

# IMPACT OF COMMODITY PRICES ON THE INFLATION AND ECONOMIC GROWTH

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## ABSTRACT

*Indian Commodity Market consists of both the retail and the wholesale market in the country. It also covers the soft and the hard commodities. The commodity market in India facilitates multi commodity exchange within and outside the country based on requirements. Commodity trading is one facility that investors can explore for investing their money. The Indian Commodity market has undergone lots of changes due to the changing global economic scenario; thus throwing up many opportunities in the process. Demand for commodities both in the domestic and global market is has been growing at a constant pace. And to meet such multiplying demand and supply of commodities the Indian Commodity has undergone a lot many reforms and continues to do so. Although the price of a few commodities itself definitely has a direct impact on the inflation, some other outside factors also come into play. The focus of the paper revolves around the impact of the price of commodities on the economic well being and growth of the country. Demand of a few commodities and its parallel supply has a substantial impact on the price of such commodities, thus creating chaos of inflation in the country's economy.*

**KEY WORDS:** *Commodity, Commodity Markets, Inflation, Price Discovery, Reform, Hedgers, Derivative*

## INTRODUCTION

A well-developed and effective commodity futures market, unlike physical market, facilitates compensates for the transactions without impacting on physical goods until the expiry of a contract. Futures market draws hedgers who curtail their risks, and persuade competition from other traders present in the market who possess market information and price judgment. While hedgers perceive long-term market interest, the traders on the other hand hold an immediate view of the market. A large number of various market players involve themselves in buying and selling activities in the market which are based on diverse domestic and global information, such as price, supply and demand, whether conditions and other various market related information. All these factors when put together, result in competent price discovery which is a result of large number of buyers and sellers transacting in the commodity futures market.

Commodity market, as perceived from the cross-country experience of vigorous commodity

futures markets, helps in competent price discovery of the particular commodities and does not wane the long-run equilibrium price of commodities. At times, price behavior of a commodity in the futures market may show certain aberrations responding to the element of speculation, but it quickly returns back to the long-run equilibrium price, and as the information flows in, it reflects the fundamentals of the individual commodities. In commodity market, speculators play an important role in providing liquidity to the futures markets and might as well sometimes benefit from price movements, but they do not have a organized influence on prices. An efficient architecture for regulation of trading and to ensure transparency as well as timely flow of information to the market participants would augment the utility of commodity exchanges with efficient price discovery and reduce price alarms triggered by unforeseen demand supply mismatches.

The prices of the commodities fluctuate, responding to the pulls and pushes of demand and supply. A failure of a particular crop or trend for a certain kind of clothing can cause the price of that crop and the cost of that kind of clothing to rise, just as an unexpected surplus in the production of onions will cause the price of onions to fall.

## **OBJECTIVES OF THE RESEARCH**

1. The first objective of our study is to analyze the intensity of impact of price fluctuation of commodities on the economic prosperity of the country.
2. Our next objective lays the basis on the thought as to how these price fluctuations of the commodities affect their substitute commodities.
3. To observe the subsequent relationship between price of commodities and inflation that prevails in the country.
4. To scrutinize the connection and affect, that the price of commodities have on their complimentary commodities.

## **RESEARCH METHODOLOGY**

The research methodology of our study lies within the parameter of Descriptive and Explanatory research methodology. Our attempt is to explore and explain while providing additional information about the concerned title.

## **COLLECTION OF DATA**

**SECONDARY DATA** =The data included in our study is based on “Secondary Data”, where in we have included information from various annual business journals, government bulletins and business ethics gazettes.

## **TYPES OF COMMODITIES**

Commodities can be broadly classified under two main heads

1. **SOFT COMMODITIES:** Soft commodities play a major part in the futures market. They are used both by farmers wishing to lock-in the future prices of their crops, and by speculative investors seeking a profit. Soft commodities are typically grown.

Producers are often large players in the "softs" market. Farmers, for instance, regularly hedge their crops by selling futures contracts and locking in prices. This demand, combined with the natural growing cycle of many of these commodities, can create a natural seasonality in prices, which investors must consider as they're looking into the space.

The main examples of that are Corn, wheat, soybean, Soybean oil, sugar. Many soft commodities are subject to spoilage, which can create huge volatility in the short term. Weather plays a huge role in the softs market, which makes predicting supply especially difficult.

