

# Recent Experiences in Price Instability

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It is obvious that in the large groups of oilseeds, oils and meals world market prices cannot move up so quickly and sharply as a result of speculation (such as we have seen recently at the Kuala Lumpur Commodity Exchange (KLCE) if there are no other weighty factors preceding and supporting it. And there were two very weighty factors, namely government interference and the weather, and they have been supplemented later by the reaction of the Malaysian oil palms against the weevil.

## **The Current Unusually Sharp Boom Started with Excessive Government Interference, this Time in the US**

There is general agreement that the US Payment-in-Kind Program (PIK) was the starter and, more importantly the preconditioner for the unusual steepness of the recent boom – and thus also for the unprecedented round of speculation at the KLCE.

Under the PIK programme the plantings of corn were reduced by 26%, of cotton (and thus cottonseed) by 30%, soyabean by 11% and sunflowerseed by 38%. The PIK program cost the US Government a whopping US\$9.4 billion in 1983, of which corn producers alone received US\$5.4 billion.

When talks about PIK started in November 1982, oilmeals were the first commodities of our sector which reacted to it. This was quite natural as they followed grains, for which PIK was primarily devised.

Although oilseeds should have followed

even more readily than meals because they had to compete directly with grains for the much more limited land available for planting, they were able to follow grains and meals but reluctantly as seed oil prices continued to be depressed until February, completely neglecting PIK (*Figure 1*).

At the time the PIK was announced it became known that the weevil-caused palm oil production boom in Malaysia was over and the average West Malaysian palm oil yield per hectare had started to decline in December. Thus, in the middle of January 1983, the market had the first indications that a decline of the two leaders of our markets – soyabean and palm oil – was in the making. Yet our market did not take these indications seriously at least not immediately.

The prices for most oils and oilseeds remained depressed until March 1983. Perhaps it meant demanding too much from the imagination of market participants if one expected them to recognize the forthcoming price instability already during the first quarter of 1983 and take appropriate actions at that time. In fact, nobody – including meteorologist – could foresee the climatic disaster of the coming summer. After all, apart from the uncertain weather in the US, it was entirely doubtful at that time how the oil palms in Malaysia would react to the weevil stress.

## **Only the Coincidence of Government Interference with Natural Calamities – Severe Drought in Several Countries and the Malaysian Weevil Melodrama – Has Made the Recent Boom so Pronounced \***

In fact, the boom did not start in the soya complex. It really started in the coconut and palm complexes during April 1983, caused

