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The Future of Raw Material Prices and the World Economy

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The Future of Raw Material Prices and the World Economy

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Abstract
Raw material prices dramatically increased in the last quarter of 2001. It has been argued that growth of the world economy and expansion of foreign trade are major effective factors in increasing raw material prices. On the other hand, from the last quarter of 2001, growing political instability and regional battles have also placed pressure on prices. In reality, the uncertain trend of raw material prices is not today’s issue; the problem has been present in recent centuries. However, as a result of the collapse of the world monetary system in the 1970s, uncertainty of exchange rates and interest rates have increased these fluctuations of raw material prices and have had a negative effect on the world economy. Our aim is to evaluate the issue of raw material prices in the light of developments in the world economy and to expose the uncertainty and the risks inherent in projections of raw material price fluctuations.

INTRODUCTION

The future of raw material price (commodity) expectations has importance for both producers who demand raw materials and professionals who operate in the financial markets. We can determine from retrospective perspectives that the prices of raw materials could rise in certain periods and fall in others, or vice versa.

During the historical process, it is possible to determine that raw material prices (energy, metals, etc.) have been affected by political factors and war in the context of aggregate raw material supply and demand. However, other factors might have several impacts on raw material prices, such as growth in global production level, or feasible periods of economic depression. The analysis of raw material prices in a historical perspective is not our aim. We have focused on causality of commodity price trends and expectations in the period 2000–2006.

All nations recognize that the world was transformed from bipolar to multi-polar or a hegemonic global system after the political events of 1989. As a result of this process, globalization and multinational capital investments have emerged on to the world agenda. This has created not only the free movement of capital but also a new initiative for shifting production from developed countries to developing countries. Because of the heightened competition in the world economy, companies were forced not only to produce at lower cost, but also at the same quality levels. These large competitive pressures led to shifting the production facilities from developed countries to Asian countries, especially China.

Developments in the World Economy after the Year 2000

Since the US economy had been producing approximately 30% of the world’s national income, its effect on the world economy has been the most significant of all nations. Hence, US economic policies were radically changed in the mid-1990s by means of tax discounts and budget expenditure augmentations. There was a budget surplus in the President Clinton era, but the budget structure has changed rapidly with the negative effect of budget deficits in the Bush presidential era. Therefore, a relatively inactive US economy was activated and also attempts were made to temper the damages from the 1997 Asian crisis. There is no doubt that growth in the US economy indicates a growth in the global economy.

The overseas operations in Afghanistan, Iraq, etc. have been financed with part of that increased growth.
US budget expenditure. Monetary policies have accompanied expanding fiscal policies. The US Central Bank (FED) began to reduce interest rates step by step in the year 2001. This trend was maintained until 2004, and FED interest rates reduced from 6.5% to 1%. As a result of that policy, the credit market pumped cheaper resources and liquidity increased by new expenditure in the market.

These policies initially created great affluence. The same expanding monetary and fiscal policies have been used in the Japanese economy for a considerable time. The Japanese economy had faced up to the unemployment problem resulting from the decrease in automobile demand related to the boost in oil prices in the years 1990 and 1991 (especially during the First Gulf War). The economic environment was negatively affected by consumer confidence and consumers had also preferred saving to spending. The economy came up against long-term recession in the context of a reduction in the marginal propensity to consume. The threat of recession diminished, even though the government had operated several measures such as increasing the government expenditure, reducing interest rates and expanding monetary policies. Consequently, as shown in Figure 1.1, Japanese economic authorities have determined an interest rate that is very close to zero.

The European Union and the United Kingdom have reduced interest rates in parallel to this trend. Therefore the global economy rapidly eliminated the negative effects of the Asian crisis and volume of international trade has risen rapidly during this period. China applied new economic policies in 1998 and has become an important base for international investments. Thus, international demand has been created for accommodating

**Figure 1.1. Interest Rates in Monetary Policy (%).**

**Figure 1.2. Inflation Rates (CPI, Annual % Change).**
the huge increase in production by expanding monetary and fiscal policies. Consequently, multinational companies and their Chinese investments are protected from the devastating facts of the Asian crisis by technological improvements and productivity. Finally, demand also accelerated. Everybody seemed to be satisfied.

### Escalation of the Commodity (Raw Material) Prices and Inflationist Pressure

However, there has been another improvement in the process. The aggregate demand for dealing with the huge production trend was created, but on the other hand the increasing commodity prices gave a sense of the economy that 'there was something going wrong'. In this scenario, global production output had to be stabilized and in parallel the commodity demand had to be reduced (Matthies 2006). Only after the year 2001 (especially after the terrorist attacks on the United States), did commodity prices in the world economy engage with an energy-led trend of growth. The global economy was operating under new effects of cost-oriented pressure and inflationary tendencies.

With the aim of shifting the manufacturing units to East Asian countries, productivity would be raised and as a consequence of the growth in production of ‘quickies’ (low-cost products) inflationary tendencies would be put under control. Nevertheless, this bargain did not succeed. Inflation was the most threatening intruder resistant to all economic policies. In 2006, inflationary pressure warning signals emerged regarding the escalation of global economic growth rates and utilization of even more capacities (IMF 2006).

The increasing production costs and the rapid expansion of aggregate demand brought back the impression of inflation to the world economies. Despite any indications to the contrary, the blind increasing of commodity prices would inevitably cause inflation. As a result of the above-mentioned points, in mid-2004, escalation of interest rates returned to the scene, in order to control commodity demand and prices; and the FED raised interest rates by 0.25% (Japanese Government 2005).

