

The Positive Side of Oil

A meaningful improvement in global inflation will undoubtedly be positive for the world economy.

Price action on the financial markets of late resembles a duck paddling in the water; at one level it appears as if nothing is happening but just beneath the surface a lot of particles are churning that may suggest the character of the market is indeed changing. While global equity prices have been virtually unchanged over the past month, the good news is that almost every trend which defined the first half of the year is reversing, thereby setting the stage for a possible end to the bear market conditions. Commodity prices have witnessed one of the sharpest declines in recent times while financial stocks are showing signs of resilience even in the face of all the dire news still emanating from that sector. Such a turnaround of these two sectors is necessary to ease the inflationary concerns affecting the system. The reversals in July have probably marked a major turning point in shaping the future of our economy.

To put it all in a long-term perspective, the price of oil over the past decade has risen by a magnitude similar to that of the U.S. economy between 1990 & 2000. By June this year, the relative performance of the energy sector had far surpassed the 1970s experience. The only other time one sector was able to pull so far away from the broader market was when IT stocks topped the table in early 2000.

There are fundamental reasons in play that suggest a new phase in oil and other commodities has begun. The third quarter of this year will probably mark the first time in the current scenario that oil consumption growth could turn negative on a global basis. Oil demand in 'Organization for Economic Co-operation and Development' (OECD) countries is now reducing at the rate of 3% on a year-on-year basis. With the OECD still accounting for more than 50% of global

demand, even if emerging market demand continues to grow at a pace of more than 3%, it will not prevent overall oil consumption from declining. Furthermore, there's growing evidence to suggest that China is joining the economic slowdown and global industrial production growth could slip to below 2% by year-end.

Changes in demand patterns of oil tend to be very long lasting. As history has shown, the price of a commodity reverts to its marginal cost of production once demand for it turns negative. In the case of oil, the price of its marginal cost of production is around \$80 a barrel. The \$80 level also marks the point where the oil prices went into a spiral last November and started to destabilize global equities.



A new phase in oil has begun



The price of oil over the past decade has risen in similar magnitude to that of the US economy between 1990 and 2000

Of course, there are certain view-points which suggest that focusing on demand patterns is misleading as the real problem is that crude supply of oil is struggling to grow. While there is some merit in that argument, given the rapid depletion of existing oil fields and limited spare capacity, the most important point to remember is that whenever oil demand has turned negative, it has always led to a bear market regardless of the supply situation. Even in the 1970s, the big price spike in 1973 due to geopolitical tensions resulted in oil demand turning negative the following year and a subsequent cooling off in oil prices.

It takes a while for major trend reversals to become apparent and this process is a complex process. The U.S. economy in 2000 declined sharply from its high point in March that year but there were so many comeback attempts that even as late as September the index was only 10% below its all time high. However,

by the end of the year the NASDAQ had halved in value and the phenomenon of ever rising prices truly showed itself. Similarly, it's possible that after hitting the point of demand peak, oil could be back at its marginal cost of production of \$80 a barrel by the end of this year. However, the journey to that point could be volatile with many countertrend rallies.

While oil tends to grab the headlines, a much less discussed but even more significant development with regard to the inflation outlook in India is the recent behaviour of agricultural commodities. Prices of several commodities from wheat to rice are down by over 30% from the high point in March-April this year. What this means is that just as hysteria was building on how the world is running out of food, it seems a massive supply response was on its way that has now led to a sharp decline in agricultural prices.

Based on these trends, it may be likely that inflation is close to rolling over globally. The base effects could become favourable in the future as the commodity price surge began in August last year. And if commodity prices continue on their downward trajectory, a lot of the current inflation effect could dissipate by the end of the year.

Currently, commodity prices are falling due to rising concerns that global growth is slowing with emerging markets too putting on the brakes in their expansion plans. This begs the obvious question of whether equity markets will be able to rally in the face of a slowing global economy. Historically, stock prices almost always move ahead of the turning point in the economic and earnings cycles. At previous inflection points in global equity markets, stocks often rallied six months before analysts were done with the downgrading process. Valuation measures such as the price-to-earnings or P/E ratios are very sensitive to changes in inflation and interest rates; they usually expand first in anticipation of a better economic outlook and earnings growth follows.

