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The Global Rise in Food Prices and the US Slowdown: Issues and Challenges in Monetary Policy

Formulating Monetary Policy

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- *Tensions, tradeoffs and risks* caused by the rise in commodity prices are likely specific to
  - The economic structure of the country in question
    - composition of trade
    - Composition of consumption basket (IT countries)
  - The monetary and fiscal-policy framework of the country in question
- Difficult to be too general

Outline

1. The Composition and Importance of Canada's Terms of Trade

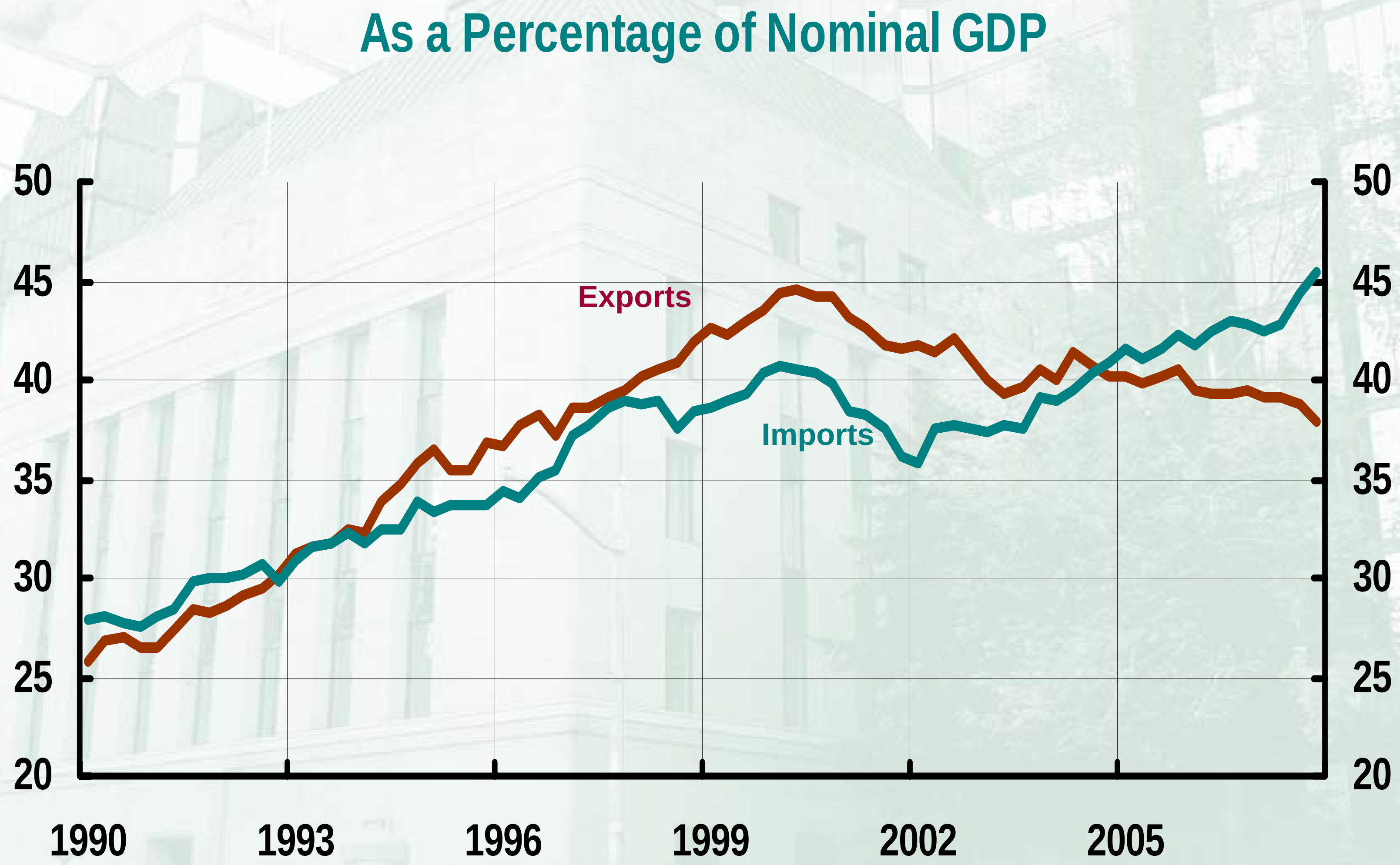
2. The Transmission of Terms-of-Trade Movements to the Canadian Economy

