

Commodities surge still gathering pace

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[Cereals](#), [iron ore](#) and [oil](#). The three commodities, the most important for the day-to-day working of economies around the world, could derail the recovery next year.

The cost of cereals, oil and iron ore has surged already to two-year highs, up between 40 and 150 per cent from the lows of 2009 at the height of the global financial crisis, and analysts and traders generally anticipate further increases into next year.

The three are critical for the world – both in economic and political terms. For example, high prices for cereals, such as [wheat](#), corn and [rice](#), not only push up food inflation, but could also trigger food riots. The cost of iron ore, used to make steel, is critical to the global economy as it filters into steel prices and, ultimately, into the cost of everyday goods such as cars and washing machines. The same is true for oil prices, which add inflation at the petrol station, but also along the supply chain due to higher power and transport costs. Iron ore and oil are key for the profitability of some of the world's largest heavy industries, including mining, steelmaking and petrochemical.

The benchmark Reuters-Jefferies spot CRB index, a basket of raw materials, has surged well above 300 points, its highest level in more than two years. The index is up 65 per cent from the low of early 2009 during the depths of the global financial crisis.

If commodities prices continue to rise into 2011 as many analysts expect, there are worries that inflation will spike in emerging countries, forcing central banks to tighten their monetary policy to slow down consumption. In a sign of the dangers ahead, China tightened its monetary policy last week responding largely to higher food inflation. Besides, households in the US and Europe, already suffering from high unemployment, are set to devote more of their income to purchasing energy and food, leaving less to spend in other areas. The result would be an even weaker rate of growth of private sector consumption.

One of the most critical questions for the global economy into 2011 is whether the surge in commodities prices reflects a supply or a demand shock. If higher consumption is mostly at play, the boom in raw materials will have little impact on economic growth – it will merely be a reflection of underlying strong economic activity. But if supply factors are mostly at play, the consequences could be far more severe for global activity.



Sources: Thomson Reuters; FAO

So far, economists believe that a mix of supply and demand factors are driving price moves.

The oil market is a good example. True, oil demand is surging, with consumption rising in 2010 by 2.3m barrels

a day, the second highest annual growth in 30 years, and with a further increase expected next year. But supply factors are also playing a significant part after Opec, which controls 40 per cent of global supplies, cut output in an effort to keep oil prices between \$70 and \$90 a barrel.

As such, economists are starting to worry about oil prices, particularly as West Texas Intermediate and Brent, the main benchmarks, approach the psychological level of \$100 a barrel. On Thursday, Brent crude hit \$93.33 a barrel. "Real prices, which are already twice their long-term average, are dangerously approaching previous pain thresholds," says Veronique Riches-Flores, economist at Société Générale in Paris. Speaking for many in the oil market, she warns that European countries are particularly exposed because a weak euro is exacerbating the cost of oil.

The case of iron ore is very similar to oil: both supply – lower exports from India, the world's third-largest exporter of the commodity – and higher demand are fuelling price rises. The result is that iron ore prices have risen to \$170 a tonne, near a two-year high. Many observers believe that prices will rise in 2011 above \$200 a tonne, an all-time high, inflating the cost of steel and forcing up prices of everything from cars to washing machines.

Cereals are even more worrisome. The price of humble wheat and corn is rising mostly on the back of supply factors after a string of bad crops due to inclement weather. The prices of other agricultural commodities, particularly oilseeds such as soyabeans, palm oil and rapeseed are also rising fast. And food inflation is now a major political and economic headache in emerging countries from China to India to Mexico.

If prices rise further, as many predict in the agricultural market, higher food prices could force higher interest rates, slowing down economic growth in emerging countries.