

Asia's big appetite ensures a healthy commodities market



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What a difference a year can make. Twelve months ago, the spectre of deflation depressed the pundits. Inflation has now taken its place as the anxiety of the moment. What is awakening this new fear? "Soaring commodity prices" is the answer. But are we watching a temporary blip, a harbinger of global inflation, or a long-term upswing in the prices of commodities, as China becomes a bigger force in the world economy?

Since October 2001, the Economist all-items index of commodity prices has risen by 59 per cent. The prices of industrial raw materials have jumped by 73 per cent. Crude oil prices are up from below \$20 a barrel in December 2001 to over \$31 today. Food prices jumped 5.6 per cent in March, while soybean prices surged by 12.2 per cent in March and are up by 80 per cent over the past eight months. Prices of metals are up by nearly 50 per cent over the past 11 months.

These price rises are certainly not the mark of a global economy threatened by deflation. But they must be put firmly in context. Since the early 1980s, commodity prices have seen three surges – in the late-1980s, the mid-1990s and now – and also three declines – in the 1980s, the early 1990s and the beginning of this century. Today's surge is no greater than the previous ones, even in nominal terms. In real terms (with commodity prices deflated by the US consumer price index), prices are well below the peaks reached in previous cycles: the all-items price index is 24 per cent lower, in real terms, than it was in

December 1994, 43 per cent lower than in May 1988 and 58 per cent lower than in January 1980 (see chart).

The recent surge in commodity prices has, as usual, also coincided with a weakening dollar. In euros, the price rises in commodity prices have been very modest (see chart). The all-items index of commodity prices has risen by just 19 per cent in euros since October of last year. The extent of the commodity price rise is greatly exaggerated by use of the dollar as the unit of account.

So far, then, this is a modest, and in no way abnormal, rise in commodity prices. But the story would be rather different if this were the beginning of a sustained upsurge in commodity prices. Is this likely? To answer that question, we must look at determinants of the improvement in demand: the cyclical recovery; the weak dollar; and the rise of non-Japan Asia, particularly China.

The recovery story is now well established. April's *Consensus Forecasts* shows 3.7 per cent global growth this year, up from 2.6 per cent last year. The Asia Pacific Region is forecast to grow by 4.3 per cent, up from 3.8 per cent last year, with China on 8.3 per cent and Japan at 3 per cent. The US is forecast to grow by 4.6 per cent, up from 3.1 per cent last year and even the eurozone is forecast to achieve 1.6 per cent, against 0.4 per cent in 2003. Given this recovery, a surge in commodity prices from the very low nominal and even lower real levels reached 2½ years ago was normal.

The dollar cycle turned at much the same time as that in commodity prices. This is partly because of the change in the dollar's value as a unit of account and partly because commodities are a classic hedge against uncertainty about the prospective value of the world's most important currency. Here the forces at work are the vast US current account deficit and the expansionary

Federal Reserve monetary policy. These raise questions about the long-term purchasing power of the dollar, externally and internally. In all probability, the dollar will be a fairly weak currency in the medium term. This will support commodity prices, at least in terms of dollars.

The recovery and the weak dollar are temporary forces. But there is also one structural shift in commodity markets: China. The Asian giant's impact on commodity markets is substantial already (see chart). Its share of world consumption of soybeans, for example, rose from 11 per cent in 1997 to 19 per cent in 2003. Its share of world consumption of cotton rose from 25 per

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cent in 1999 to 32 per cent last year. Its share of world consumption of refined copper jumped from 11 per cent in 1999 to 20 per cent last year, which was almost one-third higher than that of the US. Its share of world consumption of oil has also risen, though much less dramatically, from 5.5 per cent of the world total in 1998 to 7 per cent last year.

Between 2001 and 2003, world consumption of refined copper rose by 6.3 per cent. But the consumption of the rest of the world (without China) rose by just 1.4 per cent. Similarly, world consumption of cotton rose by 3.4 per cent between 2001 and 2003, while the consumption of the rest of the world (less China) fell by 2.4 per cent. Again, world consumption of

soybeans rose by 9.3 per cent between 2001 and 2003. Without China, it rose by only 3.3 per cent.

What is surprising is that commodity prices have not been even stronger, given China's growing impact. The explanation is that China is partly replacing production by others. But it is bound to have an increasingly big effect. Today, China's economy is the sixth largest, in current dollars. In the 12 months to November 2003, China's merchandise exports and imports were both third largest in the world, after the US and Germany. Yet the rise of Japan and even of the east Asian newly industrialised economies (Hong Kong, Singapore, South Korea and Taiwan) was just as significant in the past. The difference lies mainly in what is to come. As convergence on the standard of living of the more advanced countries continues, China's impact will become much larger than those of its east Asian predecessors.

The conclusion then is that this has not been an impressive rise in commodity prices, so far. Without China's growth, both demand for and prices of commodities would have been even weaker. The future should be different, however. China and, in time, India will generate much of the incremental world demand for primary commodities over the coming decades. It is far from clear that this will be enough to produce a decisive reversal in the long-term trend decline in the real prices of commodities. More likely is increased volume, as supply is expanded to meet the Asian giants' demand.

Either way, China's arrival is excellent news for the world's embattled suppliers. It may not guarantee ever-rising prices. But it does guarantee a more dynamic market. For that alone, the producers will be grateful.

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