Economic SYNOPSES
short essays and reports on the economic issues of the day

2011 ■ Number 14

Food Prices and Inflation in Emerging Markets

Brett Fawley, *Research Associate*
Luciana Juvenal, *Economist*

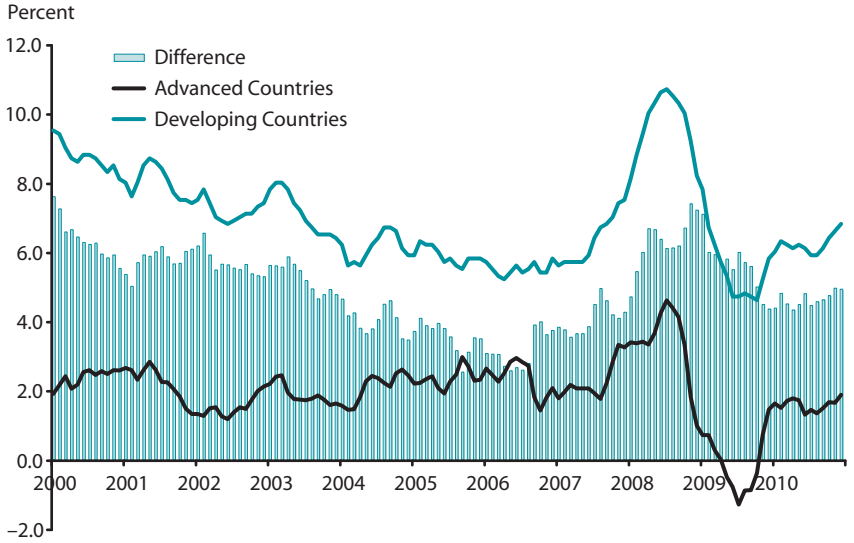
The unbalanced pace of international recovery has been a persistent theme in the wake of the 2007-09 global recession. Output in emerging countries grew more than twice as fast as in advanced countries from 2009 to 2010 (7.5 percent compared with 3.5 percent).[1] Consequently, developing countries face significant pressure to tighten their monetary policy ahead of advanced countries. For example, since April 2010, Brazil has increased its overnight interest rate target from 8.75 percent to 11.75 percent, while the U.S. federal funds target has remained near zero.

For many developing countries, the confluence of better growth prospects and higher interest rates has attracted unwelcome inflows of foreign capital. Some, like Brazil, have imposed capital controls to stem the resulting currency appreciation and declines in trade competitiveness. Others, such as Russia, are using bank reserve requirements to contain inflation while avoiding interest rate hikes. But even as developing countries remain wary of foreign capital inflows and reluctant to raise interest rates faster than advanced countries, the impact of rising food prices on inflation may further decouple economic conditions and optimal policies.

Rising food prices contribute more to inflation in developing countries because food is a much higher share of the consumption basket in emerging markets than in wealthier countries. For example, food accounts for 15 percent of the U.S. consumer price index (CPI) basket, but 50 percent of the Philippines' CPI basket. Compounding the differences, research shows that there is a much more significant pass-through from food prices to nonfood prices in developing countries compared with advanced countries, where there is almost none (Guimaraes et al., 2010). Higher food prices in 2007-08 triggered protests for higher wages among the world's poor, providing one example of the possible heightened transmission mechanism from food prices to nonfood prices.

The experience of the past decade illustrates the sensitivity of inflation in emerging markets to rapidly rising food prices.

Year-over-Year Inflation



SOURCE: International Monetary Fund (IMF). World Economic Outlook Database—WEO Groups and Aggregates Information, October 2010. The IMF defines 33 countries as advanced and 150 as emerging and developing.
For a full list, see www.imf.org/external/pubs/ft/weo/2010/02/weodata/groups.htm#oem.

The experience of the past decade illustrates the sensitivity of inflation in emerging markets to rapidly rising food prices. While developing countries have historically had higher inflation than their more-developed neighbors, the chart shows that from 2000 to 2005 inflation rates in developing and advanced countries converged as inflation rates in developing countries declined and the credibility of their central banks improved. From summer 2005 to summer 2008, however, a 73 percent surge in general food prices abruptly pushed differences in global inflation rates back to their previous (and more disparate) levels.

After a partial retreat during the financial crisis and ensuing recession, food prices are again making headlines: They have already rebounded past their summer 2008 peak. Some of the culprits underlying soaring prices, such as bad weather and drought, are likely temporary negative supply shocks. Others, though, may represent true structural shifts in markets. In particular, the Food and Agriculture Organization of the United Nations cites government-sponsored demand for biofuels as a significant source of ongoing price pressures in agricultural markets. If the gains in global food prices prove persistent, the larger share of food in the consumption baskets of developing countries and the stronger pass-through from food to nonfood prices in those countries suggest that the demands on monetary policy in developing and advanced economies will only continue to diverge. ■

Guimaraes, Roberto; Osorio Buitron, Carolina; Porter, Nathan; Filiz Unsal, D. and Walsh, James. "Inflation Dynamics in Asia," in *Regional Economic Outlook: Asia and Pacific: Consolidating the Recovery and Building Sustainable Growth*. Chap. 2. Washington, DC: International Monetary Fund, October 2010, pp. 41-55; www.imf.org/external/pubs/ft/reo/2010/apd/eng/areo1010.pdf.

[1] See the note below the chart.

Posted on May 12, 2011
Views expressed do not necessarily reflect official positions of the Federal Reserve System.