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Klaus Matthies*

Sedate Price Trends on World Raw Materials Markets

The pronounced economic recovery in the world's industrial nations has not so far made any major mark on the markets in raw materials. There has not been any net increase in industrial raw materials prices, and indeed oil prices have actually fallen substantially. What are the prospects looking a little further ahead?

World market prices for raw materials have fallen in the current year. The HWWA index in dollar terms was down 8% in November against the beginning of the year, putting it back to its mid-1996 levels (see the graph on page 304). Like the increase that preceded it, the decline since the start of this year is chiefly attributable to oil prices: world spot prices for crude oil fell by 16% between January and November. By way of contrast, prices of non-energy raw materials hardly changed during the year.

Even though the economies of the industrial countries have been picking up, and hence also the demand for raw materials, that has not worked through into prices of industrial input commodities, which in dollar terms have become 3% cheaper. Nevertheless, from the point of view of German manufacturers and any other users outside the dollar zone, the appreciating US currency has made industrial raw materials palpably more expensive: the price index in deutschmark terms was up 5% in November vis-à-vis the start of the year.¹ The exchange-rate influence has been more pronounced still on a year-on-year basis, where November price levels of industrial raw materials are down 2% in dollar terms and up 12% in deutschmark terms.

While dollar prices of agricultural raw materials fell only slightly this year, those of non-ferrous metals have dropped back again significantly following a recovery phase which lasted into the summer; the net effect left them 7% down on the beginning of the year. Movements have at times varied considerably from one metal to another. On the one hand, aluminium and zinc prices rose, even though the hike in zinc prices to new seven-year highs during the summer due to market uncertainty over supplies from China eventually proved short-lived. On the other, the prices of lead and nickel have kept on downwards. Copper, too, gave a lot of ground again after a temporary

increase in the early part of the year, and prices finally came near to the bottom they reached last year following the copper scandal.

Oil prices have fallen by approximately 16% this year, thus wiping out the greater part of the strong gains they made in 1996 (see Figure 1). Levels of stockpiling in oil-consuming countries, which fell back considerably last year (partly in the expectation of falling prices) and ironically were one of the main causes of the price increases, have now returned to "normal". Evidently, supply and demand are currently quite well matched on the world oil market. The outcome of OPEC's summer conference, namely that production quotas should be maintained around the same levels for the time being, appears to have been pretty well in line with the market's expectations – as well as the expectation that the actual production levels would continue to exceed the agreed limit. Most OPEC producer countries are apparently not unhappy with the prices as they are, even though they have again slipped below the officially declared target of \$21 per barrel.

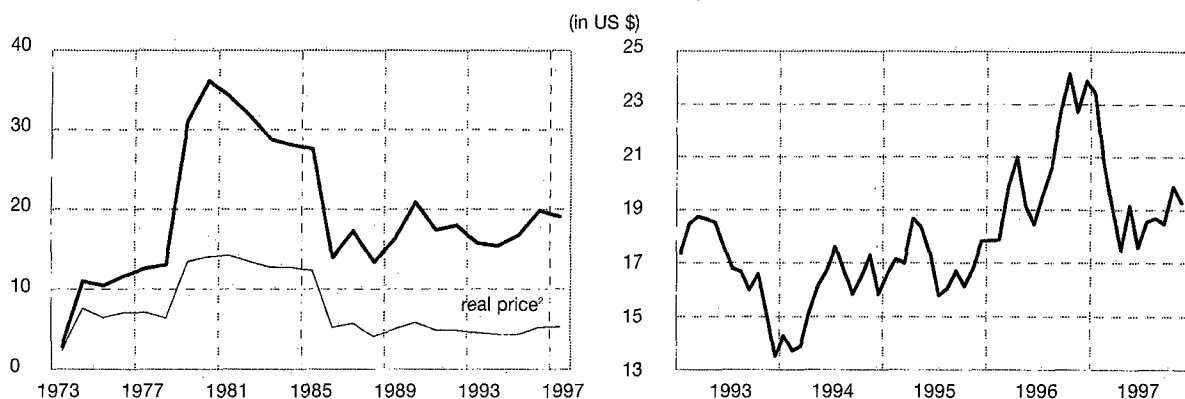
Just recently, price movements have again been strongly affected by uncertainty as to how much oil Iraq would be exporting. Until the beginning of December, supplies will be in line with the country's existing agreements with the United Nations, but at time of writing it is still unclear what will happen afterwards due to the continuing dispute over the surveillance of Iraq's weapons capability.

