A Review of Fall in World Commodity Prices and its Prospective Impact on Pakistan's Economy

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Abstract

After nearly a decade the skyrocketing pricing in commodities are eased now. The projection suggests that commodity prices are likely to further soften in near term. The current situation is quite challenging for Pakistan as its major earnings are from exports of rice, fruits, cotton, sugar etc. that are on decline and are expected to carry on in future. However the fall in oil prices has given the Pakistan's economy a measure to reprieve. As Pakistan is facing immense energy crisis and handsome amount of subsidy is provided to power sector. This is an opportunity to eliminate subsidy on power sector. This paper analyses the aspects and its outcomes of commodity price cycle with reference to Pakistan. Present study provides short term and long term polices to shelter Pakistan from the adverse effects of price instability.

Keywords: Commodity Prices; Economy; Emerging Markets; Balance of Payment.

Introduction

During the decade of 2000-2010; the world experienced a striking surge in the prices of commodities. The prices of customary staples such as maize, rice and wheat increased drastically, reaching their maximum levels in nearly thirty years in 2008. Similarly the prices of energy and metals were more than doubled in five years from 2003 to 2008. The rapid velocity of industrial development and urbanization in China, India, and other emerging economies caught the attention of financial and metal industry analysts who have argued that the world economy has been going through the phase of a super-cycle expansion. However, the upward trend in global commodities prices' did not continue indefinitely. It lost momentum post 2010 decade with the onset of global economic slowdown. Subsequent to the slump in economic activities, the trend in global commodities' prices also receded. The international commodity prices peaked in mid-2011 and have fallen slightly since then. Many analysts now argue that the upward phase of the commodity 'super-

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cycle' that started in the early 2000s has run its course (Erten & Ocampo, 2013).

The slowdown in economic activity in emerging markets is primarily categorised as the trigger of commodity prices' decline. The World Bank's three industrial commodity price indices also reflect that energy, metals, minerals and agricultural raw materials experienced similar declining patterns (of more than 35 percent each) in early 2011s. Keeping in view the earlier trends, the global prices are expected to continue on a falling trajectory for the year 2014-2015; Prices of precious metals are also expected to decline by 3 percent in 2015, on top of the 12 percent decline seen in 2014. Among the global slump, sufficient supplies, poor demand, and a strengthening U.S. dollar have weighed on prices of these commodities as well. Secondly, metal and oil demand has also slowed in China and India, the world's primary consumer of raw materials (IMF, 2013).

Though the receding global prices carries impact for the global economy, the developing countries are likely to find the declining prices more constraining than the developed world. An extrapolation from the current trend in prices indicates further decline in commodities prices, thus proving to be unfavourable for an exporting economy.

Fall in commodity prices are quite challenging for a developing country like Pakistan who drives its major revenue from the export of agricultural products. The falling prices reduce Pakistan's export earnings that may potentially exacerbate the current account deficit. On the other hand, the fall in crude oil prices has given Pakistan's economy breathing space in the form of lower oil import bill. As oil commodities make up nearly a third of Pakistan's imports, any fall in oil prices reduces the import bill, generates less demand for dollar and reduces pressures on the rupee. This paper discusses the impacts of decrease in commodity prices with reference to Pakistan. Current study also provides useful policy recommendations for the policy makers to safeguard Pakistan's economy from the adverse effects of lower commodity prices.

Literature Review

Commodity prices have been showing a downward trend for the last two years due to lack of effective demand conditions across the globe. Wheat, Coal, Iron Ore, Palm oil, Nymex and Brent Crude has all shown sharp fall of 20 to 30 % in the last two years. Trend in price indices of major commodity items has been given in Fig-1.This trend in price fall is against the background of advanced economies like U.S, Euro zone and Japan where governments are doing record amount of stimulus to stimulate demand conditions in these economies but results are not encouraging so far (Baffes, 2014).

[redacted]

The Chinese economy has been in the hold back phase for the last two years, which has led to reducing demand for basic commodity items in China. The Chinese government is changing its growth model from 'Export Led Growth' to a model based on 'Internal Investment and Consumption'. China has also embarked on environment targets to reduce carbon emissions. This has led Chinese economy to close some of its industries mostly in steel sector (IMF, 2014). The construction sector in China is also facing a sharp hold back as real estate prices have fallen in 699 out of 700 districts of China for the last two quarters. Due to this reason prices of lead, iron ore and steel have fallen from USD 130 per ton in the beginning of the year to USD 72.10 per ton (lowest prices for Iron ore over the last five and half year). Apart from China, the western world has accumulated in high levels of debt and these countries are unable to inspire their economies as the demand from the end consumers is weak. The governments in these countries are unable to stimulate demand as they are fiscally constrained. The debts to GDP ratio of these countries are high with United States (U.S) Debt to GDP at 72%, Euro zone at 90% and Japan at 226%. The U.S inflation measured by personal consumption expenditure is running at 1.4 % against the Federal Reserve target of 2 %. The Euro zone inflation is running at 0.4 % against target of 2% set by ECB (Nagarajan, 2014).

