Klaus Matthies*

Asian Demand Pushes Up Commodity Prices

Dollar prices for industrial raw materials have increased along a wide front, and oil prices are almost as high as they were before the Iraq war. Due to the weak dollar, however, consumers in the euro area have been relatively unaffected so far. Demand for raw materials will remain strong. Must we brace ourselves for a further sharp increase in commodity prices?

Prices for internationally traded commodities have increased considerably along a wide front in recent months. In March, measured using the HWWA index on a dollar basis, they were 20% higher than a year previously. This development was most marked in the case of industrial raw materials which rose by 30%. Since the autumn of 2001, when prices reached a long-time low, quotations for industrial raw materials have increased by 60%. In the euro area, however, this price increase was far less pronounced due to the appreciation of the euro against the US dollar. In euro terms, prices for industrial raw materials have only increased by 18% since the autumn of 2001 (see Figure 1).

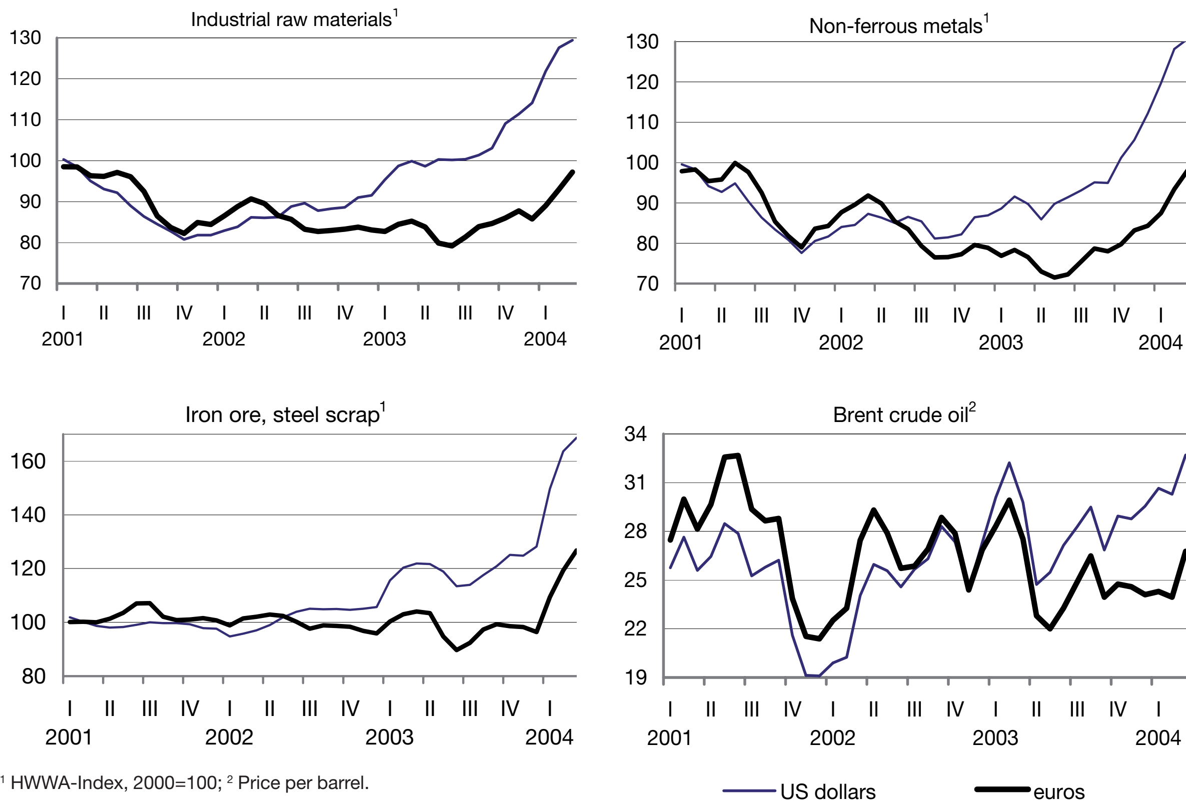
The strong rise in prices for industrial raw materials is primarily the result of growing demand, accentuated in some cases by short supplies. This situation applies to a wide range of commodities, but particularly to metals and minerals. Price developments have been strongly influenced by a number of emerging economies in Asia, especially China and India. In the past year, consumption, and consequently imports, of non-ferrous metals increased at an accelerated rate in the Asian countries (see Figure 2).