3. Canada's Recent Experience and the Outlook

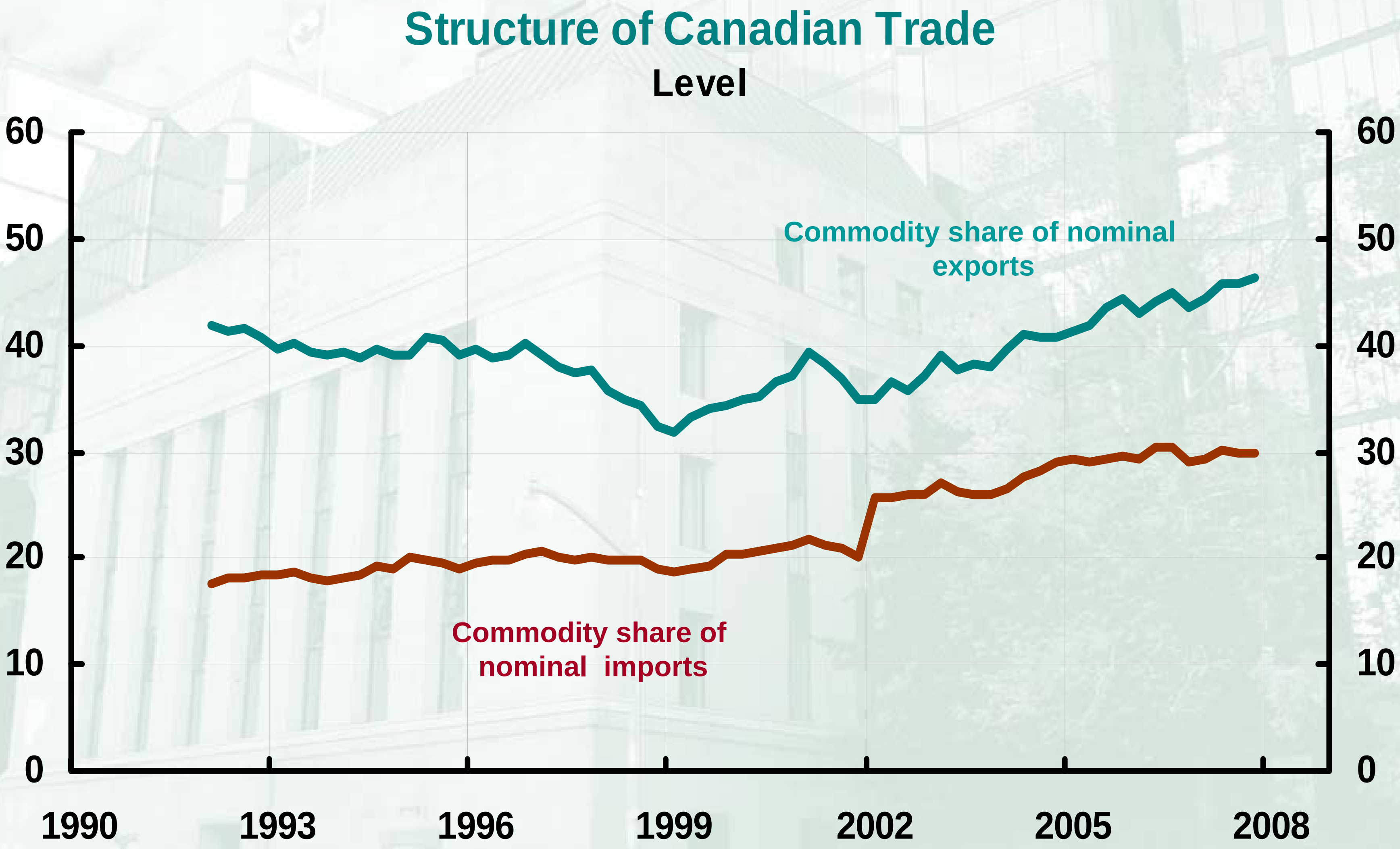
4. Policy Questions Going Forward

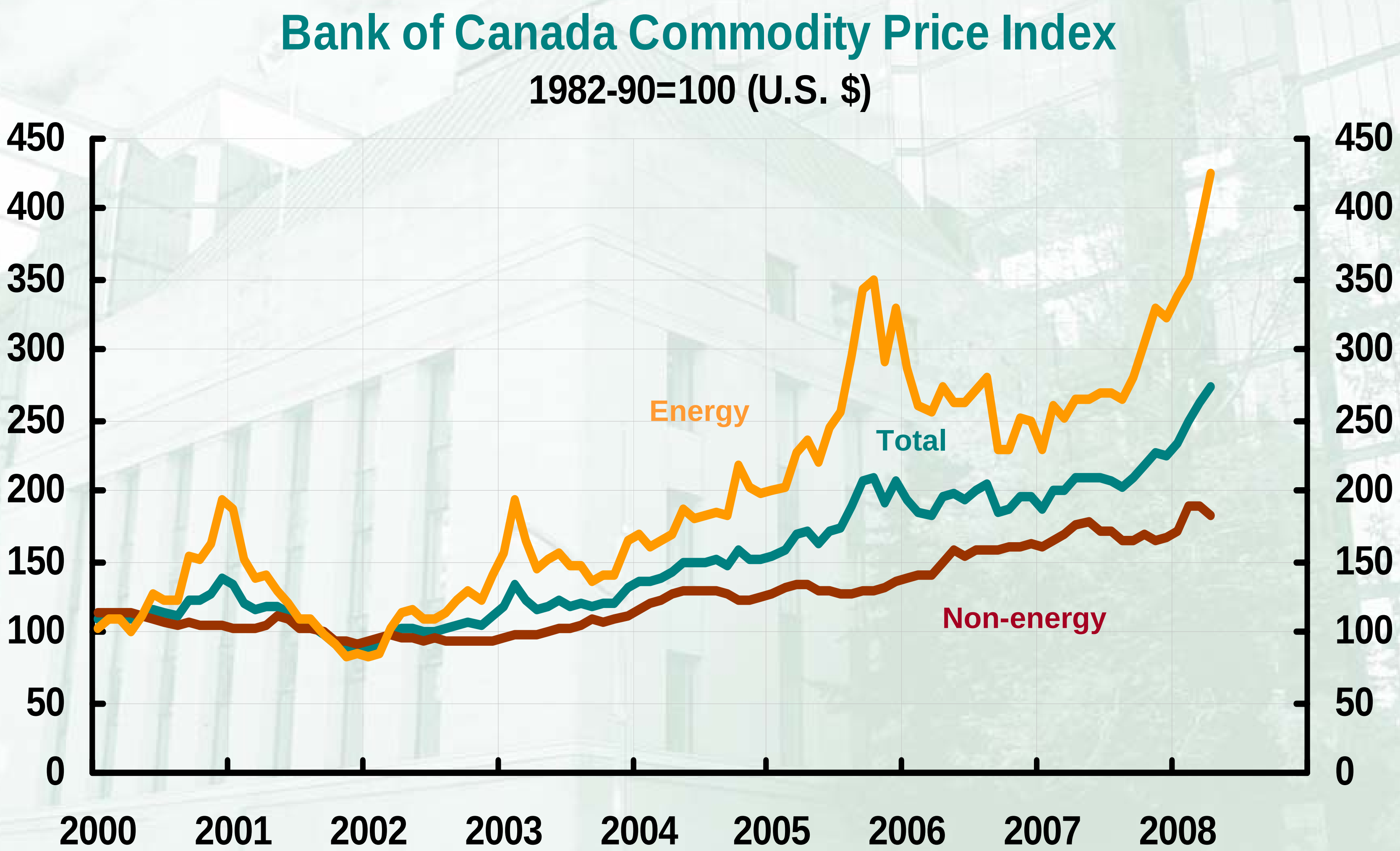
The Composition and Importance of Canada’s Terms of Trade

