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Oil's Surge Ignites Cost Increases For Products From Plastics to Shoes

By TIMOTHY AEPPEL
Staff Reporter of THE WALL STREET JOURNAL
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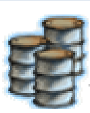
The recent rise in oil prices is reverberating far beyond the world's energy-intensive industries, spurring cost increases for everything from military tents in Iraq and weed killer in Iowa to shoes and Barbie dolls in China.

The continuing surge is causing companies which a year ago saw higher oil prices as a passing phenomenon to rethink their strategies. Many are moving more aggressively to cut costs and raise prices to offset raw material and energy costs that now appear likely to stay high for the foreseeable future.

While rising oil prices are contributing to slower growth and higher inflation, they haven't yet threatened to derail the global economy, which remains robust and able to absorb the jolt, economists say. Some companies are absorbing higher fuel costs themselves, while others are passing on only a portion of the cost to customers.

Still, Germany, Italy and Japan, all of which had slower growth than the U.S. before oil prices started rising in late 2003, have seen their economies contract partly because of higher oil costs. Many developing countries also are struggling with higher oil bills.


CRUDE FACTS

[1]

Track the ups and downs of oil prices since 1970.

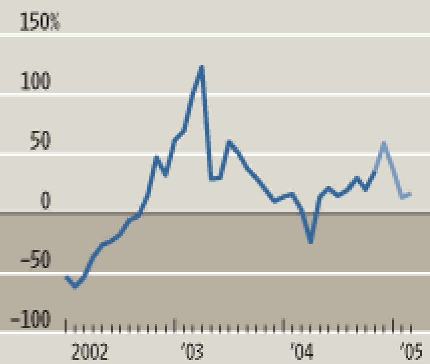
In the U.S., the Federal Reserve yesterday said the rise in energy prices "has not notably fed through to core consumer prices" as it raised the federal funds rate a quarter point to 2.75% for the seventh time since June. The rate is charged on overnight loans between banks. But the Fed did warn[2] of growing pressures on inflation. And the Labor Department said higher energy and food prices fueled a 0.4% jump in producer prices last month.

The price of oil futures, meanwhile, closed down $1.43, or 2.5%, at $56.03 a barrel on the New York Mercantile Exchange, off the all-time peak of $57.60 hit last Thursday. In inflation-adjusted terms, oil prices remain well below where they were in the 1970s and 1980s.

Around the globe, rising oil prices are percolating in myriad ways. Airlines are suffering, for instance, but the direct impact on cargo carriers is more severe, because they often fly bigger, four-engine planes, travel longer routes and stay in the air more hours. Still, intense competition among passenger carriers has forced airlines to absorb more of the cost of increased fuel, while carriers have passed costs on to customers.

The Oil Effect

Inflation for crude-energy materials, based on producer-price index, seasonally adjusted



Note: November 2004–February 2005 data are preliminary

Source: Labor Department

Meanwhile, the prices of materials derived from oil, including plastic and synthetic rubber, also are going up, affecting computers, packaging and car tires. Even military tents have been hit. Seaman Corp., which buys petroleum-based coatings for industrial fabrics used among other things for tents the U.S. military sends to Iraq, saw a double-digit price jump in oil-derived raw materials just before Christmas. It recently was told to expect another wave of increases within 90 days. The closely held Wooster, Ohio, company has passed part of the increase on to its customers, but also has seen its profit margins squeezed.

In the U.S. farm sector, some economists expect profit to drop about 20% this year from last year's record high of $74 billion, in part because soaring energy costs are raising prices on everything from fuel and fertilizer to weed killer.

In Iowa, corn farmers are paying 20% more to fertilize their fields this spring with anhydrous ammonia, a nitrogen-rich chemical made from natural gas. Prices for natural gas, used broadly in manufacturing, chemicals and power generation, have tracked oil's rise and are near their historic highs. Meanwhile, makers of many pesticides, which use petroleum-derived compounds, are trying to pass along higher costs with retail price boosts this spring of 3% to 5%.

The long-term effect of such changes is unclear. Ken Rogoff, a Harvard University economics professor and former chief economist for the International Monetary Fund, says a key difference between today and the oil crisis of the 1970s is the transformation of "inflation expectations." Three decades ago, higher oil prices quickly spiraled into wage and price inflation. Since then, central banks around the world have proven able to move quickly to stem inflationary pressures by tightening monetary policy.

