

Inflation and the commodity super cycle



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Inflation and the Commodity Super Cycle

1. Introduction

Economists have, for decades, believed in the theory of cyclical growth, characterized by periods of growth, followed by years of depression or slump. Events, economies, and political systems move through cycles similar to the natural life cycles of living beings. These cycles, while observable, have no obvious reason and involve changes between periods of comparatively swift increase of production, income and prosperity and periods of relative stagnation. (Business Cycle, 2007) These periodic movements do not follow an established or expected pattern and behave randomly, with extended, or short, growth or slump years. In the stock and commodity markets, these boom and bust periods have been famous for causing widespread prosperity or destruction. Cycles generally comprise of four distinct phases namely contraction, trough, expansion, and peak. Whereas expansions and contractions account for the major portion of the cycle, the troughs and peaks denote the lower and upper turning points where contractions change into expansions and vice versa. These cycles have been the focus of detailed economic study for ages with governments trying, mostly without success, to smoothen slumps, periods that have historically caused widespread unemployment, losses and suffering.

2. Commentary

Business cycles are as applicable to commodities as to other elements of the economy and are generally measurable in movement of national or regional GDP. Economists have tried to explain these differences through growth theories that while helping in understanding the phenomenon continue to <https://assignbuster.com/inflation-and-the-commodity-super-cycle/>

have many grey areas. Economic growth represents the increase in value of the goods and services produced by an economy. Measured in terms of GDP, (Gross Domestic Product) economic growth is universally calculated by taking account of the growth in GDP on a year on year basis. It is furthermore calculated in real terms, care being taken to net out the effect of inflation in the price of produced goods and services. The current method of using GDP, while being followed on a global basis, has a number of disadvantages and can at best be treated as a rough indicator of economic performance.

Occasionally, commodities move into a phase of upward movement in prices for extended periods, which continue for many years, sometimes even many decades. They mainly occur because of major economic developments that are significant enough to drive demand and consumption on a global basis for long periods. Super cycles form because of the industrialization or urbanization of a major economy, (Heap, 2005) a process that normally occurs over decades, and leads to situations wherein increases in supplies of commodities are unable to catch up with increases in their demand. These imbalances, while originating in particular geographical areas, occur for years and result in substantial price increases of commodities, and that too on a global basis, for extended periods.

Two discernible super cycles have occurred during the last 150 years. (Heap, 2005) Huge economic and infrastructural growth in the USA, during the turn of the nineteenth century, created a super cycle in commodities. Later, commodity super cycles developed during the post war reconstruction of Europe followed by enormous economic activity in Japan. Many economists

feel that the movement of commodity prices since the turn of the millennium indicates that the global economy is in the midst of a strong commodity super cycle, a phase that has just about started and still has a long way to go. Gary Dorsch, writing for SafeHaven (2006) states that the Reuters Jefferies Commodity Price Index (CRB), which comprises of futures in “live cattle, cotton, soybeans, sugar, frozen concentrated orange juice, wheat, cocoa, corn, gold, aluminum, nickel, unleaded gasoline, crude oil, natural gas, heating oil, coffee, silver, copper and lean hogs” has reached levels 91% higher than what it was four years ago, its highest level in 26 years. Appendix C shows a graph that tracks the sharp rise of the Jefferies CRB index over the last four years. Apart from the behavior of the CRB index, prices of oil have increased seven times from their 1999 levels.

Copper has also behaved in virtually the same manner from the lows it saw in 2001. “Now it’s the turn of the grains, where wheat and particularly corn have exploded higher on the US futures exchanges.” (Guthrie, 2007) A number of other experts are reinforcing this phenomenon. While metals, led by base metals such as copper, aluminum and zinc, as well as precious metals like gold, silver and platinum have, until now, along with oil, led the price charge, prices of agricultural produce are also beginning to rocket. “Recently however, commodity traders have doubled sugar prices to 24-year highs, and are moving into coffee and soybeans.” (Dorsch, 2006)

While tracking of commodity prices is an ongoing activity, the frenetic movement of prices during the last seven years has added another dimension to the issue. Numerous articles, either prophesying its continuation for many more years or predicting a roll back in the near future,

pack the pages of financial journals and magazines. Each minute movement in commodity prices is subjected to detailed scrutiny, compared with trends and used as a base for future forecasts. While numerous major and minor reasons affect commodity price behavior, this paper focuses on a few major reasons, widely accepted to be the primary causal factors behind the constant and significant price increases of the past few years.