As the economies of the industrial countries continue their present expansion, the demand for raw materials will be boosted too. Even though industry's needs will be less pressing in the USA as some of the heat comes out of the cyclical growth there, demand from Europe will increase at an accelerated rate as the upward cycle gets established. In the rest of the

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¹ This movement has also been reflected in German import prices, which have increased significantly in 1997.

Figure 1
World Market Prices of Oil¹



¹ Spot prices in US\$ per barrel, fob, Arabian Light (left-hand graph, showing annual averages, and Jan.-Oct. average for 1997) and Brent (right-hand graph, showing monthly averages; November 1997: up to 21st).

² 1972 dollars; export prices of manufactured goods from the industrial countries are used as the deflator.

Sources: IEA; OPEC; UN; own calculations.

world, increases in raw materials consumption are now likely to turn out rather lower than had first been thought, due to the dampening effect of the financial crises suffered by a number of Asian countries. Given that the pace of expansion in the consuming countries is generally more modest than in many of the upward cycles seen in the past, the dollar prices of industrial raw materials are likely only to rise gently for the time being (see Figure 2 for the trends in raw materials prices and OECD industrial output). Another particular reason for this is that supply conditions are quite elastic at present. On the metal exchanges there are no signs yet of any return to "normal" from the sharp fluctuations that have been partly caused by the market activities of large trading companies and commodity funds. Rather, it is fair to assume that, on many commodity markets, the changed composition of market participants will be responsible for substantially more volatility while the influence of cyclical economic changes has tended to fall off. Taking the annual average for 1997, industrial raw materials prices are likely to be 1% below the equivalent figure for 1996; the expected increase in the coming year is approximately 4%.

Easy Conditions Persisting for Oil

The supply-and-demand fundamentals of the oil market are likely to be little changed in the year ahead, so there are no particularly adverse conditions in prospect. Expansion in the oil-producers' output will pretty well keep pace with the relatively strong increase in world oil consumption. The average year-on-year increase was 2.4% in 1996, is likely to be

2.8% in 1997 according to the latest available information, and can be expected to grow at about 2½% in 1998 with the upward economic cycle persisting in industrialised countries. On the basis of current information on planned output in non-OPEC countries, supply may if anything increase rather more quickly than demand with the result that, once seasonal variations are stripped out, price levels are hardly likely to rise. However, this assumes, first of all, that Iraq will continue to export a similar volume of oil under the UN agreement, and secondly that the OPEC countries will stick to their present production levels. With these factors in mind, the import price of crude oil for the OECD countries, which normally deviates little from the Brent crude price, can be expected to be around the \$19-per-barrel mark in the coming year.

All in all, despite considerable fluctuations at certain times the oil price has ended up practically unchanged relative to the low levels it fell to in the mid-1980s. The same applies to the "real" price of oil calculated using the export prices of industrial products as a deflator (see Figure 1). On a long-term comparison, the real price of oil, which increased six times over in the price hikes of the 1970s, is now just two-and-a-half times its level of 25 years ago. Measured on the same basis, the world market prices of other raw materials, which also rose sharply in the early 1970s, have since maintained a weaker trend than the prices of manufactured goods, leaving them lower in real terms than in 1972 before the increases began, and non-energy raw materials are down one third in real terms (see Figure 3).

Raw Materials Prices Now Less Significant

In the course of structural change since the mid-1960s, raw materials inputs have become considerably less important as determinants of prices in industrial countries. Admittedly, the trend was interrupted for a number of years in the 1970s by the oil-price explosion when other commodity prices rose too. In this phase, the value of raw materials imported or consumed relative to overall gross domestic product in the industrial countries shot up, especially for oil. However, the ultimate effect of this was to amplify the efforts being made to substitute and to reduce the specific consumption of raw materials. Another factor tending to dampen down the demand for raw materials has been the increasing attention paid to environmental protection. A further factor affecting petroleum products has been that the price of the end-products has been increasingly influenced by taxation (particularly on consumption) over time, and hence less and less by the crude oil price. All

