AllianceBernstein

ECONOMICS: EASTERN EUROPE, MIDDLE EAST AND AFRICA PERSPECTIVES—AUGUST 13, 2010

Rising Wheat Prices Could Sow Inflation Pressures in Emerging Markets

- **Alexander Perjessy**
  Senior Economist—Global Economic Research

A sweeping heat wave and drought across key nations in the Commonwealth of Independent States (CIS) have slashed the region's expected wheat production, which could boost food prices and inflation pressures for many emerging markets.

Fears of global shortages of wheat have pushed its prices up more than 40% since June, and the Russian government's upcoming ban on wheat exports hasn't helped matters.

With CIS grain crops accounting for over 26% of global wheat exports, we believe wheat and other grain prices could rise further—and stay higher—in coming months. This would hurt many emerging markets and the Eastern Europe/Middle East/Africa (EEMEA) countries in particular.

Food Prices Are Well Below Their 2008 Peak … for Now

Fortunately, prices of wheat and other food are at less than half of their 2008 peak. The damage from CIS crop failures has so far been cushioned by stockpiles of wheat and other grains—they're about 25% higher, globally, than they were in 2007—and a positive outlook for crops of other major producers.

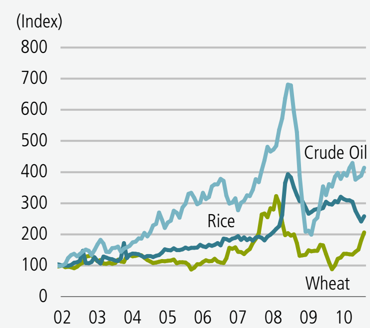
Supply disruptions are driving this year's increases, in contrast with the 2007–08 crisis, which was provoked by structural and demand factors: surging emerging-market food demand, the shifting of acreage to bio-fuel production, rising fertilizer prices and soaring crude-oil prices. This implies that rising wheat prices could be short-lived, as does the fact that other key soft commodities like corn and rice haven't joined the price rally.

Still, Russia's wheat stocks from previous bumper-crop years barely cover domestic demand, even factoring in the export ban, which would leave more wheat on hand. And demand from emerging consumers is rising along with crude-oil prices. Rice prices, vital to Asia, have stayed relatively steady, but they've historically tracked the broad trend in wheat prices with a lag **(Display 1)**.

Additional export bans would put more pressure on grain prices—Ukraine and Kazakhstan could take these actions to protect domestic consumers. Hoarding by major importers would also have an impact, as witnessed during the 2007–08 food crisis. These responses pushed up food prices even in the absence of a fundamental shortage, which happened with rice.

Display 1
Food-Price Scare All Over Again?

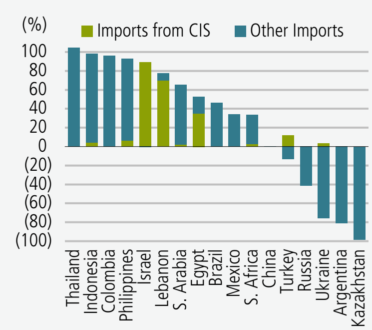
Commodity Price Indices



Source: Bloomberg, International Monetary Fund and AllianceBernstein
As of August 2010

Display 2
Vulnerability to Global Wheat Shortages

Net Wheat Imports as % of Domestic Wheat Consumption



Source: Food and Agriculture Organization, US Department of Agriculture and AllianceBernstein
As of August 2010

Estimating the Impact of a Wheat Price Shock

We've researched the potential impact of a shock in wheat prices on emerging markets, and the EEMEA region in particular. Based on the sources of imported wheat consumed in each nation, we've ranked emerging-market countries by their exposure to grain shortages **(Display 2, previous page)**.

Several Middle Eastern and North African countries appear highly vulnerable—Lebanon, Israel and Egypt in particular, where imports from CIS nations account for more than half of total grain consumption. Outside EEMEA, the most exposed countries are Thailand, Indonesia, Philippines, Colombia and Brazil. Meanwhile, higher wheat prices aren't likely to fully compensate CIS producers for the overall loss in wheat production. Hence the only emerging-market country that might benefit from the wheat-price shock is Argentina, which contributes 3.5% to global wheat exports.

