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Ocean hot spot brings economic risks

Few phenomena demonstrate humans' vulnerability to weather extremes like El Nino. In simple terms El Nino refers to the warm phase of a cycle of changing sea-surface temperatures off the Pacific coast of South America. However, its impacts stretch far beyond a small corner of the Pacific Ocean. Among the most important are: droughts in Australia, Indonesia, the Philippines, West Africa, Southern Africa and India; warmer-than-normal winters in the northern US and Canada; heavier-than usual rainfall in the south-west US and west coast of South America; and a weaker Atlantic hurricane season. Most meteorological models suggest that an El Nino has developed in recent months. This will be the first such episode since 2009/10.

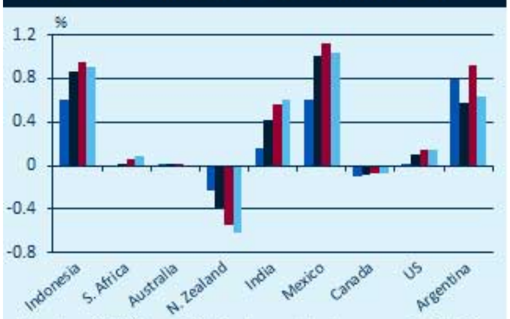
The economic effects of this El Nino will depend on its intensity. Climatologists divide El Nino episodes into four types - weak, moderate, strong and very strong. The last very strong episode was in 1997/98. We will not know how strong the current El Nino episode will be until the second half of the year when it reaches its maximum intensity. Nevertheless, there are some impacts, both negative and positive, that we should watch out for over the coming months.

Chart 1: Economic winners and losers

Effects of El Niño on Real GDP growth (cumulated response in %) after: 1 Quarter 2 Quarters 3 Quarters 4 Quarters

Source: IMF (as of April 2015)

Chart 2: Inflation shocked higher in general



Effects of El Niño on inflation(cumulated response in %) after: 1 Quarter 2 Quarters 3 Quarters 4 Quarters

Source: IMF (as of April 2015)

According to recent analysis by researchers at the IMF and the University of Cambridge, the large countries where growth is most negatively impacted by El Nino are Indonesia, South Africa, Australia, New Zealand and India (See Chart 1). For the most part these are the countries that are highly susceptible to drought and are large producers and exporters of agricultural commodities. The most positively affected countries include Mexico, Canada, the United States and Argentina, where the climactic changes lead to more favourable temperature and rainfall patterns for producers. Indeed, this El Nino could be the force that finally breaks the severe Californian drought that has devastated that state's farmers over the past couple of years.

While the growth impacts of El Nino episodes vary considerably, the fact that those countries that are negatively affected by El Nino have smaller populations and economies than those that are positively affected means, on balance, El Nino tends to boost global economic growth.

The price impacts are unambiguous - they push both fuel and non-fuel commodity prices and therefore overall inflation up. That El Nino would put upward pressure on non-fuel commodity prices and in particular agricultural prices is unsurprising - many of the countries most negatively affected by El Nino are large exporters of agricultural products such as wheat and other food grains, palm oil and cocoa (See Chart 2). The positive effect on energy commodities initially seems more surprising but stems from increased demand for coal and oil because thermal and hydro-electric production declines, as well as a more generalised increase in energy demand due to stronger global growth.

For the developed economies where inflation is currently too low, and food is a modest component of consumer price baskets, the higher inflation that could result from the current El Nino will not be a problem and could actually be beneficial to the extent that it helps lift inflation expectations out of the doldrums. However, in some emerging markets it could prove more of a nuisance. Many have been taking advantage of the low global inflationary environment and policy easing in some of the large developed economies to loosen their own monetary conditions against a backdrop of tepid domestic growth. Food also tends to comprise a much larger proportion of total consumer spending making it harder to look through inflation shocks originating in the food sector. As a result, countries like India, Indonesia and Turkey could find themselves having to reverse policy course just as the Fed is commencing its own policy tightening cycle. It could also make it more difficult for the Brazilian central bank to commence policy easing in the first half of 2016 as food inflation could be rising just as administered price inflation is coming off.

For investors, it will pay to monitor the current El Nino episode closely because where growth and inflation go, so do monetary policy and the asset prices that are shaped by them.

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