Eco-Commodities

Which way are commodities headi

By Shahid Javed Burki

RECALLING what happened to the economy in 2008-09 when a number of commodities important for the country saw their prices go through the roof, it is a good time to reflect on which way commodity markets are heading in the next few months.

Could a rise in commodity prices – the price of oil, for instance, has increased significantly in the last few months – could hurt the recovery that is taking place? Expert opinion is mixed on the question of the future of commodity prices. But one thing is clear. The way the global economy has begun to recover from the Great Recession of 2008-09 will have a profound impact on the behaviour of commodities in the later months of 2010 and in 2011.

The major difference between the recovery now underway and those that occurred after the previous recessions is that the engine of global growth is no longer the United States. This time it is China. When the United States led recoveries from recessions, it was the consumer that provided the fuel the distressed economies needed.

When the recovery begins with China it is led by investment, most of it provoked by the funding provided by the government. Private consumption is the largest single contributor to the American national product. In China it is investment. The products the American consumers demand have a very different commodity content compared to the products needed by the Chinese investors. In other words the price pressures that will appear during this period of recovery will be different from those that were felt in the previous recoveries.

Some years ago Alan Greenspan, the long-serving chairman of the Federal Reserve Bank, the American central bank, said that his country's product was getting lighter. By that he meant that the commodity content of American output was declining while the contribution of "weightless" knowledge was increasing. This meant that when the rate of American GDP began to increase, the demand for physical commodities did not rise by as much as was the case in earlier growth spurts.

The situation is very different in emerging markets such as China and India that are now leading the way in the current recovery. The revival of the Chinese economy was helped by a large government stimulus package which was aimed at increasing the investment in physical infrastructure. To take one example: when American consumers go shopping after taking some rest during a period of recession they tend to spend money on electronic appliances that need sophisticated chips that have very little physical material embedded in them. There is not much metal content in IPhones. For devices such as these knowledge is the main component in their manufacture.

On the other hand, when the Chinese begin to spend money on building roads, railways, ports and airports as they are doing now the demand for different types of inputs goes up. Heavy machinery is needed as are cement, steel, copper and other materials that go into construction. In this recovery one will, therefore, see much greater impact on the prices of the commodities that the Chinese economy requires compared to those that the rich countries need.

Another significant change is occurring in the pattern of commodity consumption in the mature economies of the developed world comparing to those that are in the early phases of development. Input of energy per unit of output in the rich world is much lower than in the developing world. In other words, when global growth is the result mostly of the increased activity in developing countries, we can expect the demand for energy to increase more rapidly than was the case when recovery was led by industrial nations.

According to Goldman Sachs, the investment bank that coined the term "BRICS" to lump to together Brazil. Russia, India and China, these four emerging economies contributed almost 30 per cent to global growth in dollar terms between 2000 and 2007 and 45 per cent since the crisis began in 2007. This means a 50 per cent higher contribution by these four countries to global growth in the post-recovery period compared to the pre-recovery period.

There is one other reason why we should expect a significant impact on com-

modity prices as economic recovery takes hold this time around. Most countries that have used public policy intelligently to revive growth have ensured that the poor will not be left behind in the process. All large emerging economies, Pakistan included, have made sizeable public sector contribution to either providing increased employment opportunities to the poor or providing them with direct income support. China did the former; Pakistan the latter. India followed both approaches. The poor spend a much larger proportion of their income on food; therefore, when their incomes increase, the aggregate demand for food increases significantly. This will put pressure on food prices.

Finally, there is the matter of extensive drought this year in South Asia. Whether this is part of the changing climate pattern because of global warming is hard to say. Nevertheless, decline in the output of some of the winter crops in South Asia will have significant consequence for food prices. What are troubling for Pakistan are some of the trends relating to wheat production in the United States. Wheat is Pakistan's staple food crop. US winter wheat plantings are likely to drop to their lowest levels in almost a century, forecast at 37.097m acres, 14 per cent down from the previous year. There is likelihood that

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wheat prices will rise because of the reduced plantings in America. If the drought affects the availability of water for wheat in this season, Pakistan may have to return to the world market for large purchases at a time of rising prices. This will once again put a great deal of pressure on the balance of payments.

As already indicated above, oil prices have begun to increase. They are now above $82 a barrel for February deliveries and may rise further although the OPEC has declared its intention of keeping them in the $75-80 range. Even in that range the pressure on the country's balance of payments will be considerable.

The conclusion I would reach from this is obvious. Islamabad's policymakers have done reasonably well in the last few months in bringing the rapid economic plunge of 2008-09 to an end. Signs of recovery have begun to appear but that is happening at a time that commodity prices have come under considerable pressure once again. If they rise sharply, the impact on the incipient recovery will be considerable.

The most important thing Islamabad can do at this time is to keep a careful watch on what happens to the international commodity markets as well what is likely to be the impact on agricultural output for the current season's crops. If it is anticipated that domestic output will be less than expected and commodity prices seem set to rise, there may be reason to take some defensive operations in the forward markets.