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Effects of higher commodity prices on Economy

At a Glance

Introduction

The last two and a half years have been difficult for the world economy on account of the COVID-19 pandemic. Repeated waves of infection, supply-chain disruptions and, more recently, inflation have created particularly challenging times for the governments and other financial regulators. The inflation rate is mushrooming and this is burning a hole in the common man's pockets. The ongoing geopolitical tension between Russia and Ukraine has fuelled an increase in fuel, edible oil and other household goods prices.

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Rising Commodity Prices : Effect on Indian Economy

It's been more than 100 days since the Russia-Ukraine war marred the Indian economy. With the invasion, prices of essential commodities rose, and along with it, the annual inflation rate went up to 7.04 per cent in May 2022. Vanaspati oil, wheat, mustard oil and sugar were the most impacted commodities due to this crisis. Price of Vanaspati oil on May 31 this year was 26.6 per cent higher than the same day in 2021 whereas wheat was 14.3 per cent higher. Prices of mustard oil and sugar were 5.1 per cent and 4.1 per cent more than the corresponding day in the last year.

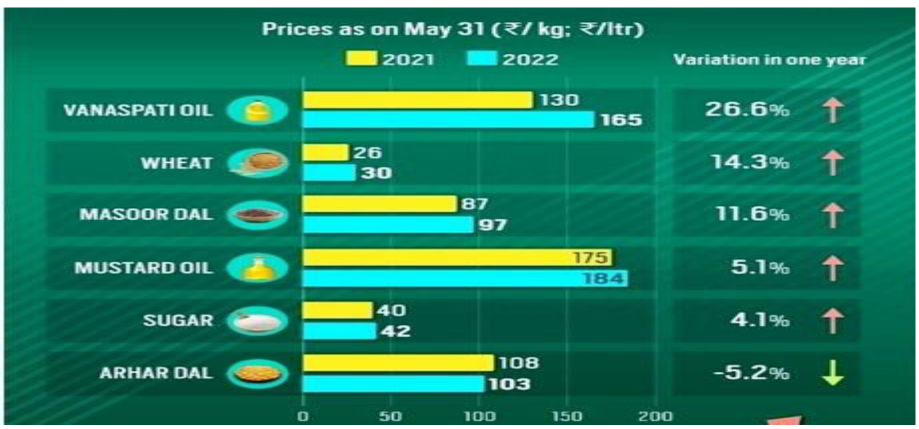

Figure1: Variation of prices as on 31 May 2022

As if the rise in prices of commodities was not enough, rise in crude oil prices only exacerbated the already worsening situation. At the beginning of 2022, Brent crude prices stood at around $80 per barrel. Soon after the Russia-Ukraine crisis hit global economy like a thunderbolt, Brent crude went as high as $128 per barrel. Crude oil prices scaled a new high with Brent crude reaching $122.8 per barrel on May 31. Markets have also been heavily impacted by the ongoing standoff between Russia and Ukraine as foreign portfolio investors (FPIs) pulled out over Rs 1 lakh crore from the Indian markets in the three months since the stalemate began, Rs 50,000 crore more than the combined withdrawal of previous nine months.

Other cause for heavy selling by foreign investors in Indian markets are monetary tightening around the world due to inflation. Foreign Portfolio Investments (FPI) pullout has led to the depreciation of the Indian rupee versus the US dollar. The Indian rupee has been on a downward spiral for the last few days and on 29 June 2022, it hit a record low of 79.03 against the US dollar. Weak rupee has also impacted imports adversely, especially oil imports.

Figure 2: Foreign portfolio investor pull out in last 3 months

India’s GDP numbers have also felt the impact of the ongoing Russia-Ukraine war. Experts believe that inflation will be a persistent issue for a while and the economy has been tackling a surge in prices for a while now. Deloitte India Economist said, “The government’s intervention in the form of duty cuts on imports, subsidies on fertilisers and cooking gas, duty cuts on fuels to protect customers and businesses from high inflation is likely to impact the fiscal deficit in the coming quarters.” While government of India’s chief economic adviser also acknowledged heightened inflation.

As per the latest data by the Ministry of Commerce and Industry, in India the annual rate of inflation is recorded 15.88 per cent (Provisional) for the month of May, 2022 (over May, 2021) as compared to 13.11 per cent in May, 2021. The high rate of inflation in May, 2022 is primarily due to rise in prices of mineral oils, crude petroleum & natural gas, food articles, basic metals, non-food articles, chemicals & chemical products and food products etc. as compared to the corresponding month of the previous year.