The continuing upward movement in commodity prices came from the ‘buoyant global demand’, accompanied by supply constraints and political tensions. Prices of fossil fuels – crude oil, coal and natural gas – climbed to record levels. Oil prices, after having reached a historical high in October 2004, stood even higher in March 2005. The increase in world oil demand was concentrated in developing countries and the USA. China by itself accounted for one-third of the boost in consumption last year. Rapidly rising oil demand was accompanied by very low additional production capacity and relatively low inventories. Since autumn 2004, however, the production surplus increased inventories back to more normal levels. Oil consumption would continue to rise strongly in 2005, but at a more subdued pace than 2004 owing to the high price level and the anticipated slowdown in global economic growth. The lack of idle production capacities, however, will keep oil prices extremely volatile. The risk of much higher oil prices remains, as a result of possible delays in project completions, a sudden larger shortfall in deliveries or a much stronger than expected increase in oil demand. Any price explosion to US$ 80 or even US$ 100, as suggested by some experts, would only be short-lived as it would certainly cause massive oil saving and substitution reactions. Prices continued to rise on metal markets, with some quotations (aluminum, copper, nickel among others) ascending to long-time high levels. The demand was strong, with a major influence coming from the needs for Chinese imports. Prices of non-ferrous metals are expected to reach their peak in the first half of 2005 and then start to decline as demand moderates and supply constraints ease in response to new capacities gradually coming on stream. On average, non-ferrous metal prices will be 10% higher in 2005, after a record 37% increase in 2004 (Matthies 2005).

In this manner, interest rate regulations might be the right solution for controlling the higher demand or reducing the raw material prices. Conversely, the unexpected scenario might be that the situation matures. Especially for East or Southeast Asia, what will happen to the massive production of these countries related to entirely
Western-oriented monetary investments? Could it be possible that the stagflation nightmare might come back to the United States through the unintended result of increasing interest rates? On the other hand, non-operating revenues in the financial markets would collapse, i.e. the financial asset prices and the recent years’ vitality in the housing sector could disappear in these circumstances, and selling pressures would have chaotic effects or shocks in the financial markets. Fortunately, the ‘roaring nineties’ (Stiglitz 2003) have begun to be questioned in the early stages of the new millennium. Unfortunately, nobody has been able to give the right answer to these questions.

The expectations for increasing interest rates are still up-to-date. As is clearly seen from the economic indicators, especially by the leadership of the US, the central banks interest rates have a strong upward trend and this affects global economic relations. In this way ‘high-powered money’, by restricting means of money supply, is contracting in Japan and the US.

**CONCLUSIONS: VARIOUS SCENARIOS FOR THE FUTURE OF RAW MATERIAL PRICES (RISK PERCEPTION)**

**While Raw Material Prices Fall**

- Such countries as the US will attempt to increase the inflation rates to prevent raw material price appreciations (increase in monetary values). Economic growth will be brought under control by the dampening of cumulative demand.

**Figure 2.** *Global Commodity Price Trends.*

**Figure 3.** *Prices of Raw Materials, Food and Tropical Beverages.* Source: HWWA, AIECE Commodity Group, April 2005.
In contrast, a possible recession in the US economy would be perceived by the world commodity trading countries as a diminishing demand of this ‘gigantic consumer’. How would this perception affect the high production capacity of Asian countries? If other countries sustain this perception, will there be a worldwide recession in the economies? These are the most critical problems to be considered by economists. For instance, how would China be affected by a reduction in US demand? Will she choose a more competitive strategy for selling her products to other countries or submit to being more economically restricted? At that point, what would be the international investor’s position in China related to their financial statements? How about the loan restitutions, and will long-term pecuniary problems transpire in the system?

Such initiatives for reducing prices will have a negative impact on commodity manufacturing countries. For example, Russia is one of the most significant raw material producer countries in the world. Russians were able to escape the 1998 financial crisis because of this unique situation. Today Russia also has US$ 275 billion international reserves. This amount is kept in the country via exported Eurobonds from the OECD countries. Like Russia, China also holds US$ 1 trillion in the Eurobond market. Not only the possibility of diminishing demand for Chinese products but also the negative improvements in the Russian international exchange reserves, economic growth and budgetary deficit financing problem of all countries and the financial instrument situations which surround interest rates will all have to be questioned within evolutionary perspectives (see also, Doroodian, Boyd, 2003).

Under these circumstances and inevitable risks, reductions in world raw material prices will have a negative impact on financial assets and mortgage markets. Consequently, the non-operating revenues in the world will be reduced correspondingly with the inevitability that this collapse will not be limited to the financial markets. Meanwhile the primary markets will also be reflected adversely.

Sharp price fluctuations in the raw material trade would bring income distribution problems among the trading countries.

While Raw Material Prices Rise

• If raw material prices cannot be controlled, then the inflationary consequences will have to be met. In that case, interest rate escalations will continue.
• How would the hazards of increasing interest rates be ameliorated in financial assets? What will have to be done to prevent panic selling in the financial markets?
• While increasing prices have a positive impact on income distribution in the raw material producer countries, what will be the shocks and pessimism among the other countries in terms of economic growth and inflationary pressures?

In contrast to raw material prices, decreasing or increasing returns also highlight various risks. Furthermore, there are political risks as US presidential elections come closer, the Middle East remains unstable and the debate on forthcoming nuclear programmes continues. These will all have considerable effects on mid-term expectations. As a result, the future of raw material prices is considered to be risky. To this end, using active risk management methods will be helpful for solving the possible difficulties in the market as a whole and in practice ‘tractable risk frontiers’ have to be taken into account by the market forces.

References


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