Pacific Island commodity prices

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So far in 1989, the movement of the prices of most primary commodities can, at best, be described as hesitant (Chart 1). Production in industrial countries has continued to expand, providing a base for continued active demand for most materials. However, the pace of growth has decelerated. Hence, there has been little incentive for producers in the Organization for Economic Cooperation and Development (OECD) countries to increase their inventories of materials and final products. Consequently, the impetus to demand has been weaker in 1989 than in 1988. Further, the fear of accelerating inflation appears to have lessened[1] thus weakening the precautionary demand for inventories. The widespread rise in interest rates has also increased the cost of holding stocks, putting downward pressure on demand.

The steady rise in most commodity prices in 1987 and 1988 has stimulated supplies of many products, thereby partly offsetting the price effects of increasing demand. Several groups of commodities have experienced specific supply effects. The general level of food prices (Chart 2) has been strongly influenced by the effects of weather conditions on US supplies of grains and oil seeds (soy beans). The previously drought stricken winter wheat growing area received rains in April and, consequently,

Chart 1

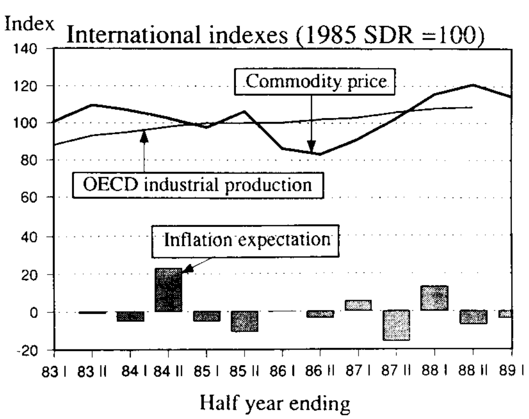
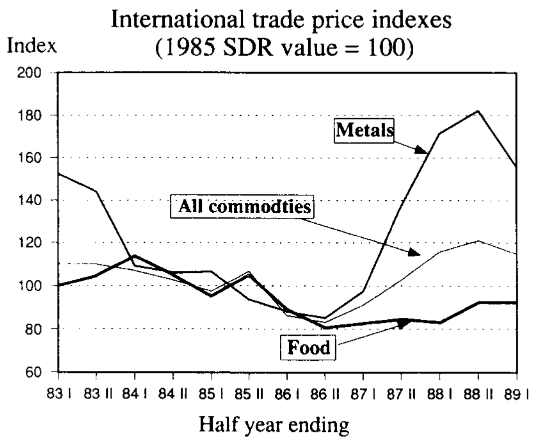


Chart 2



1 See Appendix in PEB 3(2), December 1988, pp15-17 for description of the inflation expectations index.

the rise in wheat future prices declined. The final condition and likely yield from the 1989 crop is still uncertain. As usual, metal prices have moved sharply with shifts in demand and supplies. The easing of demand for inventories has undoubtedly contributed to the decline in most metal prices. The supply situation remains uncertain. Labour relations in Peruvian and US copper mines and smelters remain unclear, while the prospects for Papua New Guinea production are doubtful. Similarly, aluminium supplies remain uncertain, and labour relations and other difficulties make the supply of iron ore from Australia and China difficult to predict.

The volatility in the minerals price index is strongly influenced by the price of *copper* (Chart 3). This reached record levels at the beginning of the year largely on the basis of rumours that there could be further supply disruptions in Latin America and Papua New Guinea. Early in May, prices dipped when copper stocks rose 15 per cent but, at the end of the month, the London Metal Exchange reported that stocks had fallen by 14 per cent and this led to an increase in the current price of USc116 per pound. Demand for copper remains firm, with wire and brass mills in Europe experiencing record output in the first half of 1989, and the standard of living rising rapidly in Southeast Asia with a consequent demand for consumer and industrial equipment. However, current high prices are having some demand effects, such as a decline in European demand for copper roofing. Early in the year, China was predicted to have promising growth rates. The events of June make the prospect of further economic progress unlikely. In mid-April, the International Bank for Reconstruction and Development (World Bank) indicated that prices could rise markedly if there was a supply reduction, possibly in Peru or the United States. This was when the Papua New Guinea supplies appeared to be assured. The current disruption of Bougainville output, that could well continue for a few or many months, could push up the price markedly. The longer term discouragement of investment in Papua New Guinea mining could contribute to the strength of this price. Unfortunately, Papua New Guinea cannot benefit from any price increases resulting from the undermining of its resource development prospects. Leaving this consideration aside, the World Bank is forecasting future (1995 and 1990) prices of copper to rise in real terms[2] slightly above their depressed 1986 levels, but below their high 1988-89 plateau. This forecast appears reasonable when it is realized that current prices are approximately one and one half times the estimated average cost of production for many companies.

