Matthies, Klaus

Article — Published Version

Commodity prices remain high

Intereconomics


This Version is available at: http://hdl.handle.net/10419/41978

Terms of use:

Documents in EconStor may be saved and copied for your personal and scholarly purposes.

You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.

If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.
World market prices for most raw materials have continued to increase in recent months. Altogether, the HWWI/HWWA commodity price index in US dollars has increased by 17% since the beginning of last year (March 2007 compared to December 2005) but the rate was more than twice as high (38%) if energy commodities – where developments were shaped by the sharp rise in oil prices last summer and the subsequent downward correction – are left out of the calculation.

Crude oil prices, after their decline from record heights last summer, remained rather high. Most of the time spot quotations for Brent oil did not deviate much from 60 dollars per barrel in recent months, although in January, under the influence of high refinery stocks and mild winter weather in the northern hemisphere, they fell temporarily to 50 dollars. At the end of March, prices rose by several dollars after the seizing of British naval personnel by Iran raised concerns about an imminent military conflict. In real terms, compared to the export prices of manufactured goods, crude oil prices in dollars are still below the record level of 1979/80.

OPEC Limits Oil Supplies

The concern of oil producing countries that abundant oil supplies would induce a larger fall in oil prices led to OPEC production cuts in November and again in February. The resulting downward trend in oil stocks in consumer nations and lower temperatures in North America in February helped moving crude oil prices back to the 60-dollar mark. At their latest meeting in March OPEC oil ministers described the state of the oil market as comfortable, although some officials were wary that a slide in US equities could dampen the economy and thus reduce demand for oil. The conference decided to leave production curbs unchanged for the time being and to concentrate on improving producers’ quota compliance. At their two previous meetings, the 10 participating countries had agreed to reduce production by a total of 1.7 million barrels per day, and in mid-March OPEC stated that total cuts were close to 1.2 million.

World oil product demand, having increased by 1.6% in 2005 and 1% in 2006, will rise by 1.8% this year according to IEA estimates. OPEC’s estimate is only slightly less at 1.6%. Most of the additional demand originates in developing countries; China accounts for almost 30% and Middle Eastern countries for another 20%. Oil supplies from non-OPEC countries will rise by about 1 million barrels per day, extending the growth which has been evident since mid-2006. Output growth reflects gains from new projects in the Caspian region, Africa, Brazil and the USA, but declining production from mature fields in the North Sea, the Middle East and Mexico limits the expansion. The resulting “call on OPEC crude” will be about the same in 2007 as in 2006, meaning that the member countries would have to lift crude oil production from the current reduced level later this year.

We expect that OPEC’s crude oil production will be raised to meet increasing demand in the course of this year. Crude oil prices should then remain near the 60-dollar mark. There is a risk of rising oil prices if OPEC production does not keep up with rising demand or in the case of larger supply disruptions. Much lower prices could result from a stronger dampening of the world economy curbing global oil consumption.

* Research Associate, Hamburg Institute of International Economics (HWWI), Germany.
ECONOMIC TRENDS

Strong Demand for Industrial Commodities

Industrial raw materials prices in dollars increased by a third during the course of 2006, a number of price quotations climbing to new record levels. The upward trend, which has slowed down since the second half of last year, has continued so far. On average, industrial commodity prices have increased by 42% since the end of 2005.

Price increases were most pronounced in the metals markets. The index value for non-ferrous metals rose by about fifty per cent last year, whereby most of the increase took place during the first half of the year. In addition to supply failures and low inventory levels, as was the case for copper and nickel for example, this development was also due to a growing interest on the part of investment funds – a factor reflected in increasingly volatile prices. Metal quotations initially declined at the start of 2007, but then recovered to continue their upward trend once more. The extent of price rises since the end of 2005 varied considerably, from 23% in the case of aluminium to 245% for nickel.

Copper prices continued to fluctuate strongly in recent months. In early February 2007 the spot quotation was down to 5,200 dollars per tonne, well below last May’s record level of 8,000 dollars. But in early April the price climbed back to over 7,000 dollars. In view of expanding inventories, somewhat slower consumption growth, and a probable increase in supply, prices should tend to fall this year. Risks include renewed production failures and a further increase in Chinese demand. Where aluminium is concerned, prices are particularly strongly influenced by China’s output – more than 40% of global production – and Chinese commodity policies. The expectation that bottlenecks in the supply of raw materials together with high energy prices would limit China’s aluminium production has so far proven unfounded. In January, China imported five times as much bauxite as in January 2006. Changes in taxation aimed at reducing output from aluminium smelting plants have so far had little effect. Given the high levels of inventories on the international commodity exchanges as well as among producers it may be assumed that expanding supplies and a somewhat slower increase in demand will ease tension on the aluminium market during the rest of this year. The price of nickel reached a record high of 50,000 dollars per tonne in mid-March – more than ten times the autumn 2001 price level prior to the ongoing commodity price rally. China’s fast-rising requirements for high grade steel will probably shore up nickel prices for the foreseeable future. Although the supply of nickel is on the increase, production capacity expansion is progressing at a slower pace than expected. Given the extremely high level of market prices, however, efforts to substitute nickel in the production of high grade steel will intensify.