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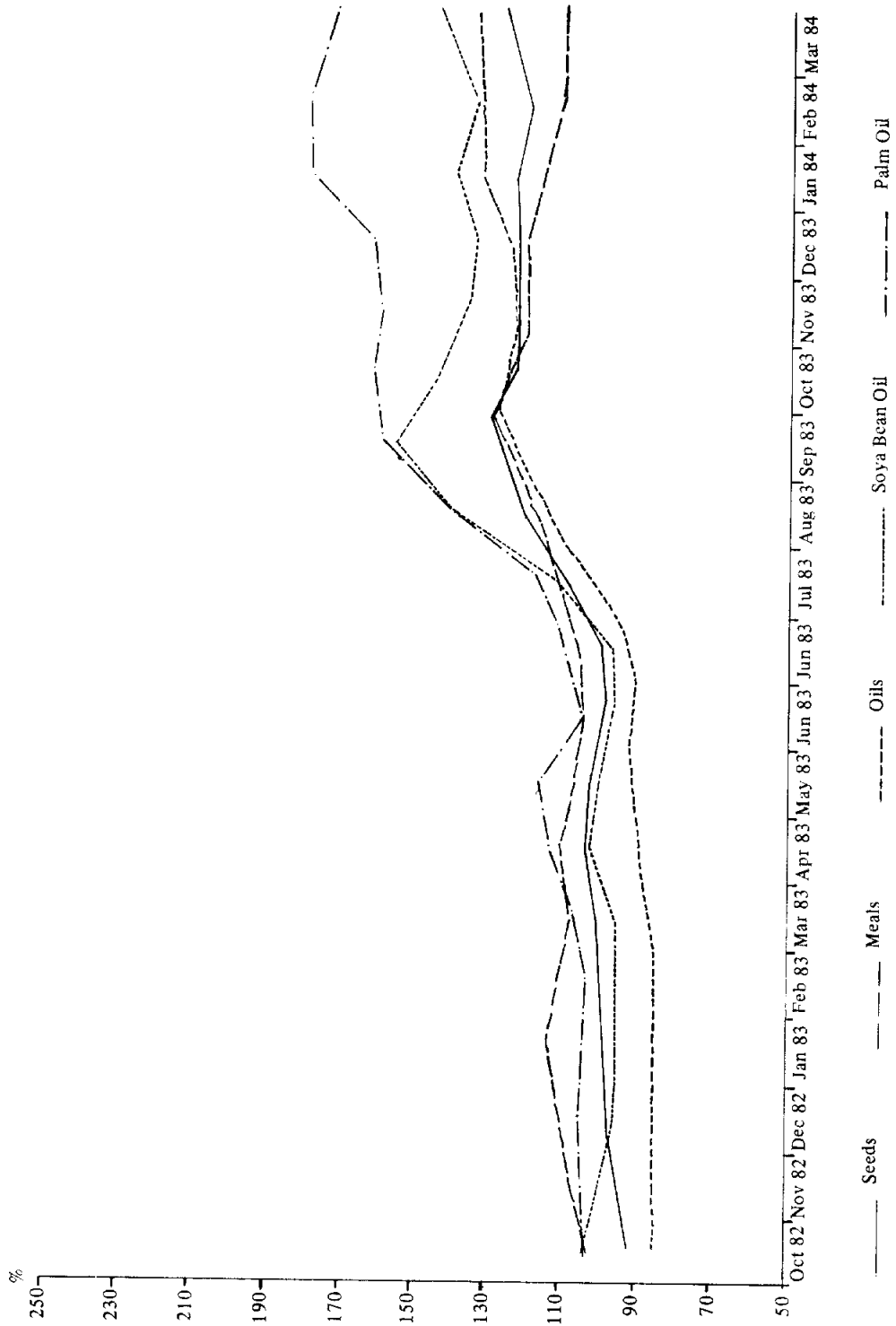


Figure 1. Major Oilseeds, Oils/Fats and Meals (monthly Oil World Price Indices)

by the long and severe droughts in the Philippines, Malaysia and Indonesia. Those droughts started in October, 1982 in the Philippines and in January, 1983 in Malaysia and Indonesia. But it is generally known that droughts have noteworthy effects on coconut and oil palms only if they last more than just one or two months. And those effects will not be translated into lower production until 13 – 14 months after the drought in the case of coconuts and 10 – 11 months in the case of oil palms.

Moreover it had become apparent by April/May that the Malaysian oil palms were persistently reacting to the overstress caused by the weevil: From April onward not only the yields per hectare but also the absolute production of palm oil declined sharply vis-a-vis a year ago, despite the considerable acreage increase. The effects of the drought could not become apparent in actual production until from October 1983 onward.

Yet the general boom faltered in May and even reversed in June (except for laurics) as the US government again interfered, this time to contain price rises. Once it had become apparent that farmer participation in the PIK program had far exceeded the plan, United States Department of Agriculture (USDA) tried to dampen the bullish effect by publishing over optimistic '83/84 soyabean crop and carry over estimates on April 22 and May 11.

Although these estimates were clearly unrealistic, the market was only too willing to believe in them. As a result the boom faltered during May and even reversed in June. This could only increase the confusion among market participants – one of the most certain effects of price instabilities.

When we ask ourselves whether at this stage the forthcoming boom could have been recognized, the answer can no longer be an unreserved 'No'. Of course, even at the end of June it was not yet possible to foresee the severe US drought, so that there was no reason for expecting any sharp declines in yields. But the official acreage estimates of 10 May already showed so sharp declines for corn and sun-

flower (–28%) cotton (–30%) and soyabean (–9%) that a declining price tendency must have appeared entirely out of place and at least a moderate boom should have been expected.

