Inflation and Supply Chain disruptions: A "Persistent" Pain?

15 August 2022

Vipin Malik, Chairman, Infomerics Ratings
Dr. Asim K. Karmakar, Assistant Professor in Economics,School of Professional Studies, Netaji Subhash Open University, Kalyani, Nadia
Sankhanath Bandyopadhyay, Economist, Infomerics Ratings

Abstract

Inflation is probably the biggest challenge, which the global economy is facing currently, including India. The inflation has started to increase gradually post-pandemic across Advanced Economies (AEs) as well as Emerging Markets and Developing Economies (EMDEs). The geopolitical issue got complicated after Russia invaded Ukraine, which caused tremendous hardship for the global economy and disturbed the entire supply chain.

The World Bank energy price index was 81 per cent higher than 2020, while metals and minerals and agro-products have also been firmed. Energy prices have increased sharply in the first quarter of 2022 due to geopolitical aspect, and succeeding economic sanctions imposed by US and other countries. Many Central Banks (CBs) in an attempt to combat inflation, have raised their policy rates including the Reserve Bank of India (RBI) that have raised the repo rate by 40 basis points to 4.40% in an unscheduled meeting during April 2022 (before the June'2022 monetary policy). The Fed has a target federal funds rate in the range 0.75%-1%. Going forward, a global recessionary fear cannot be ruled out which can originate from US with a global ramification impact. In this regard, the paper is an attempt to unfold the global inflation scenario and suggesting the way forward.

Keywords: Inflation, repo rate, bank rate, interest rate, monetary policy, crude oil prices, dollar index, geopolitical, standing deposit facility, cash reserve ratio.

JEL Code: E31, E32, E43,E44, E52,E58.

I. Introduction

While globally inflation is on the upsurge, the Russia-Ukraine tussle has made the situation more precarious. Growth forecast for major economies like US, China, EU are revised downward. Commodity price are sky-rocketed; and inflation is likely to be high going forward. For 2022, inflation is projected at 5.7 percent in advanced economies and 8.7 percent in emerging market and developing economies. The global economic growth projected to slow from an estimated 6.1 percent in 2021 to 3.6 percent in 2022 and 2023. The rule-based framework is in doldrums following the Russian invasion in Ukraine and consequent issues that are emanating from this.

It is interesting to note that, inflation has started increasing even before the war. Many central banks have started raising interest rates signaling that the era of easy money policy is over. For instance, Bank of England has increased Bank Rate by 0.25 percentage points, to 1% in a majority voting. On 13th April 2022 the Bank of Canada increased its target for the overnight rate to 1% with the Bank Rate at 1 ¼ % and the deposit rate at 1%.

The Bank will begin quantitative tightening effective 25th April 2022 Maturing Government of Canada bonds on the Bank's balance sheet will no longer be replaced and, as a result, the size of the balance sheet will decline over time. On 12th April 2022 the Central Bank of New Zealand raised interest rates by a hefty 50 basis points to 1.50% its fourth hike in a row as it seeks to reduce second round effects from sharply rising inflation The risk of more persistent high inflation expectations has increased The Committee agreed that their policy 'path of least regret' is to increase the Official Cash Rate by more now, rather than later, to head off rising inflation expectations and minimise any unnecessary volatility in output, interest rates, and the exchange rate in the future.

Many European countries depend largely on Russia for their energy requirements, which is supplied through a network of laid pipelines –running through Ukraine. If the conflict and sanctions continue, energy supplies to Europe at peak wintertime will be disrupted heavily and a global repercussion impact is likely.

Sanctions by the West will cause collateral damage for both the Russian and Western economies leading to high inflation. Russia closed its air space to 36 countries. Also, many shipping lines will now need to take a different route, adding to fuel costs.

Since, India among others depends heavily on Russia for crude oil, natural gas, edible oil, many intermediate commodities, inflationary pressure will build up. India needs to strategically handle the crisis, with gradually strengthening trading relations with other emerging market economies.

II. Food Inflation is on the upsurge

Food inflation is rising rapidly. During September 2021 and April 2022, consumer food price inflation in India has risen from 0.68% to 8.38% year on year. The FAO food price index (FFPI) has reached an all-time high in March 2022; though moderated slightly in April 2022 [averaged 158.5 points in April 2022, down 1.2 points (0.8 percent) from the all-time high reached in March, though still 36.4 points (29.8 percent) above its value in the corresponding month last year. The drop in the FFPI in April was led by a significant downturn in the vegetable oil sub-index, along with a slight decline in the cereal price sub-index. Meanwhile, sugar, meat and dairy price sub-indices sustained moderate increases.].

