FIJI TIMES

.

Saturday, August 25 2012

Inflation and Falling Commodity Prices

T. K. JAYARAMAN

Two news items hit the headlines early this week.

One is about falling commodity prices and its likely adverse impact on commodity export dependent Pacific island countries (PICs). The other is about rising prices and its favourable impact on growth and incomes of farmers.

How could inflation be good for growth? Is it not bad for consumers? Are inflation and growth compatible?

Let us check the first news item in detail.

Falling price level

The latest *Pacific Quarterly Report* issued by ANZ Bank says lower commodity prices are hurting PICs. World prices of palm and coconut oil, sugar, cocoa, coffee and rice have been falling in the first half of 2012 and are expected to fall further, except rise in rice price which has levelled off. So too prices of minerals, including gold and crude.

The resource rich Melanesian country, PNG, which exports gold and oil and non-mineral agricultural commodities, including coffee and cocoa, and Solomon Islands, which exports palm oil will be adversely affected. Their export earnings will be declining, if export prices are falling.

The Polynesian countries would also suffer. Samoa and Tonga are dependent on coconuts and related products. Thus, PICs producing hard and soft commodities will be badly affected if their export prices decline as against prices of manufactured imports.

The economic jargon is terms of trade. If the ratio of export price index to import price index declines, it takes an adverse turn. The country's growth would be hit hard. If agricultural output prices fall, agricultural incomes fall. Reduction in farmers' incomes raises poverty level.

Rise in farmers' incomes

The other news item is from India. A federal government minister said, "*Dal,* wheat, rice, vegetables have become expensive. The farmer will gain profits from this and I am happy with the rise in prices".

That touched off a firestorm of criticism.

When confronted by the Press, the minister retorted: “Rise in food plate is benefiting farmers...And the government is in favour of farmers' profit”.

That was sufficient for the opposition parties. There was a call for resignation of the minster.

“Is Inflation injurious to economy?”

Inflation reduces the real income of the people. Fixed income earners and pensioners would soon find their income buying less of goods and services than before. Consumers would pay more for their normal level of consumption. Their purchasing power would be reduced. Thus, inflation amounts to tax on income. Consequently, it reduces incentive to work or to save.

On the other hand, producers will be happy if prices of goods they produce rise. Producers’ incomes would rise. Rise in income acts as an incentive. An increase in price brings forth more supply from the producers and they would work harder, bringing more area under cultivation.

If inflation is good to growth and also harmful to growth, is there any tolerable level?

Economists are bothered about the threshold level of inflation. Studies by IMF economists showed threshold level varies depending on the level of development. It was 1% to 3% for industrial economies and 11% to 12% for developing economies.

A study by USP economists says Fiji’s threshold level inflation is 3.6%. As long as the inflation level is below this threshold level, the effects on growth would be positive and inflation at a higher level than 3.6% would adversely affect growth.

Close monitoring of the inflationary trends and timely control of the factors responsible for inflation are critical. In addition, it will be expedient to build up foreign exchange reserves in good times, which have to be spent on imports of staples in bad times. That requires prudent fiscal and monetary policies. Above all close coordination between finance ministry and central bank is needed.

Dian Cohen, a Canadian radio and TV commentator famously remarked:

“Having a little inflation is like being a little pregnant--inflation feeds on itself and quickly passes the ‘little’ mark”.

Dr. Jayaraman teaches economics. His website is www.tkjayaraman.com