# **GLOBAL COMMODITY** PRICE UPDATE

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### FOOD PRICE SHOCK SQUEEZES POCKETBOOKS AND NARROWS STIMULUS OPTIONS IN EMERGING MARKETS

Most Severe Drought in 50+ Years Hits U.S.

Impact on U.S. **Economy Small** 

Inflation Squeezes **Emerging Market** Pocketbooks

The most severe drought in over 50 years is enveloping the continental U.S. and severely damaging 2012 agricultural yields. The U.S.D.A. estimates that one sixth of the corn crop will be lost, with the outlook for wheat and soybean harvests similarly stark. The drought is drawing comparisons with the 1934-1936 Dust Bowl; thankfully, its direct effects on households and the larger U.S. economy will be much more limited. Agriculture accounts for less than 2 percent of U.S. GDP, meaning lost income will be small relative to the overall economy. In addition, federally funded crop insurance will compensate farmers for much of their losses.

However, the drought will have dramatic indirect effects on the global economy by raising prices of wholesale agricultural products ("soft commodities"). U.S. corn prices are up 10 percent year over year through August 2012, wheat up 16 percent, and soybeans 25 percent (See Chart 1). The food price shock will have only a limited effect on U.S. consumers, since food occupies a small share of a typical household budget, about a sixth. The shock will cause a mild and transitory increase in U.S. CPI inflation, but is not expected to raise the "core" measure of inflation, which omits food and energy prices to measure inflation's underlying trend.

By contrast, the shock is much more worrisome for emerging market households who spend a much larger share of their budget on food than do advanced economy consumers (See Chart 2). The United Nations' food policy agencies (FAO, IFAD, and

#### **CHART 1: DROUGHT SENDS FOOD PRICES SOARING**

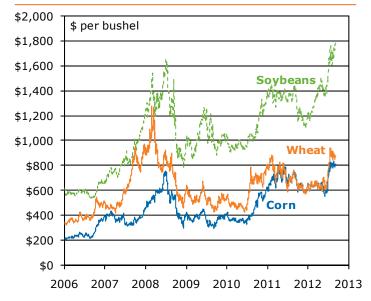


Chart sources: Bloomberg, The PNC Financial Services Group

#### **CHART 2: FOOD SHARE OF CPI LARGER IN POOR COUNTRIES**

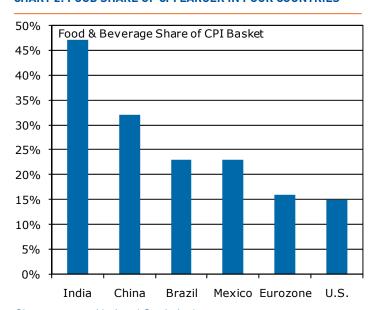


Chart sources: National Statistical Agencies, The PNC Financial Services Group



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WFP) issued a joint statement in early September warning that high food prices threaten to impoverish these developing economy households. The food price shock poses large downside risk to emerging market consumer confidence and real consumer spending. Some evidence of its effects may be apparent in the drops in Chinese consumer confidence in July and in Brazilian confidence in August, although it is difficult to say whether consumers are concerned by price increases or weak economic growth. Emerging market consumer spending can be expected to soften through year-end as the shock reverberates globally. A drag on emerging market GDP growth will persist until the first half of 2013, when Southern Hemisphere harvests will hopefully improve the global balance of food supply and demand.

Less Room for Emerging Market Central Bank Stimulus In addition to crimping consumer spending, high food prices may also discourage emerging market central banks from loosening monetary policy in the final third of 2012 to target stronger growth in 2013. Although inflation has fallen sharply in China and Brazil (less so in India), imported food inflation increases the danger that looser monetary policy could reignite domestic overheating pressures or raise general inflationary expectations, which Chinese, Indian, and Brazilian central banks have struggled to control over the past 12 months. In addition, central bankers may want to prop up their currencies' exchange rates with higher interest rates and lower the local-currency prices of imported food commodities. Since U.S. dollar prices of soft commodities are similar globally (See Chart 3), the exchange rate is the most potent tool in the central banking toolkit to stop an inflationary shock at the border.

Generalized Inflation
Is the Low
Probability, High
Impact Risk to Watch

There is a final channel through which the food shock could hurt global growth: the (admittedly small) risk that other supply-side shocks set off a generalized wave of inflation. To reiterate, our baseline expectation is for food prices to return to predrought levels by March 2013 as Southern Hemisphere harvests restore a more normal balance to global food supply and demand. However, if a second drought further stresses global food supplies, commodity inflation could persist long enough to "bleed through" to core inflation, generating self-fulfilling expectations of higher trend inflation. Oil prices would probably have to spike as well for inflation expectations to rise, which seems possible given the ongoing threat of confrontation between Iran and Israel. While several unlikely events would be necessary for this risk scenario to play out, it is a key risk to monitor until the food shock subsides.

#### CHART 3: SOYBEAN PRICES HAVE RISEN 30-60 PERCENT GLOBALLY SINCE THE START OF 2012

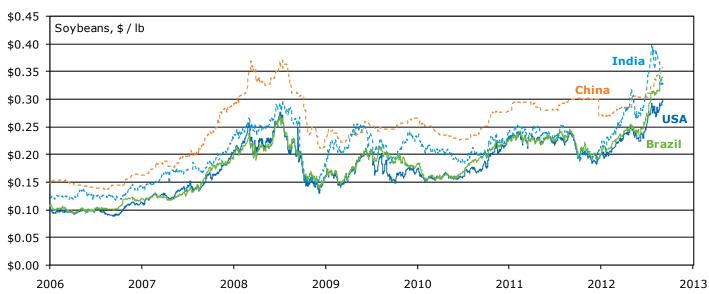


Chart sources: Bloomberg, The PNC Financial Services Group

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