Commodities then and now

Part one of a two-part series on global commodity trends over the past 30 years that are shaping the way we trade them now.

BY **ANN BERG**

The "great American grain robbery," Arab oil embargo, collapse of the Bretton Woods fixed currency system and President Richard Nixon's visit to China – these were the events shaping the global commodity trade 30 years ago. In many ways they presaged the world patterns configuring today's commodity trade, but then – who knew?

The world really was different then. From the time Churchill delivered his iron curtain speech in 1946, the schism between capitalism and communism – West versus East – dominated world thinking and geopolitical strategy, impacting the production and flow of goods everywhere.

Today's agricultural policies and trade can be seen as the unraveling of Cold War policies on both sides of the political spectrum. The current Doha Round of the World Trade Organization (WTO) is on track to eliminate export subsidies and reduce domestic support programs, however gradually. Europe's Common Agricultural Policy (CAP), created in the 1960's to ensure food security through price supports and provide a buffer against Soviet encroachment is partially shifting focus toward environmental preservation. Decoupling price from unit production and slashing or eliminating grains and oilseeds supports, are attempts to become more competitive globally.

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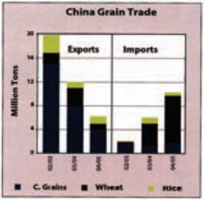
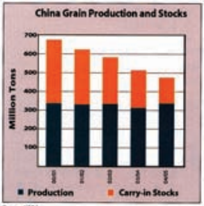
What that means for traders is they will increasingly have to factor in the impact of China, former Soviet states and an emerging powerhouse in South America.

COLD WARRIORS

China and Russia have long since abandoned their collectivist agricultural policies due to their catastrophic failure. Mao Zedong's Great Leap Forward, a policy designed to seed backyard pig iron furnaces in the midst of agricultural areas resulted in an estimated 20 million dead of famine in 1960. Mao's second experiment – the Great Proletariat Cultural Revolution – created civil strife leaving the country militarily vulnerable to the USSR. In 1972, Nixon visited China, paving the way for foreign investment, technology transfers and formal diplomatic relations between the two countries. China's entrance into the World Trade Organization in 2001 cemented its capitalistic embrace and it now stands as the second largest economy in the world. Having reached its arable land capacity, China is expected to become a significant future grain and oilseed importer based on rising disposable income levels.

In the 1980s, while the U.S. restored ties with China, it remained at odds with the Soviet Union over its protracted struggle in Afghanistan. When the Soviet Union collapsed in 1989, its agricultural sector was so decayed it needed 50 million tons of wheat and coarse grain imports during the same year despite its abundance of arable land. Following agricultural reforms, Russia, Kazakhstan and Ukraine have returned the former Soviet Union to an exporter once more, registering an impressive 20 million tons of grain exports in 2002 – an import/export shift equivalent to almost 3 billion bushels in 1 1/2 decades.





Source: USDA

SOUTH AMERICAN RISE

The collapse of communism has had reverberating effects in other continental areas. Thirty years ago, a military junta governed Brazil and another battled for power with the Peronist government in Argentina. Political unrest, "dirty wars," mountains of debt and triple-digit inflation plagued both countries. Argentina has since developed a solid corn and soybean export market and Brazil emerged as an agricultural superpower owing in part to its larger fertile landmass. Once a coffee republic, it is now the world's largest sugar producer, ranks second to the U.S. in soybean production and is a major cotton producer. Slightly smaller than the U.S., experts believe the amount of untilled potential cropland equals the entire U.S. cropland acreage base.

Brazil has embarked on several free market reforms since the reestablishment of a civilian president in 1990. Privatization of inefficient state-owned companies and monetary policies to tame inflation have spurred massive investment in the country's numerous commodity sectors besides agriculture, such as steel, wood pulp, textiles and chemicals. The current administration under President Lula da Silva has pursued an aggressive trade policy and recently prevailed in a World Trade Organization (WTO) lawsuit against EU sugar and U.S. cotton subsidy programs. And the 2001 currency devaluation increased Brazil's competitiveness in all export markets.

Not all nations have

embraced capitalism. Most African nations suffered power vacuums once U.S. or Soviet support withdrew in the early 1990s. That left the majority of them hobbled with corrupt governments, civil wars or ethnic strife. Lack of security and transparency and confiscatory tax policies have stymied investment despite the vast resources of the continent. Investment-oriented emerging markets elsewhere have enjoyed rapid agricultural growth. Since 1973, once war-torn Vietnam has increased coffee production 100 fold. It now vies with Columbia as the second-largest producer of the bean.

Source: USDA

WHERE DOES THAT LEAVE THE U.S.?

The future for the global grain and oilseed complex reveals various broad trends. The once unchallenged U.S. should maintain its status as the world's largest corn producer and exporter, but it likely will continue to lose participation in wheat trade, which peaked in 1981 at a 45% market share. The U.S. will soon forfeit its primary position in the oilseeds market to South America.

The Ricardian principle of comparative advantage will spur acreage increases in foreign countries with fertile land and that maintain favorable political and economic environments. In Brazil, where \$300-per-acre land is a fraction of the U.S. cost and optimum weather allows multiple bean harvests per year, even American farmers are picking up stakes to farm there. Under the Avaça Brasil initiative, the Brazilian government is spending billions on improving its transportation system and infrastructure. Sensing this primary market shift, the Chicago Board of Trade is developing a South American soybean export contract.

Except for some tinkering, planted and harvested acreage will not decline significantly in the near future in the industrialized countries, although market signals will alter the crop mix. Despite recent actions by the WTO, domestic subsidy programs will probably linger in both Europe and America for political reasons. The EU can tame burdensome supplies with CAP mandatory set-asides, however, and the U.S. could opt for acreage allotment buyout programs as it did recently for tobacco growers. Other growing areas – such as the former Soviet Union, will probably maintain their acreage base and export their surpluses. If the industrialized nations ever became serious about reducing their annual \$300 billion agricultural support programs – analysts concur that all basic commodity prices would ratchet higher.

The real conundrum for the commodity trader is: "Which will grow faster - Chinese demand or Brazilian supply?" Since both are rapidly expanding, any disruption of either trend will have an enormous price impact. A supply shock such as a global shortfall would produce spectacular one-year markets. But a sudden drop in demand would cast a longer shadow on commodity prices. Currency revaluations, global protectionism, capital controls and multiplying wars may jeopardize the economic growth worldwide and negatively impact commodity demand from the former sleeping dragon.

On the other hand, Chinese demand is not the only factor. Soaring population growth in the Middle East, Asia and Africa and their growing food demands could prove a formidable challenge to the major world producers for decades to come. One thing is clear: Any price or supply-demand forecast failing to pay serious heed to the political and economic policies of producer and consumer countries will miss its mark. TS

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