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Commodity Prices Continue to Fall

Commodity prices have fallen sharply on world markets in the wake of Asia's economic and financial crisis. In view of the worsening situation in Russia this decline is likely to continue for the time being. Can a gradual price recovery be expected next year?

Following a short-lived consolidation this spring, world commodity prices in the past months have again fallen markedly in the wake of Asia's economic and financial crisis. In August, calculated using the HWWA index on a US dollar basis, they were 12% lower than at the start of the year and one quarter lower than in June last year, before the crisis erupted (see graph: HWWA Index of World Market Prices of Raw Materials). Oil prices fell particularly sharply; by the start of September, spot market quotations for crude oil had fallen to a 10-year low of $12 per barrel for Brent crude. Only recently they rose by $2 in response to the news of better production discipline on the part of OPEC countries. Non-energy commodities which, following a marked drop in the second half of 1997, had hardly changed at all in the first quarter of this year, have also fallen again by 9% since then. There has also been a considerable decline in the price of foods and tropical beverages, particularly coffee – in anticipation of a rich harvest in Brazil – and sugar. While the weather phenomenon El Niño has had considerable effects on agricultural yields in some countries, this has not been reflected to any great extent in international commodity prices.

Industrial Commodity Prices in Decline

Industrial commodity prices have fallen further, primarily as a result of lower demand. With production in most of Asia's newly industrialised economies (NIEs) collapsing as a result of the region's financial crisis, demand for commodities has also slumped drastically; furthermore, Japan – the region's largest consumer and importer of industrial commodities – has been hit by recession. In addition, devaluations in the NIEs in particular have made imports much more expensive in local currency terms, and rising interest rates have badly hindered foreign trade financing. The marked slide in commodity consumption in Asia has only partially been offset by increasing demand in North America and Europe.

In the past, price developments in the world's commodity markets were influenced primarily by the economic situation in the industrialised countries (see Figure 1). However, during the 1990s in particular, other countries have also gained considerable influence, especially the strongly expanding "commodity-hungry" NIEs of Southeast Asia. The East Asian countries' demand for metals, for instance, increased by an average of 12% p.a. in the five years preceding the crisis, five times as fast as total world commodity consumption (see Table 1). The fact that industrial commodity prices have continued to fall despite economic expansion in the industrialised countries clearly demonstrates the increased importance of the crisis economies with regard to global commodity consumption. However, the decline in prices has also been sustained by the fact that the sharp devaluation of local currencies has provided a strong incentive to the region's producers to expand exports. It is thus fair to assume that the 20% to 30% increase in export volumes from Thailand and Indonesia since the start of last year[1] is largely due to an increase in commodity sales.

Given the on-going turmoil in the international financial markets, forecasting commodity price developments is currently subject to particular uncertainties. With the financial crisis spreading to Latin America, and given the worsening situation in Russia, the risk of a marked slowdown in the world economy has increased considerably in recent weeks. Although it is assumed here that a global downward spiral will not occur, total production in the industrialised economies in the last few months of this year and in 1999 is likely to increase more slowly than was

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[1] Cf. Better news in East Asia, in: The Economist, 29.8.1998.

Table 1
Metals[1] Consumption in East Asia 1991-1998

	Year-on-year change in %			Share of world consumption in %		
	1991/96	1996/97	1997/98[2]	1991	1996	1998[2]
Southeast Asian crisis economies[3]	11.4	-1.8	-21.8	4.8	7.3	5.5
of which: Korea	10.6	-3.9	-32.5	2.8	4.0	2.7
China	14.0	-6.7	16.2	5.8	9.9	8.7
Hong Kong, Singapore, Taiwan	8.8	14.1	-4.4	2.4	3.2	3.1
East Asia excluding Japan[4]	12.2	-1.7	-2.6	12.9	20.4	17.3
Japan	-1.1	-2.5	-7.6	13.0	11.0	9.5
East Asia total[4]	6.3	-2.0	-4.5	25.9	31.3	26.8
World	2.4	2.9	5.5	100.0	100.0	100.0

