DOI: 10.1007/s10272-006-0186-3

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Raw Material Prices at New Record Highs

Crude oil prices as well as most other commodity prices continued their upward trend this year, and several quotations reached new historic highs. But there is a ray of hope for buyers of raw materials that prices might come down somewhat.

Crude oil prices climbed to a new all-time high in late April, with the spot quotation for Brent oil touching 74 dollars per barrel. The new record was established only seven months after hurricane damage in the US Gulf of Mexico region had raised prices to a then historic high. Between the peaks the Brent price had receded to 53 dollars per barrel, but new concerns that geopolitical tensions might harm the international oil flow caused prices to rise anew. Security problems in several important oil producing countries, particularly Iraq and Nigeria, combined with heightened tensions concerning Iran's nuclear policy with the possibility of a US military strike, added to the buoyancy of oil prices that resulted from rising world oil demand and extremely limited idle production capacities. Non-commercial buyers helped to increase the "risk premium" in crude oil prices, and speculative length and open interest on the WTI contract at the New York Mercantile Exchange rose dramatically.[1] In recent weeks oil quotations weakened with the apparent improvement in diplomatic relations between the West and Iran. Oil users in the euro area benefit from their relatively strong currency: 68 dollars per barrel for Brent oil at the end of May were the equivalent of 53 euro.

Within the last two years crude oil prices in US dollars have almost doubled. In real terms, with export prices of manufactured goods of industrial countries as a deflator, this year's oil prices are at least as high as the peak levels seen in the early 1980s. But from a consumer's point of view, when oil prices are deflated with the US consumer price index, real oil prices are still much lower today (cf. Figure 1).

The increase in world oil demand slowed to 1.3% last year, after 4% in 2004. The former strong rise resulted from, among other things, China's large fuel-oil needs for power generators following a surge in electricity demand. Since then the completion of additional power stations, especially hydropower, has led and will lead to a decline in fuel-oil usage. World oil supplies increased as well, so there were no general shortages, although a mismatch between crude oil qualities and refinery oil processing capabilities widened the spread between light, sweet and heavy, sour crudes.

Global oil demand is bound to rise again moderately this year, although earlier IEA estimates of an increase by more than 2% have been reduced. The latest forecast saw a 1.5 per cent rise, again led by Asian emerging economies, Middle Eastern countries and the USA. The main reason for the downward revision was increasing evidence of a more slowly rising oil demand, above all in South East Asia, as a result of the higher oil price level as well as of a reduction in subsidies for oil-products consumption.

On the supply side an addition to output capacity is to be expected. The oil production of non-OPEC countries, having hardly risen last year due to the hurricane-related shortfalls in the USA, is estimated by IEA and OPEC to rise by about 1.4 million barrels per day this year – under the assumption that US crude oil production will have recovered at the end of the second quarter and that no new hurricanes will damage oil facilities this autumn. The combined spare capacity of the OPEC countries will be extended by about one million barrels per day in the course of the year, according to OPEC. This figure does not include Iraq. Iraqi oil supplies (exports and inland deliveries), having reached two million barrels per day (b/d) last September, fell to 1.5 million b/d at the beginning of this year, i.e. only half the original target level. Since then production has risen to about 1.8 million b/d. The Iraqi government expressed hope recently that production can be raised to 2.5 million b/d by the end of the year, but after attacks on the pipeline to Turkey oil exports from the northern fields could be severely reduced for a period of up to one year. In general, the investment decisions of foreign oil companies in Iraq are hampered by political stability concerns and will remain so until the security situation has considerably improved .

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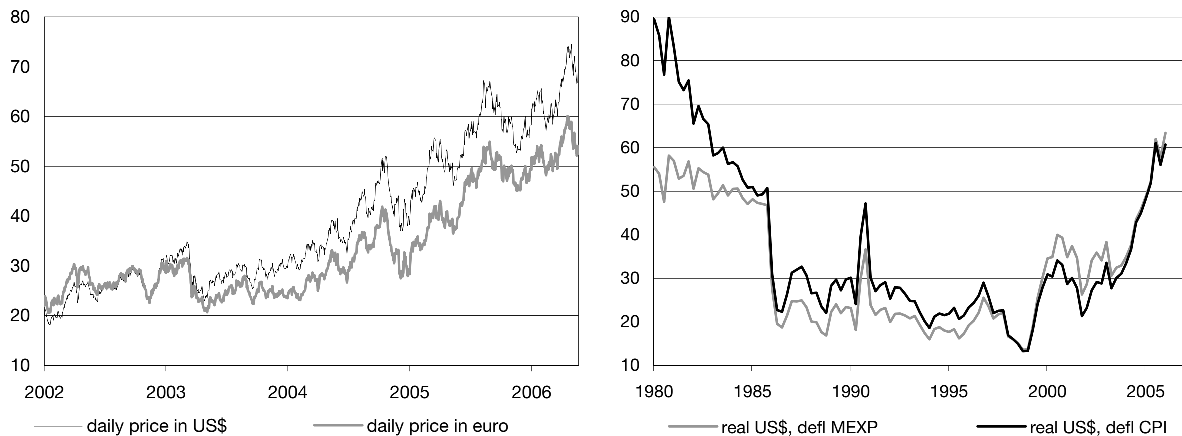
[1] Cf. IEA Oil Market Report, 12 May 2006, p. 1.

