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It's All About Commodities

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For much of the past decade, the emerging markets of Brazil and Turkey were considered identical twins. Following their long history of high indebtedness and hyperinflation, which led them to the edge of the abyss in 2002, both economies embarked on a path of structural reform and staged remarkable recoveries. They appeared to share a common destiny, with their stock markets and currencies trading in sync. Till oil did them part.

The commodity-price explosion led by oil since late 2007 separated the fate of resource-rich Brazil, and resource-poor Turkey. Their divergent paths are symptomatic of the way the world has been operating this year. The only axis around which the global economy revolves is oil. In the first half of 2008, stock markets of most oil-exporting countries soared to new highs, while those of oil importers plunged 15 percent on average.

Brazil has been a significant beneficiary of the oil-obsessed world; commodities account for nearly half of its exports. Turkey, in contrast, is one of the worst-performing markets this year due to an extremely large oil-import bill and no other major commodity export to offset the oil shock. The market value of the Brazilian oil giant Petrobras is now larger than the entire market capitalization of Turkey. Within the developed world, too, the performance gap between energy stocks and the rest of the market is massive. In fact, today's outperformance in the energy sector has surpassed that of the 1970s. The only other time one sector was able to pull so far away from the broader market was in early 2000, when tech stocks topped the league tables.

But oil could sow the seeds of its own destruction. The price surge is causing a widespread inflation problem, even in oil-exporting countries. It's telling that the markets of Brazil and Russia have over the past several days joined the global bear run. In the United States, shares of energy companies are declining despite forecasts of ever-rising oil prices.

The message from the marketplace is that oil and other commodity prices have reached a point where they are choking economic growth. While the commentariat is fretting over inflation, it's interesting to note that market indicators most sensitive to inflation are rather well behaved. Gold prices have for many months been locked in a narrow trading range, with the ratio of gold to oil prices at a record low. This suggests that high oil prices are acting more as a tax on growth rather than stoking inflation fears; in the latter case, people would be scrambling to buy gold. Similarly, the yield on inflation-protected securities issued by the U.S. government has been fairly stable, reflecting well-anchored inflationary expectations.

All these signs refute warnings that the world faces a return to stagflation. In the early 1970s, global inflation surged above 10 percent and remained high throughout the decade, as higher oil and food prices triggered a vicious price-wage spiral. A major difference between now and then is the spread of the free market. In today's globally integrated world, production can move swiftly to the lowest-cost factory, trade flows freely, and it is difficult for workers to demand wage increases that are not supported by productivity growth.

The attitude of central bankers is the other big difference. Policymakers across the world are now intensely focused on taming inflation at any cost, as illustrated by the fact that nearly two dozen central banks have tightened monetary policy since late April, when oil prices jumped higher at an even more frenetic pace.

Rising interest rates will resolve the near-term inflation problem at the expense of global growth. Red-hot emerging-market economies will cool off for a while, easing demand pressure on commodity prices. Global economic growth is likely to slow to a below-trend pace of3 percent in the second half of this year from over 4 percent in 2007 with emerging market growth too likely to come off the boil from 8 percent last year to 7 percent in 2008. This is what cyclical downturns are all about: periods of below-trend growth are necessary to cleanse the system of budding

excesses so that the structural uptrend remains intact. And the scale of today's price excesses should not be exaggerated. To put the current situation in a long-term perspective, average inflation in emerging markets is currently running at 8 percent, up from a record low of 4 percent in 2005 but still well below the 20 to 30 percent levels of the 1970s and '80s.

Today's global economic structure doesn't allow the stagflationary impulses of the 1970s to build for long. The main risk to the world economy in the months ahead is a substantial slowdown in global growth rather than a rise in price pressures. A downturn should take the edge off commodity prices. There is a limit to which commodity-exporting and -importing countries can diverge. Turkey and Brazil may yet be reunited.

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