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Relaxation on the Oil Market

While the prices of industrial commodities have risen only slowly, oil prices reached their highest level for nine years in early March. Can their more recent decline be expected to continue over the medium term?

The rise in world market commodity prices which started one year ago has continued in the last few months. Measured in US dollars against the HWWA-Index, in March they were more than fifty per cent higher than one year earlier (cf. HWWA-Index of World Market Prices of Raw Materials, p. 104). Until recently, the increase reflected, above all, the rise in oil prices caused by moves from the oil exporting countries to tighten supply. At the beginning of March, the price of Brent crude oil at over 30 dollars a barrel was three times its year-earlier level. Since then, however, the oil price has fallen back to 25 dollars due to expectations of higher production levels from April on.

In real terms, measured against the development of the export prices of industrial goods, crude oil was in February four times its 1972 value, prior to the first oil price shock. Even so, and in spite of a steep rise since the spring of 1999, the real oil price is still far below the peak reached in the early eighties (cf. Figure 1). Since then, the importance of oil consumption to the developed economies has declined: oil imports in the IEA countries only account for about 4% of the value of total imports; in the first half of the eighties they accounted for 13%.¹ Moreover, in contrast to oil prices, real world market prices for other raw materials have been on a downward trend since the first half of the seventies, thus easing the burden on industrialised countries' import bills. In real terms, industrial commodities are a good one-fifth cheaper today than they were then.

Tightening of Oil Supply

Consumers have responded to the step-by-step reduction in oil output in OPEC and some other coun-

tries by drawing down stocks. By the turn of the year, oil stocks held by industry in the OECD had shrunk to their lowest level for three years. While oil supplies are tighter, demand is once again rising more strongly. The rise in oil consumption, which according to the IEA amounted to 1.7% in 1999, will gather pace this year and next year as the world economy continues to recover. In particular, this will reflect a significant rise in demand in South East Asia. But higher oil prices will dampen the increase in world-wide demand. In this situation, future oil prices will depend, above all, on the output policy of the oil-producing countries. To date, OPEC members have shown a rather high degree of compliance with the agreed production limits. Leakage in the last few months has amounted to about 1 million barrels a day, or about 4% of their combined output.

The production cuts of the two last years have clearly boosted the incomes of the oil exporting countries, in most of which oil revenues account for more than half of export income.² They suffered major income losses during the preceding price collapse. The oil income of the OPEC countries, which in 1998 fell by about one third, rose by an estimated 35% in 1999. Assuming an average oil price this year of 24 \$ a barrel, that income would rise by about one third again: even without any increase in export volumes. Since that should significantly ease the strained budgetary situation in many OPEC countries, there was little underlying inclination to relax the agreed curbs on production.

Meanwhile, high oil prices and sharply reduced stocks in the consumer countries have prompted a

¹ IEA: Monthly Oil Market Report, 11. 2. 2000, p. 3.

² Cf. On the export revenues of OPEC countries see K. Matthies: Raw Materials Prices Remain Low, in: INTERECONOMICS, Vol. 34 (1999), No. 2, p. 103.

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number of producers to express reservations about holding current output levels unchanged. Increasingly, they shared the concerns of the consumer countries that the world economy could be dragged down by high oil prices. For the oil producers, it would have meant the risk of denting the recovery in oil demand that has begun. On a medium term view, they could also expect stronger growth in oil production in other countries.

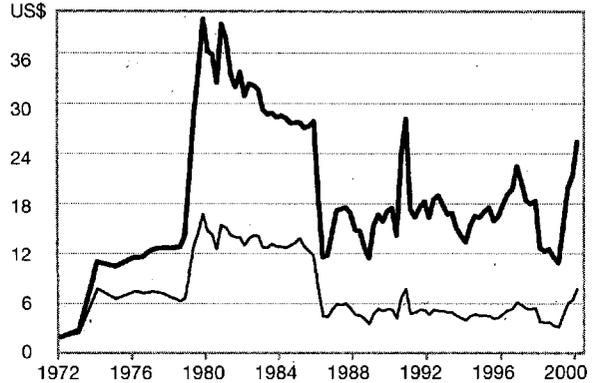
Differences over Future Production Policy

In deciding their future production policy, the oil nations face the difficult task of setting exports at levels that maximise their oil incomes while ensuring that high oil prices do not impair world economic growth. At the same time, OPEC members attach great importance to avoiding action which could jeopardise the unity they managed to restore last year. Otherwise, any agreements could be quickly undermined by individual countries going it alone.