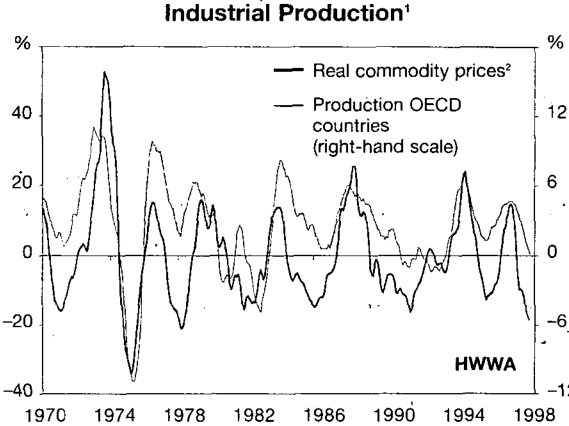
[1] Base metals: aluminium, lead, copper, nickel, tin, zinc. [2] 1st Quarter. [3] Indonesia, Malaysia, Philippines, South Korea, Thailand. [4] Total of the countries listed.

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

expected as recently as the middle of this year.[2] This is equally true of commodity consumption. The economic situation in the Asian countries will play a considerable role in the further development of world commodity demand. As long as the success of stimulation measures in Japan in particular – which could also trigger off new growth in other countries in the region – fails to materialise, commodity demand in the region is unlikely to recover.

In view of this weak demand situation, a general change of direction in industrial commodity price trends is somewhat improbable unless there are marked reductions in commodity production. While persistently low price levels occasionally increase the pressure to limit production for reasons of profitability, this pressure is partly reduced – e.g. in the case of metals – as markedly lower-cost capacities are put into operation. Furthermore, in Asia's crisis economies and in other exporting countries whose currencies have been devalued recently, such as in Latin America or Australia, commodity producers will use their enhanced price competitiveness compared to other commodity suppliers to further increase their exports. This is equally true of deliveries of metals from Russia – the country's most important export goods after oil and natural gas (see sidebar) – following the devaluation of the rouble. Even given a gradual slight improvement in the Japanese economy in the course of the rest of the year and a consolidation of the situation in Asia's NIEs, prices for industrial commodities will thus remain depressed. In 1998, they will be around 13% lower than the previous year on a US dollar basis. On average, a further slight fall can also be expected in 1999, although prices are expected to stabilise slightly in the course of the year.

Figure 1
Prices for Industrial Raw Materials and Industrial Production[1]



[1] Change over previous year (moving 3-month averages).

[2] Deflated with export prices for manufactured goods from industrialised countries.

Sources: HWWA; IMF; OECD; author's own calculations.

Oil Prices Remain Weak

The world oil market is also strongly influenced by the poor growth situation in Asia and its effects on other regions. In the case of crude oil, it is again the developing countries and NIEs which have been largely responsible for the increase in consumption seen in the past few years. This year, there has been a noticeable decline in demand for oil in Asia's crisis economies. Global demand remained depressed as a result; in the first half of 1998 it was just 1% higher than in the corresponding period of the previous year. This compares to a 3.3% supply side increase fed by abundant stocks and further increasing production volumes. The oil producing countries were thus unable to halt the decline in prices and reverse the

[2] Cf. on this subject: Günter Weinert et al.: Festigung der Konjunktur im Euro-Raum, HWWA-Report No. 184, Hamburg, August 1998, Table 7, p. 47.

trend despite output reductions agreed on this spring, even though non-OPEC producers were also involved this time. Further reductions were thus announced at the OPEC conference in June. Spot market prices have nonetheless failed to increase – indeed they fell again after the conference to their lowest level since early March, prior to the first agreement on production volume reductions.

Russia as a Commodity Producer

Last year, Russia earned more than half of its export revenues from the sale of oil, gas and non-ferrous metals (see Table). Russia plays an important role in the international commodity markets not only as a supplier – particularly of energy resources and metals – but also as a purchaser, e.g. of sugar and grain. In 1997, Russia was the world's third largest oil producing country (behind Saudi Arabia and the USA) with an 8% share of total production, and the second largest natural gas producer (behind the USA) with a 24% share. As far as base metals are concerned, Russia is the most important producer of nickel and tin with a share of production of around one quarter and in the case of aluminium is third (behind the USA and Canada) with 13%.