If inflation does indeed prove to be just a food and energy problem and does not lead to a price-wage spiral then the relevant template for the current emerging market boom would be US market behaviour in the late '80s and early '90s.

The US enjoyed a secular bull market from 1982-99 where the market compounded at an average annual rate of 18%. However, this upward trend was punctuated by some sharp corrections including an oil price spike and a credit crisis-induced bear market in 1990. A surge in oil prices following the first Gulf War pulled US inflation up from just below 4% in 1989 to 6% by the end of 1990. The economy faced a mild recession and the recovery was moderate with the economy expanding below trend in 1991 and 1992. However, once inflation peaked and their Government contemplated cutting interest rates, the

market rallied strongly even in the face of weak economic news.

Similarly, emerging markets could rally into this year-end as inflation fears recede on the back of declining commodity prices. Given the inflation concerns, bad news on growth may well turn out to be good news for markets.



Oil prices could come closer to their marginal cost of production

One up on 'Oil Street'



Is the sky-high price of oil only temporary? Yes. Will oil prices stay high for a while? Yes.

That's not as contradictory as it sounds. All it's saying is that the present very high world price of oil is the product of two sets of factors: short term and long term.

The short-term factors should be temporary, allowing the price to fall back to a more reasonable price over the next year. But the long-term factors could be longer lasting, preventing the price falling to anything like the level it was at just two years ago.

The reason behind the rise

The price of oil has risen because global demand for oil has been growing faster than global supply.

Over the past two years, the world economy has grown quite strongly, causing the demand for oil to increase by 5.5 per cent. The rapid industrialisation of China accounts for almost a third of this increase,

with other developing countries in Asia accounting for another slice.

Global supply capacity has been expanding, too, but not at the same rate. New oilfields are being developed, but they're not as big as new fields used to be, and they generally involve oil that's harder - and thus more expensive - to get at.

Also, the Organisation of Petroleum Exporting Countries (OPEC) is currently producing at very close to its capacity and, in any case, now accounts for less than 40 per cent of global supply, down from more than half in the mid-1970s.

So that's the basic long-term story. Even with China joining the economic slowdown, further expansion of its economy will keep pressure on oil demand, with oil consumption per person likely to rise significantly from current low levels as Chinese incomes rise.

On top of these longer-term developments, however, there's been considerable anxiety about the potential for short-term disruptions to supply.

The restoration of Iraqi oil production, for instance, has been limited by the dilapidated infrastructure and constant interruptions to supply caused by sabotage. Terrorist activity in Saudi Arabia, the world's largest oil exporter, has led to market concerns over the security of its oil supply.

Russia has become a major oil exporter, but the largest Russian oil company is facing bankruptcy because of unpaid taxes. And to that one can add political tensions in Nigeria and Venezuela and hurricanes in the Gulf of Mexico.

All these anxieties seem to have caused the market to add a significant "risk premium" to the world price. This means, speculators in the market seem to be pushing the price higher than it needs to go. This is the familiar characteristic of asset and commodity markets, where price rise lead to more price rise until the longer-term market fundamentals reassert themselves.

So that's the reason for expecting the price eventually to come down a little, but perhaps not as near as it was not too long ago.

The impact of the rise

But what does the present sky-high price of oil mean for the world economy?

For the answer to that question, one needs to look at just how sky-high is the price actually. In nominal terms, it's the highest on record. In real terms, however, it's about the same as it was after the first OPEC oil shock in late 1973, but still way below what it got to following the second OPEC shock in late 1979 - \$US100 a barrel in today's dollars.

But there are four reasons the latest price increase isn't likely to do nearly as much damage.