China, whose economy grew by 9% last year, has nearly doubled its share of global non-ferrous metal consumption in the last six years (to over 19%) and so displaced the USA as the world's largest consumer. Given insufficient expansion of its own raw materials production, China has become increasingly active on the international commodity markets where its demand is having a decisive influence on price developments for a number of industrial raw materials. Thus, for example, the price for iron ore negotiated at the start of each year between major iron ore producers and consumers in Europe and Japan was increased substantially this year – by 19% – as a result of the rise in Chinese imports. Growth in China's stainless steel production sent prices for scrap steel and nickel to record heights, and in March quotations for copper and lead were higher than they have been since the mid-1990s. In the case of rubber – more than 70% of which is used in tyre production – the price rise that began two years ago with the strong expansion of motor vehicle production in China has also continued. After several years of very low prices – which led to a marked reduction in the planting of new trees (that need seven years to reach maturity) in Southeast Asia, the world's main production area – prices for natural rubber last year climbed to their highest level since 1996.

Besides the influence of the business cycle, the rise in prices for industrial raw materials has been sustained by speculative purchases on the part of investment funds. In the case of certain metals in

* Senior Economist, Department of International Macroeconomics, Hamburg Institute of International Economics (HWWA), Germany.

Figure 1
Development of Raw Material Prices



[1] HWWA-Index, 2000=100; [2] Price per barrel.

Source: HWWA.

particular price exaggerations can be assumed to be substantial.

Increasing Demand for Industrial Raw Materials

There will be further growth in demand for industrial raw materials as the global economic recovery continues, especially as the negative effects of rising prices have so far been limited as far as consumers outside the dollar area are concerned. China's raw material imports will also continue to increase as economic growth remains strong, driven by the commodity-intensive car manufacturing and construction industries.

In contrast, any expansion in raw material production will probably take place gradually. Capacity utilisation is currently at a high level and significant volumes of new capacity cannot be created quickly. Furthermore, the relatively modest increase in export revenues in those countries whose domestic currencies have appreciated substantially against the US dollar – for example the mining countries of Australia, Canada and South Africa – has so far provided producers with little incentive to expand capacity. Where metals are concerned, producers were in some cases unable to react sufficiently at first due to outages at several large production facilities.

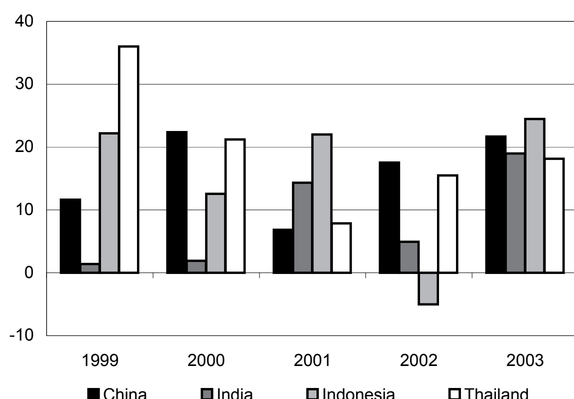
Prices for industrial raw materials will thus continue to increase substantially this year. On average for the year, in dollar terms, they are even likely to rise more sharply than last year.

Oil Prices Remain High

Crude oil prices, which had increased substantially up to the start of March last year as the Iraq war grew closer, picked up again after a brief decline and at 33 dollars per barrel for Brent crude in March stood at almost the same level as a year ago in dollar terms. The main reason for this, as in the case of industrial raw materials, was a marked increase in demand and relatively low inventories. Other energy commodities also became more expensive.

In the case of coal, it was above all China's growing domestic requirements that led to a marked increase in imports of coking coal for the steel industry and lower exports of coal for power stations. As a result – together with increasing import demand in the USA

Figure 2
Metal Consumption[1] in Asian Countries



[1] Base metals (aluminium, copper, lead, nickel, tin, zinc); year-on-year change in %.

Source: World Bureau of Metal Statistics.

where for environmental reasons domestic coal is to some extent being substituted by imports of low-sulphur coal – world market prices for hard coal rose to record levels recently.