Oil prices have shown a descending trend with prices down by 30% in the last one year and have dropped at five years record low of $ 50/ barrel. The supply of oil has increased due to shale oil production in U.S (in Nov. 2014 U.S has crossed even Saudi Arabia in oil production), increased production from Libya and Iraq against speculations of supply cut due to political unrest in these countries. Similarly Saudi Arabia is not inclined to cut production because of its various social welfare programs, which were initiated in the past two years. These all led to increase in oil supply and combined with weak demand in the global economy has led to commodity prices falling in recent years. The United

States is the only economy that has shown signs of improvement. However, the growth in this economy is less dependent on commodities due to higher efficiency levels prevailing in the economy (IEA, 2015).

Future Predictions about Commodity Prices

Historically, the world economy has seen three super cycles of commodity prices, in the end of the 1900 century when U.S industrialization started, after the Second World War and third time when China was going for massive industrialization. As now China is rebalancing its economy to make it more consumption dependent rather than export dependent as explained earlier (Gruss, 2014). Moreover, with significant capacity created in the commodity sector, commodity prices are expected to be subdued in the coming years according to both IMF and World Bank predictions (Table 1). For the commodity consuming nations like China & U.S this rings in as positive news and for commodity exporting countries like Russia, Brazil it's not encouraging (IMF, 2014).

Table 1: World Bank Commodity Price Forecast in real 2010 $ (Source[3])

Commodity/unit	2014	2015	2016	2017
Crude oil ($/bbl)	95.5	89.7	89.2	88.8
Palm Oil ($/mt)	776	769	756	744
Maiz ($/mt)	178.7	182.8	182.4	182.1
Wheat ($/mt)	266.1	267.2	262.5	257.9
Sugar ($/kg)	0.36	0.35	0.34	0.33
Cotton ($/kg)	1.74	1.78	1.79	1.8
Gold ($/toz)	1,199	1,163	1,132	1,103

Falling Commodity Prices and Pakistan

Commodity price instability has negative impact on economic growth, countries financial resources, income distribution, and may lead to increased poverty instead of poverty alleviation. Pakistan like many developing countries derive major share of its export earnings from commodities exports (Page & Hewitt, 2001). In commodity exports Pakistan earns major from exports of rice, fruits, cotton, sugar etc. Exports data of Pakistan reveals that earning of Pakistan in exports of these items is dilapidating (Table 2). For example earning from basmati rice, wheat, raw cotton etc. are on decline. If we look at future forecast of commodity prices and weaker demand for primary goods worldwide, we may presume that our export earnings will further decline in future and as a result there will be added stress on Balance of Payment (BOP) which is already being survived through IMF. Ceteris paribus, as long as oil prices remains low there is no worry for Pakistan in short run but what if OPAC decides to cut its supply in future.

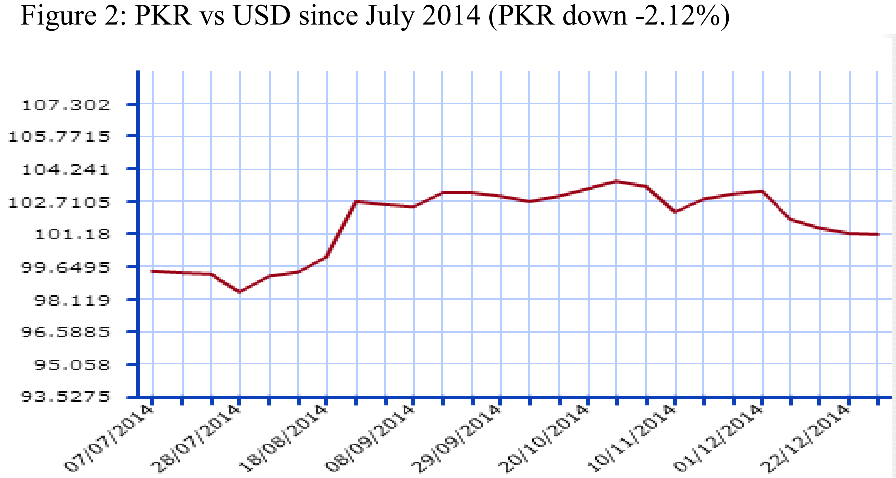
Table 2: SBP Exports (BOP) by all Commodities in Thousand US$