The Importance of Trade to the Economy



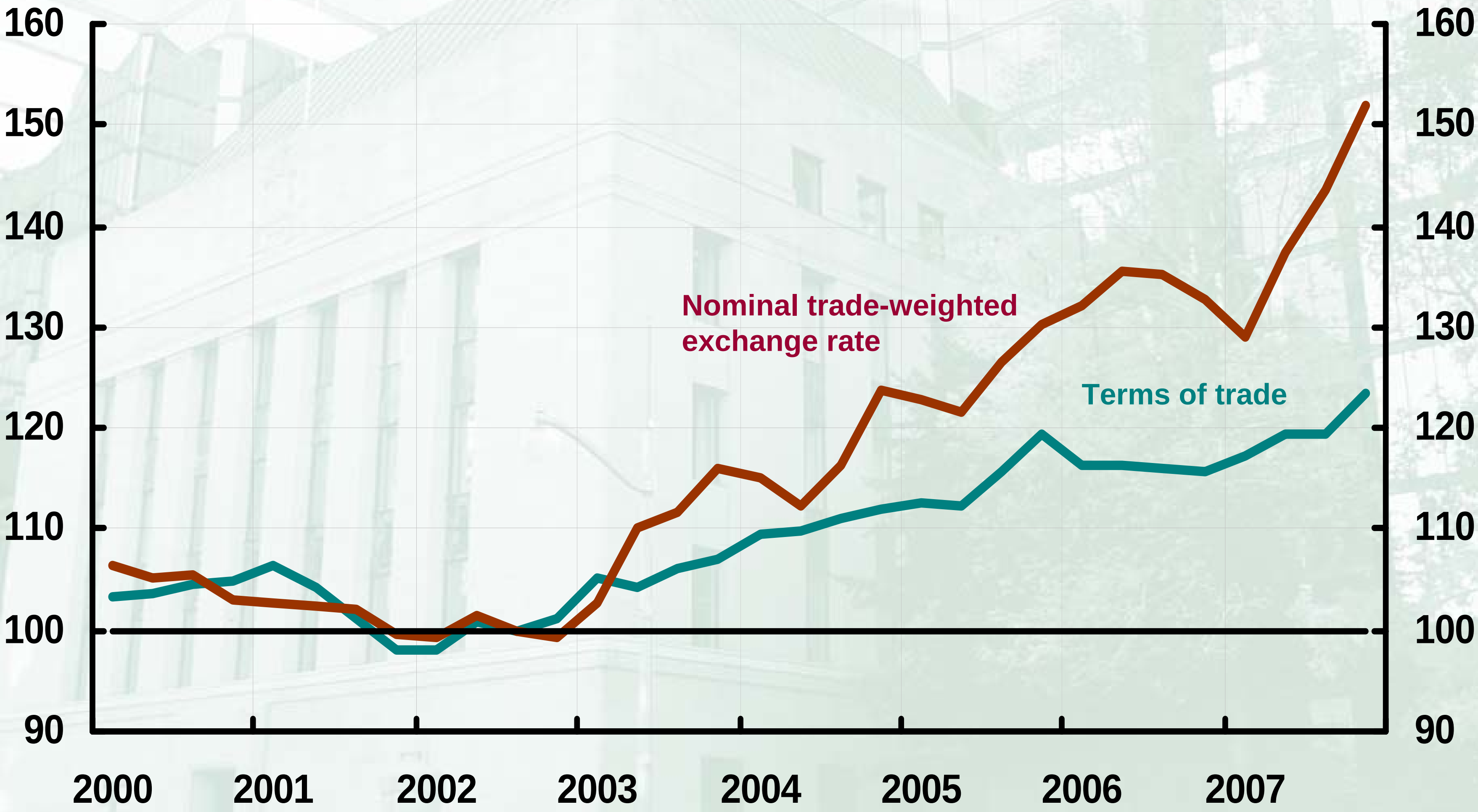
…and the Importance of Commodities in Trade



