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Slower Price Rises in Commodity Markets

The rise in commodity prices continues due to strong demand from emerging economies in Asia. But not all prices are going up. Several industrial raw materials seem to have peaked earlier this year. Is this the beginning of a general change in price direction?

Most raw materials were getting more expensive this year, and the HWWI commodity price index in US dollars rose by 30% between January and September. The increase largely results from rising crude oil and coal prices, which raised the energy index by 41%. Non-energy prices, on average, went up by a comparably moderate 7%.

Crude oil prices, following their decline in the latter half of 2006, have recovered strongly this year. The monthly spot average for Brent oil rose from 54 dollars per barrel ($/b) in January to 77 $/b in July, with the daily quotations surpassing the record level reached in the summer of 2006. After somewhat lower prices in August prices strengthened again in September when worries of an economic downturn were overshadowed by renewed geopolitical concerns and tight fundamentals. At the end of September the Brent spot price even surpassed the 80-dollar mark. The spread between the higher quality US crude West Texas Intermediate (WTI) and Brent oil, which most of the time fluctuated around one dollar per barrel, widened to about 4 dollars recently. It had been the other way round earlier this year when Brent oil was more expensive for several weeks due to abundant supplies of WTI crude at its delivery point. The latest larger surge of the US price reflected heightened concerns about oil product supplies in the coming winter season after several oil platforms in the US Gulf of Mexico had been abandoned following the issuing of storm alerts. Gulf oil production has not yet been affected noticeably, though. In Europe the oil price rise was dampened by the increasing strength of the euro. When converted to euros, the real oil price, deflated with export prices of manufactured goods, still lies below the high level reached in the early 1980s, after the second oil price crisis, whereas the real dollar price is higher today (cf. Figure 1).

Tight Oil Market

Underlying the current bullish sentiment is a rather tight world oil market. Crude oil supplies from OPEC countries are now about 1.2 million barrels per day (mb/d) lower than they were in October 2006, when OPEC ministers were concerned about ample supplies and falling prices of crude oil, and decided to reduce their production. At the same time the rise in global oil demand stepped up. In the second quarter of 2007 oil consumption rose by 1.3 mb/d compared to the same period last year, with China, India and the Middle East accounting for most of the increase. Oil consumption will increase at a year-on-year rate of 2 mb/d in the second half of 2007 according to recent IEA projections. In 2008, world oil demand is projected to increase by 2.4% compared to 2007, after 1.7% this year and 0.9% in 2006.[1]

Oil production by non-OPEC countries will expand little during 2007, as additional output from new projects in the Caspian region, Africa and Brazil will not be much higher than the decline in production in mature fields in the North Sea, the Middle East and North America. An additional 1 million barrels per day are to be expected from sources outside OPEC, but not until 2008. The resulting "call on OPEC crude" will rise accordingly, meaning that the member countries would have to raise crude oil production in order to dampen crude oil prices. Effective spare capacity in OPEC countries rose to around 2.7 mb/d in the course of this year. OPEC's sustainable production will rise marginally by the end of this year but according to OPEC plans 1.3 mb/d of production capacity will be added next year.

In the spring of 2007 OPEC ministers had described the state of the oil market as comfortable and decided to leave their production curbs unchanged. The same was generally expected for the OPEC autumn meeting, but in September the conference declared that the OPEC-10 (excluding Angola and Iraq) would increase the volume of crude supplied to the market by 0.5 mb/d starting November 1, mainly due to the fact that the high-demand winter season necessitates keeping the market adequately supplied.[2] The communiqué also stated that OPEC will continue to monitor the

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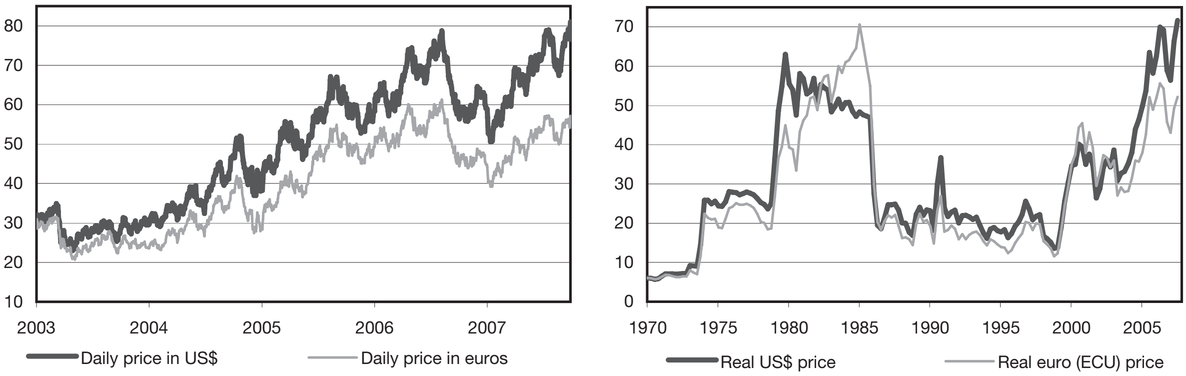
[1] Cf. IEA: Oil Market Report, September 2007.

