Propagation of Global Commodity Prices to Inflation in Malaysia

Introduction

Global commodity prices have surged since early 2007 and have continued to remain high with the exception of the brief and sharp decline in 2009 following a contraction in global growth. Within this period, there were also sharp and large swings in prices of the key commodities, especially crude oil prices. The high and more volatile global commodity prices in the recent years are the result of rising global demand, global supply disruptions and the increased financialisation of commodities amid excess global liquidity. This situation is expected to remain for a sustained period, as these factors are expected to continue.

The increase in global commodity prices has a varying impact on inflation across different countries. The magnitude of the pass-through from global prices to domestic inflation is structurally determined, amongst others, by the contribution of these commodities, either directly or indirectly, to items in the Consumer Price Index (CPI) basket, the extent to which the domestic prices of these commodities are subsidised by the Government, whether a country is a net exporter or importer of commodities, as well as exchange rate movements. This article looks at the channels through which global commodity prices are propagated to domestic inflation in Malaysia based on recent episodes of higher commodity prices in 2008 and 2011.

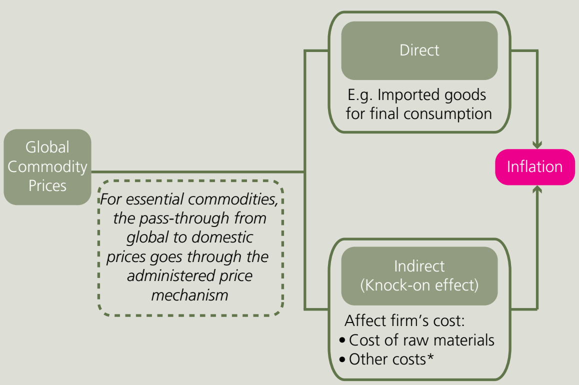
Propagation of Global Commodity Price Shocks in Malaysia

For Malaysia, global commodity prices are one of the key drivers of domestic inflation. The transmission of global commodity prices to inflation is, however, influenced by the Government's administered price mechanism. Domestic prices of essential commodities, such as rice, sugar and fuel, are administered or subsidised by the Government[1]. Hence, the degree of adjustments to administered prices in response to changes in global commodity prices would be a key determinant of the ultimate impact on inflation.

Changes in global commodity prices can be transmitted directly and indirectly to domestic inflation. The **direct effect** happens when changes in global commodity prices are transmitted directly into changes in the prices of final goods and services that are purchased by consumers. The **indirect effect** or the **knock-on effect** of higher global commodity prices on domestic inflation occurs when the prices of other non-commodity related consumer goods and services are raised by businesses in response to the increase in their cost of operations arising from the higher commodity prices. These costs include the cost of raw materials, transportation, logistics and utilities. The magnitude of knock-on effect is conditional on several factors. First, the extent to which the increase in cost affects profit margins. If higher commodity prices lead to a significant increase in costs, businesses may be more inclined to pass on the costs to protect their margins. Second, the structure of the market for the products. In a competitive market, concerns about losing market share may constrain the extent to which firms can raise prices. Conversely, in a monopolistic market,

Chart 1

Direct and Indirect Effects of Changes in Global Commodity Prices to Inflation



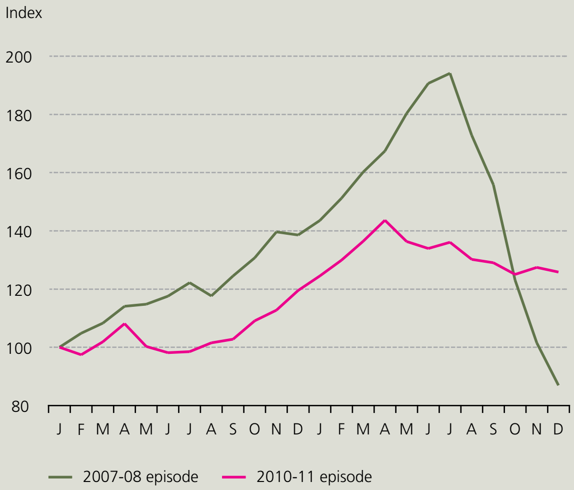
* Other costs include transportation, utilities, packaging, logistics and distribution

Source: Bank Negara Malaysia

[1] Details of the Government's Administered Price Mechanism are available in the White Box on Determinants of Inflation in Malaysia, published in the Bank Negara Malaysia 2010 Annual Report.