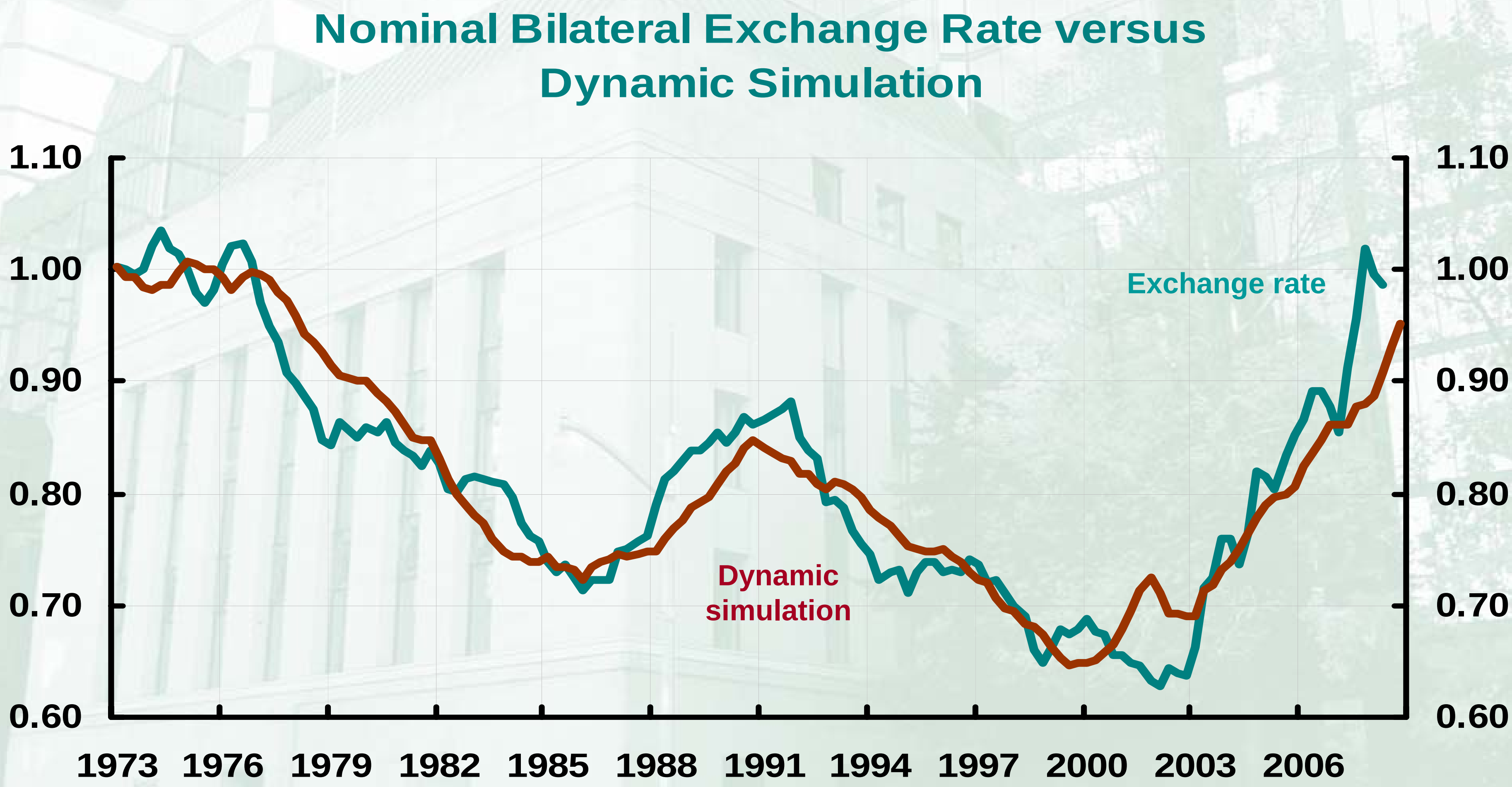

Bank of Canada Commodity Price Index
1982-90=100 (U.S. $)
450
400
350
300
250
200
150
100
50
0
2000
2001
2002
2003
2004
2005
2006
2007
2008
Energy
Total
Non-energy

