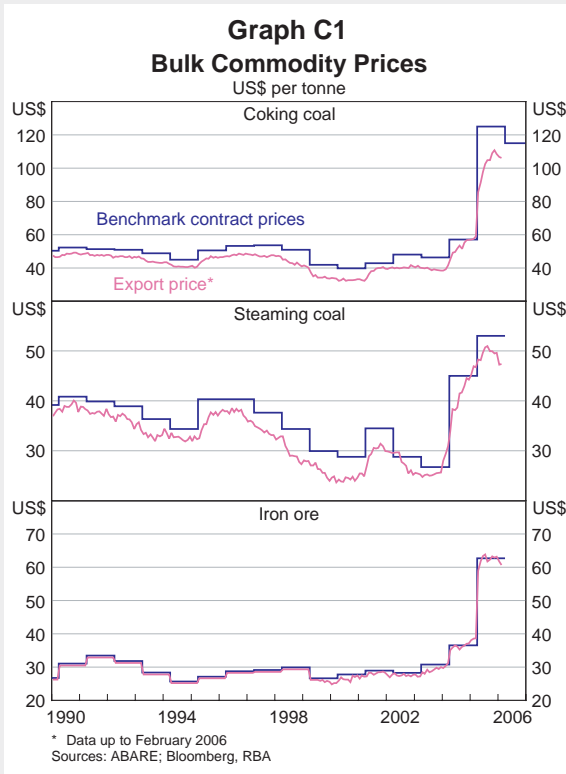


## Box C: Commodity Contract Prices and Trade

Australia's terms of trade have risen by more than 30 per cent over the past three years, boosting national income by about 5½ per cent. The rise has been driven by a surge in commodity export prices, especially for coal and iron ore, which together account for around 15 per cent of the value of total exports. With demand from the global steel industry much stronger than expected, export prices for coking coal and iron ore have more than doubled in recent years. Similarly, growing electricity demand in China and India has underpinned strong rises in steaming coal export prices.

In the past, Japan was the major destination for Australia's coal and iron ore exports. Japan accounted for roughly half of Australia's steaming coal exports and about 40 per cent of coking coal and iron ore exports in 2004/05. More recently, however, China has also become an important market, as its rapid industrialisation has led to very strong demand for raw materials. In particular, China now accounts for almost half of Australia's iron ore exports.



Export prices for Australia's bulk commodities are generally set by annual contract (for the Japanese financial year (JFY), 1 April to March 31), rather than on the spot market (Graph C1). At the time that this *Statement* was being finalised, contracts for coking coal had been settled, but contracts for iron ore and steaming coal were still being negotiated. Overall, coking coal contract prices fell by about 18 per cent, after rising by around 110 per cent in the previous contract year. Prices for hard coking coals fell by between 8 per cent and 16 per cent. However, prices of lower-quality pulverised coal injection and semi-soft coking coals declined by roughly 35 per cent. The larger decline for lower-quality coals reflects stronger actual and predicted increases in their global supply, as well as switching from lower-quality coking

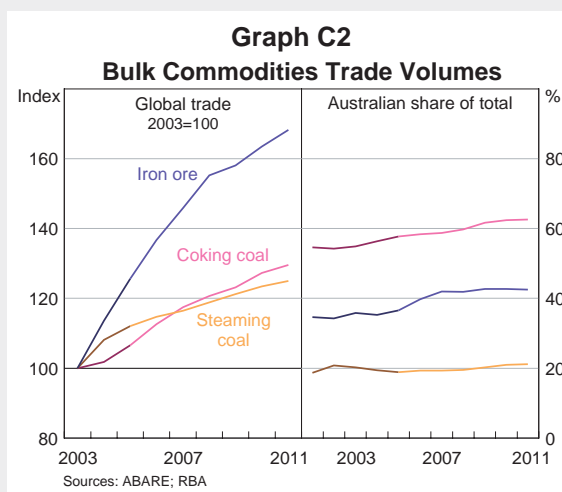
coal to cheaper steaming coal or more efficient hard coking coals. Steaming coal contract prices are also expected to fall, albeit more modestly, in JFY2006, after roughly doubling over the previous two years; producers and consumers expect faster growth in global supply capacity than in demand in the coming year.

In contrast, iron ore contract prices are expected to rise by at least 10 per cent in JFY2006, following a 72 per cent rise last year. The envisaged increase reflects expectations of further strong growth in steel production and limited new supply. Although coking coal and iron ore are both primarily inputs into steel production, their prices are likely to move in opposite directions in JFY2006. This divergence can be partly explained by the fact that China is a large and growing net importer of iron ore, while it is only a small net importer of coking coal.

Overall, the expected decline in coal contract prices in JFY2006 will be broadly offset by the rise in iron ore contract prices, with little overall effect on the RBA Index of Commodity Prices (ICP). This compares with the 22 percentage point contribution to the ICP's growth from the rise in these contract prices last year. Therefore, bulk commodity export prices are likely to remain high in 2006, supporting the terms of trade at an historically strong level.

Australian incomes have been substantially boosted by these developments, but almost all of the gain has come from higher export prices rather than from increased volumes. The volume of coal exports has been broadly unchanged over the past three years. Growth has been limited by capacity constraints in the mining sector, some transport infrastructure bottlenecks, and the long lead times required for large mining projects to come on line. Export volumes of iron ore have shown more growth, possibly because this sector's vertically integrated supply chain may have allowed faster expansion of capacity.

Australia's experience with supply constraints has been broadly replicated in other exporting countries.<sup>1</sup> However, most forecasters expect global supply capacity to increase more quickly in coming years, leading to moderate declines in prices. Nevertheless, according to projections by the Australian Bureau of Agricultural and Resource Economics (ABARE), Australia's coal and iron ore exports are expected to expand faster than total world trade in bulk commodities (Graph C2). Much of this anticipated increase in Australian export volumes stems



<sup>1</sup> The other main global exporters are Canada, Russia and the United States for coking coal; China, Indonesia, Russia and South Africa for steaming coal; and Brazil, Canada and India for iron ore.

from expansions in mine and port capacity that are already under construction or in advanced stages of planning. Australia also has advantages in responding to increases in Chinese demand for iron ore, given the competitiveness of Australia's relatively cheap high-quality iron ore and its favourable location. ↗