2. **HARD COMMODITIES** :On the other "Hard" commodities are typically mined from the ground or taken from other natural resources: gold, oil, aluminium. In many cases, initial products are refined into further commodities, as oil is refined into gasoline. Because "hard" commodities are easier to handle than "soft's," and because they are more integrated into the industrial process, most investors focus on these products. That's changing, to an extent, as former "softs" like corn and sugar are transformed into ethanol-based energy products, but still, hard commodities dominate the marketplace. For instance approximately thousands of crores rupees in oil futures trade hands each year.

Unlike the soft commodities, the hard commodities not necessarily depend on the weather conditions. Since, major dominance of soft commodity lies in the hands of agricultural products in India which largely depends upon the annual monsoons, on the other hand where hard commodities are concerned they don't largely depend upon the weather conditions.

The major examples of hard commodities are as follows: Aluminium, Copper, Gas Oil, Lead, Heating Oil, Nickel, Palladium, Platinum, Silver, Tin, Unleaded Gasoline, Zinc etc.

## **POTENTIAL OF INDIA'S COMMODITY DERIVATIVES MARKET**

The Indian commodity futures background has been surfacing and the national level multi-commodity futures exchanges have made a great growth since their inception. Trading volumes of commodity futures taken as a whole have risen at a compounded annual growth rate of 58 per cent between FY2004-05 and FY2012-13.

India's commodity futures market has been emerging as a feasible and safe ambition for risk management and price discovery. In addition to the benefits to the direct stakeholders, commodity futures market has also led to the development of ancillary services such as warehousing, broking, assaying, quality testing centers, and so on. This has not only facilitated, thousands of direct and many more indirect employment opportunities but also the growth of commodity futures market.

The exchange-traded commodity derivatives market in India has a huge growth potential, waiting to be realized. One measure of this probable is the futures-to-physical market multiplier. In India, this multiplier for approximately many commodities is way below those of the global benchmark exchanges. Higher the multiplier, more thinly commodity price risks can spread across the market, bringing down the impact cost of hedging.

## **BENEFITS OF COMMODITIES TRADING**

1. **A Safe Refuge during Crisis:** Often investors do not feel confident about [investing in commodities](#) but think about precious metals like silver, gold, and platinum; they offer a clear protection during inflation and times of economic uncertainty. They are a good source of investment even during tough times.
2. **Diversified Investment Portfolio:** An ideal asset allocation plan means having a diversified portfolio. Commodities are an important component of having a diversified investment portfolio. If you are already investing in stocks and bonds, it is suggested that you consider investing in raw materials simultaneously. This way, whenever there is a stock market crash, you are not putting all your eggs in a single basket.
3. **Transparency in the Process:** Trading in commodity futures is a transparent process. The course of action leads you to fair price discovery which is controlled by large-scale participation. Such a huge participation also reflects different perspectives and outlook of a wider section of people who are dealing with that commodity.
4. **Profitable Returns:** Commodities are riskier form of investments with huge swings in prices. Companies either hit it right on a resource discovery or experience heavy losses. This opens up opportunities for you to make profits in the commodity market provided you plan your investments right.
5. **Hedging:** Whenever the rupee becomes less valuable, you need more money to buy commodity goods from different parts of the world. Especially during inflation, the prices of commodity goods go up as other investors sell off their stocks and bonds to invest in commodities. Therefore, you can benefit from some commodities in your portfolio that act as a potential hedge against risks.
6. **Protection against Inflation:** When the economy is dipping, money is worth less – inflation occurs. The prices for commodities usually go up during high inflation; accordingly the price of raw materials also sees an upward trend. Therefore, a few commodities in your portfolio will help you benefit from this upswing.

## **PRICE OF THE COMMODITY VS INFLATION: THE CONNECTION**

**Inflation** is a state that happens when the buying value of a currency is lowered. This is usually examined by **comparing the prices of a commodity** on two different dates. This means that when inflation occurs, it helps drive up the prices of commodities. When inflation occurs, it drives up the price of oil, gold, silver, corn, soybeans, wheat and all other commodities.

### **Case-1: If the future price is greater than the spot price**

The market here has a very clear arbitrage opportunity where in traders buy assets, and proceed with its delivery at maturity. The disparity between the spot price and the future price will constitute the trader's profit. As the arbitrage opportunity is subjugated by traders, spot price rise resulting in the alteration of the initial difference and future price tends to fall.