Terms of Trade and Nominal CERI

2002 = 100



Low-Frequency Exchange-Rate Movements Explained Well by Commodity Prices



The Transmission of Terms-of-Trade Movements to the Canadian Economy

Canada’s Inflation Targeting Framework

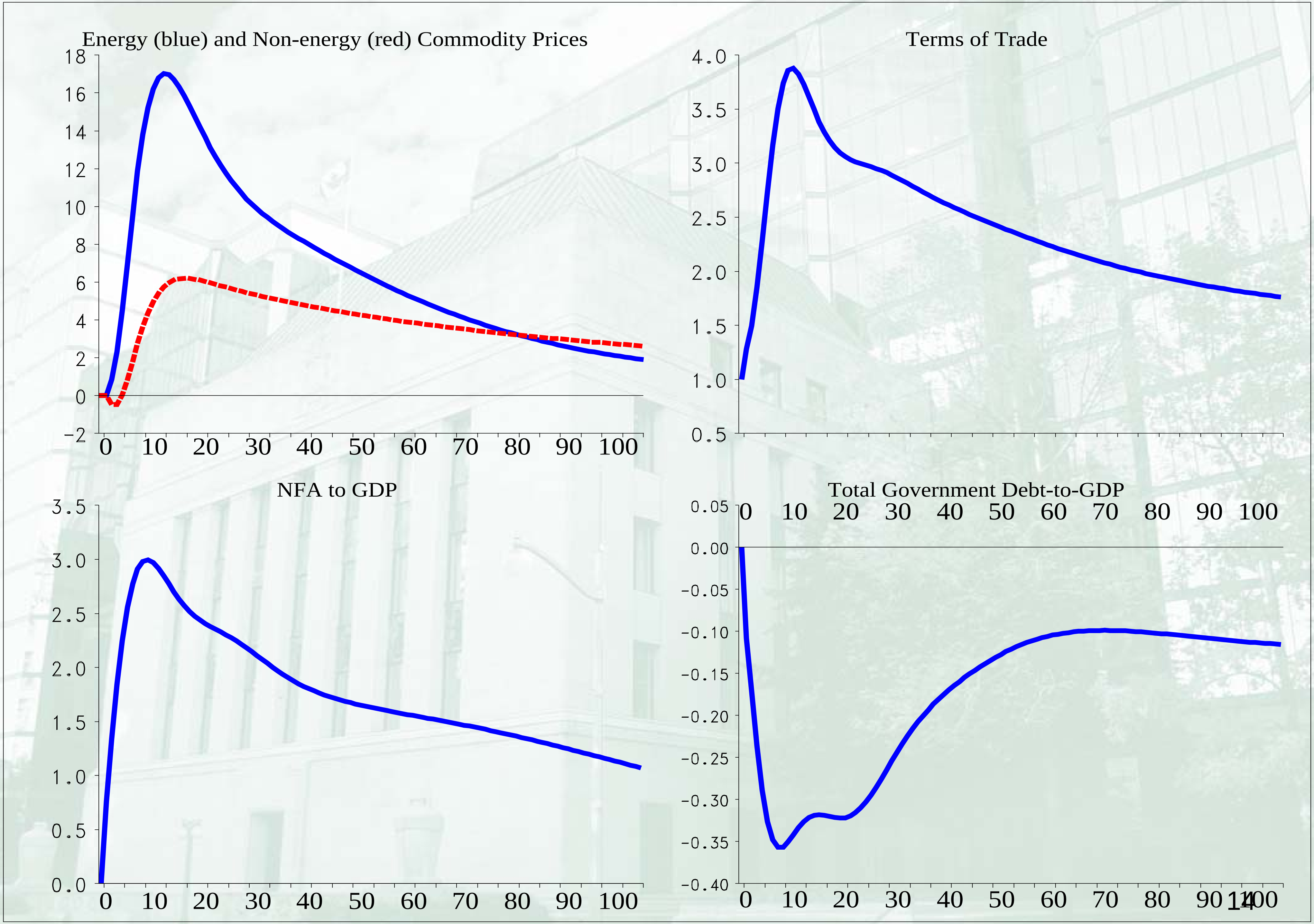
- Inflation control target + flexible exchange rate + transparency and communications
  - Aims to maintain total CPI inflation at the 2 per cent midpoint of the 1-3 per cent target range
  - Uses core inflation as an operational guide, which continues to be a useful indicator of future total CPI inflation (Armour 2006; Armour and Laflèche 2006)
  - Policy seeks to return inflation to target over an 18-24 month horizon

