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Commodity Prices at Record Level

Crude oil quotations have reached a historical high and prices for industrial raw materials continue to rise. However, the feared negative effects of higher commodity prices on economic growth appear to be limited in the consumer countries and producers would like to maintain the higher price level. Will they succeed?

In March, the HWWA energy price index – which comprises the development of world market prices for crude oil and steam coal – topped the previous record set last October on a US dollar basis. This development was due to the renewed increase in oil prices. In contrast, quotations for steam coal – which in the wake of strong demand had increased dramatically up to the autumn – have fallen somewhat during the same period. From the consumer's point of view, the development of the price of coking coal – which is used primarily in steel production – has been far more dramatic. In the wake of the ongoing steel boom coking coal has become a scarce and expensive commodity. Most of the international coal trade is conducted on the basis of long-term contracts at prices that are renegotiated annually. At the end of 2004 it was agreed for this year to raise fob prices to more than double their previous level. In addition, increasing demand for shipping space has led to a sharp rise in ocean freight rates.

Following its peak level in October, the world market price of crude oil showed a tendency to fall up to the end of the year. Subsequently, however, it began to rise once more, and at the end of February the price of a barrel of Brent crude again crossed the 50 dollar threshold. Thanks to the depreciation of the dollar, the price rise was not as sharp in euro terms; in March, 53 dollars for Brent oil were the equivalent of 40 euros. In real terms – i.e. in relation to export prices for manufactured goods – oil prices are currently still lower than the peak levels seen in the 1980s. Today's high oil prices are the result of the ongoing strong increase in oil demand coupled with a largely inelastic supply as well as concerns about possible delivery bottlenecks fuelled in particular by continuing attacks on production facilities in Iraq.

Global oil consumption increased by 3.4 % last year. Three quarters of this additional demand was generated in non-OECD countries, with China accounting for the largest share (32%). Chinese oil consumption increased by 15% in 2004. Higher demand did not cause supply problems because output also expanded; OPEC production reached its highest level for 25 years. However, there were shortages of the low-sulphur, light oil varieties such as Brent and WTI, which are in particularly great demand. Since many refineries are not geared to processing heavier oils, quality-related price differences escalated last year.

The rapid expansion of global oil production has meant that the amount of unutilised production capacity has diminished substantially to less than 2% of the daily output volume. Compared to previous years, the amount of reserve capacity in the oil producing countries is extremely low at present. As a consequence, the short-term capacity to offset sizeable delivery failures by increasing production elsewhere is largely exhausted.

Higher OPEC Price Target

For more than a year now the price for the OPEC basket of seven oil varieties has been well above the organisation's target corridor of 22 to 28 dollars a barrel. OPEC representatives have repeatedly spoken out in favour of increasing the price target, not least in view of the ongoing weakness of the US dollar, which has resulted in a devaluation of revenues from oil exports. However, oil revenues in the OPEC countries have increased substantially in recent years, from a low of 120 billion dollars in 1988 to 338 billion dollars last year.[1] In the second half of the 1980s and during the 1990s, annual revenues were consistently lower than 200 billion dollars.

The fact that the price band had become unrealistic finally found official recognition when it was taken out of operation temporarily at the OPEC conference at the end of January.[2] Furthermore, OPEC also altered the composition of the reference basket to better re-

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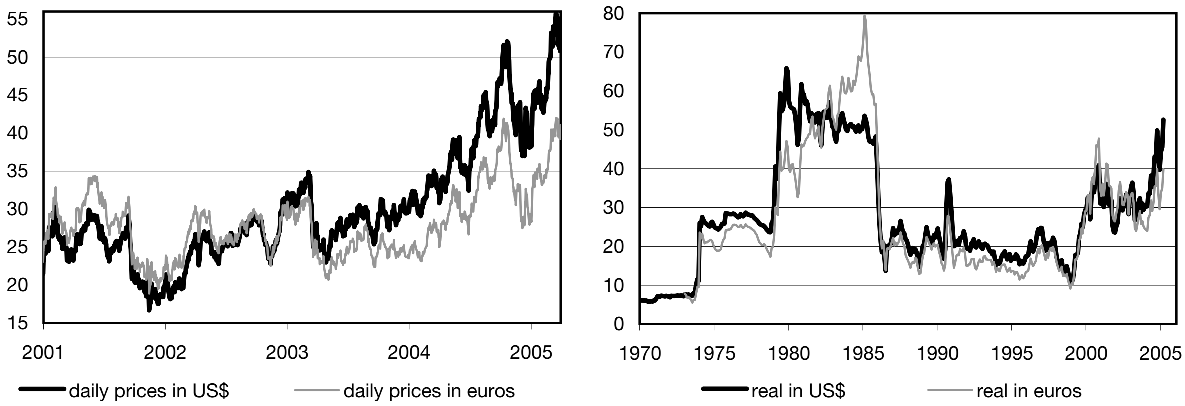
[1] Cf. EIA/DOE: OPEC Revenue Fact Sheet, January 2005.