But the alternating influence of government interference and natural calamities were resumed very soon. Hot and mostly dry weather began to establish itself over most of the important US grain and oilseed growing areas in early July and remained there until the third week of August. Some meteorologists believe that this drought, like that of South-east Asia, was a consequence of the unusually strong El Nino.

Now all the ingredients of a decade boom, *i.e.* a boom occurring only once in a decade, were mixed together and it developed almost as quickly as a yeast cake. The ferments causing the steep rise during July and August were mainly the US government intervention (PIK), the US and South-east Asia droughts, and the biological problems of the Malaysian oil palms. The steep boom developed inspite of some negative externals such as above all the rising US-dollar. That speculators jumped on the band-wagon, accelerating the rise, was nothing to be wondered at since everybody was now convinced that the boom was justified. On the side of consumers this conviction meant that, after having lived on a hand-to-mouth basis up to the beginning of the boom, they were now ready to extend their forward cover. This could only fuel the boom further.

In early September 1983 the big question for market participants and observers was how far prices would still rise on the prospective supply shortages. Remembering the last similarly short supply season eleven years ago, people considered soybean prices of US\$12 possible again. That price level, however, had not been reached until the later months of the 1972/73 season. By 26 August 1983 the future's price for November soyabean reached US\$9.50, after a steep rise of 55% in ten weeks. During the same period (to 25 August) world market prices on a US dollar basis in the nearest forward position rose 48% for soyabean meal, 80% for soyabean oil and 72% for crude palm oil. That is,

from the very beginning the prices for oils have been considerably firmer than for meals and this has remained so until now (*Figure 1*). The reason, of course, is that the rationing of a supply shortage is more difficult for oils and fats (as there are hardly any substitutes for them) than for meals.

It is only natural for the market that, once the extent of the decline in the prospective supplies is fairly well known, it concentrates on the development of demand. Unfortunately this invariably is much more difficult and time-consuming. While in the case of drought oilseed yields and crops are shaped within less than two months, it takes much longer for demand to unfold and become apparent. And even on the demand side the influence of governments has been decisive for increased price instability this season. Many of these decisions were, and still are, impossible to predict:

- 1) The Soviet government's decision regarding soyabean meal imports. During the period October 1983 to February 1984 they unexpectedly imported almost half a million tonne or 46% less than in the same period of last season. This shortfall of demand (around 5% of the world imports of this period) has been the decisive factor in the much longer and steeper than expected reaction of the prices for soya meal and most other oilmeals since September. At the same time this has been one of the major reasons for the renewed rise of vegetable oil prices, after only a short reaction of about two months.
- 2) Other state trading countries have added to the bullishness in vegetable oils by importing even more this season, despite the much higher prices. This is true for India, but probably also for Pakistan, Iraq, Algeria and others. In addition, many governments with planned economies (not only in the socialist bloc but also in de-

veloping countries) have increased the subsidies, so that consumers can continue to buy oils and fats at only slightly higher prices than last season. Therefore hardly any rationing is taking place in those countries.

The government intervention on the demand side means that the adjustment of consumption to the smaller supply must be accomplished by the countries with free market economies, so that the rise in world market prices for oils and fats has to be all the sharper. This has already happened so far. Prices have risen sharply since April 1983 and in March 1984 the *Oil World* Price Index for oils and fats was almost double the level of a year ago.

But our markets have never been, and will never be, one-way streets. The higher and the longer the rise, the steeper the reactions and *final* fall. Even if the the fundamental situation caused by the government interference and weather conditions remains bullish, a reaction invariably is unavoidable after two or three months. This is due to the (generally welcome and necessary) participation of speculative trading, which is in paper contracts and therefore are usually liquidated before the positions taken expire. To answer the question about the probable length of the reaction no doubt was a very difficult task last autumn.

The fact is that most market participants and analysts, including the author, underestimated the length and the extent of the reaction, at least, for meals. It was approximately normal only for oils and fats at about two months and about nine percentage points (in the *Oil World* Price Index for food oils and fats). But it has been much longer than generally expected for oilmeals, namely already six months, as *Figure 1* shows. Oilseeds have been somewhere in the middle, turning up with oils in January and again in March, but in between declining along with meals in February.