Russia: Production and Exports of Major Commodities

	Production		Exports	
	Volume	Share of world production in %	US$ billion	Share of total exports in %
Oil	6.12 mb/d	8.2	21.9[a]	25.1[a]
Natural gas	531 billion cbm	23.9	16.4	18.8
Metals[b]			6.4	7.3
Aluminium	2.90 million tons	13.3	3.8	4.3
Nickel	0.23 million tons	23.0	1.5	1.7
Copper	0.63 million tons	4.6	1.1	1.3
Other Exports			42.7	48.8
Total exports			87.4	100.0

[a] Crude oil and oil products. [b] Total of metals listed.

Sources: IEA, BP, World Bureau of Metal Statistics (Production); Russian Economic Trends, Monthly update, April 1998 (Exports).

With the devaluation of the rouble, local producers have an enhanced incentive to increase exports, but the opportunities to do so are severely restricted by technical and financial bottlenecks. In the case of metals, Russia today – in contrast to the collapse of the Soviet Union in the early 1990s – has no significant stockpiles which could be used for export purposes. With the possible exception of nickel, there appears to be no possibility of a short-term production expansion. This is equally true of oil production, since Russia's industry is likely to have greater problems than ever in purchasing expensive foreign equipment following the loss of value to the rouble. Given the payment difficulties experienced by domestic customers, the natural gas sector has for some time now been attempting to increase exports, albeit with little success. By far the largest proportion of deliveries are sold on the basis of long-term purchase contracts; up to now, spot market transactions such as those in the United Kingdom have been of no significance to the markets for Russian gas in continental Europe.

One reason for the continuingly weak prices were the oil market's considerable doubts that the producers' announcements would actually be followed up by corresponding reductions, since the spring resolutions were also only partially implemented. OPEC production remains above the agreed volume, not least due to violations on the part of Iran. However, in the face of rising budget deficits, Venezuela – where oil usually accounts for more than three quarters[3] of total exports and the oil sector generates around half of total budget revenue – is also trying to cut its oil production by less than the agreed amount. Oil deliveries from Iraq, which do not fall under the reduction agreements, are also rising faster than expected; since the United Nations has authorised an increase in Iraq's output, only technical problems stand in the way of an expansion to pre-1990 Gulf war levels. Despite assurances of lower production levels, Russia has increased its oil exports which in the past few years represented the country's most important source of foreign exchange. Following the devaluation of the rouble they can be expected to expand still further since domestic demand for oil will presumably fall in view of the worsening economic situation and the pressure to procure foreign exchange will increase. Nevertheless, for the time being fears of a possible lengthy interruption to Russian oil exports in the wake of the country's financial crisis, coupled with the news that the OPEC countries recently showed a much higher compliance with pledged production cuts than reported earlier, ultimately led to a two dollar increase in spot market prices.

OPEC Criticised

Since global oil consumption is likely to increase at just 1% this year, compared to 2.8% last year, oil prices will remain low given the on-going abundancy of supply. A risk of price swings still remains, however, should Iraq's most recent refusal to cooperate with United Nations inspectors lead to a renewed heightening of the conflict. The prospect of continuingly low oil export revenues – which will be around one third lower this year than in 1997 – has once again provoked criticism within OPEC regarding its present production policy and the fact that several

[3] In 1996 the proportion reached as much as 89%; cf. OPEC: Statistical Bulletin 1996, p. 5 f.

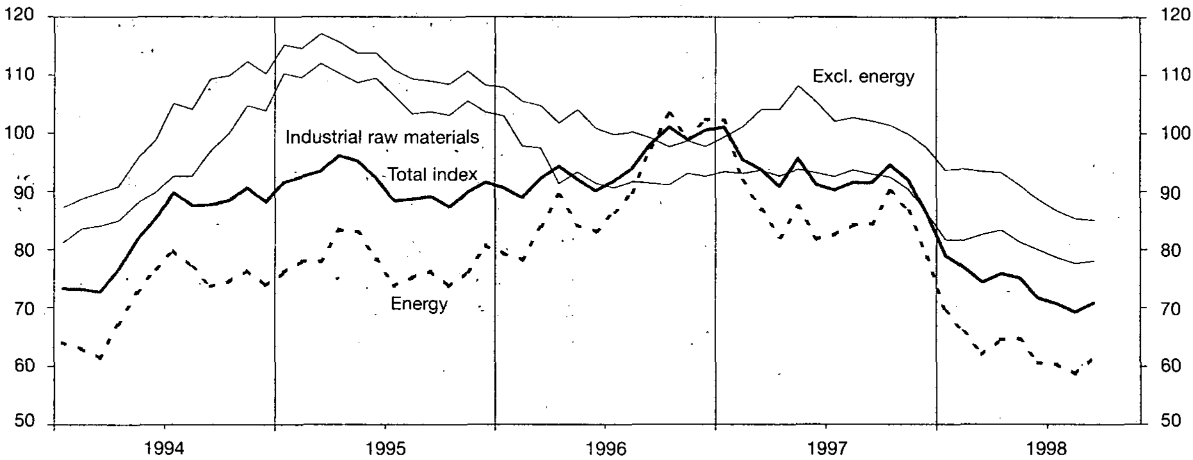
members have disregarded agreed output quotas. In the meantime, some oil producing countries are considering alternatives to the current organisation which, despite its 40% share of the world's oil supply, is clearly ineffective in times of crisis.

