

Press Points for Chapter 5: *The Boom in Nonfuel Commodity Prices—Can It Last?*

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Key Points

- **Metal prices have increased sharply due to strong demand, particularly from China which has contributed 50 percent to the increase in world consumption of the main metals in recent years, which has outstripped the supply response.**
- **Contrary to popular wisdom, speculation appears to have had a limited impact on commodity prices.**
- **Looking ahead, IMF analysis suggests that metal prices will decline progressively from current levels as new production capacity comes on stream.**

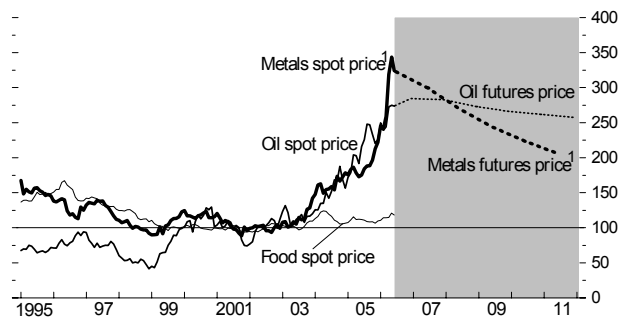
Many commodity prices have surged to record highs this year—metals prices have risen by 180 percent in real terms since 2002, even outstripping the increase in oil prices (157 percent in real terms—first figure). Chapter 5 assesses the contribution of possible explanations to the current boom in nonfuel commodity prices and examines whether the current price levels will be sustained.¹

Looking first at metal prices, the chapter argues that the principal driver

of the price surge has been the rapid growth of world demand, particularly in China, which has outstripped the expansion of supply. For example, consumption of aluminum grew by 7.6 percent annually during 2002–05, compared with 3.8 percent during the previous decade. Given long investment gestation lags in the metals industry, metals prices can rise significantly in response to unexpected demand increases. As for the role of China, the country contributed about 50 percent to the increase in net world consumption of the main metals (aluminum, copper, and steel) over the past four years. Due to its rapid growth and

Key Commodity Prices

(2002 = 100; monthly data in nominal terms)



Sources: Barclays Capital; Bloomberg Financial Markets, LP; IMF, Commodity Price System database; and IMF staff calculations.

¹Weighted average of aluminum, copper, lead, nickel, tin, and zinc prices.

¹ This chapter complements the oil market study “Will The Oil Market Continue To Be Tight?” in the April 2005 *World Economic Outlook*.

rising share in the world economy, China is expected to retain its critical role in driving commodity markets.

The chapter finds that the response of food and other nonfuel commodity prices to strong global growth have been much less marked than for metals. This is a result of several factors. First, the use of metals has grown faster with rising income than the consumption of agricultural commodities. Second, the supply response in the agricultural sector to shifts in prices is considerably quicker than in the metals industry. The fairly modest increase in food prices over the past several years has mostly reflected U.S. dollar exchange rate changes and higher input costs, especially of fertilizers whose price is linked to oil.

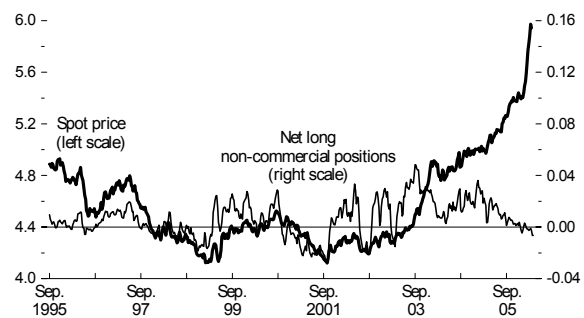
Contrary to the popular wisdom, financial investors do not seem to have played a major role in driving nonfuel commodity price movements.

Speculative investments in commodity futures markets have increased significantly over the past several years, but investors have built both long and short positions with offsetting effects on price movements. There is little statistical evidence that movements in net speculative positions lead spot price changes (in fact, the opposite is true—

investors seem to be following price trends rather than creating them). For example, net speculative positions in the copper market declined during the run-up of copper prices earlier this year (second figure).

Copper Prices and Speculative Investments

(Spot price in log scale; net long non-commercial positions in millions of contracts)



Sources: Bloomberg Financial, LP, and Commodity Futures Trading Commission.

Looking forward, metals prices are expected to retreat from their current highs.

Analysis of the aluminum and copper markets suggests that the prices of these two metals are above their sustainable levels under various assumptions about global growth, additions to productive capacity, and price responsiveness of supply and demand. In the baseline scenario, the real price of aluminum and copper is forecast to decline by 35 and 57 percent, respectively, by 2010. This finding is consistent with the historical experience—metals prices tend to converge to production costs in the medium term, while the current prices are well above these production costs (the ratios of market prices to costs are between $1\frac{1}{2}$ - $2\frac{3}{4}$ for the main metals). Moreover, futures markets also predict a gradual decline in the prices of most metals during the next five years (first figure).

Given the temporary nature of the current nonfuel commodity price boom, it is critical that policymakers in exporting countries either largely save the current income windfall or use it in a way that supports future growth in noncommodity sectors.