The current food inflation is emanating due to largely supply-side issues. According to the FAO [6 May 2022] Press Release, "*International wheat prices edged upwards in April, albeit marginally, gaining 0.2 percent. Continued blockage of ports in Ukraine and concerns over 2022 crop conditions in the United States of America kept prices elevated, but the price increases were moderated by larger shipments from India, higher-than expected exports from the Russian Federation, and slightly dampened global demand as a result of high prices. International rice prices in April went up 2.3 percent from their March levels, sustained by a combination of strong local demand in various Asian exporters, purchases by Near Eastern and Chinese buyers and weather setbacks in the Americas*."[1]

The **FAO Dairy Price Index** averaged 147.1 points in April 2022, which has been increased by 1.3 points (0.9 percent) from March 2022, thereby maintaining its

[1] "FAO Food Price Index retreated slightly in April from the all-time high registered in March"(06/05/2022)FAO Press Release; https://www.fao.org/worldfoodsituation/foodpricesindex/en/

eighth consecutive monthly increase and elating the index 28.0 points (23.5 percent) above its value from the last year. In April 2022, the dairy product prices continue to increase, driven by the obstinate global supply tightness, as milk output in Western Europe and Oceania continued to track below their seasonal levels. International quotations for butter increased the most, indicating tight supply conditions. Inventories remain low, especially in Western Europe, amidst a surge in demand for near-term deliveries, partly induced by the current shortage of sunflower oil and margarine. Despite a decline in foreign purchases, persistent internal demand and stumpy inventories in Europe provided support to world skim milk powder and cheese prices. On the other hand, whole milk prices fell moderately, mainly due to a demand slowdown in China.

The FAO meat price index sets a new high in April 2022, as it has averaged 121.9 points in April, up 2.7 points (2.2 percent) from March 2022. The upward pressure on meat prices remain firm due to higher bovine, poultry and pig meat prices. Avian influenza outbreaks in the Northern hemisphere and tight export condition from Ukraine have put an upward pressure on poultry prices. Higher ethanol prices in Brazil, coupled with the sustained strengthening of the Brazilian Real against the US dollar continued to reinforce the increase in world sugar prices.

Before the war, Ukraine had a drought from 2020-to 21, while Russia, in December 2020, announced export curbs on wheat, corn, barley, rye, sunflower, and rapeseed for suppressing domestic inflation. The Ukrainian drought and Russian export controls, supplemented by the pandemic-induced shortages of migrant workers in Malaysia's oil palm plantations; have cumulatively increased global prices of edible oils and cereals.

The Russia-Ukraine tussle has escalated the commodity inflation; further Indonesia's initial restriction (even a temporary ban) on palm oil shipments to contain local inflation and swelling petroleum crude prices, making it all the more attractive to divert sugar, corn, palm and soyabean oil for bio-fuel production.

III. Implications and Impact for India

Geopolitical tensions propelled initially oil prices to $105/ barrel, On 3 March'22, it further increased to $113/barrel, and subsequently to $139/barrel. It reflects lookwarm response by the US-led initiative for a co-ordinated release of 60 million barrels from emergency stockpiles of 31 IEA member countries.

What would be interesting to watch is how far oil prices rise over the coming days. Oil markets are extremely close-fitting and any disruption in oil supply or demand could have a prodigal impact on global growth, particularly on Asia's emerging economies.

In the worst case scenario, where Russian oil supply is disrupted, oil prices could go up significantly higher - which now seems a strong possibility. According to the International Energy Statistics (IES), while the USA and Saudi Arabia together have 32% share of global oil production, Russia's share is 11%. In oil exports, Russia ranks 2nd after OPEC countries. Russian oil is also relatively cheap and better quality unlike countries like Venezuela.

For Oil market Companies (OMCs), retail prices are normally under market prices; and the excise duty cut in November'2021 was mild; and now the excise duty is reduced to ₹ 8 per litre for petrol and ₹6 per litre for diesel.[2] Will the Government of India (GoI) incur further revenue loss, with another round of reduction? Such possibility is less likely. It is interesting again to note that, in April 2020, when global oil prices was negative, our domestic oil price did not decline, since historically excise duty is high along with dealer's commission, including State level VAT. All such structural issues have made very difficult to reduce oil prices in India.

In the short run, a change in prices of crude products will affect the inflation directly due to their weighted contribution in the index (Headline inflation will be impacted). Over time the retail prices of all other commodities manufactured using crude as an input will also increase. Strengthening crude oil prices might affect – aviation, paint, tyre, OMCs, whereas upstream oil exploration companies might be benefitted due to appreciation of crude oil prices.

