



GLOBAL ECONOMICS UPDATE

El Niño risks concentrated in EMs

- **The likelihood of an El Niño event in the second half of this year adds to upside risks to global inflation and downside risks to activity. For the advanced economies, higher prices of agricultural commodities could slow the decline in food inflation. But the risks are bigger in EMs where food has a higher weight in the CPI and where production could also be damaged.**
- The World Meteorological Organisation has announced that there is a 90% probability of an El Niño event in the second half of this year, referring to a warming of the ocean surface or above average sea surface temperatures in the central and eastern tropical Pacific Ocean. These events occur every few years and typically lead to drier weather across West Africa, South-East Asia and northern South America and wetter weather in southern South America.
- **From an advanced economy perspective, this might threaten to cause a renewed increase in food inflation, which has only recently started to ease back from its highest rate since the 1970s.** Given that the relationship between El Niño events and agricultural commodity prices has been variable and that we do not know how strong this El Niño will be, we have not changed our commodity price forecasts at this stage. (See [here](#).) But we have stressed that there are upside risks to prices, particularly of sugar, cocoa, coffee and rice.
- However, previous experience suggests that there is only a limited threat to headline CPI inflation in advanced economies. Food accounts for 12% of their CPI baskets on average, with the sugar and sweets, coffee and rice components combined making up around 2% of the basket. Overall food inflation rose by a percentage point as sugar and cocoa prices ramped up during the strong El Niño event in 1997/1998, adding 0.12ppts to the average headline CPI rate in the OECD. So this can perhaps be thought of as a “strong El Niño” scenario.
- **But there is no clear causal relationship and there have been numerous examples of OECD food inflation falling during other El Niño periods.** (See Chart 1.) That is partly because the impact on commodity prices itself is variable. But it also reflects the fact that other factors are more important in determining the price of food for consumers in advanced economies, such as processing, packaging and retailing costs. As Chart 2 shows, there is almost no relationship between annual changes in the global sugar commodity price and CPI inflation in sweet goods including biscuits, sweets and jam in the major DMs, for example.
- **It is possible that El Niño will put upward pressure on gas and coal prices due to reduced hydropower generation in Asia or higher demand for air conditioning.** That would boost energy inflation and also add to any upward pressure on food prices. After all, we explained in a recent [Global Economics Update](#) that energy prices were the most important driver of higher food inflation in advanced economies last year, while the fall in agricultural commodity prices at that time apparently had little impact.
- **In all, we estimate that the combined contributions of food and energy could be around half a percentage point larger in a “strong El Niño” scenario over the next year than under our baseline scenario. That would leave average advanced economy inflation at 3% rather than 2.5%.** But we would stress that the effect is highly uncertain and global demand and labour market conditions will be the more important determinants of food and energy inflation as well as price pressures generally in the advanced economies.
- **The effects on emerging markets could be more serious for three reasons.** First, food is a more important part of the consumer price basket and since processed foods are less commonly consumed and labour costs are generally lower, the price that consumers pay is more closely related to the raw commodity price than in advanced economies. **Accordingly, past experience suggests that El Niño conditions are often associated with higher food price inflation in EMs.** (See Chart 3.) The risks are biggest in Africa and South Asia, where food makes up a particularly high share of CPI baskets. (See Chart 4.)
- **Second, any reduction in agricultural production will hit GDP in certain EMs directly.** The biggest risks relate to lower production of cocoa (predominantly from Côte d’Ivoire and Ghana), sugar (especially from India, Thailand), coffee (Vietnam, Indonesia) and rice (Philippines, Thailand). Agriculture accounts for a

Jennifer McKeown, Chief Global Economist, jennifer.mckeown@capitaleconomics.com

Gareth Leather, Senior Asia Economist, gareth.leather@capitaleconomics.com



larger share of GDP and employment in Africa and South Asia than in other parts of the world, making these regions particularly vulnerable to a strong El Niño. (See Chart 5.)

- A sharp reduction in the volume of crops that can be exported could result in balance of payments strains for some economies. Parts of Africa (as well as Laos) stand out as being dependent on agricultural exports and also having large existing external vulnerabilities.
- **Third, there could be broader economic effects.** Several countries, mostly in Africa, are heavily reliant on hydroelectricity. (See Chart 6 and our [Climate Databank](#).) Lower rainfall could hinder electricity generation and possibly lead to power rationing. Meanwhile, heavy rainfall in Chile is already leading to disruption in the country's copper mining industry.
- **In all, the prospect of an El Niño event has not led us to change our forecasts at this stage given the uncertainties around its strength and the impact on commodity production and prices. However, it has increased upside risks to inflation and downside risks to activity which will only worsen the dilemma for central banks. The risks are greatest in EMs, where El Niño conditions threaten to prevent more central banks from cutting interest rates and could cause balance of payments strains to intensify for some.**

