INFLATION PRESSURES AND POLICY CHALLENGES

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Amidst an overall slowdown in global growth, inflation is rising, posing, as it is, a challenge to economic policy making. Higher food and fuel prices remain the driving forces behind rising inflation. Despite a drop from their summer peak of near $150 per barrel, oil prices remain high in real terms, which is due to inelastic demand but also, supply concerns. Food prices on the other hand have been boosted by adverse weather conditions impacting the supply side whilst at the same time demand conditions remain strong.

Headline inflation in the United States reached 5,6% in July compared with 2,4% the year before. Core inflation however, which excludes food and energy from the calculation, was only 2,5% compared with 2,2% the year before which indicates that indeed the main source of the inflation surge this year is food and fuel prices. Similarly in Germany headline inflation was 3,3% in July against 2,1% the year before. The acceleration of inflation was more marked in the emerging and developing economies where according to the International Monetary Fund, headline inflation will reach 9% in 2008.

Headline inflation in Cyprus was 5,6% in July compared with 2,4% the year before. On average for the seven months to July headline inflation was 5% against 1,9% in the same period the year before. The impact of food and fuel prices is most prevalent. In the seven months to July agricultural commodities were up 10%, the prices of petroleum products were up by 16% and the prices of electricity increased by 20%.

Headline inflation in Cyprus is considerably higher than in the Euro-zone, which is attributable to a number of factors. First, Cyprus has a higher degree of dependence on oil as its primary source of energy compared to the Euro-zone countries, suffering as a result, from the rise in oil prices in international markets. Second, Cyprus has been experiencing considerable inflation pressures from the services sectors of the economy in more recent years, reflecting an adjustment in income distribution patterns. Third, the introduction of the Euro in January of this year, has added to inflationary pressures as well, mostly as a one off consequence of rounding.

A slowdown in economic activity will ease inflationary pressures somewhat in the second half of the year and through next year. However, an examination of the origins of rising food and fuel prices suggests that price pressures are unlikely to abate much except if the current slowdown develops into a deeper and more protracted global recession.

The European Central Bank, in the face of rising inflation raised its refinance rate to 4,25% last July and refused to lower it thence. In the US by contrast, the Federal Reserve had lowered the fed funds rate in successive meetings from 5,25% in September to 2% in April and kept it unchanged thence.

In contrast to the Federal Reserve, which is also tasked with stimulating growth, the European Central Bank has only one purpose, to control inflation, which makes monetary policy in Europe less flexible. This in turn, generates problems in that a one-fits-all monetary policy applied across an increasingly more diverse area as the Euro-zone, is bound to lead to conflict. Especially for the newest members of the European Union all of which aspire to replace their national currencies with the Euro, the most pressing concern is naturally increasing their rate of growth. The balance of priorities is different in the most advanced economies like Germany, where there is a clear bias toward price stability. A falling euro, higher oil prices, slowing growth and rising inflation present the European Central Bank with serious challenges that are bound to make the old continent a little more noisy in the period ahead.