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Moderate Rise in Commodity Prices

The economic slowdown in the industrial countries during the course of last year has left its mark on the international commodities markets. Measured against the HWWA index on a dollar basis there has only been a moderate rise in commodity prices in the last one and a half years since the steep rise in 1994 - with pronounced short-term fluctuations; in August of this year the level of autumn 1994 was exceeded by about 9%. The slightly faster price rise since the end of last year is largely a reflection of the recovery in energy raw materials, where world market prices have again risen markedly, by nearly a fifth since mid-1995. In industrial raw materials in contrast, the price curve has been pointing downward for about a year. In the second quarter, the price decline steepened noticeably but then came to a standstill in the middle of the year; in August industrial raw materials were 28% under the peak of June 1995. Prices for agricultural raw materials and non-ferrous metals in particular fell sharply.

The again somewhat more rapid increase in production in the Western industrial countries and in the USA in particular in the course of this year has so far had little impact on the prices for industrial raw materials. Contributing to this was the fact that the pace of growth was only modest and manufacturers were apparently reluctant to abandon their caution with regard to stockbuilding due to the continued uncertain economic outlook. On top of this the price trends over recent months have been heavily affected by exceptional factors. This is especially true of the metal markets, where non-physical trade has advanced to a crucial determinant of short-term price movements. The exposure of sizable year-long losses on the part of a Japanese trader, incurred by attempts to force up copper prices, led to considerable turbulence on the copper market and caused the copper price to plummet: in August it was about a third lower than at the same time last year. The quotations of other metals were also pulled down in

the wake of the fall in copper prices. The HWWA index for non-ferrous metals, in which copper plays a major role, fell by a fifth in all within a year; leaving aside copper the price drop in basic metals still amounted to about 10% on average. The situation on the copper market is certain to remain unstable for some time; the trend of quotations in the coming weeks will in part depend on the volume of sales by the house which is in difficulties and which is believed to have at its disposal about 5% of the world's copper stockpiles. In the course of the second half of the year, though, there is likely to be a gradual normalisation on the non-ferrous metal markets.

In view of the relatively propitious general conditions in the second half of 1996, economic growth in the industrial countries ought to strengthen; in the USA and Japan production will continue to expand rapidly and in Western Europe a clearer uptrend will again take shape. The upswing will gain greater momentum in the coming year. The brighter economic outlook will also spur the buildup of stocks, which are currently at a low level. With all this the demand for commodities will also rise more rapidly and the prices for industrial raw materials will pick up again. The price rise will however proceed at a relatively restrained pace at first in view of the only moderate growth in Europe, but also in the USA, compared with prior recovery phases. Annual average prices for 1996 for industrial raw materials are likely to remain some one-tenth under the previous year's figure (1995: +19%) due to the drop in the first half of the year and will be little higher on average in 1997.

Unlike industrial raw materials prices, the world market price for crude oil has risen markedly since autumn of last year. Spot prices for North Sea Brent oil, which had risen to 21 dollars a barrel in April, were no lower at the end of August despite the seasonal drop in demand. With tensions in the Gulf mounting again after Iraq despatched troops to the Kurd regions, prices went up again. The rise in oil prices

was partly the result of keener demand for heating oil in response to the harsh winter in the USA and Europe; American manufacturers suffered short-term supply problems due to low reserves. In addition, there have been delays in the start of production in new North Sea fields. The trends in spot prices over recent months have also been heavily marked by uncertainty about the outcome of the negotiations between Iraq and the United Nations over a partial lifting of the oil export ban to finance imports of food and medical supplies.