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



[1] Per barrel; real prices: quarterly prices (until 81Q1 Arab Light), deflated with manufactures export price or US CPIU, basis 2005.

Source: HWWA.

Under this supply/demand constellation oil prices will remain high, a view obviously shared by most OPEC countries. Oil production by the OPEC-10 (OPEC without Iraq) in April matched the production ceiling of 28 million barrels per day that has been in place since July 2005. Although some members like Iran and Venezuela demanded a production cut, the OPEC ministers decided at their spring conference – and again at the beginning of June – to leave quotas unchanged. That does not foreclose a reduction in the coming months if oil prices should fall too far. There is no official OPEC price target after the suspension of the old target band, but interviews suggest that the oil producers have grown accustomed to the current high level. The OPEC president said in March that the group was aiming to keep the barrel price for US crude oil between the upper 50s and lower 60s. Barring major supply disruptions and an escalation of geopolitical tensions the quotation for Brent should come down to about 60 dollars per barrel later this year. But there are upside risks. Much higher prices than currently would result from larger supply shortfalls, e.g. if the situation in Iraq deteriorates or the dispute with Iran intensifies. Concerning US crude oil production, a recent US government forecast warned that an active hurricane season could threaten rigs and refineries again this year.

Lower Coal Prices Expected

In the world coal market,[2] prices for steam coal stopped descending from the mid-2004 record level last November. The reversal can be explained by several supply-side obstacles. As most of them are temporary, deliveries should recover in the coming months. Capacity expansions by major coal exporters are making progress, whereas the rise in world demand for steam coal is slowing. In two main importing areas – Japan and Europe – the import volume is expected to be stagnant. Contract prices for coking coal, which are negotiated annually and more than doubled to an all-time high last year due to strong demand from steel producers, probably have reached their peak, as coking coal supplies are catching up with demand. Rising supplies from additional capacities coming on stream seem to have improved the position of buyers in this year's negotiation round that so far resulted in price reductions of about 8%.[3]

Alternative Fuels as a Solution?

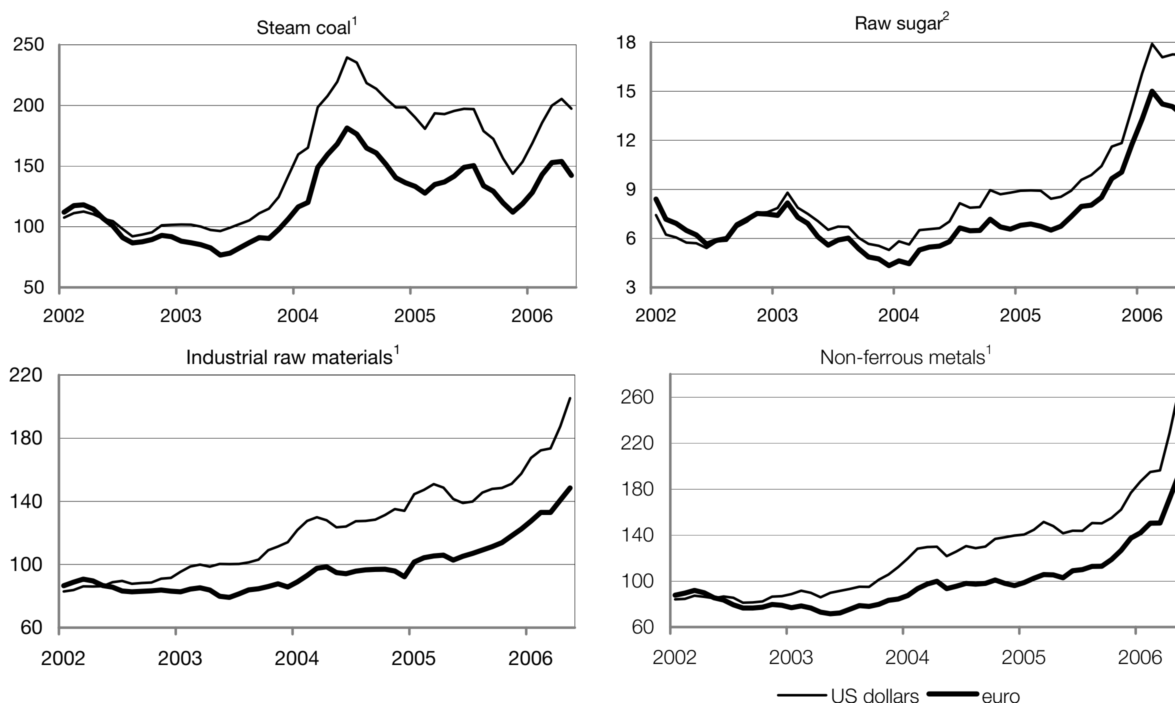
The drastic rise in recent years of fossil fuel prices and accompanying concerns about an impending world energy shortage have intensified the search for alternative supplies. This in return leads to the rise of other raw material prices. Apart from a newly emerging demand for uranium, the price of which has more than doubled since the beginning of last year with an increase in the intended or actual construction of new nuclear power plants, the focus is on several commodities that up to now have primarily been classified as food items.