"As long as everyone believes the world central banks will raise rates fast enough to anchor inflation expectations, oil won't matter," says Mr. Rogoff.

Still, some economists warn that if oil rises to a higher level and stays there, as some analysts predict, consumers could stop spending, curtailing economic growth. The scenario is that spending cuts would eat into employment, further damping consumer sentiment.

Moreover, companies face other sources of inflationary pressure besides oil and natural gas. Commodities of all types, particularly key metals such as copper, have soared recently, while a weaker U.S. dollar has exposed the U.S., China and other dollar-linked economies to import-price inflation.

Though consumers so far are absorbing higher gasoline prices at the pump, they are being hit in other ways. At a recent conference, Mattel Inc. Chairman and Chief Executive Robert Eckert told analysts and investors the toy maker was forced to take "a very modest price increase" of 2% to 4% in January on its products, including Barbie dolls, to partially offset what he sees as a long-term higher cost level for key materials and services linked to oil. Those include resin plastic, a petroleum-based product that is a universal component of Barbie and other toys, as well as transportation. Barbie dolls are made in China and Indonesia and distributed world-wide.

Rising oil also is boosting the cost of raw materials for diapers, pantiliners, Swiffer dusters and other consumer products made with petroleum-based fabrics. Polymer Group Inc., a producer of fabrics made from petroleum-based products, said on Friday that rising costs of polypropylene and other key petroleum-based raw materials have forced it to raise prices globally, including on all products sold in the U.S.

The North Charleston, S.C., company said the price of polypropylene climbed more than 50% in 2004 and has risen an additional 10% to 15% since December. Polyester prices also have risen 15% since January, the company said. Dennis Norman, a Polymer Group spokesman, declined to specify how large price increases will be and said they will vary by global region. The company operates 21 manufacturing facilities in 10 countries.

Polymer Group says its largest customer is Procter & Gamble Co. P&G declined to comment on whether the company would raise prices on its products using PGI material.

Similar effects are being felt outside the U.S. Europe was somewhat buffered from rising oil prices last year by the weakness of the dollar against the euro. That made oil imports less costly than they would have been otherwise. But a relatively stable exchange rate this year has meant Europe has felt the renewed rise of oil prices fully.

High oil prices were one factor that recently led Germany's BMW AG to warn its 2005 profit might not be quite as high as last year's record mark. The Munich-based luxury-car maker says it expects its 2005 results to be "approximately" at last year's level, suggesting they might be lower, even though the company foresees record sales volumes this year.

In China, costlier oil has rippled through the fast-growing manufacturing sector in the form of higher costs of plastic and other petroleum-based materials that are used to make everything from toys to pharmaceuticals to house paint. So far, manufacturers have managed to absorb much of these costs without prompting higher prices for consumers. Strong and rising demand around the globe for Chinese products means many companies are enjoying growth in their overall profits even as high oil prices diminish their profit margins.

But there are indications the situation could change if oil prices stay high. Paul Goodman, chairman and CEO of DFP Shoe Co., a maker of women's footwear in southern China, says that during much of last year, fierce competition prevented him from raising his shoe prices even as the cost of polyurethane and other inputs rose sharply with the price of oil.

In recent months, he said, he and his competitors have increased the amount they charge their buyers by about 5%. The increase is still smaller than the rise in production costs. "You can't just whack buyers over the head" with a big jump in price, he said. Still, he said, he anticipates shoe prices will continue to creep up if oil prices don't come down.

High oil prices are costing manufacturers in other ways. Chronic electricity shortages throughout China have led many factories to purchase generators that run on diesel fuel. China's electric grid becomes especially strained in the summer, when air conditioners are running across the country, and higher oil prices will mean higher diesel costs as the weather heats up.

Companies world-wide also are stepping up efforts to curb energy use in the face of higher prices. Kerry's Bromeliad Nursery Inc. in Homestead, Fla., one of the U.S.'s largest commercial orchid growers, has been hammered by the rising price of natural gas to heat its greenhouses as well as surcharges on shipping plants to big box retailers like Home Depot. The company recently put insulated shades in its greenhouses that can be closed at night to cut the heat loss, shaving more than 20% off its heating bills.

"When you're standing next to a three-inch gas main hissing loudly," said President Kerry Herndon, "you're listening to the sound of money burning."