In the case of tin, substantial production failures in Indonesia – the second largest tin producer after China – have spawned record prices. A considerable number of plants were closed down last October as part of a range of official measures to curb illegal ore-mining activities. Tin prices rose by two thirds during the course

Figure 1
Nominal and Real Brent Crude Oil Prices¹

¹ Price per barrel; real prices: quarterly prices (until 1981Q1 Arab Light), deflated with manufactures export price, basis 2006.
Source: HWWI.
of last year and have risen by a further 20% this year. Supplies from Indonesia, which constitute around 40% of the world total, will be considerably lower this year, and since China’s tin production is largely consumed at home, it is predominantly down to Australia, Bolivia and Brazil to offset the shortfall. The tin market situation should ease later this year when at least some of the Indonesian plants resume production, so that prices will probably return to normal levels in the course of next year at the latest. Last year’s record increase in the price of zinc was supplanted at the end of the year by falling quotations. In the first weeks of this year zinc prices dropped by a quarter and have recovered little since then. According to estimates drawn up by the International Lead & Zinc Study Group (ILZSG), zinc consumption will increase this year, primarily in China. Last year, however, thanks to a strong increase in production, and in contrast to previous years, China was actually a net exporter of zinc. Further production capacity will go online during the course of this year, making sharp price rises unlikely. Lead prices have risen strongly since the middle of last year, and global supply could tighten still further as a result of environmental measures in China, where smaller producers are affected most of all. However, price rises should be limited by weak demand this year, with the ILZSG expecting a fall in demand in the USA, stagnation in Europe and little increase in Asia.

**Steel Boom Driving Commodity Prices**

Raw materials for steel making continue to be in great demand as a result of the ongoing boom in the steel industry. Prices for scrap steel began to pick up considerably last autumn, and some are now edging towards the record levels seen at the end of 2004. In the case of iron ore, rising demand coupled with the slow expansion of production capacity has led to an increase in spot market quotations. As a consequence, the contractual price for iron ore fines that is renegotiated every year between the large producers and the steel industry was raised by 9.5% for the current year. Several large European steel companies were initially unwilling to recognise the result that was first accepted by China in December, but finally conceded in March. This price rise – the fourth in consecutive years – means that the price of ore has almost trebled since 2002. In contrast, this year’s negotiations on coking coal are likely to lead to a reduction in prices. Two years ago, the steel boom caused a 120% increase in the price of coking coal, but last year ample supplies prompted a first modest downward correction.

Compared with metals, there was relatively little rise in the prices of agricultural raw materials, which at the end of last year were around 20% higher than a year previously. The increase was sharper in the case of wool due to the decimation of Australia’s sheep flocks following a long period of drought. Developments in food commodities were similar to those of agricultural raw materials, although prices did not begin to rise until the autumn. Particularly sharp price increases were recorded for cereals, above all for maize, and for some vegetable oils. This development documents increasing demand for the production of biofuels. It is also possible that speculative buying is exercising consid-
erable influence on the markets, since a similarly sharp price increase in the wake of the biofuel boom took place a year ago in the case of raw sugar. Here, however, delays in the implementation of ethanol projects together with ample supplies of raw sugar worldwide reversed about half of the increase within a year.

**Only Modest Further Price Rises Expected**

Given that prices for most commodities have now reached a high level and that world economic growth is slowing somewhat, demand for raw materials can be expected to increase at a slower rate than in the recent past. Moreover, there are strong incentives to augment the supply of raw materials, and much of the capacity expansion initiated in recent years is gradually approaching production maturity. This will dampen any price increases. Yet even if prices for industrial raw materials do not rise any further this year, the industrial raw materials index in US dollars would, on average for the year 2007, still be 15% higher than the previous year's level following an increase of one third last year. Having said this, the great interest in commodities among non-commercial agents can be expected to lead to a high level of price volatility; it also bears the risk of a substantial downward correction. On the other hand, considerably higher commodity prices could materialise if import requirements among the developing countries and emerging economies increase more rapidly than assumed or if rising costs or bottlenecks delay the planned expansion of production capacities.