While Saudi Arabia pressed for an extra 1.7 million barrels per day (+7%), Iran wanted to limit the extension to 1.2 million barrels (+5%). Iran feared that a larger increase in supplies, along with the usual seasonal dip in second quarter demand, could quickly lead to a price decline on international oil markets. Since Iranian oil production appears to be bumping up against capacity restraints, the country could hardly offset a drop in income, resulting from lower prices, by raising output. The OPEC Conference at the end of March decided to extend the joint production limit along the general lines of the Saudi Arabian proposal. If the actual oil production of the 10 OPEC countries³ is raised by the same amount, i.e. if "cheating" by several countries continues, the crude oil price can be expected to fall during the course of the year. We calculate that Brent crude oil will drop to 22 dollars per barrel by the beginning of next year.

Quite aside from the differing interests of the oil nations, the goal of keeping oil prices within a target range by regulating output looks over-ambitious – if only because of the paucity of adequate data. The figures available for production, consumption and stocks are not up-to-date. They are unsuitable, therefore, as a basis for fine-tuning production in order to influence spot market prices. In any case, such interventions are hardly an effective tool for stabilising oil markets. Even if the OPEC countries, by co-ordinating output, were to succeed in boosting the oil price, for an appreciable period, above the average level of the

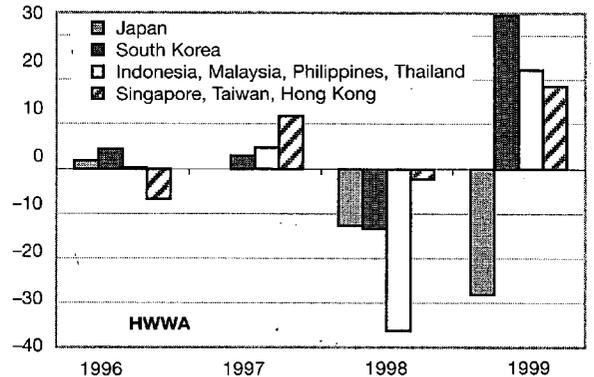
Figure 1
Development of World Market Prices for Oil¹



¹ Spot prices fob in US\$ per barrel for Arabian Light, quarterly figures (1972-75 annual figures). – ² Deflated with export prices for manufactured goods from industrialised countries. Base year 1972.

Sources: IEA; OPEC; author's own calculations.

Figure 2
Metal Consumption in South East Asia 1996-1999¹



¹ Base metals (aluminium, copper, lead, nickel, tin, zinc); year-to-year change in %, 1999 partly estimated.

Source: World Bureau of Metal Statistics; author's calculations.

past 15 years, oil markets can be expected to continue showing a high degree of volatility.

Slow Recovery for Industrial Raw Materials

In contrast to crude oil, the rising price trend for other raw materials has remained relatively moderate. These commodities are still markedly cheaper than before the price collapse that followed the Asian crisis. After firming temporarily in the second half of 1999, the prices of foods and tropical beverages have lately resumed their downward path.

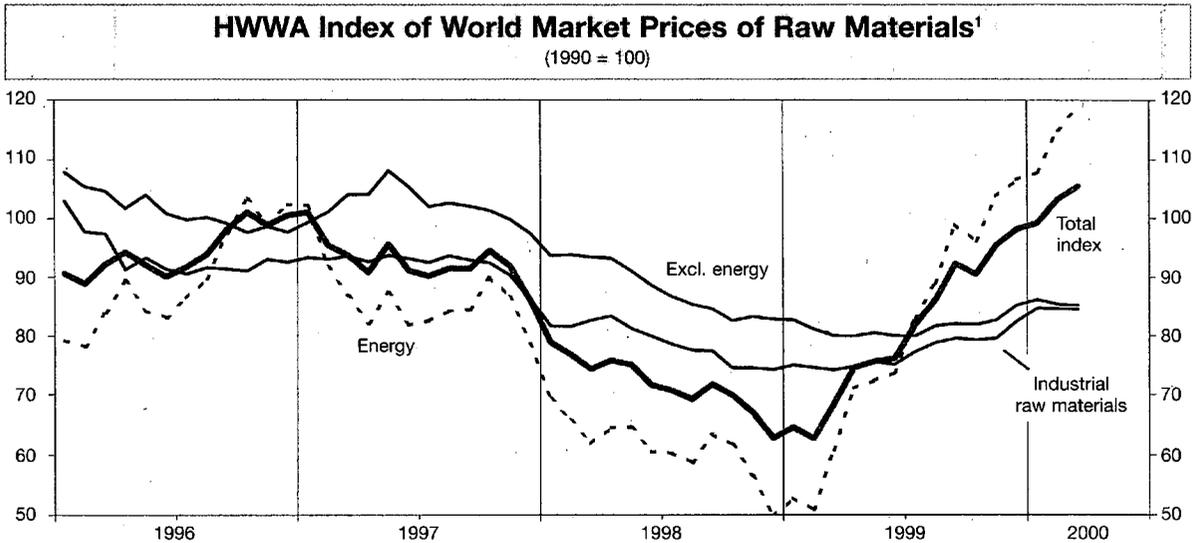
³ Iraq is not included in the output limit.

