Commodities: A partial pump primer

By Chris Giles

What does the fall in prices mean for a fragile global economy?

Few economic forces are more important than commodity prices. When they rise they transfer riches and power from consumers to producers; when they fall, it is as near as anything in economics to a free lunch for consumers. With so much at stake, turning points are important for the global economy. Such a moment appears to be at hand.

Across a wide range of commodities, prices are falling and sometimes falling fast. The Bloomberg commodity index – which acts as a benchmark for commodity investments – fell to its lowest level in five years this week. Prices are being pushed down by the increasing supply of most commodities and a weakening global economy, including a slowing China, the world’s largest consumer for many of these raw materials. Whether it is oil, corn, iron ore, coal, cotton or copper, prices are falling quickly.

The International Monetary Fund estimates that global commodity prices are 8.3 per cent lower than at the start of the year. In its recent World Economic Outlook report, the IMF demonstrated how a $20-a-barrel oil price decline would increase the real income of consumers, boosting domestic demand and growth in consuming countries and hitting exports and demand in producer nations. The fund estimated the net effect would increase world gross domestic product 0.5 per cent alone, and if economic confidence were improved as a result, that figure could rise to about 1.2 per cent. Gavyn Davies, chairman of Fulcrum Asset Management, says the figures were plausible and by any measure “quite big”.

Andrew Kenningham, economist at Capital Economics, has calculated that an equivalent change would transfer $640bn – or nearly 1 per cent of world GDP – from oil producers to consumers. “Our rule of thumb is that consumers typically spend half of their windfall. This is $320bn or around 0.5 per cent of world GDP,” he says.

With other commodity prices falling alongside oil, the effects can be expected to amplify, benefiting global growth but also creating losers as well as winners. The effects are most obvious in growth forecasts. In 2011, when commodity prices were expected to remain persistently high, the IMF forecast Brazil’s economy would expand more than 4 per cent in 2014, a rate it would be able to sustain into the medium term. Now it is expecting near stagnation this year with a slow climb towards a 3 per cent medium-term rate. Russia, which also has to deal with the added impact of western sanctions, shares the same fate.
Some effects can be complicated, however. As well as redistributing money between countries, there are also winners and losers within the same nation. While falling oil prices act as a tax cut for US motorists, it hits the country’s shale oil industry. In 2011, the surge in food prices was a boon to Brazilian agriculture but a huge burden on its urban poor.

Exchange rate movements can complicate the picture, since most commodities are priced in dollars. In parts of Asia currencies are falling relative to the dollar. As a result says Jeff Currie, head of commodities research at Goldman Sachs, consumers in India are not seeing big gains because oil prices in rupees are not falling fast, and in countries such as Indonesia, the government is offsetting lower fuel prices with cuts in fuel subsidies so, again, consumers have not seen the full benefit. After taking account of currency and tax changes, Mr Currie says the US is the only country in which consumers are likely to see a big benefit.

As a big consumer and importer, the eurozone will benefit from the turndown in commodity prices, but economists warn Europe must avoid getting too much of this good thing. Falling commodity prices could tip the eurozone into outright deflation, potentially delaying consumer purchases on the expectation of even lower future prices.

This is all theoretical, but could undermine efforts by the European Central Bank to stabilise medium-term expectation of inflation to about 2 per cent a year. Thomas Harjes of Barclays says: “Market-based measures of inflation expectations are increasingly indicating that the ECB is at risk of losing its credibility to return inflation back to the close-to-2 per cent target, even over the medium term.”

**Oil: Prices driven down for motorists**

Countries such as Russia, Venezuela and Iran are on edge as the price of crude oil, which has dropped sharply since mid-June, continues to struggle at about $85-$86 a barrel, writes Anjli Raval. But in countries that are net importers the price plunge has worked as a tax cut for consuming nations.

“Given that net oil consumers [advanced economies] tend to spend a higher proportion of their incomes than oil producers [notably the Gulf states but even Iran and Russia], the net impact of lower oil prices is to boost global demand,” says Andrew Kenningham, economist at Capital Economics. “That will not solve all the world’s problems, but taken in isolation it is a clear positive, not a negative.”

Forecourt prices have been slashed, even in western Europe where retail taxes rather than the wholesale cost of refined gasoline and diesel make up more than half the retail price. Falls in the price of crude take many weeks to feed through. Even so, in the UK, average petrol prices dropped to 125.4p a litre this week, a low last seen in January 2011, according to government statistics. In the US the price of a regular gallon was $3.07 this week, 15.6 per cent down from an April peak this year of $3.64.

China, the largest energy consumer in the world, is pulling back on oil demand. But falling crude prices have been a boon for Asian economies, reducing costs for businesses and consumers and giving lawmakers space to lower interest rates.

**Corn: Meat beefs up overall demand**

Corn is the world’s most widely grown grain. Harvested on 180m hectares, it turns up in products from tortillas to toothpaste, writes Gregory Meyer.
The price of corn has declined by more than 15 per cent this year and is less than half of the highs reached in mid-2012. But do not expect a dash to consume more of it.

Many of the forces driving corn use are fairly static. The ethanol industry, estimated to consume a third of the crop in the US, the world’s biggest grower, has essentially reached capacity in the US as motor fuel demand holds steady. Global biofuel growth is expected to be slow.