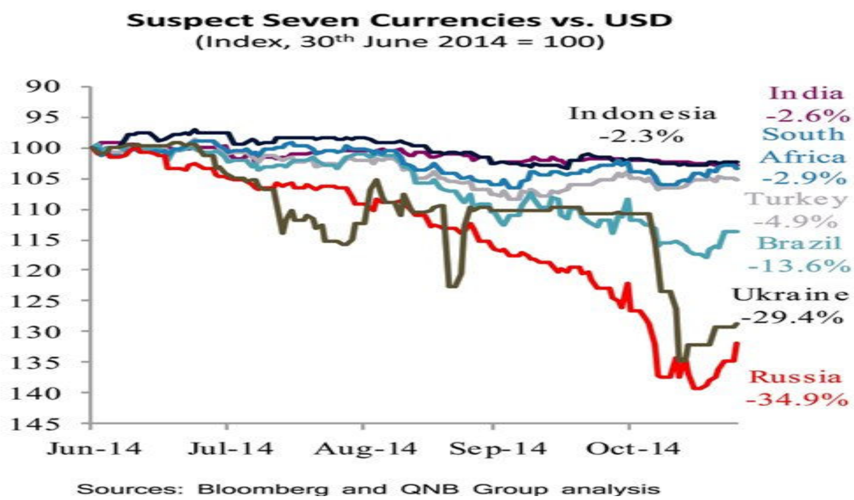
Commodity	June to July			November (Revised)
	FY 12	FY 13	FY14	FY-15
Basmati	1,064,366	822,420	993,973	75,144
Wheat Unmilled	62,344	29,702	3,197	0
Raw Cotton	479,881	167,441	208,171	22,055
Chemical and Pharmaceutical Products	1,264,558	1,199,606	1,137,643	86,372
Cement	503,221	530,986	486,607	40,722

Policy Recommendation for Pakistan (Short Run)

Countries around the world are responding to low commodity prices by taking necessary measures to reduce their current account deficits and to stabilize their currencies. In this scenario the areas that are being focused by world economies including Emerging Markets are (i) currency adjustment (ii) elimination of fuel and energy subsidies and (iii) export shift. Emerging Markets (EMs), like Pakistan, is also at risk of balance of payments crisis due to fall in commodity prices. Some of them have found solid ground (India and Indonesia) but others are still struggling to hold the loss of confidence in their economies (Brazil, Russia, Ukraine and to a lesser extent South Africa) (Mongardini, 2014). In currency stability, Pakistan seems on track with India, Indonesia, and South Africa etc. in short run as it dropped just 2.12% since July-2014 (Fig-2).

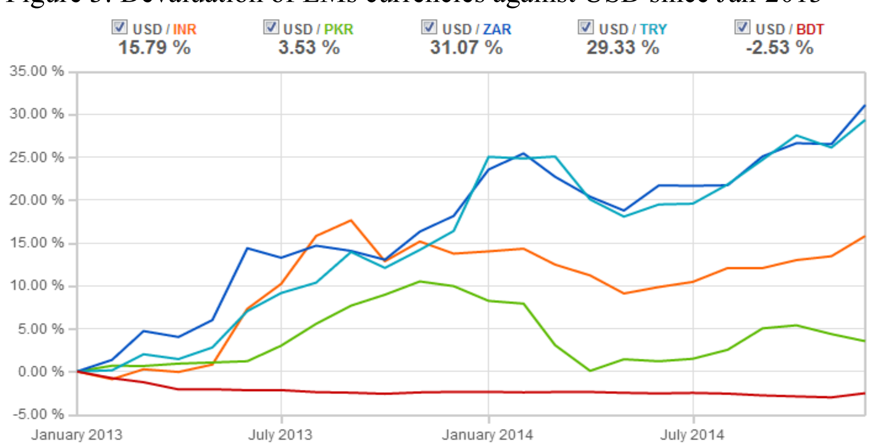
Figure 2: PKR vs USD since July 2014 (PKR down -2.12%)





However the long term strategy of these countries deals with exchange rate adjustment. These countries have responded to balance of payment crises with considerable devaluation in their currencies to adjust with falling commodity prices. Meanwhile, currency of Pakistan has been revalued since last year as compared to its regional exporting counterpart. Therefore, there is need to reconsider its currency value to boost its export in long run. Comparison of PKR (Pak-rupee) with the currencies of EMs shows that Pak rupee devalued just 3.53% against U.S $ since Jan-2013 but Indian Rupee (INR) has dropped 15.79% South African Rand (ZAR) 31.07% and Turkish Lira (TRY) has dropped 29.33% since Jan.2013.