Much of the recent political unrest in New Caledonia can be traced to variations in the price of *nickel*. The mid-year record price of US$5.80 per pound has encouraged plans to mine the hundreds of millions of tons of low-grade nickel laterite ores in the south of New Caledonia (the southern 'desert'). The smelter in Noumea owned by Societe le Nickel (SLN) has not the capacity to extract low grade ores. The Greenvale nickel processing plant in Townsville, Australia, equipped to extract pure nickel from ore of less than 2 per cent grade is negotiating with the joint owners of one of the sites chosen for mining to process the ores. If the project is established, it would add markedly to New Caledonia's exports and income. Over the longer run, the World Bank expects that the supply responses to current high prices will bring a return of the real price of nickel to its 1987 level by the mid 1990s.

World *sugar* prices have fluctuated between USc8 and USc15 per pound in 1988 (Chart 4). Prices declined in January, but climbed back to reach an eight month peak of USc14 a pound in April. Some analysts even expect price rises towards the spectacular highs of the early 1980s (USc17-29). Stocks are only 30 per cent of annual production currently — the lowest level for eight years and there is little scope for stocks to rise in 1989-90. The continuing rundown in world stocks will cause prices to be highly sensitive to any threatened crop failures or unexpected policy changes. Cuba and Thailand will probably account for most of the increases in output, and world production is expected to reach a record 107.2 million tonnes. However, poor weather has downgraded the crop in the USSR, eastern Europe and the European Community (EC) countries, and world consumption is expected to increase to 109.4 million tonnes this year, providing one of the sweetest years for sugar producers in almost a decade. The USSR is attempting to ensure that there is sugar in the shops. Thus

2 The World Bank's 'real price' is a nominal price deflated by an index of the average import cost for primary product exporting countries. Hence, it is more a terms of trade than a price concept.

despite the Soviet Government's reluctance to spend in the cash market because of pressure on its foreign exchange reserves, it purchased 800,000-1,000,000 tonnes in the first quarter of this year. The Cubans are determined not to increase the USSR share of its sugar production as they are desperate to use their first really good crop in several years to earn some much-needed hard currency. The demand for sugar has increased markedly in China, as evidenced by the speedy growth of the local soft drink industry. This year demand is expected to grow from the 7,000,000 tonnes consumed last year. Although China can only produce approximately 5,000,000 tonnes, the swing to other cash crops by increasingly prosperous farmers has affected sugar production so that even this level may not be reached. In the long-term, the current political upheaval in China is unlikely to affect its growing sugar demand, but may further reduce its supply. The EC continue to maintain a domestic sugar price and an import price for African, Caribbean, and Pacific countries above the international market price. Approximately half of Fiji's exports are made to the United Kingdom under this arrangement at a price of approximately USc25 per pound. The World Bank considers that, in the short-run, large price increases may take place in the international market. Such movements might be expected to bring forth markedly increased supplies in countries like Australia, India, and Thailand, resulting in rapid price decreases. The US stabilization price (that applies to only very small supplies of Fijian and Papua New Guinea sugar) is expected to decline, as is the margin between EC import and international market prices.

Members of the International *Coffee* Organization will meet again in June to decide the fate of the 25- year old Coffee Agreement. The dismantling of the pact could herald a price war in a glutted market. Brazil with 30 per cent of the market share, refuses to consider any important quota reducing proposal, while America insists that the two-tier market be abolished. Consumers want a bigger market share for arabica coffee, and an end to the practice of selling excess coffee cheaply to non-members of the agreement. A coffee price of USc127 a pound at the beginning of June (Chart 5)[3] is at a two-year high. Prolonged dry weather reduced the normal supply from Brazil, Columbia and many parts of Central America, with consequent price increases. Papua New Guinea, a robusta exporter, is benefiting from this short-run movement. The World Bank finds little evidence to suggest that coffee prices will alter markedly before the turn of the century.

The prices of *copra* and *coconut oil* rose slightly in the first half of 1989, largely as a result of decreased supplies from the major exporter — the Philippines. These prices are strongly influenced by the increasing supply of competitive oil seeds and oils. This was initially due to increased exports of Malaysian palm

Chart 3

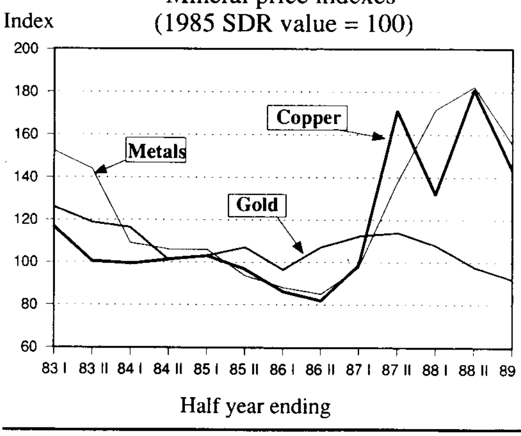
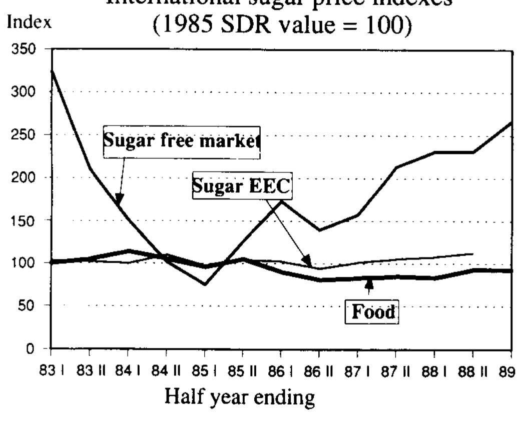
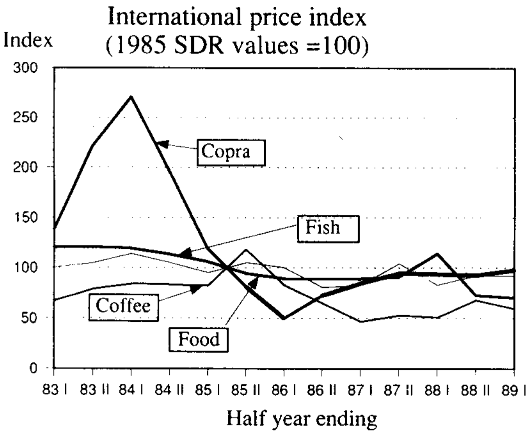


