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## Rosenberg: Monetary policy and commodity and energy prices

*How should central banks react to rising commodity and energy prices? First Deputy Governor Irma Rosenberg discussed this issue when she gave a speech today at the workshop "Commodities, Energy and Finance" in Vienna.*

"Energy and commodity prices have risen rapidly in recent years. This is largely due to emerging markets such as China and India becoming increasingly integrated into the global economy – what one often means when talking about globalisation. At the same time, globalisation has entailed low prices for imported products from emerging markets, and via stiffer competition has contributed to curbing the price increases for import-competing products in industrial countries. This has made it easier for the central banks to maintain price stability. For some considerable time the economic discussion focused on the inflation dampening effect of globalisation. The challenge facing some central banks, such as the Riksbank which I represent, was rather how to stimulate economies by means of monetary policy in order to push up inflation towards the target," began Ms Rosenberg.

"However it would now seem that globalisation has instead begun to push up inflation, as increasing demand from emerging markets pushes up world market prices not just for energy and metals but also for food commodities. Perhaps it is only now that the low inflation policy, which to all appearances has been conducted so successfully in many countries, is being put to the test," continued Ms Rosenberg.

"How then is inflation affected by rising energy and commodity prices and how should monetary policy deal with such price movements? The principles for this are essentially simple when applying so-called flexible inflation targeting. It means that the central bank tries to stabilise inflation around the inflation target and, provided that confidence in the inflation target is maintained, also gives consideration to stabilising production and employment. Another and more concrete way of describing this is that the central bank tries to find a path for the policy rate which will ensure that the forecasted inflation rate is reasonably close to the target at the same time as the real economy develops in a balanced manner. These universal principles can be applied regardless of the nature of the

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shock facing the economy. In this sense, one could say that rises in energy and commodity prices do not pose any specific problem from a monetary policy point of view – in many ways it is a case of 'business as usual'," said Ms Rosenberg.

"But even if the principles for the way in which monetary policy should be conducted are simple in theory, the practical implementation is far from simple. An assessment must be made of the way in which rises in energy and commodity prices affect the economy, not only inflation but also the real economy. An increase in energy and commodity prices can affect the economy in various ways. The price increases have a direct effect in that energy and food, for instance, are included in the inflation measure. But the real economy is also affected indirectly. For households, higher energy prices act roughly like a tax increase and curb domestic demand," continued Ms Rosenberg.

"A more rapid increase in energy and commodity prices means that the production costs increase. The effect can be compared to the one that follows from a drop in productivity. It tends to dampen production and growth. At the same time, the rise in energy prices in recent years has, to a far greater extent than the rises in the 1970s and 1980s, been fuelled by strong demand in the world market rather than by supply shocks. The negative effects on the real economy of the rapid rise in energy prices have been wholly or partially counteracted by favourable price developments in other areas and by strong international growth. Thus it is not possible to give a standard answer as to how monetary policy should react to an increase in energy and commodity prices. Each shock must be analysed separately and the question of which policy is most appropriate must be determined from case to case," observed Ms Rosenberg.

"What is characteristic to energy and commodity prices is that they tend to fluctuate considerably during an economic cycle. Periods with rapid price increases may be followed by periods of far calmer development or even by a decline in prices. These fluctuations also spread to consumers. Such rapid shifts in inflationary impulses are often impossible to predict and cannot be immediately counteracted by means of monetary policy. This is because of the lag in monetary policy's impact on economic activity. It is, therefore, common in the monetary policy analysis that, over and above the more comprehensive inflation measures, central banks also study inflation measures that exclude short-term effects in energy and commodity prices. In my view, this is not a question of whether there is reason to disregard energy and commodity prices when balancing monetary policy. Instead, it is a question of trying to differentiate between those price impulses that risk having a lasting effect on inflation and those that are temporary and which will ebb away without any forceful monetary policy counter-measures," said Ms Rosenberg.

"The way in which the practical monetary policy should react to rising energy and commodity prices is a question that the Riksbank, like many other central banks, is grappling with at present. In Sweden rising energy and food prices contributed to inflation increasing rapidly in autumn 2007. CPI inflation is currently more than one percentage point above the target of 2 per cent. In particular with regard to energy, but also to a large extent food, the rapid increase in prices reflects a substantial rise in world market prices. The assessments that need to be made in this type of situation have to do with the extent to which the effects will last, as well as how much the price increases have to do with increased demand and changes in supply," said Ms Rosenberg.

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"In the forecast presented in connection with the monetary policy meeting at the Riksbank in mid-February the assessment was that world market prices would not continue to rise at the same rapid rate in the future. The inflationary impulses are therefore considered mainly to be temporary and inflation is therefore expected to fall back again in a year or two. But to some extent it also concerns effects on inflation which risk being more permanent and which should be counteracted by monetary policy," observed Ms Rosenberg.

"It is also very important that confidence in monetary policy and the inflation target is maintained. The fact that inflation is above the target must be regarded as a temporary departure. The inflationary impulses cannot be allowed to take root in the economy and to push up inflation permanently. In this context, it is important to be particularly vigilant with regard to how inflation expectations develop. In Sweden, by means of specific surveys, we continuously monitor developments in inflation expectations among different social groups and with varying time horizons. These surveys reveal that inflation expectations have risen recently, not just in the short-term but in the long-term as well. In addition to continued good growth and high cost pressures, this was a key reason that justified the decision to raise the repo rate in February," concluded Ms Rosenberg.