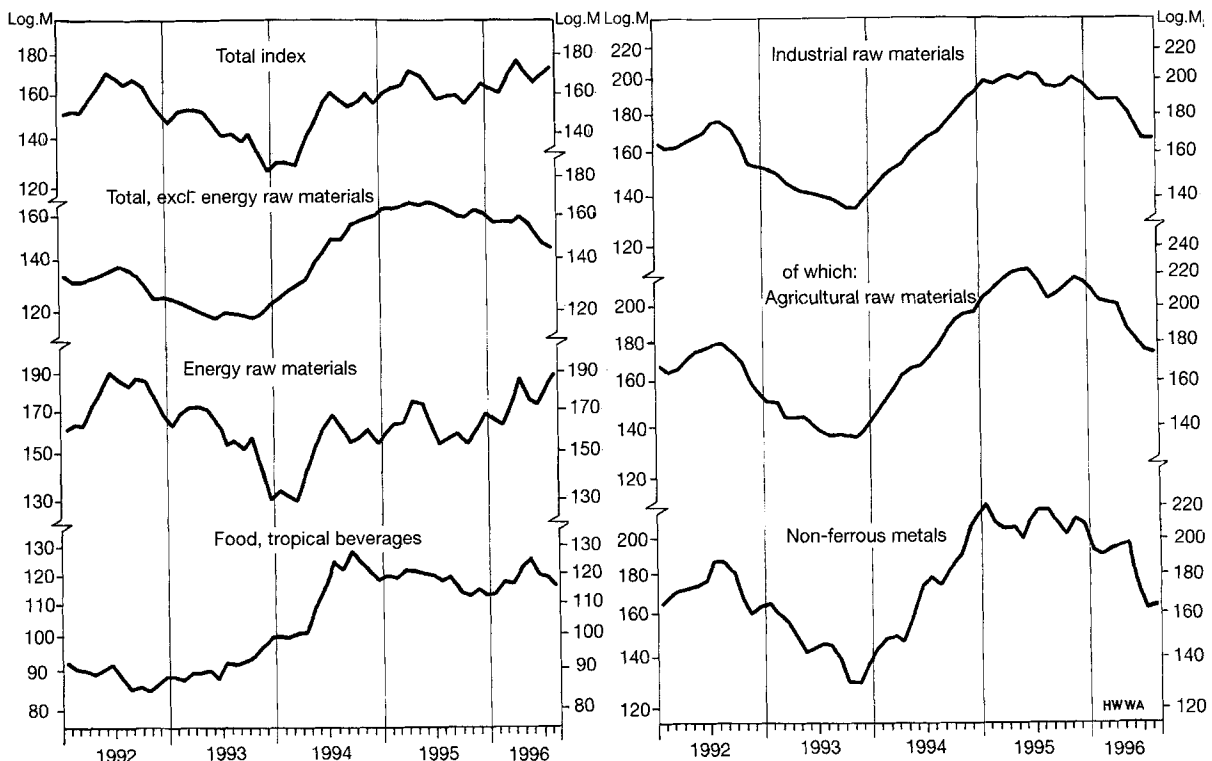
World oil consumption has risen progressively in recent years, increasing in 1995 by 1.9%, considerably more than in the first half of the 90s. Non-OECD countries have accounted for three-quarters of the increase and industrial countries, whose demand has been inhibited by slower economic growth, for only one quarter. In the first half of 1996 oil consumption is estimated by the International Energy Agency (IEA) to have risen by as much as 2.3% over the same period in 1995. The economic recovery in the industrial countries and a sustained momentum in Southeast Asia and the

emerging democracies in Central Europe mean that a further strong increase in oil consumption is to be expected. In all we can expect a rise of 2 1/2% both this year and next.

Oil supply has again risen slightly more than consumption despite keener demand; the resultant pressure on prices has, however, been offset by exceptional influences. The highest rise in output came from producers outside the OPEC, in particular the North Sea countries and Mexico. But especially this year more oil was produced in the OPEC countries too, where production has continued to be above the agreed ceiling, in particular as a result of Venezuela's exceeding its quota. Output in the successor states to the Soviet Union has largely stabilized. Altogether, world oil supply in 1995 rose by 2.2% (1994: 1.6%) and in the first half of 1996 by 2.9%. According to the information available on the enlargement of capacity, the expansion in supply will continue apace in the foreseeable future, so that the scope for oil price rises will remain within bounds.

Despite basic agreement with the United Nations, the exact date for the limited resumption of Iraqi oil

Figure 1
HWHA Index of World Market Prices of Raw Materials¹
(1975 = 100)



¹ Monthly averages, on dollar basis.

supplies could not be set even before the recent hostilities. In addition to technical problems, above all bureaucratic obstacles and political constraints hampered the implementation of the accord. Since the US military buildup in the Gulf, it is now highly unlikely that Iraqi oil will enter the world market this year. This affords the OPEC, which had agreed at its last session in June not to compensate for Iraqi exports by cutting the quotas of the other members, a fresh breathing space to deal with the unsolved problem of reallocating quotas in preparation for the return of Iraqi oil to the market. The widespread view on the oil market that the return of Iraq has receded further into the distance should keep prices relatively high for the rest of the year; measured against the crude oil import price of the OECD countries, it should not drop below 20 dollars a barrel.