The liberalization process kick started by Deng Xiao Ping, in China, in the early eighties, led to developments that were possibly beyond his wildest expectations, and catapulted him into the ranks of those whose actions changed today's world. The implementation of economic reforms accompanied with the opening of the Chinese economy resulted in unprecedented and unimaginable growth rates. During the last twenty-five years, the country's economy changed from a centrally administered system, largely closed to international trade, to a market oriented economy with a rapidly growing private sector. Reforms, which commenced with the phasing out of collective farming, expanded to incorporate freedom from price control, fiscal decentralization, increased autonomy for state controlled enterprises, a large and diverse banking infrastructure, vibrant stock markets, the growth of privately owned and controlled enterprise and the opening of the economy to trade and investment. As China implemented the reforms in a phased manner, the restructuring and consequent efficiencies led to a year on year GDP growth well in excess of 10 % and a tenfold increase in GDP since 1978. The country, in recent years, has overtaken the most advanced nations of the world, and in terms of purchasing power parity, stands second only to the United States.

Growth has also driven enormous spending on infrastructure and urbanization, with millions of Chinese relocating from villages to urban centers. Foreign investors, from the west, as well as from East Asian economies like Japan and South Korea have invested significantly in the PRC, making it, in many ways, the world's factory. This phenomenal economic and industrial growth, involving a ten-fold increase in GDP, has made the country a huge commodity consumer. " In China, intensity of use is now three times that of the USA, with demand driven by urbanization, industrialization and fixed capital formation." (Heap, 2005) The Chinese miracle, with its huge demand for commodities has affected commodity prices profoundly in the past few years. " As China's economy expands, it is sucking in raw materials to build up its infrastructure, including roads, power stations and factories." (Cooper, 2005) This demand led to the country picking up a huge share of the overall growth in global consumption with growth in internal consumption. " The International Monetary Fund reports that its share of the overall growth in global consumption of industrial commodities between 2002 and 2005 was massive - 51% for copper, 48% for aluminum, 110% for lead, 87% for nickel, 54% for steel, 86% for tin, 113% for zinc, and 30% for crude oil." (Guthrie, 2007) Appendix A provides details about China's demand for various metals. The constantly increasing demand from China, despite regular predictions of slowdown, has served to propel commodity prices year after year. While these price surges have had their periods of relative stagnation, as well as corrections, the demand shows no sign of abating and should grow for many more years.

While China has been and should continue to be a major driver of commodity prices for many more years to come, other factors have also contributed towards price movement and their effect may well increase in future. India, the world's second largest country and its' largest democracy started opening up its economy from the mid nineties. Shackled for years under a bureaucratic mixed economy regime that favored the public sector, the country suffered from an abysmally slow growth rate for practically fifty years since it achieved independence in 1947. The opening up of the economy, and the introduction of economic reforms, while slower in implementation than China's, (due primarily to the democratic and debate oriented nature of Indian society), nevertheless picked up steam by the end of the millennium, and entered an era of high growth in the early years of the present decade. The country is now the second fastest growing economy in the world, and is achieving growth rates of nearly 9 %. Apart from India, the two other BRIC countries, Brazil and Russia, are also growing strongly, strengthening the demand for major commodities.