⁴ Cf. K. Matthies: Commodity Prices Continue to Fall, in: INTER-ECONOMICS, Vol. 33 (1998), No. 5, p. 246.

The recovery in the prices of industrial raw materials, which accelerated over the course of last year, has slowed in recent months. Hopes that faster than expected growth in the world economy would strengthen demand for raw materials have been damped by rising interest rates which increase the cost of holding stocks of raw materials. Aside from pulp, the upward price trend was sustained largely by the strength of some non-ferrous metals. The demand for metals rose last year due, above all, to marked economic recovery in the developing countries of South East Asia following steep recession the year before (cf. Figure 2). During the nineties until the onset of the financial and economic crisis, metals demand in this region was a major source of global demand strength for metals.⁴ In Japan, on the other hand, last year's decline has accelerated.

Nickel values, which hit a five-year peak in February, have shown the strongest gains. A key

factor was a surprisingly strong rise in world demand for refined steel, above all in Asia which was accompanied, due partly to special factors, by tight supplies. The prices of other industrial raw materials, in particular agricultural commodities, have remained depressed with continued plentiful supply matching livelier demand. Raw materials demand will rise further due to continuing world economic growth; most notably, higher consumption in Asia, which last year provided the main support for raw materials demand, will continue to grow strongly. But production, too, should expand further if capacity, shut down as a result of falling prices during the Asian crisis, is reactivated as prices firm. As a result, the prices of industrial raw materials prices will probably rise only moderately. Reflecting strong rises in metals in recent months, average industrial commodity prices, which fell back by 2.2% last year, are forecast to rise by 10% this year and by a further 8% next year.



Raw Materials and Groups of Materials ¹	1999	Sep. 99	Oct. 99	Nov. 99	Dec. 99	Jan. 00	Feb. 00	Mar. 00 ²
Total Index	80.5 (11.8)	92.3 (28.6)	90.5 (29.4)	95.5 (42.4)	98.2 (56.4)	99.3 (53.8)	103.3 (64.6)	105.5 (54.3)
Total, excl. energy	81.5 (-7.7)	82.0 (-3.0)	81.9 (-0.7)	82.7 (-0.7)	85.2 (2.9)	86.2 (4.2)	85.4 (5.2)	85.2 (6.5)
Food, tropical beverages	94.2 (-18.7)	89.3 (-15.5)	89.6 (-15.7)	91.8 (-15.8)	93.3 (-13.8)	90.5 (-14.2)	87.5 (-12.9)	97.4 (-10.3)
Industrial raw materials	77.2 (-2.2)	79.6 (2.8)	79.3 (6.5)	79.6 (6.8)	82.4 (11.1)	84.7 (13.0)	84.6 (13.5)	84.4 (13.9)
Agricultural raw materials	78.6 (-0.9)	79.2 (1.7)	79.0 (6.1)	78.9 (5.7)	82.0 (8.3)	83.4 (7.3)	82.9 (5.9)	83.3 (7.1)
Non-ferrous metals	71.9 (1.0)	79.2 (13.6)	78.5 (16.4)	79.5 (17.6)	82.5 (27.7)	86.9 (37.0)	86.9 (37.3)	84.9 (33.9)
Energy	79.9 (30.1)	98.9 (56.1)	96.1 (55.7)	103.8 (83.8)	106.7 (114.5)	107.8 (104.4)	115.0 (126.5)	118.7 (95.4)

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

² Up to and incl. 24th March.