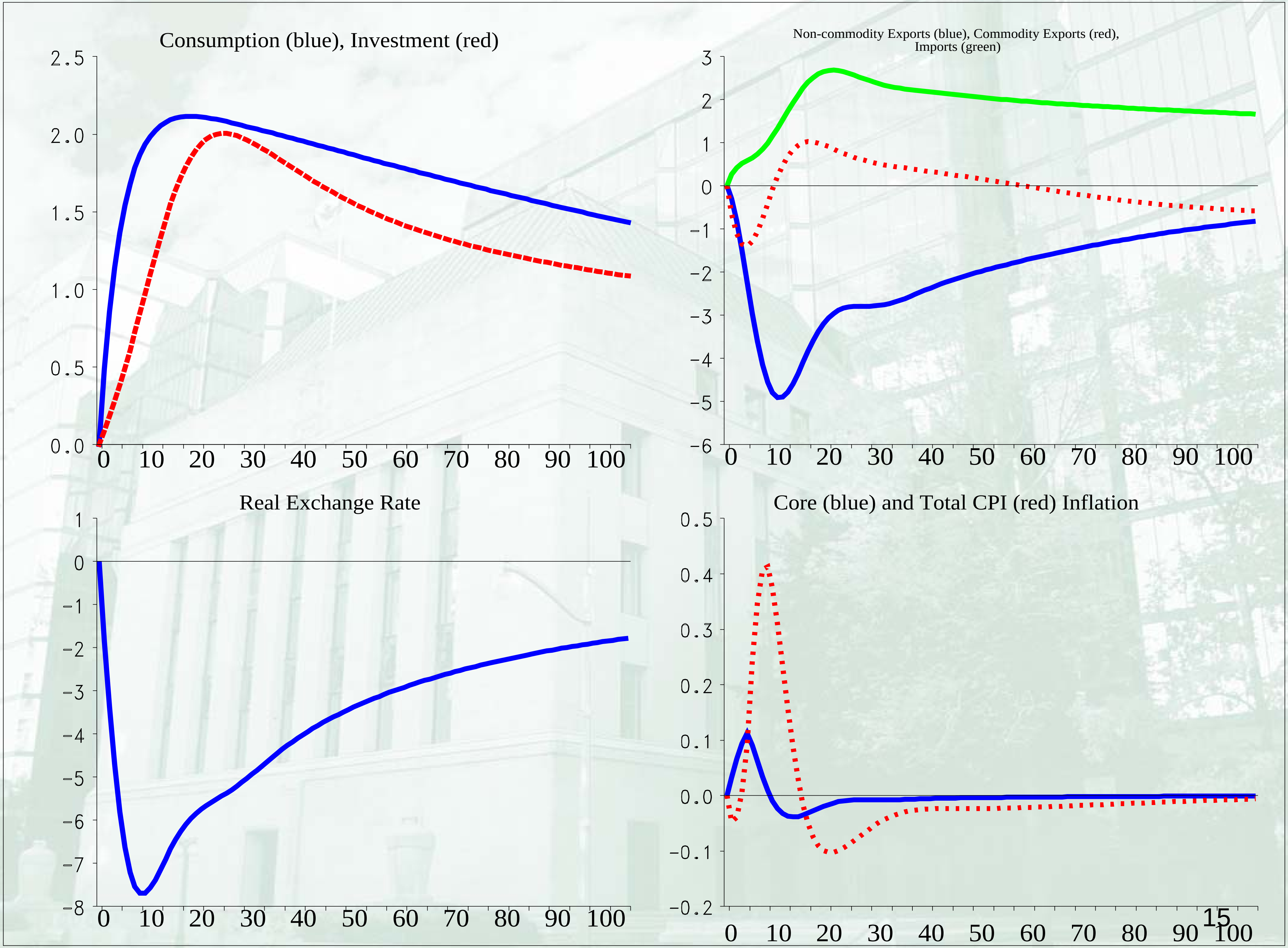
The Transmission of Terms-of-Trade Movements to the Canadian Economy

- The source and persistence of a terms-of-trade movement is critical to determining its impact
- Rapid growth in emerging-market countries believed to be an important factor
  - Particularly for oil and base metals (Cheung and Morin, 2007)
  - Raises commodity prices, lowers import prices

The Transmission of Terms-of-Trade Movements to the Canadian Economy

- The scenario:
  - An increase in total factor productivity in emerging Asia (Lalonde and Muir, 2007):
    - Causes a peak increase in energy prices of 17 per cent and non-energy commodity prices of 6 per cent
      - much higher degree of short-run overshooting in energy prices due to inelastic short-run supply
      - energy, non-energy distinction matters for Canada (Issa, Lafrance and Murray, 2006)
    - Causes a reduction in the U.S.-dollar price of imported goods in Canada


Energy (blue) and Non-energy (red) Commodity Prices
Terms of Trade
NFA to GDP
Total Government Debt-to-GDP


Consumption (blue), Investment (red)
Non-commodity Exports (blue), Commodity Exports (red), Imports (green)
Real Exchange Rate
Core (blue) and Total CPI (red) Inflation