To estimate the potential impact of a wheat-price shock on overall inflation, we modeled food prices for major emerging economies as a function of global wheat prices, controlling for domestic inflation momentum and movements in currency exchange rates. We then used the percentage of food in each country's consumption basket to estimate the likely impact of a permanent 30% increase in global wheat prices on inflation, as measured by domestic CPI **(Display 3)**.

Display 3

Sensitivity of Inflation Outlook to Wheat Prices

Impact of a Permanent 30% Increase in Wheat Prices on CPI

	Wheat Price Elasticity of Food CPI* (%)	CPI Weight of Food (%)	CPI Weight of Bread & Cereals (%)	Impact on Inflation: in Basis Points	Impact on Inflation: in % of 2011 Inflation Forecast
Czech R.	**0.5†**	17.0	2.9	23	10
Egypt	0.3	43.9	n/a	79	8
Hungary	0.3†	23.2	4.5	18	6
Israel	**0.8**	18.4	2.8	42	17
Kazakhstan	**0.8**	38.8	9.7	97	15
Poland	0.1†	24.1	4.2	4	1
Romania	0.1†	37.4	7.9	12	2
Russia	**0.4**	32.2	5.2	36	5
Turkey	**1.0**	32.7	5.9	94	15
Ukraine	**1.3**	53.3	8.4	208	20
S. Africa	**0.7**	20.2	4.2	45	8
Brazil	**0.9**	15.1	3.8	40	8
Chile	**1.0**	18.9	4.6	58	17
Colombia	**0.6**	28.2	3.8	48	13
Mexico	0.2†	26.6	5.8	19	5
China	0.6†	33.0	2.8	55	16
Indonesia	0.8†	36.1	4.7	92	16
Malaysia	**0.6**	31.4	4.6	55	21
Philippines	**0.6**	46.6	13.3	81	18
Thailand	**0.7**	33.0	2.9	73	25

*Estimated % change in Food CPI over 12 months resulting from a 10% increase in global wheat prices. Based on a regression of month-over-month changes in seasonally adjusted food prices on a set of distributed lags of changes in global wheat prices, controlling for domestic inflation momentum and currency exchange rates. †Not statistically significant at the 5% level.

Source: Haver Analytics and AllianceBernstein

As of August 2010

Asia, EEMEA Are Most Vulnerable

Based on our research, Asia stands to be the most exposed to the inflation impact of a permanent increase in wheat prices—in terms of the acceleration of domestic inflation relative to the baseline consensus forecast for 2011. This conclusion assumes that rice prices don't decouple from wheat prices, which is what happened during the 2007–08 food crisis. Asia's vulnerability stems from the region's large 30–45% share of food in its CPI baskets, although the region has less direct exposure to wheat prices.

In EEMEA, the most exposed economies are Israel, Ukraine, Turkey and Kazakhstan, in order of sensitivity. Headline inflation in Israel, Turkey and South Africa might be pushed uncomfortably close to the upper limits of their central bank's inflation target ranges.

Russia and Egypt are noticeably absent from this most-vulnerable list, despite the large share of food and grains in their consumption baskets and Egypt's heavy dependence on wheat imports, especially from the CIS. This is likely due to government interventions during previous bouts of wheat price volatility, on which our estimates are based: Russia banned wheat exports in 2008, and Egypt generously subsidized bread and other wheat products.

Likely Reactions from Policymakers

If inflation increases because of a wheat-price shock, we believe that most central banks will look through the inflation spikes in setting policy, as Turkey did when seasonal food prices and excise tax hikes drove inflation into double digits earlier this year.

We expect that central banks would focus on the supply-side nature of such a shock, and put more weight on ongoing concern about the fragile economic recovery, which should limit second-round effects of wheat prices on the rest of CPI. In Ukraine, Kazakhstan, Egypt and Russia, we believe that central banks will be more inclined to allow their currencies to appreciate—their most effective monetary policy tool—if inflationary pressure becomes more pronounced.

As in 2008, the Egyptian authorities would likely deploy budgetary spending to prevent sharp price increases in food, and especially bread, ahead of the upcoming general and presidential elections. This will not be an option in Ukraine, which has just agreed to an ambitious fiscal-consolidation program funded by the International Monetary Fund. ■