WPI INFLATION FOR MAY AT 15.88%

Index Numbers & Annual Rate of Inflation (Y-o-Y in %)*

All Commodities/ MajorGroups	Weight (%)	Mar-22 (F)		Apr-22 (P)		May-22 (P)	
		Index	Inflation	Index	Inflation	Index	Inflation
All Commodities	100.0	148.9	14.63	151.9	15.08	154	15.88
I Primary Articles	22.6	170.9	15.94	174.9	15.45	179.8	19.71
II Fuel & Power	13.2	143.9	31.78	151	38.66	154.4	40.62
III Manufactured Products	64.2	142.3	11.26	144	10.85	144.8	10.11
Food Index	24.4	168.2	9.29	172.9	8.88	176.1	10.89

*Note: P: Provisional, F: Final, *Annual rate of WPI inflation calculated over the corresponding month of previous year*

Month Over Month (M-o-M in %) change in WPI Index#

All Commodities/ MajorGroups	Weight (%)	Dec-21	Jan-22	Feb-22	Mar-22	Apr-22 (P)	May-22 (P)
All Commodities	100.0	-0.28	0.35	1.04	2.48	2.01	1.38
I Primary Articles	22.6	0	-0.53	0	2.03	2.34	2.8
II Fuel & Power	13.2	-1.62	1.12	2.22	4.05	4.93	2.25
III Manufactured Products	64.2	-0.07	0.51	1.24	2.45	1.19	0.56
Food Index	24.4	-0.82	-1.71	0.24	0.9	2.79	1.85

Note: P: Provisional, #Monthly rate of change, based on month over month (M-o-M) WPI calculated over the preceding month

Figure 3: Variation in WPI Inflation

Facing the hiccups of the entropic economic situation, in India too commodity prices have shot up substantially across the board, with adverse fallouts on net commodity importers. Financial markets have exhibited increased volatility. Crude oil prices jumped to 14-year high at $140 a barrel in early March 2022 and the supply chain pressures, which were expected to settle, are rising again. After rising to a 95-month high of 7.79 per cent in April 2022, retail inflation rate for May 2022 remained at 7.04 per cent. With this, retail inflation has remained above the upper tolerance level of the RBI’s medium-term inflation target for the fifth consecutive month.

With the food prices accelerating while commodity rates hardening further, India's Wholesale Price Index (WPI) based inflation rate shot up in May 2022 to 15.88 per cent, a record high in the current 2011-12 series. With this, WPI-based inflation has been in double digits for 14 consecutive months. The figure also **makes it historically the highest in over 30 years since September 1991** (16.31 per cent).

On the basis of an assessment of the current and evolving macroeconomic situation, the Monetary Policy Committee (MPC) at its meeting on 8 June 2022 decided to increase the policy repo rate under the Liquidity Adjustment Facility (LAF) by 50 basis points to 4.90 per cent with immediate effect. Consequently, the Standing Deposit Facility (SDF) rate stands adjusted to 4.65 per cent and the Marginal Standing Facility (MSF) rate and the Bank Rate to 5.15 per cent. The MPC also decided to remain focused on withdrawal of accommodation to ensure that inflation remains within the target going forward, while supporting growth. These decisions are in consonance with the objective of achieving the medium term target for Consumer Price Index (CPI) inflation of 4 per cent within a band of +/- 2 per cent, while supporting growth.

> "The MPC also recognized that sustained high inflation could unhinge inflation expectations and trigger second-round effects. It, therefore, judged that further monetary policy measures are necessary to anchor the inflation expectations."
>
> **Shaktikanta Das**

Reasons behind rising Commodity Prices

The price of industrial commodities, including copper, steel, aluminium, lead, nickel as well as precious metals such as gold and silver have seen a sharp surge recently in the international market. As the economic activities around the world are gearing up, the production and demand for such commodities have risen. The price of copper has risen over 27 percent in the last year while that of steel has gained more than 17 percent. Aluminum rallied around 13 percent, zinc 21 percent, nickel 20 percent while iron ore more than 75 percent in the last one year period. Among precious metals, gold and silver prices have jumped over 25 percent and 53 percent, respectively. This rally in the commodity prices was on the back of a number of factors. These are:

Demand from China

An important factor behind the rally in the commodity prices from their March lows has been the rising demand from China. The manufacturing activities in the major Asian economy has been on the rise. This can be seen as the Chinese factory output in November hit a 20-month high.

