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Policy Perspectives

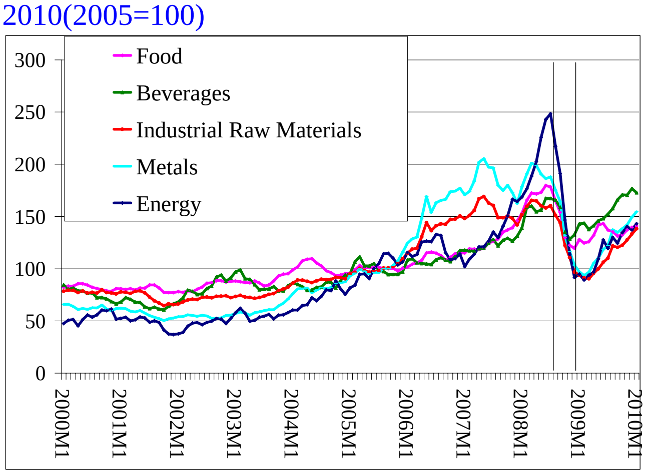
F. Gerard Adams

ITeconomy Advisors, LLC. 150 West 51st Street, Suite 2006, New York, NY 10019 / Tel: 1-212-489-1190

The Commodity Price Super Cycle

The wild swing of the world business cycle in 2007 to 2009 has been accompanied by an extraordinary swing of commodity prices, a Super Cycle. As is apparent in Figure 1, after moving fairly smoothly until 2005, commodity prices swung wildly upward to hit a peak in July 2008, declined sharply until January 2009, and have shown substantial increase since then. This "super cycle" has not only been significantly more volatile than commodity price movements in the previous twenty-five years, it has also been considerably broader, encompassing practically all categories of commodities, excluding only some agricultural raw materials. The return upswing in commodity prices in 2009 has been most pronounced in petroleum and metals.

Figure 1: Commodity Price Indexes: 2000-2010(2005=100)



A first question is: "Why did commodity prices swing so wildly?" A number of explanations have been proposed.

Commodity markets are global, so that supply and demand conditions have to be considered on a world-wide basis. On the demand side, the world economy was booming while supplies were only expanding moderately. Indeed, some economists have suggested that we are running out of resources, that we have reached or surpassed "Peak" oil.[1] On one hand there is evidence that oil production in many areas of the world is declining, not only in the US but also in the North Sea, Mexico, Venezuela, etc. On the other hand, there are radical new discoveries under salt deposits in the deep ocean floor off Brazil and in the Gulf of Mexico, for example. And other transport fuels—note hybrid and electric cars—and other sources of energy, like shale-based natural gas and biofuels, are being developed. We are not likely to run out of exhaustible resource commodities, though they may gradually become more costly. But, short run adjustment is sometimes difficult as demand elasticities are very small in the short run and as supply shortages may reflect harvest failure, labor disputes, and mine disasters. There may be times when prices rise sharply because temporarily supply does not quite keep up with demand.

The decline of the US dollar against other currencies may also have made some contribution to

[1] For a discussion see Adams 2009.

rising commodity prices. As the dollar falls, commodity prices, denominated in dollars, may be expected to rise. But depreciation of the dollar has not been as large as commodity price swings, even against the Euro, and some important countries, like the Chinese, have stabilized their exchange rate against the dollar.

Finally, there is the issue of speculation. Futures and current market prices are determined simultaneously. Under normal market conditions prices cannot get too far from realistic market prices, though expectations of abnormal market conditions can cause prices to swing widely on a temporary basis. And there is evidence of a vast expansion of speculative activity, index speculation, in commodities during the recent period (Masters, 2008). The broad range of commodity coverage and the sharp upswing of prices to the peak in mid 2008 are suggestive of speculation, as the decline from mid 2008 to early 2009 looks like a closing out of speculative positions.

In 2009, oil and metals prices have begun again to rise, though not yet to the peaks of mid 2008. Remember that when prices have fallen from a peak by 50%, it takes a 100% increase from the new low level to return to the peak. The explanation seems to lie in the new pattern of growth of the world economy. Cyclical recovery is apparent widely. But industries in the advanced countries, traditionally big consumers of primary commodities, are growing slowly. The big Asian countries, China and India, are barreling ahead at fast rates. Their industries and their heavy efforts at infrastructure development and housing are purchasing a large share of the demand growth increment for metals. Their rapidly growing stock of cars requires growing imports of petroleum. This may provide momentum to the world economy.

As prices of petroleum and of metals have been rising in recent months, we may ask whether the recovery of commodity prices is a return to speculation or a leading indicator of improving demand conditions in the world economy?

References

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