Monetary policies followed by the central banks of most countries have also played a significant role in fuelling commodity price increases. Central banks of most countries, Japan, Europe, China and India have followed super easymoneypolicies from the beginning of the millennium right up to the last quarter of 2006, and this, along with the demand from the Chinese and Indian economies have worked towards pushing prices up to record levels. (Guthrie, 2007)

While lack of faith in the measures taken by one's own government appears to be a generic trait with analysts all over the world, sustained increases in

commodity prices have led to a consensus that economic and monetary policies, followed all over the world, have been unbalanced in their blind preference towards growth, to the exclusion of inflation. The unbridled use of liberal monetary policies has contributed towards this present climate of inflation, and in strengthening the commodity super cycle. The creation of shortages because of rapid and unexpected growth in consumption is a fait accompli, and a short-term discomfort economists are ready to bear, (in the interest of growth), until increased supply stabilizes the situation. In the absence of measured intervention, unbridled increase in prices, apart from inducing speculative activity, also attracts hordes of genuine investors, big-ticket investment funds, pension funds, and even individual retail investors.

Commodity super cycles, by their nature and their reasons of origin, run for extended periods, for many years and some times for decades. Modern day literature refers to just two or three super cycle in the last two centuries, one caused by American industrial growth at the beginning of the twentieth century, and the other caused by post war reconstruction in Europe, followed by intense Japanese economic activity. The second super cycle lasted for nearly three decades from the late forties until the depression of the eighties. The current super cycle, if at all it is one, has gained momentum only during the last six years, and prima facie still has a long way to go. While China and India are both on the fast track to economic prosperity, they remain countries with low per capita incomes and consumption. The desire to achieve economic prosperity, in these economies, will not be satisfied with achievement of national GDP targets but will continue until individual aspirations of people are met in these two countries. A simple example will

serve to elaborate this argument. The per capita consumption of beef in China is 12 pounds per person whereas it is more than 100 pounds per person in the advanced countries. A recent report by Goldman Sachs states that even if, as predicted, both China and India reach the GDP levels of the USA by 2050, their per capita income will not exceed half that of the USA. This gives rise to two inferences, (a) the huge amount of latent demand in these countries and (b) the extended period over which these growth stories will possibly play out.

Much of the current discussion on commodity super cycles owes its initiation to Jim Rogers; author of “ Hot Commodities”, (2004) a firm believer in the continuation of the super cycle and the importance of China in moving the process forward. Rogers, who was the first to predict the commodities boom in 1999 believes that oil should cross USD 100 per barrel and could well, go over 150. The absence of a major discovery for nearly 30 years and Chinese demand will be instrumental in pushing up prices to much higher levels. Rogers bases his theories on continued price movements on historical facts and states that while the longest super cycle lasted for 23 years, this one is just 6 years old.

3. Conclusion

Arguments in support of the development of a commodity super cycle in commodities use examples of two historical periods, characterized by continuous upward movement in prices of commodities, and draw parallels with the current escalatory movements in prices. The fact that the movement of prices in the historical periods under reference was possibly due, in some measure to large scale and sustained industrial and economic

activity, especially in areas of infrastructure, help in surmises that the current price escalation is caused by the spurt of developmental activity in China and India. Furthermore, the expectation that high growth rates, currently being achieved by these two countries, will continue to happen for many more years has led to conclusions by experts that the current price behavior is due to the development of a super cycle that will continue for many years. While it is true that China and India are growing with rapidity, a number of factors could affect these theories and forecasts.

In the last super cycle, Europe and Japan were rebuilding their countries after the devastation caused by the Second World War. Shelling, bombing, and other ravages associated with wartime conditions, had wrecked these countries and the government and populations of these countries were driven by a fierce necessity to rebuild their nations and regain their former lifestyles. The situation with China and India is very different. Both these countries are engaged in various measures to grow and develop their economies. While poverty is widespread, their populations have managed to improve their technical and educational knowledge and skills that the advanced nations are able to use effectively. This development, along with their low per capita income and wage structures have helped in making them booming manufacturing and service locations and is helping them grow. The initiation of market reforms, opening up of economies, and withdrawal of restrictions on foreign investments has played a major role in creating conditions conducive to growth.