Figure 3: Devaluation of EMs currencies against USD since Jan-2013



The Governments of EMs are taking the opportunity presented by lower oil prices to increase fuel prices and reduce their energy subsidy bills.

The Indian Government has stopped fixing diesel prices, eliminating half of total fuel subsidies, which cost the government around 9.4% of the budget last year. Similarly, the new Indonesian President, *JokoWidodo*, announced in mid-November a 30% increase in fuel prices, and lowering Fuel subsidies that are expected to reach around 19% of the Indonesian budget this year. Similar policies were adopted by many European Union (EU) countries during previous oil price drop. Although, Pakistan is not offering any subsidy on fuel but it is providing huge subsidy for power sector *WAPDA/PEPCO/KE* which has been estimated around Rs. 203 billion in federal budget 2014-2015; Therefore, it is suitable for Government to take historical low oil prices as an opportunity to eliminate subsidies in power sector.

Policy Recommendation for Pakistan *(*Long Run)

In order to neutralise the effect of vacillating global prices, exports diversification strategy needs to be devised and implemented. Such a strategy demands less reliance on volatile perishable/non-perishable exports products and promotes export of manufactures, services, and non-traditional commodities. As this strategy has been successfully adopted by many countries in the past, it can prove to be effective for Pakistan by sheltering it from the negative impact of price instability in future. Countries that have succeeded in diversifying away from commodities into higher value-added, are mainly in Asia (e.g. Malaysia, Indonesia) and Latin America (e.g. Brazil, Chile). Diversification in these countries has not occurred as the result of domestic export-targeted measures or external preferential trading schemes. Instead, the shifting of labour from primary to secondary and tertiary activities stemmed from policies promoting long-term economic transformation and the development of supply capacity, achieved through high saving and investment rates. Therefore, Pakistan should also adopt such policies which increase public investment especially in infrastructure and in education. Simultaneously, there is a need to create suitable environment for foreign investment, along with providing export subsidies. By opening its economy and reducing anti-export biases, Brazil moved away from Cocoa and Coffee. Similarly South East Asian countries used a mix of trade liberalisation and trade promotion measures (including subsidies) to boast their non-commodity exports. It is also an interesting phenomenon that diversification occurred faster and more radically in relatively labour-abundant rather than commodity-abundant countries (Korea, Taiwan vs. Thailand). It has been noted that substantial initial endowment in natural resources/commodities leads to constant dependence on these resources rather than allowing for substitution in the long run. Therefore, while adopting a policy of diversification, Pakistan requires investing smartly in skilled development programs for human resource (Khan, 2014).

Supporting diversification through trade preferences has also been strategy for countries. Commodity protocols attached to the ACP-EU *Lomé* Convention have helped countries to generate substantial foreign exchange revenue through 'traditional' exports and utilize these revenues in diversification and export shift. The case of Mauritius is there who within slightly more than a decade, moved away from absolute dependence on a single commodity (sugar), Similarly, making use of EU trade preferences, Zimbabwe has reduced its dependence on traditional exports (e.g. tobacco) with manufactured exports along with seizing market opportunities for non-traditional exports in horticulture (cut flowers) and agro-processing (canned fruit, fruit juice). Lomé preferential margins have been most significant. Generalised System of Preferences (GSP) exempting least developed countries from restrictions under the Multi-Fibre Arrangement. This has previously helped countries like Bangladesh and Lesotho (also a *Lomé* beneficiary) to attract foreign investment in export oriented textile and clothing industry. For Pakistan there is great opportunity under GSP status to boost its textile production and textile exports. This is time to attract investment both local and foreign in textile sector once again and to utilize earning received from here to boost other exports. Having abundance of fruits and vegetable production we can also shift towards agro processing exports like frozen vegetables, canned fruit and fresh/processed juices, like Zimbabwe. Analysis of international Commodity data also revealed that prices of items like beverages, beef & chicken has increased and according to World Bank/IMF predictions prices of these items will remain on high. Therefore, it is also suggested that we should increase production of beef and chicken and export these to get our share from international Market.

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