[2] Cf. OPEC: 134th (Extraordinary) Meeting of the OPEC Conference, press release of 30.01.2005.

Figure 1
Nominal and Real Brent Crude Oil prices[1]



[1] Price per barrel (1970 to 1982 Arab Light); real prices: monthly values deflated with export prices for manufactured goods from industrial countries; base year 2004.

Source: HWWA.

flect the quality structure of OPEC production. Thus in future the basket will be composed of eleven representative prices, corresponding to the number of member countries and probably weighted according to the respective market share of each country.[3] Proposals for a new price band tend to suggest a higher target level, not least because the oil producers no longer consider the negative growth effects of high oil prices to be as serious as they did in the past. In December last year, the oil minister of Saudi Arabia – by far the most important oil producing country – still quoted 32-34 dollars as a fair price for crude oil, adding that any such target is subject to adjustment.[4] Since then, spot market quotations have increased considerably, and at the end of February he said he expected the price of oil to be in the range of 40 to 50 dollars for the rest of this year.[5] This assessment is likely to be understood as a signal for determining the future OPEC target price.

The record oil prices prompted OPEC ministers in March to raise their joint production limit by 500 000 barrels per day from April on, up to the then actual production level (excluding Iraq) of 27.5 million barrels per day. The ministers also agreed on a second increase of 500 000 barrels per day if prices should stay high. Three OPEC members, Saudi Arabia, Kuwait and the Emirates, announced that they would raise their crude oil production by 700 000 barrels per day immediately. By keeping output levels high in spring a stock buffer against seasonally stronger demand later in the year can be built up.

This year there will be another sharp increase in global oil demand, with additional consumption once again concentrated on the Asian economies and China in particular. However, the increase will be more moderate than last year (about 2 million barrels per day against 2.7 million in 2004) as higher oil prices together with expectations of slower global economic growth will have a dampening effect on oil consumption. On the supply side we can expect an expansion of output capacity. Oil production by non-OPEC countries is estimated by the IEA to be growing by about 1 million barrels per day. The combined spare capacity of OPEC countries will be raised from 1.8 million to 3 million barrels per day by the end of the year according to the OPEC president. Saudi Arabia, with an oil production of 9.5 million barrels per day in March, claims to be able to produce 1.5 million barrels per day on short notice if necessary, and plans to raise capacity by another 1.5 million barrels per day without giving a completion date. Some sceptics have expressed doubts, though, regarding the ability of the country to maintain sustained higher production. In Iraq the daily crude oil production is at least one third below the target level of 3 million barrels per day. The investment plans of private oil companies are hampered by security concerns and will remain so if the situation does not improve considerably.