Similarly high rates of growth may not continue in future because of a number of reasons. As explained earlier the imperative for growth in post

war Europe and Japan was much more acute and intense and took on the nature of a battle of survival. Education, literacy and skills available to the general populations of these countries were significantly higher than that which exists today in China and India. While there are pockets of knowledge and enlightenment in these nations, real education at the level of the general population is yet to be achieved and much skill and knowledge needs to be imported from the west. This was certainly not the situation in post war Europe and Japan and the countries had more educated and skilled populations. Furthermore, the growth is also due to economic policies initiated by governments, helped by their low cost structure, both being factors that may change significantly in the foreseeable future. India's fast growing service sector is facing huge salary increases and a huge shortage in talent, a situation expected to worsen in future. The bulk of Chinese spending is going into state run enterprises, organizations that have proved their inefficiency and lethargy irrespective of their location, the overall political climate, the nationality, skill sets and work ethics of their employees. It would be optimistic to expect anything else of Chinese state enterprises and the possibility of misuse or underutilization of these assets is strong. China also operates under a totalitarian regime and crushes all types of dissent with force and brutality. The political situation and the aspirations of the Chinese may well change with improved education and prosperity, forcing the country into political and economic instability. In such a situation, it is possibly unduly optimistic to predict that the growth evinced in the past will continue for many more years to come.

It would be safe to conclude that it is too early to confirm the development of a super cycle in commodities, primarily because of lack of certainty of China and India achieving equally high growth rates for many years to come. While the current trail of commodity price increases is, of course, due to growing demand, inflation has also been fuelled by speculation and abundance of cheap money. In these circumstances it is quite possible that the slowing down of these two economies could lead to sharp corrections in commodity prices and an easing of the commodity super cycle.

Appendices

Appendix A

China's contribution to Commodities Demand (Guthrie, 2007)

Commodity

China's Share

of Global

Consumption	2002	%
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China's Share

of Global

Consumption	2003	%
-------------	------	---

China's Contribution

To YOY Consumption

Growth	2002	%
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China's Contribution

To YOY

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Consumption

Growth	2003	%
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Cement		
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34		
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56		
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Ethylene		
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6		
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6		
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23		
----	--	--

5		
---	--	--

Alumina		
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16		
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19		
----	--	--

60		
----	--	--

59		
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Aluminum		
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16		
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19		
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39		
----	--	--

53		
----	--	--

Copper		
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18		
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20		
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112		
-----	--	--

78		
----	--	--

Nickel

8

10

13

48

Zinc

19

21

53

86

Iron Ore

29

29

39

70

Steel

23

27

77

84

Gold

6

7

3

-5

Platinum

23

18

75

-560

Pulp

18

27

18

Container Board

11

30

11

Crude Oil

7

8

57

40

GDP

4

3

7

-16

Appendix B

Comparative Economic Data of the Advanced Nations and BRIC countries

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Compiled from the CIA Factbook

Country

GDP

Exchange

Rate

GDP

PPP

GDP

Growth

Rate

Per

Capita

Income

Population

USD Trillion

USD Trillion

%

USD

Billion

USA

13. 2

13

3. 4

43500

298

Japan

4. 9

4. 2

2. 8

33100

127

UK

2. 34

1. 9

2. 7

31400

60

France

2. 2

1. 8

2. 0

30100

63

Germany

2. 9

2. 6

2. 2

31400

82

Italy

1. 8

1. 7

1. 6

29700

58

South Korea

0. 9

1. 2

4. 8

24200

49

Brazil

1. 0

1. 6

2. 8

8600

188

Russia

0. 7

1. 7

6. 6

12100

143

India

0. 8

4. 04

8.5

3700

1095

China

2.5

10.0

10.5

7600

1314

Appendix C

(Dorsch, 2006)

Reuters Jefferies Commodity CRB Index 4-yr chart:

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