### **Case-2: If the future price is less than the spot price**

The alternate arbitrage plan is performed where the trader sells the commodity, advances the proceeds at the ruling interest, and takes a firm position in the futures market. Thus the intervention by the arbitrage engenders the spot price of certain commodities to fall and future price to, so that the equality between them is restored. Hence it can be very well said that commodity trading qualified for promoting price discovery where by arbitrage intervention creates forces which corrects the inequality between the future and spot. However when we talk about India, there is hardly any unanimity of opinions on the link between price level and commodity derivatives trade. The lack of junction in this regard has lately come more into the focal point with the ban of various commodities in commodity derivatives market on the opinion that speculations arising from futures trade encourages inflation.

## **COMMENTS**

- (a) "Trading in commodity derivatives has fuelled inflation in India and the government will look at the role of futures in driving up prices". (Ramesh, Jairam)
- (b) "Once you liberalize the economy, there is no logic in intervening in it. One way to curb the inflation is to cut down money supply," (Alagh)
- (c) "Prices of commodities have gone up due to stagnant productivity and supply shortfalls and to blame commodity exchanges for inflation is misplaced accusation". (Ravikumar, PH).

## **ANALYSIS OF ISSUES INVOLVED**

It is emphasized that commodity trading drives up prices and thus inflation is also increasing up to all time high. But a capable and well-organized commodities futures market is generally

acknowledged to be accommodating in price discovery for sellers. It makes up for the transaction in commodities without affecting the physical goods until the futures contract terminates. Also, the contribution of inflation due to commodities traded on the exchange was 0.3% while for the commodities which weren't traded contributed to 0.835 to the WPI. The chief cause for the Inflation is divergence of supply and demand of commodities. Thus, a futures market cheers up competition by drawing traders who hedge their bets and reduce risks on the basis of their own price judgment and the market information available to them. As a result, the commodity market invites participation of hedgers who generally have a long-term perspective of the derivatives market, and traders, or arbitragers who hold an instant view of the market.

## **PROBLEMS CONFRONTING COMMODITIES MARKET**

- (a) **Tax and Legal bottlenecks:** There are at present certain restrictions on the transition of certain goods from state to state. These inter-state restrictions need to be removed so that an actual and true national market can be established for derivatives and commodities.
- (b) **The Warehousing and Standardization:** There is too little provision of refined, cost-effective, consistent, dependable and expedient warehousing in the country. Central Warehousing Corporation of India is in service of 500 warehouses from corner to corner of the country with a storage capacity of 10.4 million tonnes.
- (c) **The Regulator:** As the activities of the market picks up pace and the commodity volume rises, the market would eventually need an independent and strong regulator to facilitate smooth functioning. We have an apt example of the Securities and Exchange Board of India (SEBI) that regulates the securities markets.
- (d) **Cash versus Physical Settlement:** Only about 1% to 5% of the entire commodity derivatives trade in the country is completed through physical delivery.
- (e) **Lack of Economy of Scale:** The derivatives trading has allowed approximately 80 commodities; these commodities in practice derivatives and are popular for only a few commodities. All this splits in volumes and corrections makes some exchanges unviable. This problem can particularly be addressed by securing some exchanges
- (f) **Commodity Options:** Options trading is not allowed in market which is a key part of Derivatives. Both futures and options are necessary for healthy growth of market.

## **RECOMMENDATIONS**

1. **PROPER PLANNING IN COMMODITY TRADING:** There should be reasonable planning in the commodities market to deal with contingencies, it is better to be prepared for the worst and unexpected than to fight unarmed with issues. Fluctuations in commodities market is its trait, the only way to ensure efficiency in trading is by proper planning and control.
2. **PRICE RISK MANAGEMENT AND QUALITY CONSCIOUSNESS:** The chief and key factors that ensure success of any commodity market at the global level are its price risk management strategy and quality consciousness of commodities.

Commodities futures and other commodity derivatives contracts have an important role in price risk management

3. **PECULIAR FOCUS ON SUBSTITUTE AND COMPLIMENTARY COMMODITIES:** One major way to reduce the impact of inflation on the economic growth of the country is by keeping a check on price discoveries of substitute goods as well as complimentary goods.

## CONCLUSION

Commodities such as oil, metals, agricultural products and natural gas, have undergone unprecedented price rolls over the past few years. These fluctuations have engendered large movements on the whole of inflation and may have spilled over to core inflation. With so far information and observation of our study, we can say that price fluctuation is not the only and sole factor that persuades inflation to take over the country and hamper the growth and economic prosperity of the nation but there are other factors that contribute to inflation. However, there is no denying the fact that the prices of certain peculiar commodities do initiate ground level inflation, which if not catered booms into an unstoppable fire.

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