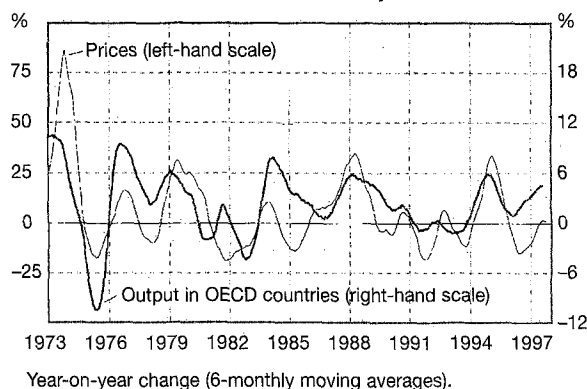
these factors have helped to decouple rates of oil consumption from those of overall economic growth. In the OECD, specific oil consumption as a percentage of GDP has declined substantially, as has the level of oil imports, and it is now down by two-fifths relative to 1972. Similar trends, though less pronounced, have occurred for industrial raw materials. For example, consumption of non-ferrous metals has risen less quickly than real GDP across the board in the seven most important industrial countries.²

No Lasting Changes in Price Trends

On a longer-term view world oil consumption, which has grown at an average of 1.5% per annum in the 1990s – or at as much as 3% per annum when the former Soviet Union is excluded – will continue to increase markedly. No small contribution to that trend will presumably come from persisting strong growth in developing and newly industrialising countries coupled with the swift growth in motorised transport there. The latest long-term scenario published by the IEA,³ which assumes a constant real oil price and further improvements in energy efficiency, projected growth in oil consumption in the order of 1.9% per annum. A similar forecast has been made by the US Department of Energy in the most recent "Outlook" publication, namely 2.1% annual consumption growth and slightly increasing oil prices.⁴ Most of the additional consumption projected is expected to come from developing countries and NICs.

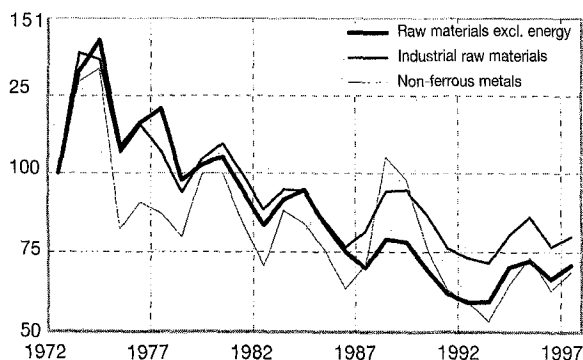
Though demand is rising, there is still an abundant supply to match. The development of oilfields away from the Gulf region, which demands high capital investment, has increased considerably even in the low-price environment that has prevailed over the past ten years; thanks to technological advances, exploration and extraction costs have come down a long way. According to recent estimates, finding and production costs in the North Sea amount to \$ 7-8 per barrel in the most recent fields to come on stream, compared with \$ 15 per barrel ten years ago.⁵ On that basis, production in non-OPEC countries can be expected to expand swiftly in future, too. The share of world output contributed by countries in the former Soviet Union (currently 10% having been twice as

Figure 2
Prices of Industrial Raw Materials
and Industrial Output¹



Sources: HWWA; OECD; own calculations.

Figure 3
Real Raw Materials Prices¹



¹ Annual averages (1997: to October), deflated by the export prices of manufactured goods from industrial countries; 1972 = 100.

Sources: HWWA; UN; own calculations.

² Cf. E. Borensztein et al.: The behavior of non-oil commodity prices, Washington DC, August 1994, pp. 10f.

³ IEA: World Energy Outlook 1996, Paris 1996, pp. 257-269.

⁴ Cf. Energy Information Administration: International Energy Outlook 1997, Washington DC 1997, p. 174.

⁵ Cf. Len Paton: After downsizing comes the squeeze on capacity, in: Petroleum Economist, July 1997, p. 36.