An informal alliance, as proposed by Saudi Arabia, consisting of large oil exporting countries from both within and outside OPEC could, being free of the bonds of formal structures, enjoy a greater degree of flexibility and so react to changes in the world oil market without most of the effects of advance-notice announcements. It is doubtful, however, in view of the conflicting interests among the oil producing countries, as to whether such an alliance would be any more successful in raising oil income than the current solution. The timid approaches for common action seen in the resolutions on production curbs this year give no reason to expect that arrangements made between the large oil exporting countries would be any more likely to limit oil supplies than formal resolutions, especially as the conflicts of interest between them – with regard to the correct level of oil prices for example – are unlikely to be less pronounced than within OPEC, since such a group of countries would have to jointly assume the role of "swing producer" which, initially at least, actually lowers incomes; the termination of this role, at times played by Saudi Arabia, was the cause of the oil price crash in 1986.

Even assuming that the production cuts announced so far are actually implemented, oil prices are likely to remain under pressure for the time being. Only during the course of the next year – given a "normal" winter in the northern hemisphere – can a moderate increase be expected if demand for oil also picks up again as the situation in Asia becomes more stable. However, a further fall in oil prices seems unavoidable should the oil producing countries fail to limit production.

HWWA Index of World Market Prices of Raw Materials[1]

(1990 = 100)



Raw Materials and Groups of Materials[1]	1997	March 98	April 98	May 98	June 98	July 98	Aug. 98	Sep. 98[2]
Total Index	92.7 (–1.7)	74.3 (–20.6)	75.8 (–16.5)	75.0 (–21.5)	71.6 (–21.4)	70.7 (–21.6)	69.2 (–24.3)	70.8 (–22.5)
Total, excl. energy	102.3 (0.8)	93.4 (–10.3)	93.2 (–10.5)	91.0 (–15.8)	88.6 (–15.9)	86.7 (–15.1)	85.3 (–16.8)	85.1 (–16.6)
Food, tropical beverages	132.0 (12.5)	125.4 (–7.3)	122.4 (–11.5)	120.2 (–20.4)	114.4 (–19.2)	110.6 (–15.2)	108.5 (–16.0)	106.3 (–17.8)
Industrial raw materials	92.3 (–1.5)	82.6 (–11.7)	83.3 (–10.0)	81.2 (–13.3)	79.9 (–14.2)	78.6 (–15.0)	77.6 (–17.2)	78.0 (–16.0)
Agricultural raw materials	92.6 (–3.5)	82.9 (–10.8)	83.9 (–9.8)	81.7 (–11.8)	81.3 (–11.8)	79.0 (–13.6)	78.1 (–15.9)	78.4 (–16.7)
Non-ferrous metals	89.8 (2.0)	75.3 (–19.6)	76.0 (–15.8)	73.1 (–22.5)	69.8 (–25.3)	69.7 (–24.8)	69.0 (–26.4)	70.5 (–20.7)
Energy	86.5 (–3.5)	61.9 (–28.7)	64.5 (–21.5)	64.6 (–26.0)	60.6 (–25.9)	60.3 (–26.9)	58.7 (–30.3)	61.5 (–27.1)

[1] On a US dollar basis, averages for the period; figures in brackets: percentage year-on-year change.
[2] Up to and incl. 18th September.