Chart 2

Global Commodity Prices in 2008 and 2011



Note: The IMF Primary Commodity Index has been rebased to January 2007=100 for the 2007-08 episode and January 2010=100 for the 2010-11 episode.

Source: IMF

or a market with a dominant player, there may be a greater propensity to raise prices. Third, the underlying demand conditions also matter. If demand is weak, or is highly responsive to price changes, businesses may maintain prices to retain sales.

The strength of the knock-on effect on inflation is reflected in the degree of pervasiveness of price increases. If there is a strong knock-on effect, there will be a widespread increase in prices across the CPI components. The more widespread increase in prices would also be reflected in the rise in core inflation. A more generalised and persistent increase in prices will consequently raise the cost of living.

The two most recent episodes of higher global commodity prices occurred in 2008 and 2011. In 2008, the increase in global commodity prices was sharp and persistent. Between January 2007 and July 2008, global crude oil prices more than doubled, while global food prices rose by more than 50% within the 19-month period. In particular, there was a sharp increase in global rice prices in March 2008 as poor harvests in the major rice-exporting countries caused supply shortages and prompted large-scale stockpiling by some countries to ensure food security, further contributing to the shortages and intensifying the pressure on prices.

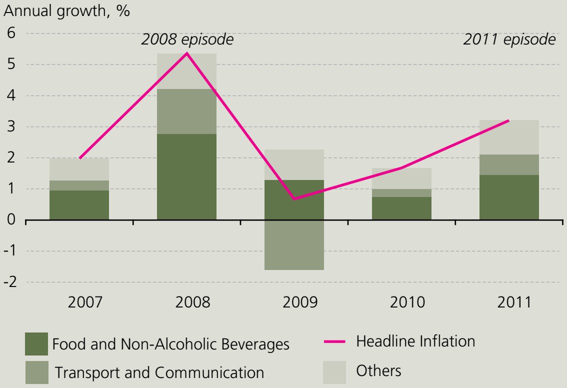
The impact of the sharp increases in global commodity prices on domestic inflation was, nevertheless, delayed due to the Government controls over some of the domestic food and energy prices. The average inflation rate in the first five months of 2008 remained subdued at 2.9%. The regional economies[2], meanwhile, registered a higher inflation rate of 8.7% during the same period (2007: 4.7%). However, as the increases in global commodity prices intensified, the Government revised the prices of several administered items, including retail petroleum products, electricity tariffs and rice to reduce the drain on Government resources in providing the subsidies. Apart from the substantial financial burden to the Government, subsidies were also becoming a source of inefficiencies in the economy and created market distortions. Prices were, therefore, adjusted over three consecutive months. These adjustments were large, with domestic rice prices being raised by 15-40% in May, fuel prices[3] increased by an average of 40.4% in June and electricity tariffs adjusted upwards by 5% in July. As a result, the headline inflation rose sharply to 7.7% and 8.5% in June and July respectively. In terms of the direct effects, inflation in the *rice, bread and other cereals* category of the CPI basket rose sharply to 18.8% in May, while inflation in the *transport* category increased by 19.6% in June. Inflation in the *electricity, gas and other fuels* sub-category was higher at 4.4% in July. Together, the direct effects of the adjustments to administered prices contributed to 40% of the average inflation between May and July 2008.

The increase in global energy and food prices, and the subsequent adjustments to administered prices also led to increases in the cost of raw materials, transportation and electricity, which in turn increased

[2] Comprised of the PR China, Indonesia, India, Philippines, Singapore, Thailand and Vietnam.
[3] Refers to prices for RON92 and RON97 petrol and diesel.