Supply disruptions

As the demand for industrial commodities was rising with the easing of lockdowns globally, the supply chains are still disturbed and the transportation issues prevail, pushing up commodity prices.

US stimulus hopes

The US House of Representatives, voted to pass a $900 billion corona virus stimulus package. Analysts believe the package would further fuel demand for commodities as people will spend more. Meanwhile, the US Federal Reserve along with the other global central banks have pumped in huge liquidity into the markets over a period of time to counter the economic impact caused by the COVID-19 pandemic and the subsequent lockdowns. This has boosted precious metal prices. Easy money is supportive for commodity prices, especially precious metals, analysts said.

Investment demand

According to a report, the hedge funds had invested over $4 billion in the commodities market till October 2020. The fund managers are recommending commodities as an asset to invest in leading to a sharp rise in returns from some of the commodities funds this year.

Impact of rising Commodity Prices on India

As the Indian economy started its unlocking phase, it saw a pent-up demand for commodities, driving prices further. However, this price increase has spooked fears of inflation in the domestic markets along with worries over increasing raw material cost for many sectors. The Reserve Bank of India (RBI) also seemed worried by the rising inflation as understood from the minutes of its recent bi-monthly monetary policy. The central bank had changed the key policy rates citing a rise in inflation. The MPC of RBI, which met from 6-8 June 2022, decided to hike the Repo Rate by 50 basis points to 4.90 %. Consequently, Standing Deposit Facility Rate stands adjusted to 4.65% and Marginal Standing Facility rate and Bank Rate to 5.15%. Further, among the worst-hit sectors from the booming international commodity prices are the auto and infrastructure sector. The Minister for road transport and highways has written to Hon'ble Prime Minister, expressing concern over a 55 percent increase in steel prices in the last six months. The spike was making infrastructure projects unviable. The recent surge in steel, aluminum, copper, palladium and rhodium prices have prompted automobile manufacturers to hike the prices of vehicles across sectors.

Rising commodity prices push demand for bank loans

According to the RBI, infrastructure credit, which accounts for 38% of the total industrial credit, grew 11.9% in February 2022, driven by the road and power sectors and the government's capex push. The surge in commodity prices in the wake of the Russia-Ukraine war may have turned out to be a boon for banks in India as lenders are now witnessing higher demand for working capital. The increased cost of raw materials has led to companies utilising their working capital limits and even seeking top-ups. The credit off take improved during FY22, with the gradual return of normalcy after two waves of the pandemic and despite a relatively milder third wave. Non-food credit extended by banks grew 9.7% year-on-year (y-o-y) as on March 25, according to data released by the Reserve Bank of India.

Auto majors such as Tata Motors, Maruti Suzuki, M&M, Hero MotoCorp, Hyundai, Kia have already announced price hikes for their vehicles. The rising steel prices do not bode well for the real estate sector as well. Steel prices have seen an unprecedented rise over the last five months as prices of HR Coils have risen by Rs 9,000 and TMT bar (12 mm, Mumbai) prices have risen by Rs 7,450 per tonne in this period. Firm international prices, pick-up in domestic demand and cost-push are expected to keep steel prices firm over the remaining part of the current fiscal year, CARE Ratings said in a report. Real estate developers are worried that the continuous upsurge in raw material prices will increase the project cost and will have a cascading effect on homebuyers. Seeking urgent government intervention, the real estate developers body CREDAI, recently wrote a letter to Hon'ble Prime Minister requesting the government to step in to curb spiraling steel and cement prices. CREDAI also urged the government to take note of alleged cartelization by cement and steel manufacturers.

India's gold imports in May 2022 jumped 677% from a year ago to the highest level in a year as correction in prices just before a key festival and wedding season boosted retail jewellery purchases. Higher imports by the world's second-biggest bullion consumer could support benchmark gold prices, but the surge could increase India's trade deficit and put pressure on ailing rupee.

