

World market prices of Icelandic import commodities have increased considerably this year, whereas prices of export commodities and fish products have either fallen or remained stable. World market prices of food products measured in US dollars have increased by 20% since the beginning of the year, and general commodity prices excluding oil products by 16%. The reasons for the acceleration in food prices include increasing use of corn and other food items for biofuel production, poor weather conditions and supply disruptions in several countries, and growing demand in China, India and other emerging market economies. Oil prices have risen sharply this year on the back of supply uncertainty and declining crude inventories. A weakening in the US dollar may have also contributed to higher dollar prices. Prices of fish products, on the other hand, have remained relatively stable and the price of aluminium has declined. These developments may be expected to contribute to inflationary pressures in the period ahead. This Box considers the effects of rising commodity prices on consumer prices and the national economy.

Impact on food prices limited so far

An increase in commodity prices in the world market affects global inflation and inflation expectations because prices of food, oil and gasoline carry significant weight in consumer price indices. In Iceland the effects of rising commodity prices on goods prices have been limited but varied by goods categories. The impact is felt directly in the prices of imported food items and other imported consumption goods, such as oil. There are also indirect effects on domestic food prices through higher costs of domestic food production, which is dependent on imports of commodities. The aggregate share of food prices in the consumer price index is just over 11%. The share has declined since 1997, when it was 15%. Imported food and beverages in the Consumer Price Index account for only about 2.5%, and the share of fuel is close to 4.5%.

An increase in commodity prices can affect the inflation expectations of consumers to a greater extent than price increases of many other goods categories. The frequency of food and gasoline purchases entails significant price awareness among consumers, and there is often extensive media coverage of changes in commodity prices. Although changes in world market commodity prices fall outside the scope of the Central Bank's monetary policy, it must respond to the extent that higher commodity prices are expected to have long-term effects on inflation expectations.

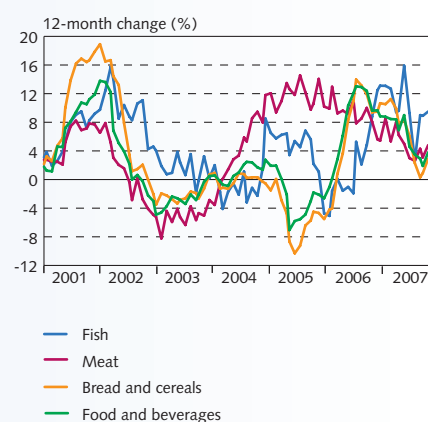
In Iceland, the effects of rising commodity prices have been limited so far. Food prices have risen by just over 3% in the past six months. The price of wheat and meal has increased by almost 7% and meat product prices by 4% over the same period. Gasoline and oil prices usually respond promptly to changes in world market prices and have increased by close to 11% over the past six months. The effects of increased commodity prices on the CPI are alternately intensified or moderated by fluctuations in the exchange rate of the króna. The strengthening of the króna earlier this year seems to have outweighed rising commodity prices and moderated inflationary pressures. It is also possible that more active price monitoring and increased media coverage of food price developments following the cut in indirect taxes last March may have served to increase restraint and lead retailers to shoulder a part of the increase in commodity prices and costs.

On the other hand, it appears likely that food prices will increase in the period ahead, especially if the króna depreciates. Also, in the event of considerable and long-lasting exchange rate instability, firms may increasingly decide to pass on higher commodity costs to consumers through price increases (see Chapter VIII).

Box II-1

The effects of rising commodity prices on consumer prices and the national economy

Chart 1
Food prices January 2001 - October 2007¹

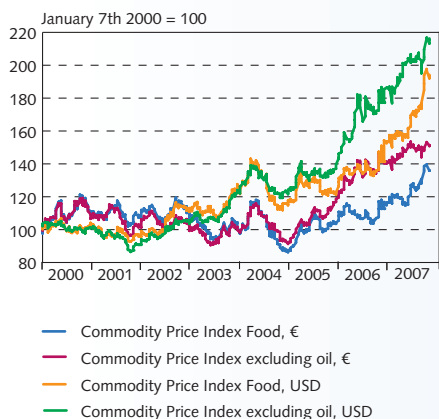


1. After March 2007 tax effects are excluded.
Source: Statistics Iceland.

Chart 2

World market commodity prices

Weekly data January 7, 2000 - October 26, 2007



Source: Reuters EcoWin.

Imported commodity prices have increased sharply since the beginning of the year but prices of exported products have fallen or remained stable

Although it is difficult to estimate precisely the effects of changes in commodity prices during the past few months on Iceland's term of trade, most indicators show that they have deteriorated. It is clear that prices of key import categories have increased considerably in recent months. Among these, an increase in oil and gasoline prices weighs most heavily. World market prices of crude oil have increased by 36% so far this year. This affects the national economy directly since oil products represent about 9% of total imports. The price effects are felt directly through higher gasoline prices for the general public, but the indirect effects can also be considerable; for example, in the form of increased domestic transport costs.

Average export prices of fish products have been more than 5% higher so far this year relative to 2006. However, they remained approximately constant during the first eight months of the year.¹ At the same time, US dollar food prices rose by 20% and euro food prices by 13%. Thus fish product prices are not closely linked to food commodity prices because only a small part, especially fish meal and fish oil, are classified as commodities.

Aluminium prices have fallen by 10% since the beginning of this year, but it is difficult to obtain an overall view of price changes of aluminium oxide used in the production of aluminium. Aluminium has accounted for 31% of total export value so far this year. Therefore it is likely that the price decline will have a considerable impact on the national economy. However, the effects of moderate fluctuations may be limited. Due to foreign ownership of the aluminium companies and the long gestation period of investment, variability in the profits of the aluminium companies may not have a strong impact on the domestic economy. The only direct link may be through receipts from electricity sales insofar as electricity prices are linked to aluminium prices. Icelandic electricity prices are generally independent of developments in world market oil prices, in contrast to what is usually the case in other aluminium-producing countries. Thus the competitive position of aluminium producers in Iceland is likely to have improved relative to producers in countries where the price of electricity is more closely linked to oil prices.

The overall effect of increased world market commodity prices on the Icelandic economy is ambiguous. On the one hand, the higher prices of fish products and aluminium have positive effects on export value and thereby on the profitability of export firms in these sectors. On the other hand, higher prices of food and oil products entail increased commodity costs for domestic food production, as well as higher transport costs. Also, rising commodity prices are likely to be reflected in rising domestic food prices in the period ahead.

1. Average foreign currency prices of fish products are weighted by the merchandise export basket.