Rupee on 7 March'22 declined to its historic low at USD/INR 76.93 (around 77) amid crude oil tension that hit $130 barrel and jittery financial market sentiments. Dollar sales by RBI at INR/USD at 76.97 prevented INR to fall further. Demand

[2] Times of India (23 May 2022).

for dollar remains high whereas few exporters sold dollar at 76.97. Expectation is that INR will decline further. The dollar index remained very strong around 99, which further became stronger crossing 100.

The yield of 10 year G-Sec increased to 6.89 on 8 March 2022 from 6.88 on 7 March 2022, which increased from 6.81 on 4 March'22. FPIs sold stocks worth INR 20,000 crore in cash segment in four trading sessions in March'22. FPIs are selling across all countries due to negative sentiments.

Since two-wheelers have higher exposure to aluminum and precious metals, the industry may have to increase prices to cover additional costs. Further, Palladium a precious metal used in catalytic converters is also trading high. Other commodity prices like – ammonia, urea, potash and phosphate, palladium, platinum, steel, nickel, copper etc; will also increase.

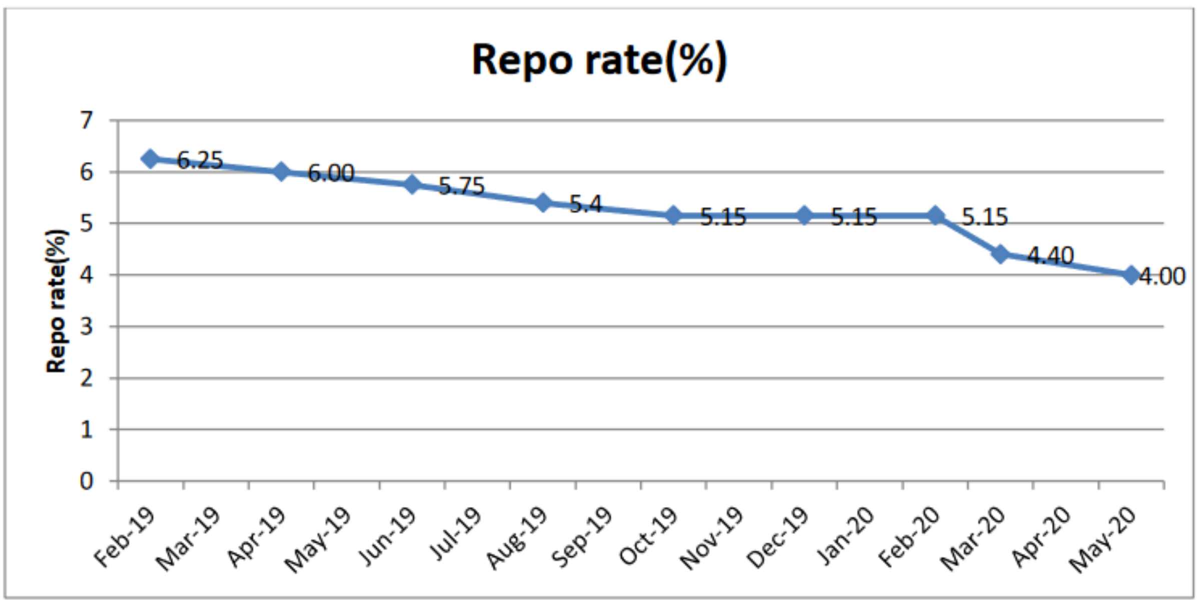
Commodity market will feel the heat going forward since Russia is one of the biggest exporters of major metals. Edible oil (sunflower oil) supply is also getting impacted. On average, India purchases 17 lakh tonne of sunflower oil from Ukraine, 5 lakh tonne from Russia and 3 lakh tonne from Argentina. Sunflower oil supply from Ukraine and Russia got disrupted due to Russia's invasion to Ukraine. On the other hand, supply from Indonesia got subdued due to lower exports and Soy oil from South America has not increased much due to drought.

The crisis is going to make a shortage of potash, which is a major ingredient used in manufacturing of fertiliser. Russia, Belarus are major sources of potash suppliers to India, and India imports some amount of potash from Russian ports, due to sanctions such supplies might be impacted. Certain Potash miners in Canada are also not keen in raising potash production; thus prices are also not getting moderated. Such developments might push up potash prices, hence might force the government to provide for more fertiliser subsidy.