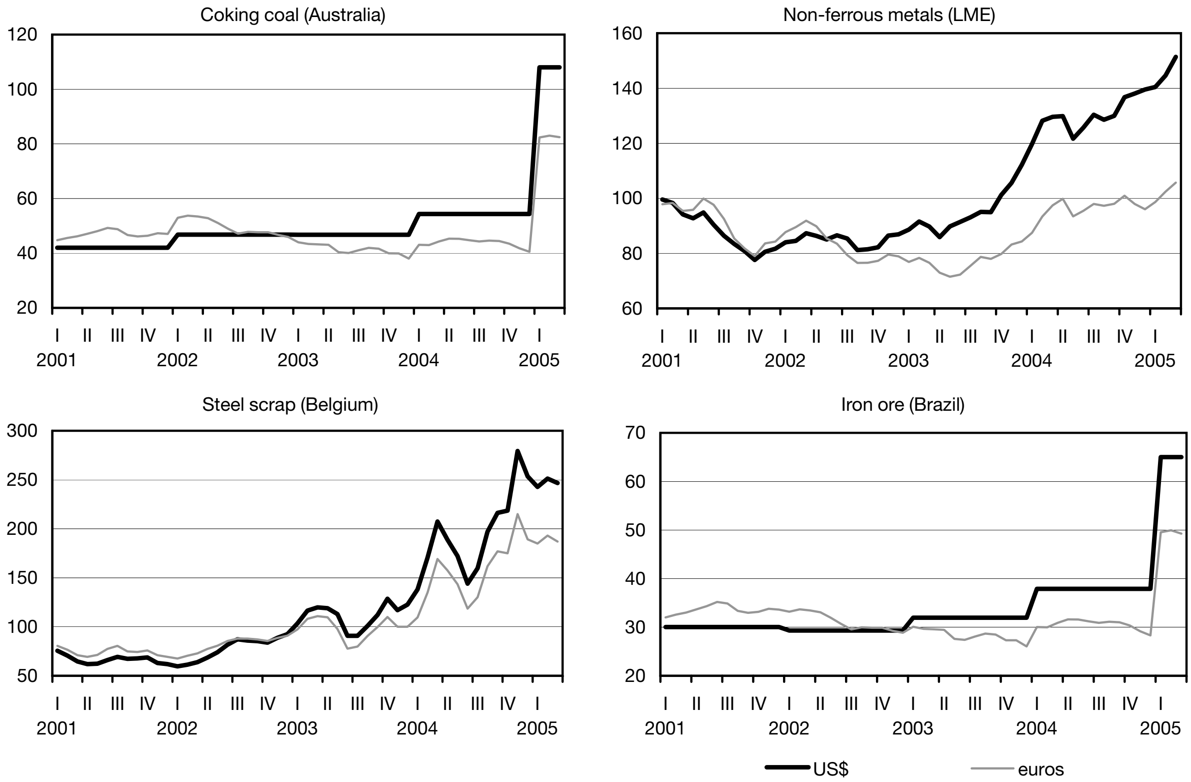
Although under normal circumstances – i.e. for the case assumed here that there is no deterioration of the

[3] Cf. OPEC prepares new crude basket, in: Tehran Times, 2.3.2005.

[4] Cf. Big oil's biggest monster, in: Economist, 6.1.2005.

[5] Cf. Javier Blas: Saudis see no easing of oil prices, in: Wall Street Journal, 24.2.2005.

Figure 2
Selected Raw Material Prices[1]



[1] Per metric ton; non-ferrous metals: index 2000=100; iron ore: cents per dry metric ton unit.

Source: HWWA.

security situation in the oil producing countries – no bottlenecks are to be expected in world oil supplies, the level of production reserves that can be mobilised at short notice will remain low this year. Consequently there will be no marked drop in oil prices, especially as the OPEC countries can be expected to counter falling prices with output restrictions. It is expected here that following the current peak the level of oil prices – with reference to Brent crude – will be around 45 dollars during the further course of the year and next year, and that price volatility will remain high.

For the medium and long term considerable investments in production and transportation facilities will have to be made to be able to satisfy the constantly growing demand to be expected in the developing countries and the emerging economies of the world. This being said, the oil producing countries in the Gulf region – which have the largest and by far the most economically exploitable reserves at their disposal – currently have little interest in any such rapid development. For the time being, oil companies' activities will thus have to focus more strongly on other production regions, so that the average costs of oil production will continue to rise.

On the coal market, development of new production capacity will only gradually improve the situation as long as steel demand remains buoyant; this is particularly true in the case of coking coal. However, projects announced by large-scale producers indicate that a considerable expansion of coal production will take place in the coming years, so that a marked downward price correction can be expected in the medium term.

Record Prices for Industrial Raw Materials

The increase in steel requirements has not only caused a sharp rise in the price of coking coal. It has also made a marked impression on industrial raw materials. Thus, for example, prices for steel scrap climbed to a record high last year, and there is no sign of much respite. Contractual prices for iron ore, which are renegotiated annually between the large producers and the steel industry, were already raised by 19% in US dollar terms last year, and this year's increase has been set as high as 71.5%. This is one of the main reasons why the HWWA index for industrial raw materials has continued its upward trend. On average in 2004, prices in US dollars for industrial raw materials were around 25% higher than the previous year's level; this year there has so far been a further increase of 14% (from December to March), and the previous record high recorded in mid-1988 has been topped. Price rises for a large number of industrial raw materials have been due to the continuing strength of demand, particularly in the Asian countries. As in the case of energy commodities, a decisive role is being played by China's ongoing high level of import demand. On the non-ferrous metal markets the general price trend continued its upward path; in March aluminium and copper prices had climbed to their highest level for 15 or 16 years. Here too, the effects of the steel boom made themselves felt to a certain extent. Quotations for nickel – which is mainly used in the production of stainless steel – reached record levels in recent weeks. Demand growth for industrial raw materials will weaken this year as global economic growth slows down. In the case of many commodities, new production capacity is gradually coming on stream following a long period of low investment. This can be expected to dampen the rise in commodity prices significantly in the course of the year.