil supply disruptions. While Iraq has the highest potential to increase oil production, political instability and security problems might impede the expansion in oil production capacity, thereby shifting the global balance of supply and demand. Similarly, an escalation of the tensions in Ukraine has the potential to affect the supply of energy, pushing oil prices higher.

With regard to food prices, the outlook is more difficult to determine. In the short to medium term, compared with the prices of other commodities such as oil, food prices are generally less sensitive to the macroeconomic cycle and typically react more to weather-related developments and other largely exogenous supply-side factors, such as the development of land under cultivation.

Conclusions – implications for global inflation

A large part of the recent decline in OECD inflation is due to a decreasing contribution from the energy and food components, which in turn is explained by more stable oil and food prices. In contrast to the previous decade, growth in oil and food prices has moderated since 2011 owing to generally better-supplied commodity markets combined with slowing growth in emerging market economies. Looking ahead, all things being equal, the commodity market in general is expected to remain well balanced. This implies that the contribution of energy and food to global inflation is likely to remain limited. However, potential supply-side disruptions pose an upside risk to this outlook.