Chart 3

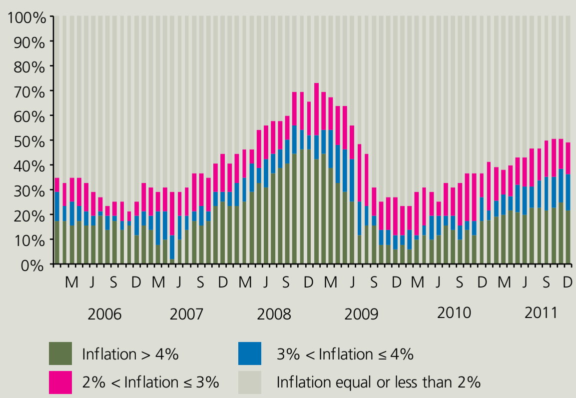
Headline Inflation, 2007 - 2011



Source: Bank Negara Malaysia and Department of Statistics, Malaysia

Chart 4

Percentage of CPI Components Experiencing Specific Levels of Inflation



Source: Bank Negara Malaysia

the cost of operations for businesses. The robust domestic demand conditions in the first half of 2008 enabled many businesses to pass on the higher costs to consumers by raising retail prices within three months of the adjustments on administered prices. There were large knock-on effects to other CPI categories, such as *restaurants and hotels* and *furnishing, household equipment and routine household maintenance*. The strong knock-on effects were reflected in a more pervasive increase in prices. Close to two thirds of the CPI components registered an inflation rate of more than 2% in the second half of 2008. Core inflation was also higher at 4% (an average of 1.8% between 1999 and 2008).

In contrast, global commodity prices rose at a more gradual pace in 2010 and 2011. Between January 2010 and September 2011, both global crude oil and food prices increased by 35% and 26%, respectively. A notable increase was in the global price of corn, which rose by 94% between June 2010 and September 2011 due to disruptions in supply and low stockpiles.

Accordingly, prices of fuel and some of the controlled food items in Malaysia were adjusted upwards in a gradual manner over a span of two years. The adjustments were undertaken as part of the subsidy rationalisation programme and the quantum of each adjustment was also smaller compared to that in 2008. The retail prices of petroleum products[4] were raised by an average of 1.3% in July 2010 and 3.1% in December 2010. While the retail price of RON97 petrol was adjusted several times in 2010 and 2011, the impact on inflation was contained as the consumption of RON97 petrol is relatively small. There was also an upward adjustment to electricity tariffs in June 2011 by an average of 7.1%. These adjustments had a direct effect in increasing inflation in the *transport* and *housing, water, electricity, gas and other fuels* categories. Given the smaller and more gradualised price increases this time, the direct impact through the petroleum products and electricity tariffs in the CPI accounted for only 19% of inflation in 2011. In terms of the food categories, the higher global corn prices led to higher prices for poultry feed. As a result, prices for chicken increased sharply by 11.4% in 2011 (average 2007- 2011: 6.7%), and contributed 5.2% to headline inflation in 2011.

Given that adjustments to administered prices over this period were paced, businesses were better able to cope with the rise in costs. These adjustments were also well-anticipated by businesses as the Government

[4] Refers to RON95 and RON97 petrol, diesel and liquefied petroleum gas (LPG).

had earlier communicated its subsidy rationalisation roadmap. While domestic demand was relatively strong, rising by 8.2% in 2011, the knock-on effects were relatively modest and took a longer period of six months to occur. The knock-on effects were observed in the same categories as in 2008, namely the *restaurants and hotels* and *furnishing, household equipment and routine household maintenance* categories. Compared to the 2008 episode, inflation was less pervasive, with a smaller proportion of the CPI categories recording an inflation of more than 2%. Meanwhile, core inflation was also relatively lower at 2.7% in 2011.

The direct and indirect effects of changes in global commodity prices discussed above are also known as the ***first-round effects***. Strong first-round effects may result in more broad-based price increases and consequently, lead to higher costs of living, which could raise inflation expectations and increase the pressure on households to demand for higher wages. If businesses accommodate the demand for higher wages and passed on the higher labour costs to consumers by increasing the prices of goods and services, this would create ***second-round effects*** on inflation. Unless policy action is taken to manage these second-round effects, they can lead to further increases in the prices of goods and services, triggering another round of wage increases and leading to even higher inflation. The repetition of this cycle is called the wage-price spiral. Should this spiral occur, inflation would become both difficult and costly to control.