Chart 1: OECD Food Inflation (% y/y) & El Niño periods

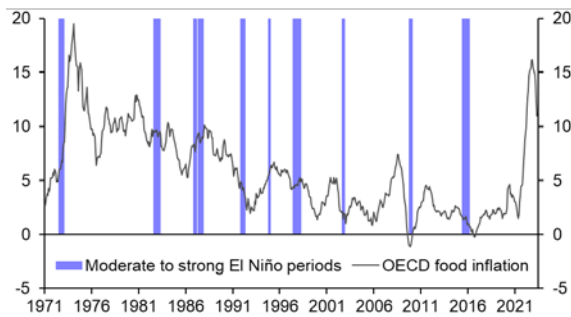


Chart 2: Global Sugar Price & Sweet Foods CPI in Major DMs (% y/y)

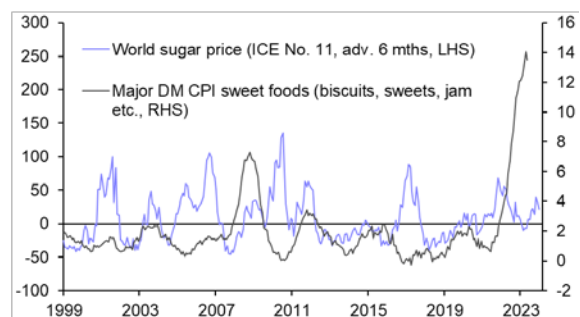


Chart 3: EM Food Inflation (% y/y) & El Niño Periods

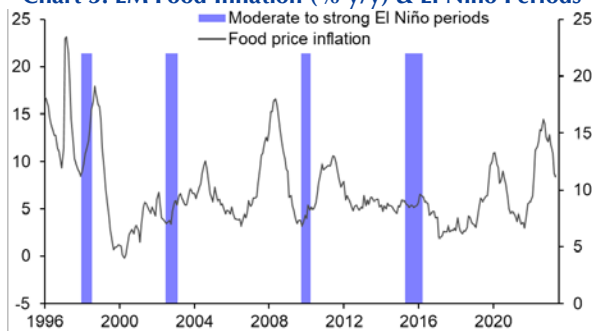


Chart 4: Weight of Food in the CPI Basket (%)

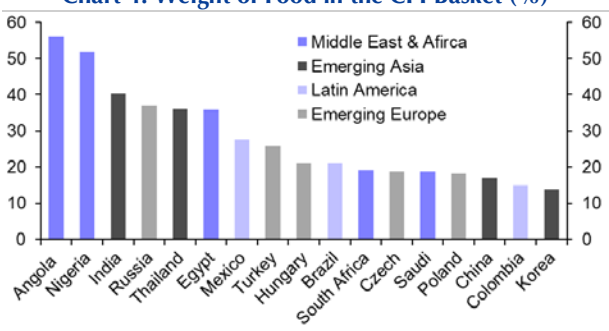


Chart 5: Agriculture (% of GDP)

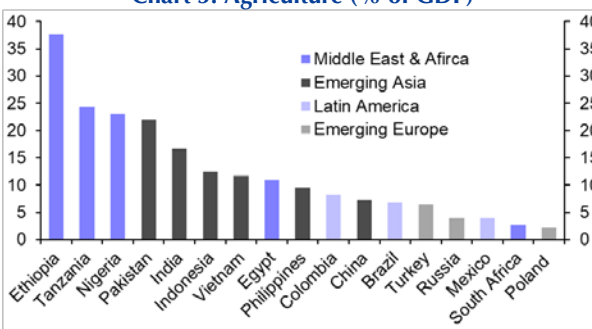
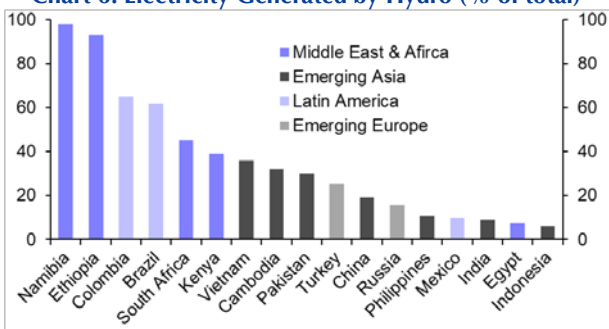


Chart 6: Electricity Generated by Hydro (% of total)



Sources: Refinitiv, CE, World Bank, OECD, World Meteorological Org.



Disclaimer: While every effort has been made to ensure that the data quoted and used for the research behind this document is reliable, there is no guarantee that it is correct, and Capital Economics Limited and its subsidiaries can accept no liability whatsoever in respect of any errors or omissions. This document is a piece of economic research and is not intended to constitute investment advice, nor to solicit dealing in securities or investments.

Distribution: Subscribers are free to make copies of our publications for their own use, and for the use of members of the subscribing team at their business location. No other form of copying or distribution of our publications is permitted without our explicit permission. This includes but is not limited to internal distribution to non-subscribing employees or teams.

