Editor's Note: The following article was produced by Fidelity's Market Analysis, Research, and Education (MARE) group, a unit of FMRCo. that provides timely analysis on developments in the financial markets.

Recent comments by the heads of the U.S. and European central banks indicate a growing concern about inflation and marked a policy shift toward potentially higher short-term interest rates in the future. Although the U.S. economy remains weak and the euro-zone countries face a deteriorating macro backdrop, it is clear that record high crude oil and commodity prices have sparked deeper concerns for central bankers, and the specter of higher inflation is now viewed as the greatest threat to the economic outlook. While this policy shift may have significant implications for the financial markets, it remains to be seen to what extent monetary policy can be effective in an environment of rising commodity prices.

Policymakers: Between a rock and a hard place

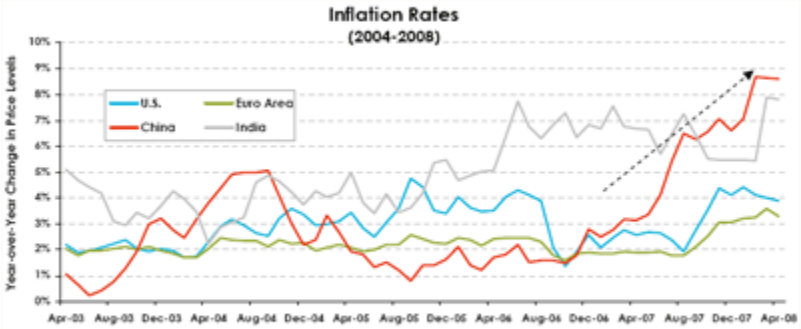
Record-high spikes in crude oil and other commodity prices are presenting the world's economic policymakers with an increasingly uncomfortable challenge. The biggest problem for central bankers is that there is no targeted solution to combat higher oil prices. Typically, central bankers raise interest rates when economic growth is strong and inflationary pressures are building, and lower them when the economy is slowing and inflation abating. But rising oil prices have the double effect of raising inflationary pressures and slowing economic growth. There is no perfect monetary response for such a situation, which heightens the risk of "policy error" in today's global economy.

Central bankers around the world are left with the unappealing choice between raising interest rates to counter inflation (which will further punish economic growth) or lowering rates to relieve the economic strain (and risk further exacerbating inflation). If interest rates are raised, it does little to mitigate the price of oil in the near-term, but it tightens credit and acts as an additional detriment to consumers and businesses already squeezed by higher energy prices. If interest rates are cut, it might actually spur additional demand and drive up energy prices even further, as well as risk a broader rise in overall inflation. This is the crux of the problem -- either raising or lowering rates reinforces one of the negative trends (slowing growth or rising inflation) that rising oil prices have already put into motion.

Range of responses

Although every country possesses unique economic circumstances, the range of central bank responses to higher crude oil prices is evidence of the lack of consensus on how to deal with the oil problem. In the United States, the Federal Reserve Board slashed interest rates to combat credit market woes and economic sluggishness, judging these problems as more immediate than unease about rising inflation. In contrast, the European Central Bank (ECB) has remained steadfast in keeping rates steady and in suggesting inflation is the greatest concern. Other developed-country responses have been mixed, including some small monetary easing (U.K. and Canada) and some continued interest rate hikes (Australia).

EXHIBIT 1: Inflation has accelerated around the world, particularly in developing economies.



Past performance is no guarantee of future results. Inflation measured by respective country's government urban consumer price index. Source: HaverAnalytics, Bureau of Labor Statistics, European Central Bank, China National Bureau of Statistics, Labour Bureau of India, FMRCo. (MARE) as of 4/30/2008.

Recently, the talk has turned tougher against inflation, shifting expectations in both Europe and the United States that the next policy moves will be to raise short-term interest rates. ECB President Jean-Claude Trichet said on June 6, 2008 that the ECB could decide to "move rates a small amount in our next meeting in order to secure the solid anchoring of inflation expectations."

