

Kolbe, Heinz

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Bearish Mood on World Commodity Markets

by Heinz Kolbe, Hamburg*

For two years now the international raw materials markets have been characterised by a lasting slump. The weak and short-lived reactions to the Falklands crisis and to the intensification of hostilities between Israel and its Arab neighbours are indicative of the situation. During this year's summer months prices on markets for industrial raw materials and food and tropical beverages hit their lowest level since spring 1978. What are the prospects for the development of raw materials prices?

Measured according to the Index of World Market Prices of Raw Materials compiled on dollar basis by the HWWA-Institut für Wirtschaftsforschung-Hamburg, the representative price quotations for the most important internationally traded industrial raw materials boasted their last peak in February 1980 and those of food and tropical beverages in October of the same year. Since then there was an average drop of 30 % for industrial raw materials and of 40 % for food and tropical beverages up until August 1982.

The pronounced increase of prices on the energy raw materials markets continued due to repeated raising of national oil prices by OPEC countries up until the end of 1981. Since then prices have dropped by an average of 6 %.

The decline in crude oil consumption by the industrialised countries – their own production remaining approximately the same – led to a corresponding drop in imports. A number of OPEC countries attempted to counteract the decline in sales to a certain extent by granting – often substantial – price reductions. This factor is not adequately covered in the index on energy raw materials.

On spot markets crude oil is at present traded at about US \$ 31 per barrel, i. e. 3 % below the standard price for Saudi Arabian light. The drop in prices is marginal compared to the massive increases in prices between 1979 and 1981.

As crude oil carries a high weight in the HWWA Index of Raw Materials Prices (58 %), the index as a whole does not adequately reflect the fall in prices on the "classic" markets for industrial raw materials and food and tropical beverages.

A slump on industrial raw materials markets is really nothing unusual. However, the heavy fall in prices since autumn 1980 has even outpaced the 1974/75 record. At that time, the normalisation following upon the first oil price shock, which had been accompanied by a marked increase in prices of raw materials, coincided with a recessionary phase in the industrialised countries.

However, the price movements of individual raw materials vary considerably. Whereas, for example, wool and cellulose were not affected by the fall, the price of aluminium in London dropped by more than half between February 1980 and August 1982. The price slides of the other important industrial raw materials are positioned between these two extremes.

The prices for food and tropical beverages, on the other hand, have almost without exception fallen by between 30 and 40 % since the price descent began in October/November 1980. The representative New York quotation for the open sugar market in August 1982 had even plummeted to a level 83 % beneath the last peak in October 1980.

Development of Industrial Raw Materials

World market prices for industrial raw materials already surpassed their peak in spring 1980. During the three previous years the need for raw materials for current consumption had risen moderately, in line with the expansion in Western industrialised countries, where the increase of real gross national product figured at an annual 3 to 4 % (OECD countries as a whole). There was a substantial surge in demand, however, as manufacturers again began increasing their raw materials stocks in response to production restrictions by many raw materials producers, who had tried to speed up the reduction of large surplus stocks. Finally,

* HWWA-Institut für Wirtschaftsforschung-Hamburg.

at the start of 1980 industrial raw materials were dragged into a general bullish speculation. The raw materials traders and consumers at that time feared that the new and drastic raising of crude oil prices by OPEC would be followed by a general upsurge in prices. In anticipation of such a development they began buying up additional raw materials. This move, together with precautionary buying connected with the worsening of the situation in Iran and the invasion of Afghanistan by the Soviet Union, triggered a boom market. Raw materials became a much sought-after object of speculation for investors, particularly with an eye to growing fears that the supply of raw materials was going to remain scarce for some time to come.

Against this background it is easier to understand the steep decline in prices for industrial raw materials over the past few years. The beginning economic downswing in the Western industrialised countries was probably the decisive factor for the trend reversal in spring 1980. Once again it was confirmed that the development of raw materials markets is decisively determined by the business cycle in industrialised countries. Speculative changes of traders' and consumers' stocks only have a short-term effect on prices.

After it had been generally accepted that speculating for even higher prices had now lost its basis in the face of the cyclically induced decline of raw materials consumption, demand began to drop. The bullish speculation made its exit from the market; large quantities were sold in efforts to realise revenue. Prices began their rapid decline.

Persistent Economic Weakness

Since then the development of world market prices for industrial raw materials has been overshadowed by the persistent economic weakness of the industrialised countries. The combined real gross national product of the OECD countries increased by only approx. 1 % each year in 1980 and 1981. 1982 is at best expected to record zero growth. Industrial production in OECD countries stagnated after 1979 and even showed a decline in the current year. Raw materials consumption has continued its downward trend. In addition, traders and manufacturers, faced with subdued economic prospects, have kept their stocks as low as possible, the more so as the high interest rates have made stockpiling an expensive business. Even speculative undertakings with regard to raw materials have been holding back. The recent recovery of prices for non-ferrous metals at the London Commodity Exchange cannot therefore be regarded as marking the start of a general turnabout for

international markets of industrial raw materials. It was more of a short-term technical reaction to the preceding price nose-dives. The recent reduction in interest rates in the USA may also have induced a certain amount of speculative activities.