In the longer run, world oil consumption can be expected to continue to rise by a large margin. Between 1990 and 1995 the annual rate of growth amounted to 2.3% (without the ex-Soviet Union -1% including it). The increase in consumption will be largely due to the sustained strong economic growth in the developing regions combined with a pronounced expansion in motor transport. In its updated long-term scenario, which assumes a constant real oil price and further improvements in energy efficiency, the IEA predicts a rise of the order of magnitude of nearly 2% a year; the bulk of additional consumption will come from outside the industrial countries. Growing demand is offset by continuing ample supply. The development of deposits outside the Gulf Region, requiring high capital outlay, increased greatly over the last ten

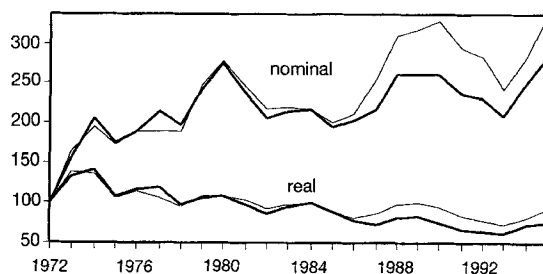
Diminishing Influence of Commodity Prices on Price Trends in the Industrial Countries

Commodity prices are on the one hand heavily influenced by the business cycle in the Western industrial countries. On the other, they also influence price trends and hence ultimately the business cycle in these countries. In the course of the structural changes of recent decades, raw materials prices have clearly lost importance as determinants of price trends. This was temporarily halted by the oil price explosions and the steep increase in other raw materials prices in the seventies. The ratio of import value or consumption of raw materials to gross domestic product in the industrial countries rose by a large margin as a result of the steep price rises at that time, particularly in the case of crude oil (see figure). The sharp rise in relative prices for raw materials spurred efforts to find substitutes and cut back on specific consumption, however. In oil this led to a decoupling of consumption and overall economic growth. Specific oil consumption in the OECD in relation to gross domestic product has dropped a good deal, and is now two-fifths below the figure for 1972. The development in industrial raw materials was similar, though less pronounced. In non-ferrous metals, for example, consumption in the seven major industrial countries has risen less than real gross domestic product over the last two decades.

Since the mid-70s price rises on the markets for industrial raw materials have lagged behind those in the industrial countries; "real" raw materials prices have thus dropped substantially. Taking the development of prices for industrial products as the basis for comparison, non-energy raw materials are a quarter cheaper today in "real" terms than in 1972, before the start of the boom, and industrial raw materials cost one-sixth less. Crude oil, the "real" price of which had risen sixfold by the start of the eighties, is now only about two and a half times as expensive as in 1972. All this has meant a marked decline in the influence of commodity prices on price trends in the industrial countries.

Raw Materials Prices (excl. energy)¹

1972 to 1995

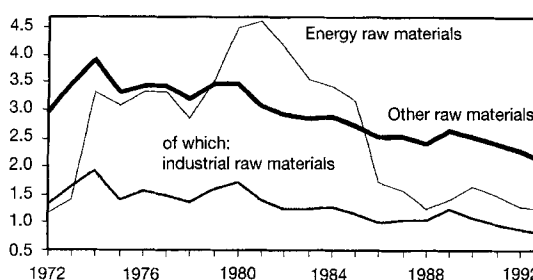


¹As measured by the HWWA Index; annual averages, 1972 = 100, on dollar basis; thin line: industrial raw materials.

Sources: HWWA; UN; own calculations.

