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What are we to make of the commodity price meltdown?

The ramifications of the turmoil in commodity markets are difficult to determine, says Roger Bootle

Stormy commodity markets have raised questions about the health of the wider global economy Photo: Mike Olbinski/Barcroft Media

By Roger Bootle

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What has recently happened to commodity prices is a key indicator of the strains in the world economy, and perhaps a forecaster of the dangers that lie ahead. Equity markets have been generally weak, while Swiss commodity giant Glencore has seen its share price drop by two thirds. What are we to make of **the commodity price meltdown**?

Throughout our industrial history, concern about commodities has usually focused on anxiety about shortages and high prices. In the 19th century, the great British economist William Jevons forecast industrial growth would grind to a halt because of a shortage of coal. In the early 1970s, the Club of Rome forecast a serious shortage

of all essential commodities would cause their prices to surge, thereby inhibiting, perhaps even stopping, economic growth.

More recently, it was fashionable to argue that world economic growth would be halted by China gobbling up the limited supplies of a whole range of commodities. Meanwhile, the world was supposedly not far off “peak oil”, the point after which oil production would fall, resulting in sky-high prices and a drop-off in industrial production.

In each case, these doom-laden predictions have been undone by the fundamental power of the forces of supply and demand. When the prices of commodities rise, at first this does little to incentivise increased supply, since it takes an extended period of time to invest in and develop new mines or develop new oil fields, for example. But supply responds eventually. When increased production comes on stream, prices plunge, stimulating consumption and depressing the incentive for further investment. This sets up the conditions for a subsequent price rise, and so on.

Moreover, commodity production is open to technological progress. As knowledge increases, it becomes possible to drill for oil, and to extract it, from places that earlier would have seemed impossible. Furthermore, high prices provide the incentive for substitutes to be developed and for consumers to economise.

One of the big difficulties in interpreting what goes on in commodity markets is deciding whether a price movement is due to a shift of supply or demand. Quite often it is both, as now. The key influence on demand has been **the slowdown in the Chinese economy**. Chinese consumption of the key industrial metals has risen from 10pc of the world total in 2000 to 50pc by last year. With production increasing, commodity producers needed the Chinese appetite for commodities to go on increasing at rapid rates.

But it didn’t. From 2011 the Chinese economy slowed and, apart from oil, commodity prices trended down. Until last summer, the oil price held up well, partly because of the uncertainty and the potential for supply disruption unleashed by the Arab Spring. Meanwhile, the prevailing market assumption was that the increase in US shale production would be comparatively modest, and would be absorbed by a reduction in Opec output. In the event, the increase in shale production was huge and Opec chose to stick with existing output levels to preserve its market share.

Could these massive oil price falls precipitate some sort of global economic crisis? At first blush, this would be extremely surprising. After all, over the last half century, the world economy has been blitzed three times by a huge rise in oil prices that sharply hit production and threatened acute global instability: in 1973-74, in 1979 and just before the financial crash of 2008. Most commentators have argued lower oil prices now are a good thing. I too stick by this judgment.

But things are not so straightforward. For a start, the losers from lower commodity prices are concentrated and visible, **as Glencore’s share price attests**. By contrast, those who gain from lower commodity prices are dispersed throughout the world economy. Even if the two effects are exactly offsetting, it would not be surprising if

the adverse effects of price falls came through sooner and more strongly than the benefits.

More than that, precisely because of the concentration of losses, it is possible there could be a marked asymmetry in regard to financial consequences. The exposure of equity investors and bond-holders to Glencore could be the tip of the iceberg. Several countries are heavily dependent on commodity exports and could be vulnerable – the oil-producing states of the Middle East, Russia and Brazil, to name a few.

There are, however, three reassuring factors. For a start, the bulk of any extended oil price fall must be behind us. The oil price has fallen from $143 a barrel at the peak to just under $50 now. It is arithmetically and economically impossible for a fall of this size to be repeated.

Second, China's slowdown may be relevant to industrial metals but is of much less importance in the oil market. China accounts for only 12pc of the world's consumption of oil and 4pc of gas.

Third, in contrast to the financial crisis in 2008, with regard to companies and countries exposed to movements in commodity prices, we pretty much know where the vulnerabilities lie. Or at least we think we do. Accordingly, the scope for a dramatic financial surprise should be correspondingly lower.

I remain of the view that we have yet to see the full beneficial impact of low commodity prices, which will be a boon to umpteen countries. Where they occur, these beneficial effects will be proportionately less dramatic than the corresponding losses, and less observable, but just as substantial. They will already be filtering through the finances of individuals and companies, thereby improving spending prospects.

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