[2] Cf. OPEC: 145th Meeting of the OPEC Conference, press release, 11 September 2007.

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



[1] Price per barrel; real prices: quarterly prices (until 1981Q1 Arab Light). deflated with manufactures export price. basis 2006.

Source: HWWI.

supply/demand situation over the coming months and hold an extraordinary meeting in early December to reassess it.

Under the assumption that OPEC's crude oil production will be raised further with increasing demand, crude oil prices eventually should retreat to the 70-dollar mark in the course of 2008. The upside risks reflect the potential for increasing geopolitical tensions combined with a still-limited global spare capacity. Much higher oil prices would occur if OPEC production does not keep up with demand or in the case of larger supply disruptions, e.g. if the security situation in Iraq worsens, or the conflict over Iran's nuclear policy escalates into a military strike on Iran's nuclear production facilities.

Other fossil fuels have also seen rising prices. During the last 12 months strong demand for steam coal pushed up the spot price for South African coal by one third. The price for Australian coal even rose by two thirds to a historically high level of 70 dollars per ton at the end of September. One reason for the strong coal demand is the comparatively larger rise in oil and gas prices in the last few years that stimulated the shift to coal in electricity production. Spot prices for coking coal also climbed to record highs recently. Most of the coking coal in the world market is traded on the basis of long-term contracts between the major producers and the steel industry, at fixed contract prices negotiated annually. Contract prices more than doubled in recent years, but have been lower in the current season. The supply situation will ease in the next few years as production capacities are gradually expanded. But for 2008 the ongoing boom in the steel industry points to another rise in the contract price. Other raw materials for steel-making are also affected. Spot quotations for Indian iron ore sales to China rose substantially in recent months and are expected to have a strong influence on the imminent contract price negotiations. Continuing strong demand from steel mills, and tight supplies that will only ease in the medium term when more new capacities are coming on stream, point to a further substantial rise in the 2008 iron ore contract price.

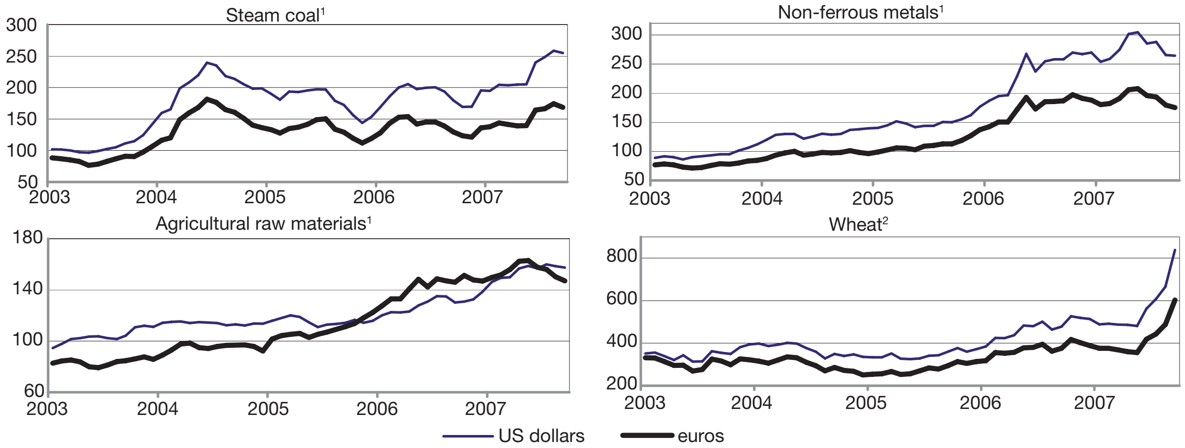
Industrial Commodities Beyond their Peak

On average, industrial raw materials prices, after a break in the second half of 2006, resumed their upward movement at the beginning of this year. In May the dollar index reached an all-time high, and descended afterwards. Only in late September did prices rebound somewhat. The changes in price direction applied to most raw materials, but they were less visible in the case of agricultural commodities.