The prolonged weakness of oilmeals, which stems largely from the side of demand, already has exercised a considerable price leverage for vegetable oils. And we may not yet

have seen the high of the upward leverage as we are going into the summer with its seasonally low demand for oilmeals and declining stocks of oils.

This leverage is due to the fact that seed oil is the sister product of meal. While the total value of the two products must be sufficiently above the value for the respective oilseeds to result in a positive crushing margin, the share each product contributes to the total value is irrelevant for the crusher. It is determined by the relative supply and demand situations of the two products. And as the demand for meals has been relatively weaker than for oils so that the crush has been more and more geared to the oil, the supplies of meals have become relatively more ample than those of oils. Hence it is small wonder that, for instance, the soyabean oil share of the combined product value already has increased sharply from about 29% before the US drought to over 40% recently. And it is likely to rise further to and perhaps above 45% during the next three or four months.

It is important to realize that the doubling of the prices for edible oils and fats during the past twelve months occurred while oils and fats stocks were still very high and even increased substantially (during October/December 1983), as we have already heard. World stocks of oils and fats did not begin to fall below the (still high) level of a year ago until from January 1984 onward. Although the decline has gained momentum since February, the larger part of the prospective decrease still lies ahead. Therefore, the question must be asked whether a large part of the price rise for oils and fats (other than lauric and palm oils) still lies ahead.

It certainly is worthwhile learning from past experience in order to find useful answers to this question. There are important lessons to be learned from all of the past four booms, but especially from the 1972/73 and 1976/77 ones. In the four booms the stocks of oils and fats played a decisive role.

During 1983/84 and next season the development of visible and invisible world stocks of oils and fats is very likely to resemble that of

1972/73 and 1976/77 and the respective following season. By the end of the present season the visible stocks of the 15 oils and fats as a group and of soya oil in particular are likely to decline to the lowest level since the end of the 1972/73 season, namely a little under five and a little over four weeks respectively. The same applies to the invisible stocks (see *Table I*, which also includes olive oil and butter). For the whole group of oils and fats this is true in spite of the expected sharp increase in Malaysian palm oil production during the current April/June quarter and especially the next quarter and the resulting expectation that its stocks at the end of September 1984 will be considerably above the 1973 level, expressed in weeks of disappearance.

Although it still is a bit too early to reliably assess the production prospects for next season it appears already now that the stocks of vegetable oils as a whole and soyabean oil in particular will not increase to any noteworthy extent, if at all, next season. It will thus be very difficult, if not impossible, to avoid a continuing tightness of oils and fats into 1984/85.

The major reasons behind this expectation are the sharply lower carry over stocks of oilseeds, oils and fats as of the beginning of next season and the relatively small planting prospects for US soyabeans. Even if world consumption of the 17 selected oils and fats included in the table is to rise only 1.5 million tonnes next season — still far below the average increase of the six seasons ending 1982/83 — world oils and fats production would have to increase by 3.6 million tonnes or 6% if the visible and invisible stocks at the end of next season are to remain only unchanged at this autumn's very low level of 9.0 million tonnes. And this would mean that such stocks would represent only 7.3 weeks of consumption, probably the lowest level since the end of the war. Even with a large increase in Malaysian and Indonesian palm oil production and with US soyabean plantings of 27–28 million hectares, as are now expected by some observers, it is difficult to foresee such a large increase in production. This is difficult also from the point of view of oil