The likelihood of second-round effects occurring depends on inflation expectations, labour market conditions and the strength of underlying demand in the economy. If inflation expectations are well-anchored, that is, consumers perceive that the increases in prices to be temporary, they will adjust consumption and spending, for instance by temporarily reducing expenditure on non-essential items to compensate for the rising cost of essential goods or, borrow or reduce savings to smooth consumption. In these scenarios, second-round effects on inflation are less likely to occur. However, if inflation expectations are not well-anchored, consumers would believe that the higher level of inflation is persistent, and thus will demand for higher wages to cope with the higher cost of living. In an environment of strong demand and tight labour supply, businesses would accommodate the wage demands and will in turn raise the retail prices of goods and services, leading to the occurrence of the second-round effects on inflation.

Despite the higher inflation in 2008 and 2011, and some signs of inflation pervasiveness particularly in 2008, there was limited evidence that supply pressures had led to second-round effects on inflation. First, wage growth in general was stable. With this, the high food inflation led to cutbacks in discretionary spending as the purchasing power of consumers was eroded, especially in 2008. Second, higher inflation was expected to be transitory. The weak global growth at the end of 2008 and the prospect of slower global growth in the second half of 2011 were expected to restrain further increases in global commodity prices. The expectation that domestic economic growth would also moderate helped to further curb domestic inflation.

Conclusion

Based on the experiences of 2008 and 2011, it can be concluded that the different magnitude of global commodity price increases had a differing impact on the propagation of these shocks to domestic inflation. With the administered price mechanism in place, the propagation of these global price increases to domestic inflation were, in most cases, delayed and incomplete. The pace of adjustments in administered prices in response to global commodity price increases were a key determinant of the strength of inflationary pressures that were transmitted through the first-round effects. The first-round effects would be better contained if adjustments to administered prices were undertaken in a gradual manner, as businesses would be better able to manage the impact on their costs. This, in turn, would result in a more gradual increase in inflation and the cost of living and reduce the risk of second-round effects occurring.

Liberalisation of Foreign Exchange Administration (FEA) Rules to Enhance the Competitiveness of the Malaysian Economy

Malaysia remains committed to further liberalising FEA rules to support and enhance the competitiveness of the economy through the creation of a more supportive environment for trade, business and investment activities.

In 2011, the Bank continued with the efforts to create a more favourable environment to promote the expansion of the private sector's productive capacity abroad in tandem with the liberal regulatory environment on international trade. The liberalisation recognises the growing trend for Malaysian companies to venture abroad given the strong economic growth in the emerging economies, particularly in Asia, and the deepening regional integration. Between 2001 and 2010, direct investments abroad by resident companies averaged 4.3% of GDP and peaked at 9.4% of GDP in 2008. Cumulatively, net direct investments abroad amounted to RM215 billion over this period, where a significant share of the investments was channelled into new areas of comparative advantage particularly in the oil and gas, manufacturing, telecommunication, finance and insurance sectors.

The increasing trend of Malaysian corporations venturing abroad underscores the importance of robust and sound domestic financial markets to meet the demand for more diverse and sophisticated financial solutions and services. Various measures, including the liberalisation of FEA rules, have been implemented by the Bank to promote the liquidity, depth and number of players in the domestic financial markets.

Productive direct investment abroad

As one of the fundamental measures to support the presence of domestic businesses globally, resident companies that meet the Bank's prudential requirements have been granted the flexibility to undertake any amount of direct investment abroad. The implementation of this liberalisation measure is sequenced to take into account the capacity of the resident companies. This is one of the Bank's strategic thrusts towards full cross-border capital mobility for productive purposes that will benefit the Malaysian economy. With this liberalisation measure, direct investment abroad by qualified resident companies will no longer be subject to the annual threshold of RM50 million equivalent in aggregate per corporate group for investment in foreign currency assets.

Access to competitive financing

To facilitate the expansion of the private sector's productive capacity abroad and to enhance the efficiency of financial management, greater freedom has been accorded to resident companies in managing financial resources within their corporate group. This liberalisation measure to allow a company to obtain any amount of inter-company loans from its related resident and non-resident companies will further enhance business efficiency.