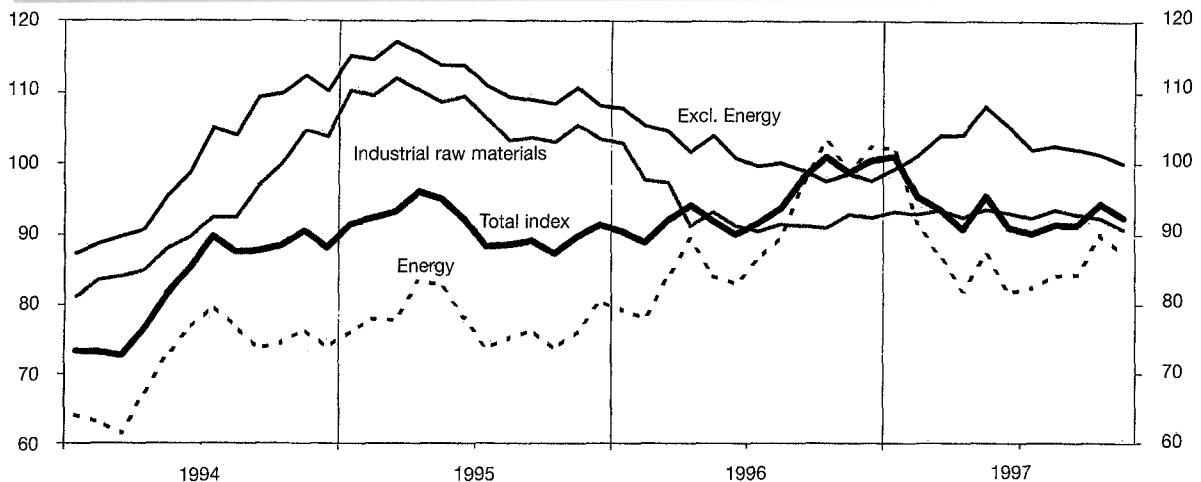
high in the mid-1980s) is not expected to rise significantly. In the longer term, the OPEC countries hold a dominant position: they currently account for approximately 40% of world production, but they hold three quarters of all proven reserves, two thirds of which are in the Gulf region alone. Nevertheless, on the basis of experience to date it is doubtful whether they will use that position to enforce higher prices, even if they are able to. Rather, given the financial constraints being felt by most of the producing countries and also given the major differences in per capita incomes and development levels within OPEC, it is a fair assumption that the substantial reserves will increasingly spur member countries to boost their oil revenues by increasing their production rates. In such circumstances, a sustained oil price increase is not very likely in the medium term.

As for industrial raw materials, there is no reversal of the long-term price trend in prospect. Certainly,

growth in the industrial countries will generate additional demand, but the elasticity of demand for raw materials is tending to decline as a result of structural change. Despite the current problems a number of countries are experiencing, in the medium term the developing and newly industrialising countries can be expected to have sustained high rates of growth of industrial production, yet here too firms will tend to make ever greater use of new, material-saving techniques. On the supply side, there are no generally applicable constraints in prospect in the foreseeable future, particularly as the former Soviet countries are now increasing their presence as suppliers on the world market, both because they need to make up for reduced sales in their home markets and, more especially, because they wish to earn more foreign exchange. Taking these factors into account, increases in the prices of industrial raw materials are likely to remain modest.

HWHA Index of World Market Prices of Raw Materials¹

(1990 = 100)



Raw Materials and Groups of Materials ¹	1996	May 97	June 97	July 97	Aug. 97	Sept. 97	Oct. 97	Nov. 97 ²
Total Index	94.3 (3.3)	95.5 (3.8)	91.1 (1.1)	90.4 (-1.7)	91.4 (-2.6)	91.4 (-6.9)	94.5 (-6.5)	92.5
Total excl. energy	101.4 (-9.6)	108.1 (3.9)	105.4 (4.5)	102.0 (2.3)	102.6 (2.4)	102.1 (3.0)	101.3 (3.8)	100.1
Food, tropical beverages	124.6 (-2.1)	151.0 (11.1)	141.7 (9.8)	130.4 (2.7)	129.2 (2.8)	129.3 (5.9)	127.7 (9.1)	127.6
Industrial raw materials	93.7 (-12.6)	93.7 (0.4)	93.1 (2.0)	92.5 (2.1)	93.6 (2.2)	92.9 (1.7)	92.4 (1.5)	90.8
Agricultural raw materials	96.0 (-13.8)	92.7 (1.8)	92.2 (-0.6)	91.5 (-2.1)	92.8 (-2.3)	94.1 (-1.9)	94.6 (-2.1)	93.0
Non-ferrous metals	88.0 (-15.8)	94.3 (-1.6)	93.5 (8.5)	92.6 (12.5)	93.7 (13.4)	88.8 (10.5)	86.3 (10.0)	84.0
Energy	89.7 (15.5)	87.3 (3.8)	81.8 (-1.5)	82.5 (-4.7)	84.2 (-6.2)	84.4 (-13.4)	90.0 (-12.9)	87.5

¹ On a US dollar basis, averages for the period; figures in brackets: percentage year-on-year change.

² Up to and incl. 21st November.