**TABLE 1. WORLD CONSUMPTION, PRODUCTION, VISIBLE AND INVISIBLE STOCKS OF MAJOR OILS AND FATS (million tonnes) (a)**

	October/September													
	83/84F	82/83 p	81/82	80/81	79/80	78/79	77/78	76/77	75/76	74/75	73/74	72/73	71/72	
Opening stocks														
Visible (b)	9.2	8.9	8.6	8.5	7.5	6.9	6.5	6.4	5.8	5.1	4.5	5.4	5.0	
Invisible (c)	1.9	1.7	1.8	1.9	1.4	0.9	0.6	0.8	0.6	1.6	1.7	2.2	2.2	
Production (g)	60.9	62.3	59.8	57.3	56.5	53.5	50.6	47.3	47.1	44.7	44.6	41.9	43.4	
Total supplies	72.0	72.9	70.2	67.7	65.4	61.3	57.7	54.5	53.5	51.4	50.8	49.5	50.6	
Consumption (d, g)	63.0	61.8	59.6	57.3	55.0	52.4	49.9	47.4	46.3	45.0	44.1	43.3	43.0	
Per caput, kilos	13.3	13.3	13.0	12.8	12.4	12.1	11.7	11.3	11.2	11.1	11.1	11.1	11.3	
Ending stocks														
Visible (b)	8.0	9.2	8.9	8.6	8.5	7.5	6.9	6.5	6.4	5.8	5.1	4.5	5.4	
Invisible (c)	1.0	1.9	1.7	1.8	1.9	1.4	0.9	0.6	0.8	0.6	1.6	1.7	2.2	
Stocks in weeks (f)	7.4	9.3	9.2	9.4	9.3	8.3	8.1	7.8	8.1	7.4	7.9	7.4	9.2	
World population (e)	4729	4651	4572	4494	4418	4344	4271	4198	4124	4050	3974	3897	3821	

(a) the seventeen oils and fats included in the individual supply and demand balances. (b) partly estimated. (c) unreported stocks (monthly at wholesalers, secondary industries, other end consumers, retailer as well as stocks afloat), estimated. (d) estimated (e) in million as of 1 July, base on UN data. (f) number of weeks for which the visible and invisible ending stocks would cover consumption (of the season just ended). (g) upwards revision mainly in Chinese lard.

meal demand, which will be affected by substantially lower milk cow numbers in the EEC and North America throughout next season and by lower pig numbers in the same and other areas during the first half of next season. The fact that oil meal demand has recently been, and may continue to be, poor relative even to the reduced supplies means that seed oils will have to make a larger contribution to financing the crush.

A major difference between the 1972/73 and the present boom is that the former was primarily caused by too high demand during the first six to nine months of the season when prices remained low and stable as supplies looked at first adequate. As against this, during the present supply-caused boom demand declined sharply during the first three to four months as buyers were shocked by the sharp price rises induced by the threatening supply shortage. But it is possible that the demand for oil meals would improve during the second half of this season, especially from the USSR, as prices now are only slightly at the level prevailing before the US drought and grain prices keep rising.

Considering the experiences with the price waves of the past 12 years and the present supply and demand prospects, it appears that the prices for most oils and fats with the major exception of laurics will continue to rise during the next three months or so. Thereafter they will depend mainly on the development of Malaysian and Indonesian palm oil output. However, even if the expected sharp increase materializes prices are likely to remain unusually high well into 1984/85. That is, even if the

second half of the prices wave for oils and fats, *i.e.* the downturn, should begin in July or August 1984 (which is by no means certain as it will depend on northern hemisphere oilseed crop prospects), it will probably take nine or ten months before the *Oil World Price Index* for food oils and fats declined 20 to 30 points from the highs. At present it is over 160 (average 1971/72 to 1974/75 = 100). It may approach or exceed the previous record of 182 (reached in October 1974) before it starts to decline gradually and probably erratically. Rising oil meal prices as a result of improving demand and further advancing grain prices could dampen the bullishness of oils somewhat, but not decisively.

A possible downturn from July to August onward could well be led by palm oil, if the expected sharp improvement in Malaysian palm oil production materializes. There will of course be no reason for palm oil to drop to much more than the normal discount from soya oil. This means that any further decline of prices would then depend on soya oil joining palm oil in the leadership.

Continued or renewed bullishness may emanate from the US dollar if it continues to decline sizeably during the remainder of this year, as most financial experts believe. Although this would probably be partly compensated by rising interest rates, the dollar would thus continue to be one of the leading price instability factors. But during the coming summer the probable price instability will emanate mainly from the fact that the stocks of oilseeds, oils and fats will then have declined to unusually low levels and the market's sensitiveness to the weather become greater.