Steps taken by Government of India to cool prices

The Government of India responded to high inflation in the economy by announcing a series of steps to cool prices and cushion the impact on the common man. This comes after retail inflation hit 7.8 per cent in April 2022 and the wholesale prices crossed 15 per cent reflecting the input cost pressures. The rising food and fuel prices have made the situation worse in the wake of the Russia-Ukraine war. The shortage of key raw materials and stressed supply lines pose a further challenge to the inflation trajectory. To bring down the prices, the government has taken the diverse steps which are shown below:

- The government announced an excise tax cut of Rs 8 per litre on petrol and Rs 6 per litre on diesel. The government will bear a shortfall of Rs 1 lakh crore due to the excise duty cut on petrol and diesel.
- Taking a cue from Centre. three states - Kerala, Rajasthan and Maharashtra - also announced reduction in state taxes. The reduction in pump prices of petrol and diesel will bring down the logistics cost for the industry.
- The government also reduced the import duty on key raw materials and inputs for the steel and plastic industry.
- The government has levied export duty on some steel products and raised it on irone ore and concentrates. Together with the import duty cut, the price of steel will come down.
- During the current and next financial year, the government has permitted duty-free imports of 20 lakh tonnes of crude soyabean and crude sunflower oil.
- Under the Ujjwala Yojana, the government has also granted a Rs 200 per cylinder subsidy. This will benefit around nine crore beneficiaries.
- The government set a limit of 100 lakh tonnes on sugar exports to ensure that there is adequate stock when the sugar season begins in October to cover three months' worth of consumption.
- The Centre has also regulated sugar exports to maintain adequate stocks in the country. From 1 June 2022, only 10 million tonnes of sugar can be exported in the current marketing year which ends in September.
- The government put a ban on wheat exports to maintain food security and cool prices.
- Over and above Rs 1 lakh crore budgeted for the current fiscal, the government will provide an additional fertiliser subsidy of Rs 1.1 lakh crore to farmers.

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Glossary

- **Stagflation:** Stagflation is characterized by slow economic growth and relatively high unemployment—or economic stagnation—which is at the same time accompanied by rising prices (i.e., inflation). Stagflation can be alternatively defined as a period of inflation combined with a decline in the gross domestic product (GDP).
- **Inflation:** Inflation is the percentage change in the value of the Wholesale Price Index (WPI) on a year-on year basis. It effectively measures the change in the prices of a basket of goods and services in a year. In India, inflation is calculated by taking the WPI as base.
- **Hedge Funds:** Hedge funds are actively managed investment pools whose managers use a wide range of strategies, often including buying with borrowed money and trading esoteric assets, in an effort to beat average investment returns for their clients. They are considered risky alternative investment choices.
- **Foreign portfolio investors:** Foreign portfolio investment (FPI) consists of securities and other financial assets held by investors in another country. It does not provide the investor with direct ownership of a company's assets and is relatively liquid depending on the volatility of the market. Along with foreign direct investment (FDI), FPI is one of the common ways to invest in an overseas economy. FDI and FPI are both important sources of funding for most economies.
- **Wholesale price Index (WPI)**: Wholesale Price Index (WPI) represents the price of goods at a wholesale stage i.e. goods that are sold in bulk and traded between organizations instead of consumers. WPI is used as a measure of inflation in some economies.
- **Liquidity Adjustment Facility (LAF):** A Liquidity Adjustment Facility is a tool used in monetary policy, primarily by the Reserve Bank of India (RBI) that allows banks to borrow money through repurchase agreements (repos) or to make loans to the RBI through reverse repo agreements. This arrangement is effective in managing liquidity pressures and assuring basic stability in the financial markets. In the United States, the Federal Reserve transacts repos and reverse repos under its open market operations. The RBI introduced the LAF as a result of the Narasimham Committee on Banking Sector Reforms (1998).
- **Marginal Standing Facility**: Marginal Standing Facility (MSF) is a window for banks to borrow from the Reserve Bank of India in an emergency situation when inter-bank liquidity dries up completely.
- **Consumer price index (CPI)**: A comprehensive measure used for estimation of price changes in a basket of goods and services representative of consumption expenditure in an economy is called consumer price index.
- **Standing Deposit Facility:** This is a facility which allows the RBI to absorb surplus funds from banks without collateral. Banks too continue to earn interest (though possibly lower than the existing reverse repo rate). In effect, it empowers the RBI to suck out as much liquidity as needed.
- **CREDAI:** The Confederation of Real Estate Developers' Associations of India (CREDAI) is the apex body of private Real Estate developers in India, established in 1999, with a vision of transforming the landscape of Indian Real Estate industry and a mandate to pursue the cause of Housing and Habitat