Adding another wrinkle to the discussion, U.S. Federal Reserve Board Chairman Ben Bernanke suggested on June 3, 2008 that the fall in the dollar was a threat to further inflation, due to its impact on making imports more expensive. Bernanke's remarks were a rare comment by a U.S. Fed Chairman on exchange rates, and they left a clear impression that higher rates were on the horizon. (Higher interest rates generally make bond yields more attractive to global investors, hence drawing investment flows that bolster the currency.) The decline in the value of the U.S. dollar has been accompanied by a spike in commodity prices, and the Fed's rate cuts have been blamed by some analysts for deepening these trends during the past several months. Whether the dollar is a significant part of the inflation problem or not, the Fed has clearly signaled a shift in focus from economy-boosting rate cuts to a tighter monetary stance that hopes to fight inflation and stabilize the dollar. Futures markets have now shifted to expecting a Fed rate hike sometime before the end of 2008.

In the developing world, continued strong economic growth has for the most part kept the emphasis on monetary tightening, with countries such as China and India continuing to raise bank deposit ratios to limit money growth. However, there is a question of how tight monetary policies actually are. Many developing countries still maintain relatively low or even negative real interest rates (after inflation), remaining reluctant to raise rates dramatically for fears of stifling growth or attracting more inflation-inducing foreign capital flows.

Lessons from the 1970s

The primary distinction between developed and developing economies is the potential for commodity prices to pass through into labor costs and incite a wage-price spiral. In the developed world, including the United States, there are few signs of wage inflation, and wage growth over the past several months has actually decelerated amid the slowing economy. In the United States, the nation's households are experiencing a decline in real wages, which has turned consumer spending sluggish. Among developing countries, however, lower-wage workers and still booming economic growth in many areas have led to rising wage inflation pressures, particularly among lower income populations where rising food and energy prices are felt most acutely. This development threatens to become a self-reinforcing wage-price spiral similar to what took place in many countries during the 1970s/early 1980s.

In the 1970s, central banks such as the Fed in the United States generally kept interest rates too low amid rising inflation, enabling commodity prices to feed into wages and push up the overall level of inflation to a double-digit annual rate. The ECB is clearly attempting to keep this from happening by taking a hawkish stance against rising commodity prices, even in the face of a slowing economy. However, the probability of a wage-price spiral in the developed world -- similar to what took place in the 1970s -- is extremely remote given the downward pressure on wages from increased global competition, greater labor mobility, and the opportunities global companies have to outsource or arbitrage lower labor costs abroad. The ECB's efforts may well succeed in controlling inflation expectations better than the Fed, and most economists believe price stability is a prerequisite for long-term economic growth. But unfortunately, higher rates in the near-term may do little to reduce oil prices (or inflation) and will likely come at the cost of economic growth, underscoring the unsavory choice these central banks face.

Investment implications

Stabilizing the U.S. dollar and bringing down oil prices would likely be welcomed by the broader stock and bond markets; in fact, it is probably the only scenario that can avoid the undesirable trade-off between higher inflation or slower growth. Unfortunately, it is questionable whether raising interest rates in developed countries does much to affect the prices of oil and other commodities. It is true that overall demand for oil can be curtailed over time through a sustained tightening of monetary policies around the world, but this would require significant tightening among emerging-market economies that are adding the most to incremental demand, and are also the regions bolstering the global economy. A severe slowdown in the developing world would no doubt significantly raise the possibility of a global recession -- a hefty potential price to pay to bring commodity prices under control.

Perhaps tough talk from central bankers can stem the higher commodity prices/lower U.S. dollar trading momentum and shift the psychological background. Over time, however, high crude oil prices will likely help slow the global economy, as well as incite the growth of alternative energy supplies and increased efficiency among users that will ultimately lead to some relief from commodity-induced price increases. In the meantime, global central bankers face their toughest test in more than two decades. With no perfect options on the table, any future action will have to strike a delicate balance.