1. We've gained a lot more experience with price volatility and there's much wider use of hedging instruments to dampen its effects.
2. Economic activity is much less dependent on oil than it was 30 years ago. The 'energy intensity' of world output - measured as barrels of oil consumed per \$1 billion of real GDP - has declined by almost half.
3. Inflation expectations in the industrial economies are a lot lower and more stable today than they were then. This means one-off increases in the price of oil are less likely to provoke compensating pay rises and thus add to the wage-price spiral. That, in turn, means there's less need for central banks to hit the monetary brakes.
4. Most importantly, the latest price rise is qualitatively different. They're the product of strongly growing world demand as well as supply shocks, whereas in 1973 and 1979 the price hikes were the result of purely supply-side shocks.

A supply-side shock is much worse than a demand-side shock because, for net oil-importing countries, the former is inflationary and contractionary at the same time. That is, it lifts the price of petrol and other fuels while it cuts people's real incomes and thus consumer spending.

So it makes the central bank raise interest rates and lower them at the same time. If the bankers raise rates to control inflation, they invite a recession, whereas if they lower rates to fight recession, they get a lasting inflation problem. Such does not seem to be the



Demand for oil has increased by 5.5% over the last two years



problem this time over. Central banks have not been displaying schizophrenic tendencies whatsoever.

A demand-side shock, on the other hand, is much easier to handle. It will lead to a rise in the price level but, since it comes at a time when demand is strong, its subtraction from demand should hardly precipitate recession. Therefore, the jump in the oil price is a comparatively small negative for aggregate demand (with the size of the loss to a particular economy varying according to its degree of dependence on oil and the extent to which it's a net importer) and will push up the consumer price index to a large degree.

The result of the rise

The central theme of this decade's bull market in crude is little different from previous oil shocks: a change in expectations about future supplies. In other words, many think we have enough oil today but might not tomorrow.

A series of largely man-made disruptions has fed that fear. In countries such as Russia and Mexico, resource nationalism has stifled investment in supply. Violence in Nigeria and Iraq has shut down fields.

The Energy Policy Research Foundation estimates the world's lost output of up to 4.5 million barrels a day is the equivalent of twice the world's effective spare capacity.

Whether the problems are below or above the ground, the result is the same: fewer barrels available. The distinction, however, is important. When oil prices are rising, producers have an incentive to keep markets tight.

But, eventually, expensive oil encourages conservation, new investment and the search for alternatives.

Russia and Mexico, for example, are taking steps to reduce oil taxes or attract foreign companies, respectively, to address stagnant or falling output.

The same point extends to the demand side. In the US, high oil prices prompt drivers to buy more fuel-efficient cars.

Meanwhile, even if Asia's drivers are becoming richer, they will never reach America's current per capita usage of oil.

Also, high oil prices will also improve the competitiveness of renewable sources of energy and make it more interesting to focus on energy efficiency (as you have seen in the last issue of INTELLECT).

First of all, there is a decreasing demand in Europe and North America where people are becoming much more conscious of petrol prices.

Secondly, the Governments and people all over the world have started looking even more for alternatives.

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New oil fields are being developed around the world

Thirdly, the following macro-policies are also being considered to help ease the pressure of the current high prices:

- ▶▶▶ Urban Policies that promote the switch from cars to efficient public transport
 - London-style (congestion charge cum improving public transport),

- Singapore-style (impossibly high taxes on cars, fantastic public transport),
- Paris-style fun initiatives like 'Velib' bicycle policies)

▶▶▶ Energy Policies that allow alternative energy providers to flourish (for example, better competition in energy markets allow more initiatives)

▶▶▶ Research and R&D Policies to find new energy-efficient and greener technologies

▶▶▶ Tax Policies (penalizing emitters)

That's the bottom line for the world economy: the current excessively high oil prices could be a very good thing. While it may not manifest itself in the short run, the silver lining here is that there is more demand than supply. It will force us to find solutions so that the demand cycle is sustained and value creation remains uninterrupted. All in all, the current oil hikes will only provide a boost for the world economy to continue to head on the path of progression.



A worker inside an oil rig