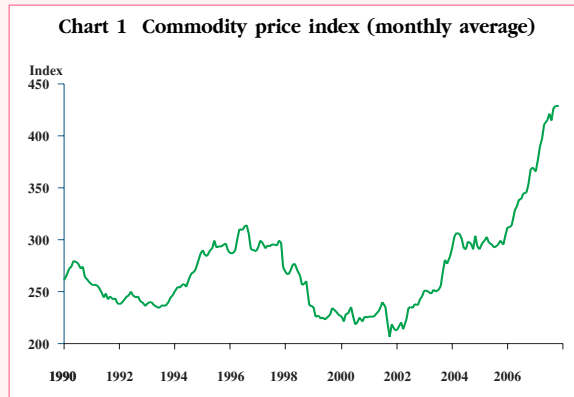


## The outlook for commodity prices and their impact on inflation

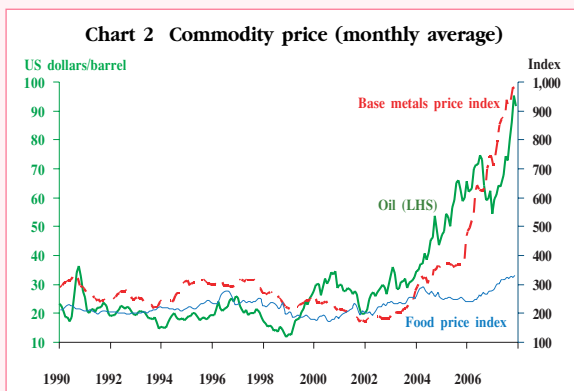
World commodity prices had continued on a rising trend since 2002. Annual growth in the commodity price index accelerated from 1.8 per cent in 2001 to 21.4 per cent in 2007<sup>1/</sup> due to surging crude oil, food and base metal prices (as shown in Charts 1 and 2). In 2008, despite the recent global economic slowdown, higher demand for raw materials in emerging markets - especially China and India - coupled with higher demand for raw agricultural materials for alternative energy production, would be the key drivers causing overall commodity prices to remain at a high level.



Source: Commodity Research Bureau

### Commodity prices in 2007 and outlook for 2008

The price of West Texas Intermediate oil increased from an average of 26.1 US dollars per barrel in 2003 to 72.3 US dollars per barrel in 2007. According to OPEC, global oil demand on average stood at 85.74 million barrels per day in 2007, an increase of 1.4 per cent from the previous year due to the continued global economic expansion. Global supply, on the other hand, was relatively tight at an average of 85.72 million barrels per day. This was lower than normal levels due to higher geopolitical risks in the Middle East coupled with unfavourable weather conditions, which led to disruptions in the transport of oil. The latter disruptions were similar to disruptions caused by the hurricane in the Gulf of Mexico, which led to lower oil stocks in the US. Moreover, the increase in oil prices also resulted from the continued depreciation of the US dollar, which prompted oil producers to try to maintain their real income by lifting oil prices in dollar terms.



Source: Commodity Research Bureau and Bloomberg: WTI

For 2008, OPEC forecasted that oil prices would persist at a high level, in line with the continued rise in global demand. Daily usage of oil should average at 87.06 million barrels, an increase of 1.32 million barrels per day from the previous year, while global oil supply was expected to average at a slightly higher level of 88.04 million barrels per day. The marginal increase in oil supply was due to the sluggish increase in oil exploration investment. Hence, there remained significant probability that oil prices would continue to remain high and volatile, given the limited excess production capacity.

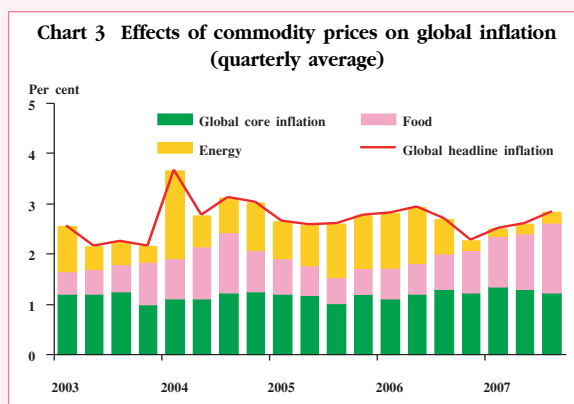
<sup>1/</sup> Source: Commodity Research Bureau

Food prices increased significantly since 2001. In 2007, the food price index increased by 21.6 per cent from the previous year, driven mainly by (1) higher production and transportation costs, given higher prices of fertilizers and oil, (2) low stocks of agricultural products, and (3) increasing demand for agricultural products such as maize and wheat, that could be used as raw materials for alternative energy production in the period of rising oil prices. Going forward, agricultural prices were expected to remain at high levels partly due to the discrepancy between supply and demand. In particular, the supply of maize, soy beans and wheat were likely to rise more slowly than the demand for these products for use as raw materials in alternative energy production, particularly given the US bio-fuels promotion policy. In addition, demand for meat products in emerging markets - in particularly China - would continue on a rising trend as standards of living increased.

The overall price of base metals<sup>2/</sup> increased by 43.6 per cent in 2007 from the previous year due mainly to a significant rise in the price of lead, iron and copper. In 2008 the pressures on the prices of copper and zinc were expected to decline owing to increased supply resulting from the expansion of production capacity in the previous period. However, the price of iron and aluminium were expected to remain high, given continued high demand in the construction and industrial sectors, especially in China and India. Overall, in 2008, the price of base metals was expected to rise at a slower rate than in 2007 as supply and demand became more balanced.

### Impact on global inflation

The significant increase in commodity prices over the past 5 years exerted a significant amount of upward pressure on global inflation. The effect of higher energy prices on inflation increased significantly in 2004, as shown in Chart 3. Nevertheless, this effect moderated towards the end of 2006, given that the rise in oil prices began to slow down, as well as the effect from a high base. In contrast, the effects of higher food prices on inflation were more significant from mid-2005 onwards, due to the factors mentioned above.



Source: BIS

Looking ahead, high commodity prices were expected to add more upward pressures on global inflation. Even though the global economy was expected to expand at a slower rate, the demand for energy and base metals from China as well as the demand for raw materials for bio-fuel production were likely to continue to increase. Therefore, global headline inflation and core inflation were not expected to converge in the near term.

<sup>2/</sup> Base metals include iron ore, nickel, lead, and aluminium