OECD Raw Materials Import Quota¹

1972 to 1993

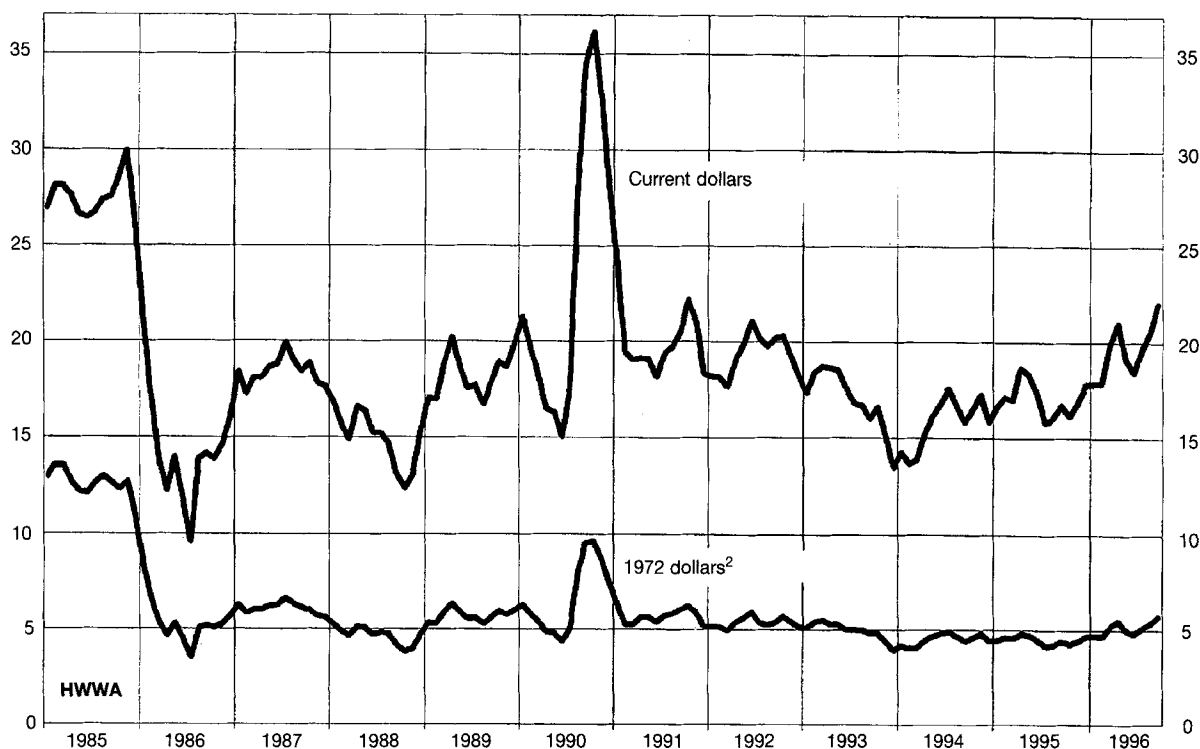


¹Relation of value of imports to gross domestic product, in %; annual averages.

Sources: OECD; own calculations.

Figure 2
World Crude Oil Prices¹ 1985-1996

US dollars per barrel



¹ Spot price for dated Brent, fob; monthly averages (September 1996: mid-month price). -² Deflated with manufactured goods exports unit value index for developed market economies; 1972 oil price: 2.0 dollars.

Sources: IEA; OPEC; UN; own calculations.

years, even with a relatively low oil price level. Technological advances in exploration and mining have made large incursions into costs over the last few years, which would lead us to expect a continuing vigorous expansion in production outside the OPEC in the future. In the longer term, the OPEC countries, which currently account for about 40% of the world's oil supply, with three-quarters of all proven reserves – two-thirds in the Gulf Region alone – hold a dominant position. Whether they will or can exploit this position

in future to push up prices is doubtful going by experience so far. Rather, in view of the financial constraints in most producer countries, the large reserves can be expected to provide an increasing incentive to raise oil revenue by expanding output. From this standpoint, a sustained rise in oil prices would appear unlikely in the medium term.

Compiled by the Department of World Business Cycles of the Hamburg Institute for Economic Research (HWWA).

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

| Raw Materials and Groups of Materials | 1995 | | 1996 | | | | | |
|---------------------------------------|--------------------|------------|-------|-------|-------|--------|--------|--------|
| | AA 95 ² | August '95 | May | June | July | August | 30. 8. | 13. 9. |
| Total index | 162.7 | 158.8 | 169.2 | 164.4 | 167.6 | 171.4 | 174.5 | 183.4 |
| Total, excl. energy raw materials | 163.3 | 162.3 | 157.1 | 149.2 | 145.4 | 144.3 | 145.3 | 141.4 |
| Food, tropical beverages | 117.4 | 119.0 | 125.4 | 119.7 | 117.8 | 115.3 | 115.5 | 111.6 |
| Industrial raw materials | 198.2 | 195.3 | 181.3 | 171.8 | 166.5 | 166.4 | 168.0 | 164.1 |
| Agricultural raw materials | 213.9 | 204.1 | 187.2 | 181.2 | 176.0 | 175.2 | 175.9 | 175.4 |
| Non-ferrous metals | 209.4 | 217.3 | 195.9 | 172.2 | 162.3 | 163.0 | 167.2 | 157.6 |
| Energy raw materials | 162.3 | 156.7 | 176.2 | 173.3 | 180.5 | 187.3 | 191.5 | 207.9 |

On dollar basis. ² Annual Average.