Price movements were more pronounced in the non-ferrous metals markets. Although the metal index decreased in recent months after a strong rise at the beginning of the year, prices are still very high when seen in a historical perspective. Tight supply still drives many metals and, even though supply will increase in time, an easing of tension is not to be expected soon. Up to now global demand for metals has not slowed down because the strong growth in emerging economies like China, which is highly metal-intensive, is continuing.

Nickel prices climbed strongly to an all-time high in the first months of this year partly due to market manipulations by two large traders. After rules were changed at the London Metal Exchange, prices

Figure 2
Selected Raw Material Prices
(Monthly averages)



[1] HWWI Index. 2000=100. [2] Cents per bushel.

Source: HWWI.

dropped sharply in the following months and, in late September, fell below the level at the beginning of this year, as nickel production capacity was expanding and demand from stainless steel producers was lower due to the high price level. Several stainless steel producers were switching more and more of their output to low-nickel and nickel-free alternatives. In Asia, usage and production of nickel pig iron increased. Copper prices also rose in the first five months of this year but stayed below the peak reached in May 2006. In the last six months copper prices remained rather high, as demand from China was buoyant. Domestic copper production in China is expanding, but demand is rising too. Analysts expect a balanced market next year, although low stocks lend price support and additional production appears to be having little effect. Aluminium prices were rather stable, and fundamentals are likely to keep prices broadly in their current range. But rapid demand growth may alter the picture. Chinese aluminium output is expected to rise this year as high prices stimulate smelter utilisation. Nevertheless, rising energy costs, growing demand and tight supplies of bauxite could eventually make China a net importer of aluminium. In the zinc market, prices are on the way down since additional production capacity is coming online. The expansion of global mine production and growing exports to be expected from China will probably lead to a surplus next year. Lead is seen as stronger in the longer term than other metals. Prices doubled in the course of this year, largely driven by concerns over supply disruptions in Australia and decreasing exports from China following a new export tax. Tin prices reached record-high levels this year due to discontinued supplies from Indonesia, which normally constitute around 40% of the world total, after the government ordered the shutdown of smelters failing to meet environmental requirements. But easing demand and the imminent return of Indonesian deliveries will lower deficit estimates for future months and result in lower tin prices.

Prices for agricultural raw materials increased by 8.6% between January and May this year and receded slightly in the following months. Stronger rises took place in wood and wood pulp prices, driven by buoyant demand. Another factor is the growing competitive demand for wood products for energy purposes, as energy users are switching to wood for heating and governments in Europe and North America, responding to climate and energy security concerns, are accelerating woodfuel demand to meet targets for renewable energy. The ongoing rise in wood pulp prices was the combined result of increasing demand and constrained supplies, due to wood fibre shortages and rising fibre prices caused by labour disputes, a downturn in the sawmill industry and unfavourable weather conditions in Northern European countries. At the end of September the benchmark quotation was the highest in 17 years. Rising pulp supplies from South America are expected gradually to ease the global supply/demand balance in the course of next year.

Prices for food raw materials recently resumed their upward movement, which had started in the autumn of

2006 and was interrupted twice this year. There were particularly sharp price increases in wheat as well as vegetable oils and oilseeds, as a result of strong demand, concerns about harvests and, similarly to the case of wood products, the increasing competitive demand for the production of biofuels. Speculative buying is also influencing price developments. The tension will probably continue due to the competing demand for agricultural land from the food and the energy sectors.

Lower Price Rises Expected

In view of the high prices for most raw materials and the perspective of somewhat slower world economic growth, the demand for raw materials can be expected to increase at a more moderate rate than in the recent past. Also, incentives to expand the supply of raw materials are high, and more and more capacity expansion projects are gradually coming online. This should dampen commodity price increases. But even if the prices for industrial raw materials stayed at their current level for the rest of this year, the industrial raw materials index in US dollars would, on average for 2007, be 15% higher than last year, following an increase of 33% in 2006. Next year's price rise should be considerably lower. Price fluctuations will remain high due to the great interest of non-commercial market participants. Much higher commodity prices could materialise if demand from developing countries and emerging economies increases more rapidly than expected, or if capacity expansion plans are further delayed by bottlenecks and rising costs.