

## THE CHANGING FACE OF COMMODITIES

(From THE ASIAN WALL STREET JOURNAL)

By Patrick Barta

Sharp increases in global commodity prices are beginning to push consumer prices higher in Asia, increasing the odds that inflation will be exported to the U.S. and elsewhere in the months ahead.

Consumer prices had been holding fairly steady, or even declining, in much of Asia in recent years, as the region's economies worked off excess capacity amid the global economic downturn. But as Asia heats up again, price pressures are building, due in large part to China's ravenous appetite for raw materials, which is driving up their cost.

Oil prices are hovering around \$35 a barrel, while the prices of other raw materials, including scrap steel and copper, have doubled or more during the past 18 months.

As a result, consumer-price inflation, while still extremely low in Asia by historical standards, has accelerated in recent months in several countries, including Thailand and the Philippines. In Thailand, for example, the consumer-price index rose to a 33-month high of 2.3% in March compared with a year earlier, after rising just 1.8% in 2003 and 0.7% in 2002. In the Philippines, consumer prices rose 3.8% in March from a year earlier, the highest rate since late 2001.

But the most important turnaround has occurred in China. Although China's inflation rate eased slightly in February, it has risen noticeably during recent months, including a 3.2% jump in January. Prices were nearly flat or declining through much of 2002 and 2003.

"We're kind of at a turning point" in consumer prices in Asia, says Rob Subbaraman, a regional economist at Lehman Brothers in Tokyo. "Broad inflationary pressures are beginning to build."

Those pressures matter to the U.S. and other countries because so many of their manufactured goods now come from Asia. In some cases, goods are made entirely in Asia and then sold all over the world, so that any price increases ripple out immediately to consumers in other countries. In other cases, Asia's goods are smaller components bought by U.S. companies to make into larger products. As the costs of those components rise, the U.S. companies are pressured to raise the prices they charge for the finished goods.

This process has worked mostly in reverse during recent years, as falling prices in Asia put downward pressure on prices for some goods in the U.S., including laptop computers. But when costs have spiked in Asia, the effects were felt. During 1999, for example, an earthquake in Taiwan disrupted the supply of computer-memory chips, sending their prices higher. That squeezed the profits of U.S. companies, including Dell Inc., and forced some to pass along the costs to customers.

Many U.S. and Asian companies are still reluctant to raise prices for fear of alienating customers. But the rise in raw-materials costs has been so steep that some companies feel they can no longer postpone price increases. Also, some companies are seeing enough demand growth for the first time in several years that they are no longer as worried about losing customers.

For example, Sony Corp. recently raised the prices of lithium batteries by an average of 10%, after the cost of cobalt -- a metal used to make electrodes in the batteries -- soared to about \$25 a pound from \$7 a pound in 2002. Lithium batteries are used globally to power electronic products from notebook computers to mobile phones. Sony says it has been able to keep prices for many of its other products from rising.

Similar price increases are spreading through other industries, including the tire business, which is highly reliant on natural rubber from Southeast Asia. Kumho Tire Co., a major tire producer in South Korea, has increased the prices of its export products between 3% to 5% since the beginning of this year due to higher rubber prices, which have risen 65% in the last 18 months. Michelin SA also raised its tire prices in the U.S., Europe and Asia by as much as 5%.

"At some point, we had to act, we can't sit on the sidelines," says Scott Clark, a vice president of marketing at Michelin. "Everyone's working on productivity improvement and driving costs down, but there's only so much" that can be done to counteract sudden run-ups in raw-material costs.

Another country where price pressure is growing is South Korea, which also makes a broad palette of the world's manufactured goods. Samsung Electronics Co.'s digital-appliances business decided early last month to raise prices of several of its products, including refrigerators and washing machines, because of a recent run-up in the prices of steel and resin, a compound used to make molds and plastic parts.