In the case of most of the renewable raw materials that can be used as substitutes for fossil fuels, e.g. oil seeds and vegetable oils, scarcely any renewed inter-

[2] Cf. Klaus-Jürgen Gern: World Commodity Prices 2006 and 2007, AIECE Commodity Group Report, May 2006, pp. 17-18.

[3] Coal contract deals for '06 said at standstill, metalbulletin.com, 17.4.2006.

Figure 2
Selected Raw Material Prices



[1] HWWA Index, 2000=100. [2] Cents per lb.

Source: HWWA.

est can be detected in the movement of world market prices. An exception is sugar which – after its conversion into ethanol – is added in increasing amounts to traditional petrol in Brazil. A growing awareness of sugar as a source for ethanol production in times of rising petrol and diesel prices led to an increased interest in the sugar contracts of the New York Board of Trade by commodity funds and trading houses. In March, the quotations for raw sugar rose to their highest level for 25 years. Added to this are actual or expected shortages in world sugar supplies. The latest harvests in Brazil, Cuba and Thailand were smaller than expected due to dry weather, and the reform of the EU sugar market,[4] with its step-by-step reduction of the reference price which defines the minimum price for sugar beets, will eventually reduce European sugar exports. So sugar quotations should remain rather high.

In the medium and longer terms, energy needs are expected to rise strongly, above all in developing and emerging economies. The increasing weight of countries outside the OECD in world energy consumption – as well as the consumption of many non-energy raw materials – is the result of strong economic growth combined with a rapid expansion of manufacturing and transport sectors. However, persistently high commodity prices could have a dampening effect on demand. This is especially true when national fuel prices are more strongly following world market price movements. Some Asian countries, among them Indonesia and Thailand, were forced last year by burdensome expenditures to cut or even discontinue subsidies for fossil fuels. In the case of crude oil a growing interest in natural gas – via pipelines as well as in liquefied form – could also have a dampening effect on oil prices. India as well as China plan to widen the use of gas significantly. But the implementation could be delayed as natural gas prices also increased strongly.

Industrial Material Prices Beyond Their Peak?

Prices for most non-energy raw materials climbed higher this year as well. The HWWA index for industrial commodities reached its historic high in the first half of May. The largest increases occurred in metal markets, where prices for copper have jumped more than six-fold since late 2001 due to strong demand in

[4] Cf. AIECE Report, p. 37.

China and India, supply problems in Chile and strong fund buying. Some non-ferrous metal prices came down from their mid-May peak, although they are still extremely high. Strong demand was also the reason for another upward movement of iron ore contract prices. European and Japanese steel producers, who had hoped for lower prices this year after the record increase of 71.5% in 2005, finally had to accept a 19% rise for 2006 in May.

With growth in world economic activity gradually becoming more moderate, the rise in raw material demand should be dampened. An important factor behind the sustained upturn in raw material prices is the long-lasting strong growth of the Chinese economy that accounts for an ever-increasing share of global demand for raw materials. As demand growth in China will probably slow only slightly, commodity prices should remain high. In line with the latest forecast of the AIECE Commodity Price Group[5] prices of non-energy commodities are expected to stabilise at relatively high levels and start retreating later this year. Concerning non-ferrous metals, some strong increases seem to be out of line with market fundamentals, so there is an especially high risk of substantial corrections in the near future.

[5] Cf. AIECE Report, p. 14.