Restrictive Supply Policies

Raw materials producers – above all, those in industrialised countries – have reacted to the lasting restraint in demand by production cutbacks (metals) and support purchases (metals, natural rubber) in attempts to check the price decline. Cotton and wool supplies in exporting countries have been artificially reduced with government support via increases in stockpiling. Supportive efforts under international commodity agreements (tin, natural rubber) have also been intensified by increased additional buying by buffer stocks and by the imposition of export quotas. Nevertheless, stocks of raw materials have in some cases increased a great deal over recent months, both in producer countries and at the international commodity exchanges.

Attempts by producer countries together with consumer countries to stabilise prices via international commodity agreements have increased during recent years. However, due to the – in some cases considerable – surpluses, from which consumer countries were the beneficiaries, the success of such attempts has remained modest. The fall in prices could only be slowed down. One prominent exception is the 6th International Tin Agreement which provisionally came into force in June this year after the consumer and producer countries had reached agreement at the last moment. This agreement provided the administrator of the buffer stock with further resources to buy tin on the open market; the cutback of tin exports to two-thirds of the "normal" amount was decided on as a supporting measure for price stabilisation. As a result of these supportive measures the London price of tin had up until the beginning of September recovered by almost 40 % within three months. The potential surplus supply of natural rubber was substantially reduced during the course of 1982 by the taking on of 200,000 tons into the International Natural Rubber Organisation's (INRO) buffer stock. Additional support is to be expected during the coming months, since the member countries have authorized further funds to be used by the administrator to buy up to 100,000 tons.

The marked reduction in the price of raw materials in recent years underlines the inadequacy of attempts to support prices via buffer stocks or export quotas without

Klaus Bolz, Petra Pissulla

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V E R L A G W E L T A R C H I V G M B H - H A M B U R G

effectively curtailing production. This has repeatedly proved to be an insoluble problem when trying to stabilise prices with the aid of commodity agreements, particularly considering that all major producers must take part. The one-sided initiative shown by some producer countries to establish cartels on the lines of OPEC, thus securing "satisfactory revenue", must therefore be viewed sceptically. The setting up of an alliance of the leading tin producers, Malaysia, Thailand, Indonesia and – possibly – Bolivia, for instance, had once again to be postponed due to lack of agreement on production cutbacks and the formation of a buffer stock. The joining together of the South-east Asian natural rubber producers led by Malaysia has also proved ineffective. For a long time the organisation has been planning to hold back 350,000 tons of rubber from the market. However, up to now such a step has not been taken, probably due to the lack of financial resources.

The Organisation of Copper Exporting Countries (Cipec) provides a particular example of the inadequacies of stabilisation efforts within one-sided associations of developing countries producing raw materials. This organisation has been complaining for years about the inadequate copper prices on international markets. Whereas in the USA drastic cutbacks in production have been implemented by the copper companies, the South-American and African member countries reject such measures pointing out that consumption in the Western world (excluding the USA) is still quite large.

Prospects for Industrial Raw Materials

Although world market prices for industrial raw materials have continued their downhill run this year, they have still achieved a better performance than was to be expected in the face of the cyclical influences on the demand side. After all, the first half of 1982 witnessed not only a stagnation of industrial production in Western Europe and Japan; in the USA it even declined. Despite this, however, the drop in the level of world market prices for industrial raw materials was not as fast between March and September 1982 as it had been before this period. It would appear that the actual cyclically-induced drop in raw materials consumption had a weaker effect than previously, since manufacturers were no longer cutting back their already reduced raw materials stocks. During the coming months hardly any change is expected in the market situation for industrial raw materials. In view of the probable continuation of the economic lull in Western industrialised countries, raw materials requirements will

generally remain low. Although a continuation of the latest downward trend in interest rates would favour a renewed stockpiling of raw materials by manufacturers, this process is likely to take time, its effects not being felt before there emerge expectations of a noticeable improvement in the international economic situation. On the other hand, raw materials prices are unlikely to fall significantly below their present level up until the turn of the year 1982/83, the more so as producers are considering taking further steps to counteract too great a pressure on prices.

The prices for industrial raw materials are expected to increase during 1983. This forecast is, of course, inevitably encumbered with the considerable uncertainties which at the present time affect all predictions of economic development in industrialised countries. In addition, imponderabilities exist with regard to the future effects of shifts in exchange-rate relationships, particularly vis-à-vis the pound Sterling and the US dollar which are of special importance for international trade in raw materials.

