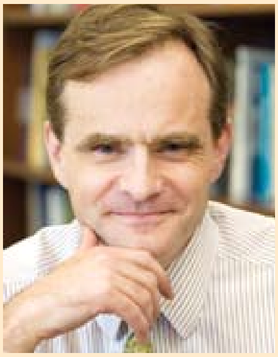
STRAIGHT TALK

Automatic "Destabilizers"

Why high food and fuel prices are having a destabilizing effect on a slowing world economy



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ECONOMISTS are fond of the term "automatic stabilizers." In general, it refers to anything that naturally tends to adjust so as to offset other changes and make a system more stable. One obvious example is unemployment benefits. As an economy slows and people lose their jobs, unemployment insurance provides them with replacement income, which helps keep consumption higher than it would be otherwise. Falling income tax revenue plays a similar role when the economy contracts—with larger fiscal deficits as a consequence.

These things happen without any change in laws: they are built into the system and kick in automatically. And they are reassuring. To some extent, any move into recession is offset automatically in a way that naturally leads to recovery.

The global version

Several important automatic stabilizers are built into the global economic system. The most important relate to how this system reacts when growth slows in a major economy, such as the United States. One effect should be a fall in long-term interest rates. And these rates have, to some extent, declined since summer 2007. Over time, lower rates should both underpin investment and help the global housing market turn around.

But another key automatic stabilizer has traditionally been commodity prices. Normally, as the United States and other economies slow, the demand for and prices of commodities—such as oil—decline. This is a well-established fact. A fall in commodity prices helps keep purchasing power and, thus, demand higher than they would otherwise be in the United States and other advanced economies. Lower inflation also means more room for the U.S. Federal Reserve and other central banks to cut interest rates and, if necessary, for governments to increase their fiscal spending. A fall in commodity prices is not such good news, of course, for commodity exporters, but it is stabilizing for global economic growth as a whole.

It's the food and the oil

But today commodity prices are rising rather than falling. The higher prices are creating inflationary pressures in many countries at a time when they should be considering countercyclical policies. And the higher prices are also harming poor people directly.

The prices of oil, metals, and food have been climbing for several years (see Straight Talk, F&D, December 2007). In part, this trend reflects strong demand from emerging markets, particularly the achievements and changing tastes of new middle classes in previously low-income countries. This increase in demand is likely to be permanent and needs to be matched by higher investment in commodities production.

Higher energy and food prices over the past few years also reflect policies in advanced economies, including the United States and the European Union, that attempt to encourage biofuels through subsidies and an unfortunate degree of protectionism. The link to oil prices arises because upstream and downstream producers feel that biofuels make their future more uncertain and thus discourage investment. The link to food is simply that land is increasingly used to produce crops as fuel for machines (substitutes for gasoline or diesel) rather than for people (calories for direct human consumption or feed for animals).

Adverse weather has also, in some instances, played a role; this may be temporary or a part of larger shifts in climate patterns. A fascinating debate is taking place in Australia, for example, on this issue. And the oil market remains tight and prone to price spikes on the back of rumors of supply disruptions caused by variables ranging from adverse weather to political risks around the world.

But it is also the case that over the past six months, as the global economy has slowed, the prices of most kinds of commodities have moved up rather than down—that is, doing the opposite of what we would ordinarily expect. Why?

The current financial turmoil increases the attractiveness of commodities as an asset class. In particular, as the dollar declines in a low-interest-rate environment, financial players expect the prices of commodities (including oil) to rise, at least in dollar terms. There is a danger that, at least for a while, these expectations can become self-fulfilling in a way that causes prices to "overshoot" levels that are consistent with economic fundamentals.

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Thus, although the more recent increase in energy and food prices may well be temporary, it also represents a very real and large negative hit for the world's poorest, who spend more than 50 percent of their income on food and fuel.

The natural reaction of governments in emerging market and developing countries is to "buffer" the increase in global energy and food prices—that is, to not pass the increase on fully or immediately to consumers—largely to avoid a disruptive impact, particularly one that would cause a massive deterioration in the living standards of the poor, leading to riots or worse. Governments buffer price increases through a range of measures, such as price controls and restrictions on food exports. One corollary of the success of macroeconomic policy over the past few years is that many countries have the capacity to buffer price increases more than in the past.

This may all sound quite benign. But, taken together, the forces we are seeing have produced a nearly 50 percent increase in rice prices so far this year. This is a major global shock, with the greatest impact on the poor.

It's all connected

Moreover, abrupt movements in major currencies feed into commodity price increases. In particular, of late, as the dollar depreciates, oil prices rise. In this context, the recent call by the Group of 7 major industrial countries for foreign exchange markets to avoid disruptive overshooting should help. But inflation in the United States is falling as the economy slows, whereas the European Central Bank remains worried about inflation as commodity prices go up. Thus, coordinated intervention against a backdrop of divergent monetary policies is unlikely to resolve anything, or even to take place.

Applying similar logic, would a unified approach to intervening in overshooting commodity markets make sense? Certainly the public sector has a right and a responsibility to transparently inform the private sector whenever it feels that markets have gone too far or too fast—so-called jawboning. But could the public sector back up such a warning with credible policy actions?

This is hard to see. There is no commodity market equivalent to central banks being willing to intervene in the foreign exchange market—remember that those banks ultimately control the supply of money on both sides of that market. The public sector in some countries has strategic reserves of some commodities, but not stocks that are large relative to global trade flows.

If anything, recent actions by governments around the world have been further destabilizing—particularly with regard to the restrictions placed on exports of staple foods. Such restrictions tend to disrupt global trade, push up prices, and perhaps lead to panic buying and hoarding.

The only commodity market in which public intervention is at all possible is that for oil. That market has large producers with market power, and intervention may, at some point, be effective. After all, very high oil prices have a tendency to cause big global economic problems (inflation, recession, or the Great Nightmare: stagflation), and big problems tend to lead to big global slowdowns and very low oil prices. Such an extreme scenario is certainly not in the interest of oil producers.

Three channels

More broadly, we can think about addressing the commodity price issue through at least three channels—or from the perspective of policy changes that could be made in at least three types of country. ***Rich countries*** could improve (or curtail) their biofuels policies by cutting subsidies or reducing protection, ***oil producers*** could commit to add spare capacity, and ***middle-income countries*** could adjust their internal pricing mechanisms and move to targeted subsidies.

We cannot continue with a situation in which the development of biofuels increases uncertainty about the future price of fossil fuels, thus discouraging energy investments both upstream and downstream, which in turn leads to large price spikes that developing countries avoid passing on to their consumers. We have built a global energy system with automatic *destabilizers*, and this is not a good idea.

Risky business

We also need to change our approach to risk mitigation and insurance at the level of both individual farmers and countries. Around the world, significant steps are being taken to bolster catastrophe insurance and develop robust futures markets. These steps can greatly help assure farmers that, if they make investments (based on today's prices), they can lock in commodity prices and reap the rewards.

We should consider adopting a similar philosophy for dealing with shocks—including changes in oil and food prices that affect imports, as well as export volumes—at the macroeconomic level. Countries should feel more confident that financing will be available in times of need, solely on the basis of their sound medium-term fundamentals and the presence of measurable negative shocks. Insurance makes sense for your car and your house. Why not for your country? ■