Chart 4



3 Food, coffee, copra, fish.

Chart 5



kernels and oil. Now South America, particularly Brazil, is becoming a major supplier of soy beans once predominantly produced in the US. If the recent US drought is relieved, large supplies of US soy beans will be added to continuing large Brazilian supplies as well as resurging Philippines supplies (as their more stringent processing methods and monitoring measures become accepted). Consequently there will be short-term downward pressure on these prices as forecast by the World Bank. However, when prices fall, the premium of the price of superior products over inferior products tends to widen. This should dampen any downward tendency for coconut product prices, as coconut oil continues to command premium prices over other oils, despite the propaganda of 'pure food' advocates. This premium partly reflects coconut oil's superior qualities for non-food uses. The World Bank forecasts that even with increasing supplies, the demand for vegetable oils will rise sufficiently over the next decade to lead to slight increases in their real prices. However, this forecast is among the most tenuous that can be made. Of 38 commodity prices examined by the World Bank, the price of copra had the greatest variation between 1979 and 1988 (the coconut oil price ranked 36th). All these comments refer to prices rather than incomes. In many Pacific islands, coconut trees are becoming senescent, with declining yields. Unless there is active replanting, the income from coconut growing will decline in any event.

Despite an almost continuous decline in the price of *cocoa* since 1977, production continues to exceed consumption. Although the agreement establishing the International Cocoa Organization expires in September 1990, this organization ceased to maintain cocoa prices when buffer stocks reached the limit of 250,000 tonnes in February 1988 and representatives of producers and consumers were not able to agree on an increase in this stock limit. Unless such an agreement can be reached, the price will probably continue to fall. The World Bank expects this price to reach a nadir in the mid 1990s, and to fail to rise, in real terms, to the levels of any year prior to 1988.

Tuna catches, particularly in the Eastern Pacific and Indian Oceans, have been rising recently, while there has been little increase in demand. Consequently the price has been falling during 1989, and there is little prospect of a rise in the near future.

The forces determining the price of *gold* are different from those determining the prices of industrial and consumption commodities. Actions such as the decision of the Taiwanese authorities to stop adding to their gold stocks are major determinants of this price. In mid June it was at its lowest level since 1986 (US$359 per ounce), despite events in China that encouraged a very short-term rise in prices. If the expectation of a decline in general rates of inflation is realized, any recovery of the gold price to its 1987 level appears unlikely. In the short-run, commodity supply shortages in the USSR and China are likely to lead to price depressing increases in supplies of gold on international markets. If Papua New Guinea becomes an important gold producer (with recent events in Bougainville, this is a most uncertain prospect) there will be further downward pressure on prices. This will exert compensating supply pressures on small gold producers with limited reserves, and on explorers looking at marginal projects while they have limited cash resources. The World Bank expects the real price of gold to be less at the end of this century than it is at present.

Technical note

This discussion of changes in commodity prices has been developed within an analytic framework (not an econometric model). Developments in industrial countries (that is, the members of the OECD) are considered to be the predominant factors determining the demand for primary products, and, hence, the first origin of price changes. However, changes in industrial output have a more than proportionate effect on primary product prices. If OECD production increases, producers and traders wish to hold larger stocks of both inputs and outputs to provide protection against unanticipated changes in demands or supplies. This accelerator effect results in a rise in demand for primary products relatively greater than the increase in industrial output.

These 'real' demand and supply influences may be augmented by 'monetary' influences. In light of experience over the last quarter century, rising output induces fear of inflation. This expectation effect encourages entrepreneurs (including sellers as well as buyers of primary products) to shift their asset preferences from financial assets to physical assets, including stocks of primary products, provided that interest costs do not rise by more than the expected increase in prices.

At the same time, in the very short-run (say up to one crop year), the supply of primary products is price inelastic resulting in increases in demand leading to price increases. In the medium-term (say more than one crop year), supplies can be increased leading to a fall back (and even a decline) in prices. Over the longer-term (say the gestation period for a tree crop or the completion of a mining investment), supplies can increase quite markedly, leading to sharp price declines. These cobweb effects contribute to the extreme variability of primary product prices.