Global oil consumption, which had more or less stagnated in 2002, last year increased by 2.1% according to an International Energy Agency (IEA) estimate. This was principally due to strong demand growth in China and the USA. In China, continuing industrialisation and a rapid increase in the number of private cars led to rising consumption of oil products, and as there was little expansion of domestic oil production imports grew substantially; following a 10% increase in 2002, they even rose by just over a third last year. China has now overtaken Japan as the world's second largest oil importer after the USA.

In the USA, oil consumption last year expanded strongly at first as a result of a sharp increase in prices for the competing fuel, natural gas. Towards the end of the year, the increase accelerated as the country's economic recovery continued. The high level of oil requirements was covered in part by existing stockpiles, which reduced industry oil stocks in the USA to the lowest level for three decades.

The relatively continuous expansion of oil production outside of OPEC that has been going on for a long time now, continued last year. After the OPEC countries, which had initially limited their production following the Iraq war, finally raised their oil output – over and above the agreed quotas –, world production in 2003 grew by 3.7%, following a slight decline the previous year. However, since the inventories in the consumer countries continue to be relatively low and there is a danger of supply disruptions – for example as a result of intensifying political unrest in the important oil producing country of Venezuela – oil prices remain high. Extensive speculative purchases, based on expectations of further price rises for the time being at least, have also helped to drive prices upwards. As a result, net purchase positions reached record levels in New York in March.[1]

In view of the high level of world oil production and the prospect of additional supplies from Iraq, the OPEC countries are concerned that oil prices could fall drastically during the spring, when a seasonal decline in oil demand usually occurs. For this reason they announced in February that they would reduce their production quotas by 1 million barrels a day or 4% at the start of the second quarter. Given that the agreed limits are currently being exceeded by around 1.4 million barrels a day,[2] implementation of the latest resolutions would even imply a reduction in actual OPEC[3] output of 2.4 million barrels a day or 10%. The OPEC members Algeria and Nigeria, where a relatively large number of foreign firms produce oil, have ordered these firms to cut their – so far unlimited – output by 10%.[4] Up to now, however, these two countries were among those members with a low degree of production discipline.

At their latest meeting on March 31 the OPEC ministers confirmed the new production ceiling. Whether or not the cut in OPEC output will actually be implemented will depend on how oil prices develop.

According to their own rules, the OPEC countries should have increased their production quotas at the start of this year. However, their refusal – in view of oil prices continuously in excess of the target price of 22 to 28 $ per barrel for the OPEC basket[5] – to apply the "automatic" adjustment mechanism introduced in the year 2000 seems to indicate that they are aiming for a higher oil price for the time being in order to offset a loss of purchasing power due to the weakness of the US dollar. Appeals by the IEA to OPEC to expand out-

[1] Cf. Sebastian Sachs, Tobias Bayer: Spekulanten halten Preis in Schach, in: Financial Times Deutschland, 3.3.2004.

[2] Estimate of the US Energy Ministry for February. Cf. http://www.eia.doe.gov/emeu/steo/pub/3atab.html

[3] OPEC member Iraq is not included in the agreements on output quotas.

[4] Cf. Carola Hoyos: Oil companies ordered to cut output, In: Financial Times, 1.3.2004.

[5] Mean price of seven types of oil, which on average is one dollar lower than the price of Brent crude.

put out of consideration for the negative effects of high oil prices on economic growth have so far failed to influence OPEC production policy. Crude oil quotations can be assumed to decline to a certain extent during the spring, but given OPEC's preference for higher oil prices, together with rising demand in the industrialised countries in the wake of economic recovery, and persistently high levels of demand in China and other Asian countries, oil prices will tend to remain close to the ceiling of the OPEC target corridor.

Rising oil consumption in China and other emerging economies as well as geopolitical uncertainties have nourished fears of possible oil supply bottlenecks. Additional output capacities in the OPEC countries – excluding Iraq – that could be mobilised at short notice amount to just under 2 million barrels a day according to IEA estimates, based on February's production figures. More than half of this amount is accounted for by Saudi Arabia. Compared to earlier years, available free capacity within OPEC is very low, and the current options for offsetting sudden supply failures through more production elsewhere are correspondingly restricted. In the longer term, substantial financial efforts will be necessary in order to increase global output capacity with regard to the increase in oil consumption that is to be expected.