The company "followed the market trend in raising the prices of its products," said a senior executive at Samsung Electronics' digital-appliances business in Seoul, who declined to give specifics about the increases. Samsung's other business units, which produce semiconductors, LCD screens, cellphones and other digital products, aren't influenced by the rising raw-material prices, a company spokeswoman said.

Higher raw-materials costs and a lower dollar are already being felt somewhat in the U.S. Consumer prices in the U.S. have risen 3.7% at an annual rate during the past three months due largely to higher energy costs. Excluding energy and food, consumer-goods prices rose in February from January, the first such increase in 18 months. Even so, inflation is only 1.7% and, excluding energy and food, just 1.2% in the 12 months through February. Federal Reserve officials don't want it to go much lower.

Commodity prices alone won't prompt the Fed to raise interest rates. Fed governor Ben Bernanke noted in January that commodity prices rose as much or more "following the 1981-82 and 1990-91 recessions, as well as in 1986-87 and 1999, with no noticeable impact on inflation at the consumer level." With unemployment still relatively high in the U.S., wage growth has slowed sharply in the past year, allowing profit margins to expand sharply. "Although prices for some commodities have risen, underlying consumer price inflation only now looks to be stabilizing at a low level after falling for some time," Fed Vice Chairman Roger Ferguson said last week.

It is possible the latest pressures will ease in the months to come, especially if China's growth slows and raw-material prices decline, as some expect. Prices still are falling for many goods in key countries like Japan.

Even so, some analysts worry that U.S. economists are underestimating the potential threat. Many in the U.S. have argued that surges in commodity prices don't typically trigger inflation because raw materials often make up a small portion of the cost of finished goods. By some estimates, commodities account for less than 10% of what it costs to produce goods and services, while labor accounts for as much as 65%.

While that might be true in the U.S., where unionized factory wages are high by international standards, it often isn't the case in Asia, which has dramatically lower wages. And since the world has shifted more and more of its manufacturing operations to Asia during the past decade, that has increased the likelihood that raw-material-induced inflation would appear first in Asia, before spreading to the rest of the world.

Bill Robertson, a director of the Airconditioning, Refrigeration and Manufacturers Association in Canberra, Australia, notes that labor costs typically make up about 25% of the cost of a finished

product in his industry in Australia, which relies heavily on low-cost manufacturers in Asia. Materials, including aluminium, copper wire and steel, make up about 50%.

"I've been chief executive of two major companies in this part of the world and I can honestly say I've never seen anything of this magnitude" in terms of commodity prices, he says. Mr. Robertson says one of his association's members recently returned from China, where he was told that electric motors the company buys would go up in price by around 25% this year due in part to higher copper and steel prices, plus vendor margin recoveries.

In past years, he says, such companies would have moved on to other low-cost manufacturing centers, like Thailand or Taiwan, to source motors. But as those countries have become more expensive, China has become the last option. "There's nowhere else to run," he says. As a result, consumers will have "to change their thinking that certain air conditioners are going to cost substantially more in the future", he says.

Henry Willmore, the chief U.S. economist at Barclays Capital in New York, says he believes the odds are "more than 50%" that Asia-inspired inflation will pick up noticeably in the U.S. during the next year. One reason, he says, is that the commodity price run-up has been broader -- and has lasted longer -- than most other commodity booms of recent decades. And unlike past commodity surges, the current rise "is largely out of control of U.S. policymakers," since the impetus for much of the inflation is in Asia.

Commodity prices aren't the only reason that inflation is emerging in Asia. Other factors include low interest rates and the decision by several Asian governments, including China, to formally or informally peg their currencies to the U.S. dollar.

Many Asian companies still are hopeful they will be able to postpone price increases. LG Electronics Inc., South Korea's largest maker of digital home appliances, says it is trying to come up with ways to offset the recent steel-price increase without raising the prices of its products in the market. But "if the raw-material prices continue to climb, the company could consider raising the prices of its new products," a company spokesman says.

Greg Ip and Seah Park contributed to this article.