IV. The Reserve Bank of India's (RBI) Monetary Policy Revisited

Though Market was expecting repo rate hike by June'2022, the RBI has increased the policy repo rate by 40 bps from 4 to 4.40% on 4 May 2022, thus providing space for further repo rate hike by June'2022[possibly by another 40 bps thus taking the repo rate towards 4.80% by June 2022?]. Interestingly, the repo rate was

4% for the first time in 22 May 2020 and after that remained same until 4 May 2022(Wednesday). Interestingly, earlier since 7th Feb 2019, the RBI was on rate cut mood; on this date it was 6.25%, on 4 April 2019, it was reduced to 6.0%, on 6 June 2019 it was 5.75%, on 7 August 2019 it was 5.40%, on 4th October 2019 it was 5.15%, it remained same on 5th December 2019 as well as on 6th February 2020. On 27th March, 2020, it was further reduced to 4.40%, before settling at 4% on 22 May 2020. Since then, it remained status quo (no up, no down) until 4 May 2022. Interestingly, a similar reverse has happened today (4 May 2022) in line what happened from 22 May 2020 to 27th March 2020.



Source: RBI Monetary Policy Documents, accessed in different years.

It may be noted from the above Chart that repo rate remained same since May 2020 [at 4%] until 4th May 2022 [4.40%]. In fact, during those days [Feb'2019-May2020] the mantra for policy rate was largely like- "*The MPC notes that the output gap remains negative and the domestic economy is facing headwinds, especially on the global front. The need is to strengthen domestic growth impulses by spurring private investment which has remained sluggish*."

Interestingly, even while in December 2021, the tone was dovish to some extent:

"*The MPC noted the supply side measures taken by the government to contain food prices as also the calibrated reductions in central excise duties and state VAT (value added taxes) on petrol and diesel. Crude oil prices have also softened since end-November. According to the MPC, such developments would ease the domestic cost-push build-up to some extent.*"

Further the February 2022 Monetary policy stated that "The MPC notes that inflation is likely to moderate in H1:2022-23 and move closer to the target rate thereafter, providing room to remain accommodative. Though it acknowledged "The potential pick up of input costs is a contingent risk, especially if international crude oil prices remain elevated." It is in this context that the MPC has decided to keep the policy repo rate unchanged at 4 per cent and to continue with an accommodative stance as long as necessary to revive and sustain growth on a durable basis and continue to mitigate the impact of COVID-19 on the economy, while ensuring that inflation remains within the target going forward"; this has changed in the April 2022 Monetary policy as "Concerns over protracted supply disruptions have rattled global commodity and financial markets, given the significant share of the two economies engaged in war in global production and exports of key commodities like oil and natural gas; wheat and corn; palladium, aluminium and nickel; edible oils; and fertilisers."

In 4th May 2022' monetary policy, another notable point was the increase of the Cash Reserve Ratio (CRR) by 50 bps to 4.50%, which is likely to withdraw liquidity of the order of ₹87,000 crore. The hike has indicated RBI's intention to control liquidity at a much sharper pace, in fact RBI's introduction of SDF and previous policy tone is also in line with the intent of absorbing huge surplus liquidity. As highlighted in the Governor's statement - average surplus liquidity in the banking system (which is reflected in total absorption through SDF and variable rate reverse repo (VRRR) auctions) amounted to ₹7.5 lakh crore during April 8-29, 2022.

In fact, the operating target, i.e. the weighted average call money rate (WACR) remained below SDF due to the large liquidity overhang in the form of daily surplus funds parked under the SDF[4.15% vis-à-vis-3.65%]. Ten-year G-Sec is up 27 bps at 7.39 after the announcement. The policy action is attempted towards [1] aimed at lowering inflation [2] anchoring inflation expectations. Post-rate hike today, market anticipates further rate hike on average towards 5.15% by end-Year.

V. Concluding Remarks:

The inflation scenario that has been initiated by the pandemic related disruptions, has been further complicated after the Russian invasion in Ukraine. The rise in global commodity prices was largely instigated by energy, natural gas and coal prices. The global crude oil prices remain volatile. The current inflation imbroglio can be explained largely by factors emanating from supply-side issues, or the so-called "cost-push" inflation, albeit a part may be due to easy liquidity pumped during pandemic catastrophe. In India, recent excise duty cut on fuel is a welcome move, though containing many inflation-contributing factors might be challenging.

References:

1. Food and Agriculture Organisation (06/05/2022): "FAO Food Price Index retreated slightly in April from the all-time high registered in March" *FAO Press Release;* https://www.fao.org/worldfoodsituation/foodpricesindex/en/.
2. IMF (April 2022): "World Economic Outlook".
3. RBI *Annual Report, 2021-22*.
4. RBI (4 May 2022): "Governor's Statement."
5. RBI (30 March 2022): *Monetary Policy Report*.
6. RBI (18 May 2022): "Minutes of the Monetary Policy Committee."
7. RBI (8 April 2022): *Bi-monthly Monetary Policy Statement, 2022-2023*.
8. RBI (8 April 2022): *Monetary Policy Report – April 2022*.
9. United Nations (2022): "World Economic Situation Prospects as of mid-2022".