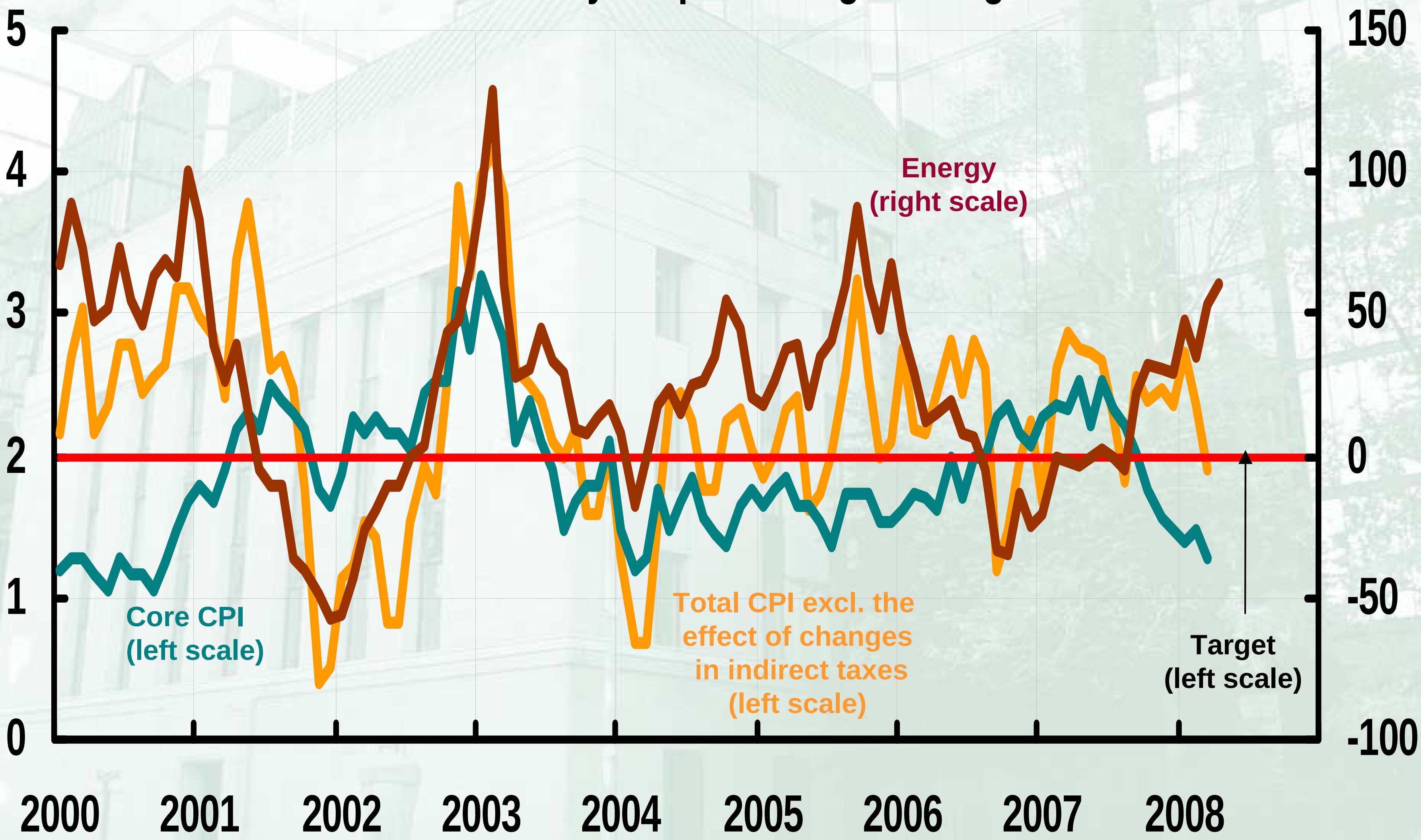
The Transmission of Terms-of-Trade Movements to the Canadian Economy

Summary of model predictions for positive supply shock in emerging Asia:

1. Improvement in Canada's terms of trade
2. Persistent increase in domestic demand
3. Appreciation of the Canadian dollar
4. Highly transitory response of total CPI, benign response of core inflation (due to well-anchored inflation expectations)
5. Limited monetary policy response