Demand for food products concocted with the crop, such as high-fructose corn syrup and starch, is also steady.

One area where cheap corn will probably induce more consumption is in the meat industry. Enticed by high prices for steaks, bacon and chicken, livestock and poultry companies are expanding. The US agriculture department anticipates animal feed demand for corn will total 5.4bn bushels in the crop year that began last month – up more than 1bn bushels from two years ago.

“The expectation, based on history, is when you have low prices you get a response in the domestic livestock sector,” says Darrel Good, agricultural economist at the University of Illinois. There are signs this is happening: Prof Good says the numbers of chickens and milk cows is rising again in the US, while hog farmers intend to allow more sows to farrow piglets.

- **Iron ore: Slowing China and oversupply dent market**

  Iron ore has been the standout performer in commodities this year – but for all the wrong reasons, writes Neil Hume.

  The price of the key steelmaking ingredient has plunged by almost 40 per cent and recently hit a five-year low of $77.50 a tonne. Benchmark Australian iron ore for delivery into China was trading at $80 a tonne yesterday, according to The Steel Index.

  The reason for the sharp fall is twofold. Vale, Rio Tinto and BHP Billiton, the big three global producers, have dramatically increased production and shipping volumes in 2014. The other big factor is slowing demand in China, which consumes about two-thirds of global seaborne iron ore.

  A falling steel price will help reduce costs for many industries, including oil and gas. Steel accounts for about 30 per cent of the cost of a large oil project, according to McKinsey, the consultancy.

  Ominously for the sector, more supply is set to come on stream in the coming year. BHP Billiton, the world’s largest natural resources group, estimates supply growth of 400m tonnes in the next three years, about twice its forecast level of increased demand.

  Among the beneficiaries have been struggling Chinese steelmakers. They are turning to the export market because weak domestic demand has pushed prices in some local markets as low as that of cabbage.

- **Cotton: Correction drives rise in consumption**

  The past several years have been traumatic for the cotton industry, writes Gregory Meyer.

  An abrupt price rise in 2008 bankrupted some of the biggest global merchants. After another spike three years later, exasperated clothiers chose fabrics with more man-made fibre such as polyester. Cotton had a 27.5 per cent share of the global fibre market last year, from a historical norm of about 40 per cent, according to Cotton Inc, a US industry body.

  Now the spindles are turning in cotton’s favour. Prices have fallen by more than 25 per cent this year to 63 cents per lb, less than a third of the 2011 peak. As China sells off a mountainous state reserve, prices are expected to remain low and steady for a long time.

  The International Cotton Advisory Committee, a research group, forecasts global cotton consumption will this year rise by 3.9 per cent, well above the average annual increase.

  “High prices really hurt the consumption of cotton in recent years,” says José Sette, ICAC executive director. “Now the prices are coming to more realistic levels in terms of the competitiveness of cotton with other fibres, and this would mean a recovery in consumption.”
One challenge cotton suppliers are set to face is cheaper polyester on the back of the fall in oil prices.

* Copper: Renewables sector set to benefit

Concerns about a slowdown in China’s economic growth are weighing on copper prices, pushing them down more than 9 per cent this year, writes Henry Sanderson.

Ironically the fall in price will be good for companies such as China’s State Grid which accounts for more than 80 per cent of the country’s grid investment. Its expansion plans, including an ambitious programme of new power lines, has been slowed by an anti-corruption investigation this year, yet are expected to ramp back up in 2015.

Lower prices could also help the car and renewable energy industries, which account for about 7 per cent of global copper demand, according to Metal Bulletin.

For producing countries such as Zambia and Congo, however, lower copper prices could mean a drop in fiscal revenues resulting in reduced investment and fewer jobs. This summer Zambia called in the IMF for help as prices dropped. The Democratic Republic of Congo forecasts its economy will grow by more than 10 per cent next year, though that will depend on how copper prices hold up.

The IMF said this month that a fall in prices compared with the historical average could lead to a 4 per cent reduction of real GDP in Congo this year. More than 95 per cent of its exports come from the extractive industries, mainly copper, cobalt, diamonds, gold and oil, according to the IMF.

* Coal: Lower electricity bills boost households

Coal provides about 40 per cent of the world’s electricity needs, according to the International Energy Agency, writes Neil Hume.

The funk in the market can be traced to the shale gas revolution, which has led to increased US coal exports, and growing output from the big rival exporters such as Australia and Indonesia, which have continued to churn out more volumes in spite of low prices. This has overwhelmed demand.

Analysts say India is the big growth market for thermal coal. The country has 145 gigawatts of installed coal-fired capacity and is targeting 214GW by 2020, according to Glencore, the commodities company.

In Europe, weak thermal coal prices – as well as rising solar and wind power – have left German households better off than their Dutch counterparts. Large coal-fired power plants generate more than 40 per cent of German electricity, whereas the Netherlands’ gas-fired plants account for about 70 per cent of installed capacity.

Coal for delivery into Europe within 90 days was quoted at $74 a tonne by Argus yesterday, close to a four-year low.

According to the Agency for the Co-operation of Energy Regulation, at the end of last year average German day-ahead power prices were €35 a megawatt hour compared with more than €50MW/h in the Netherlands.