Additionally, the limit of RM5 million imposed on foreign currency-denominated trade financing from non-residents has been abolished. Accordingly, foreign currency trade financing will now be computed as part of the prevailing limit on foreign currency borrowing by resident companies and individuals, of RM100 million and RM10 million equivalent, respectively.

Effective risk management

Given the importance of having appropriate risk management practices to the financial health of residents, greater flexibility has also been granted for them to undertake asset and liability management through the swapping of their ringgit or foreign currency debt obligations into debt obligations in another foreign currency. This liberalisation measure will help residents with exposure to international transactions to manage their financial risk exposures related to these transactions.

Greater product innovation

As domestic firms grow in size and strength and become increasingly integrated with the global markets, having a sound, robust and dynamic domestic financial market is critical to support the expansion of the Malaysian economy. In line with this, the FEA rules were liberalised to support domestic financial market players in innovating and offering new financial products to meet the diverse needs of a more developed and internationally-integrated Malaysian economy. In this regard, the scope of product offerings by licensed onshore banks has been expanded to allow greater flexibility in the trading of foreign currency against other foreign currencies with residents. Similarly, flexibility was also granted to licensed onshore banks to offer interest rate derivative contracts to non-bank non-residents for any purpose. These liberalisation measures are in line with the broad thrust of the Bank's Financial Sector Blueprint to widen the investor base and further enhance the development of the domestic financial markets.

Promote Treasury Management Operations

Efforts to create a dynamic and more internationally-integrated economy were further supported by the Budget 2012 announcement on new incentives to promote and facilitate the establishment of Treasury Management Centres (TMCs) in Malaysia by foreign and domestic-owned multinational companies. In addition to the fiscal incentives, FEA flexibilities have also been accorded to TMCs to facilitate effective management of their financial resources. These flexibilities include the ability to undertake investments and foreign currency financing to support the needs of companies with international presence.

Strengthening Malaysia's competitive position

The continuous efforts undertaken by the Bank and the Government to enhance efficiency and reduce the cost of doing business have contributed towards the improvement in Malaysia's ranking in the Global Competitiveness Report published by the World Economic Forum. Malaysia's competitiveness improved from 26th position in 2010/2011 to 21st position in 2011/2012. This was attributed, among others, to the openness of the Malaysian economy to international trade and foreign direct investment, as reflected in its liberal environment, notably on capital mobility. Similarly, the liberal environment for investment in Malaysia has also resulted in Malaysia being ranked as one of the top ten most preferred investment destinations in the world in the A.T. Kearney FDI Confidence Index for 2012.

The strengthening of the Bank's surveillance mechanisms, including enhanced regional cooperation, has enabled the Bank to intensify its liberalisation initiatives while ensuring that the benefits of the liberalisation outweigh the risks. The liberalisation measures are complemented by robust safeguards to ensure monetary and financial stability.

Conclusion

Consistent with the need for greater flexibility on cross-border current account and financial account transactions to support the growing global integration of the Malaysian economy, the implementation of FEA measures will shift towards a more principle-based regulatory framework to enhance clarity of the desired regulatory outcomes. This shift is part of the regulatory reform embarked on by the Bank to create a more facilitative and transparent regulatory environment that will support Malaysia becoming an investment destination of choice.

The policy thrust of FEA to enhance competitiveness of the economy will continue to be pursued in support of the transformation of the Malaysian economy into a high-income, high value-added economy by 2020. Important consideration would be given towards creating an enabling environment to support areas where Malaysia has a comparative advantage and to further enhance the competitiveness of Malaysian corporations. Focus will also be given to areas that will enhance the development of Malaysia's financial markets and also promote regional economic and financial integration. In this regard, continuous engagement and consultation with all stakeholders, including the industry players, will be undertaken to promote the role of the private sector in realising these desired outcomes. The progressive liberalisation of the FEA measures will continue to be reinforced by adequate prudential safeguards to ensure monetary and financial stability, both of which are integral for achieving sustainable growth of the Malaysian economy.