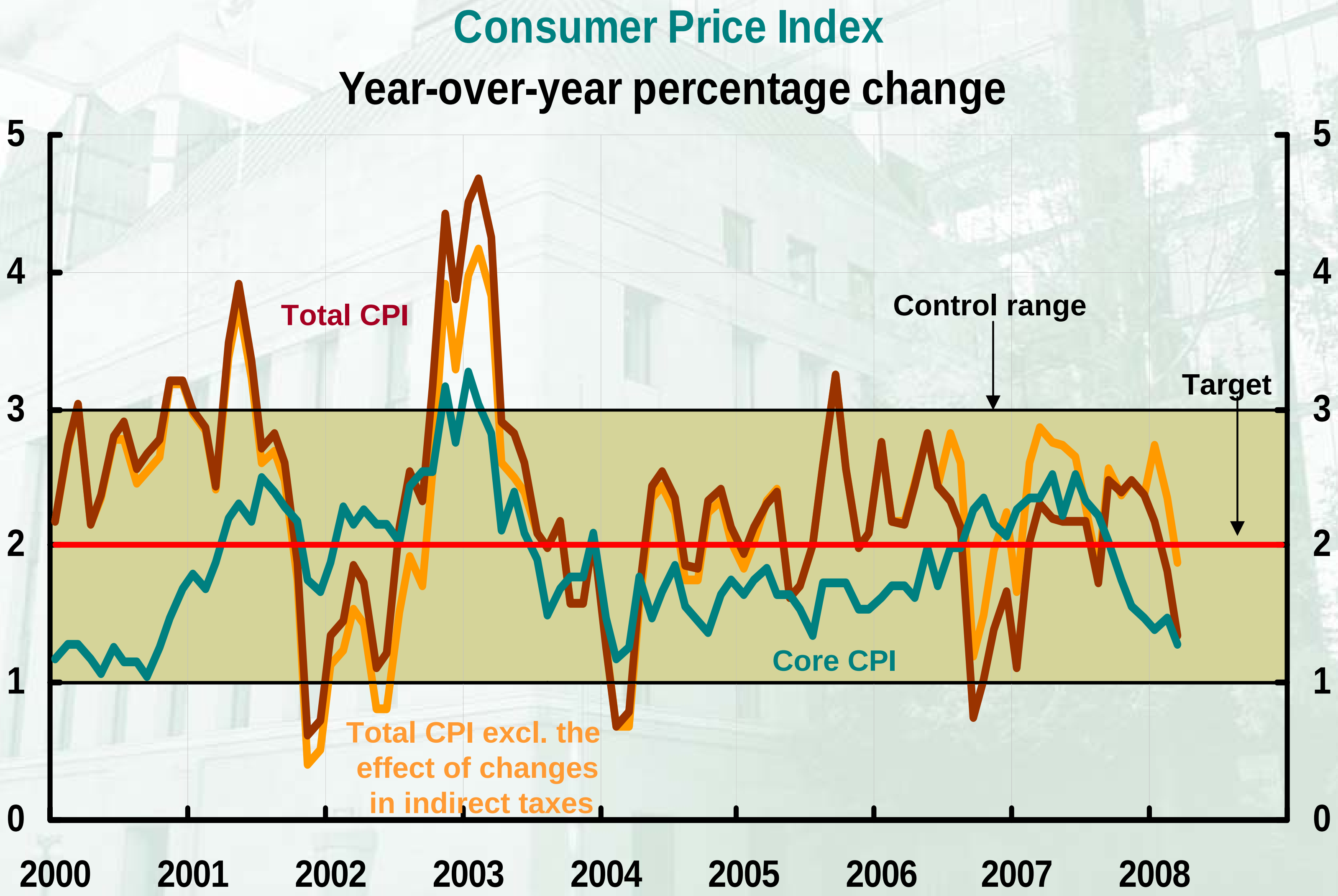
Consumer Prices Index vs. Energy Prices

Year-over-year percentage change

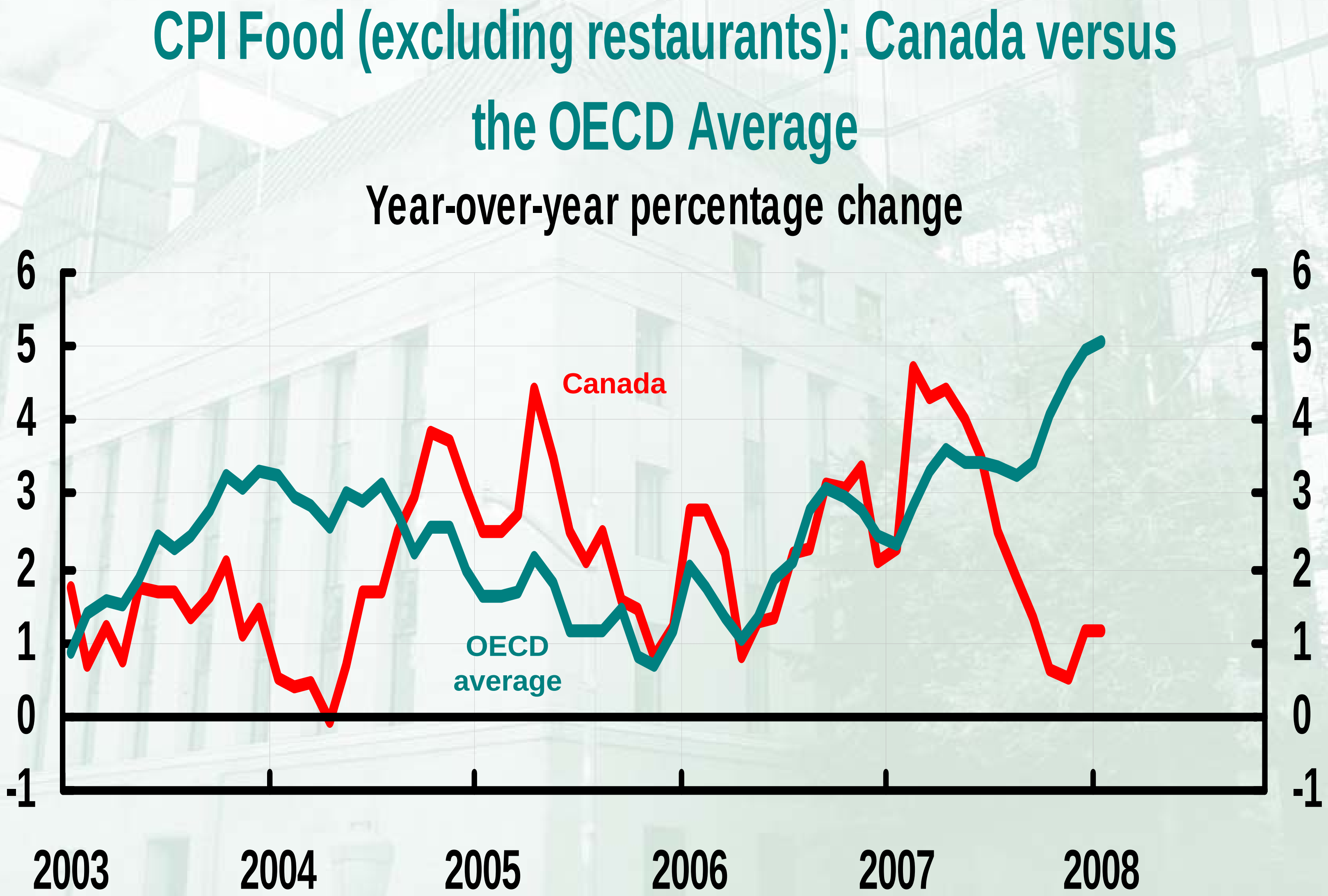


The Recent Experience and Outlook

The Recent Experience



Bucking the Inflation Trend…



Policy Questions Going Forward

Policy Questions Going Forward

1. Will 'core' inflation measures remain as useful in the future? Communications challenges?
2. Wage setting and the stability inflation expectations
3. What are the relative merits of targeting a path for the price level?

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