Restrained Price Increase

Following the latest development in monetary and fiscal policies in the USA it looks as if expansive factors will there gradually gain in force during the coming year. The real gross national product is likely to increase by 2 to 3 % in 1983. In Western Europe as a whole an even slower improvement in the general economic conditions and slighter growth can be expected. The increase of the real GNP of the industrialised countries as a whole is unlikely to exceed 2 %. Assuming these preconditions to be correct, this would imply a weak increase in the amount of raw materials required in Western industrialised countries. As manufacturers' stocks are generally very low, subsequent stockpiling could provide noticeable impulses for demand. Reacting partly also to speculative influences, prices would probably begin a gradual increase during the initial phase of the cyclical recovery, despite the relatively large supply potential. Following the tailing-off of the temporary upsurge of demand, however, the price rise is likely to flatten out. Altogether, therefore, the level of world market prices for industrial raw materials, in terms of US dollars, can be expected to increase, on an annual average for 1983, by an estimated 10 %, following the decreases of 5 % and 12 %, respectively, in 1982 and 1981.

The expected stability of crude oil prices, both in their capacity as a cost factor for the production of raw materials and in their position as a determinant factor for

price conditions on the raw materials markets, would also suggest a restrained increase in prices for industrial raw materials. For structural reasons worldwide consumption of crude oil has dropped during the last three years. This decrease, however, is likely to come to a halt in the course of 1983, since the continued saving and substitution of crude oil will to a large extent be compensated by a cyclically-induced increase in crude oil requirements. On the other hand, many oil-exporting countries are making efforts to extend their production and exports in an attempt to bring their export revenues in line with their growing foreign-exchange requirements. A great deal therefore suggests that crude oil prices will not increase in 1983. On the contrary, if the Gulf War is brought to an end, they may well show a decline. In the light of the generally improved sales prospects for the OPEC countries the only likely developments will be a reduction in the presently granted discounts and a stabilisation of the quotations on the spot markets. Considering the increasing prices of industrial goods, crude oil will, in real terms, certainly become cheaper.

Food and Tropical Beverages

The cyclical fluctuations have only a slight effect on the food and tropical beverages markets in industrialised countries. Given the achieved income level, demand for food and even for imported beverages only reveals relatively weak reactions to variations in economic activity. In developing countries, on the other hand, where in view of the lower level of income greater cyclically-induced demand movements might be expected, imports of food and beverages have already from the beginning been cut down to the absolute minimum in the face of the chronic lack of foreign exchange and the urgency of capital goods imports.

On the whole therefore changes on the supply side play a greater part in the development of world market prices of food and tropical beverages, the more so as

these changes are very pronounced due to the influence of weather conditions. A particular instability factor results from the fact that almost all countries produce a great deal of food themselves and in pursuit of their own agricultural protectionist objectives cover only their – heavily fluctuating – excess demand on the world market. Developments over the past two years bear out the particular problems associated with the food and beverages markets. Up until October 1980 the quotations for sugar, wheat, forage cereal and oil seeds increased markedly due to a heavy deterioration of harvest prospects in important cultivation areas for the 1980/81 season. After it became apparent that these expectations would not be confirmed, the slump on these markets began and has lasted up until the present day. The supply pressure due to the favourable harvests in 1980/81 and 1981/82 continued adjacent to the already high stocks in the important producer countries. Apparently one of the reasons for the restraint of importers in food and tropical beverages, mostly quoted in dollars, was the appreciation of the US dollar which was regarded by many as exaggerated. The world market prices for sugar, maize, wheat and soya beans dropped particularly heavily. The fall in prices on the coffee and cocoa markets had already set in in 1979 due to the pressure of supplies, after previous poor harvests had induced an extreme boom market.

At the moment, the estimates for harvests in 1982/83 are not yet very sound. However, the ascertainable trends, taking into account the existing stocks in producer countries, would suggest an abundance of food and tropical beverages well into 1983. On the other hand, the surplus countries can be expected to intensify their efforts to limit supplies on international markets via national support programmes (wheat, maize, soya beans) and interventions under international agreements (coffee, cocoa, sugar). Prices therefore are likely to virtually maintain their present level in the further course of this year and in 1983.

HWWA Index of World Market Prices of Raw Materials¹
(1975 = 100)

Raw Materials and Groups of Materials	1980		1981		1982			
	February	October	December	AA ²	June	July	August	September ³
Total index	214.4	237.8	242.1	240.7	226.0	226.5	225.8	225.8
Total, excl. energy raw materials	161.9	162.5	125.9	135.6	117.5	115.4	113.4	114.0
Food, tropical beverages	143.3	164.1	114.1	126.1	104.7	103.4	99.7	99.6
Industrial raw materials	176.0	161.3	134.8	142.7	127.2	124.5	123.8	125.1
Agricultural raw materials	166.4	167.4	134.2	146.4	134.5	125.1	123.9	123.7
Non-ferrous metals	225.0	179.0	151.8	165.3	123.6	130.7	131.8	134.8
Energy raw materials	245.0	281.7	309.9	302.1	289.4	291.4	291.5	291.0

¹On dollar basis. - ²Annual Average.