Oil and the Tenuous Global Balance

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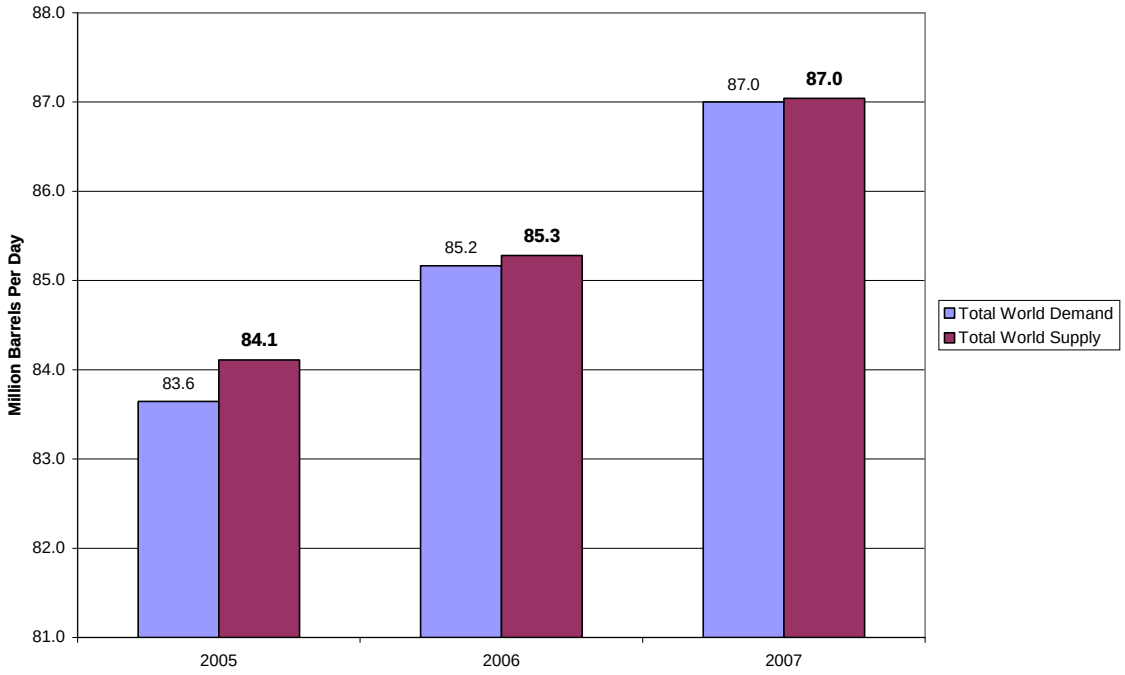
High and rising levels of oil prices have been around long enough to give cause for concern. As measured by the price of West Texas Intermediate crude, that level reached $75 to the barrel on April 21, 2006 and has remained above the $70 level since. Spot prices of Brent Crude have risen by more than 40 per over the year ending April 21. This has changed one feature of the oil price scenario during much of the last decade: that high nominal prices conceal the fact that the real price of oil is far lower than that which prevailed during the 1970s. As Chart 1 shows, measured by the Consume Price Index-deflated refiner acquisition cost of imported Saudi Light in the US, in the years since January 1974, the recent peak real price of oil was exceeded only during a brief period between July 1979 and February 1983. And signs are that if current trends persist, oil producers may regain the real price they garnered at the end of the 1979-81 shock.

Chart 1: Inflation Adjusted (CPI-U) Refiner Acquisition Cost of Imported Crude Oil in the US

Underlying the buoyancy in prices is the closing gap between global petroleum demand and supply (Chart 2) at a time when the spare capacity held by Saudi Arabia is more or less fully utilised.

Chart 2: Global Petroleum Demand and Supply



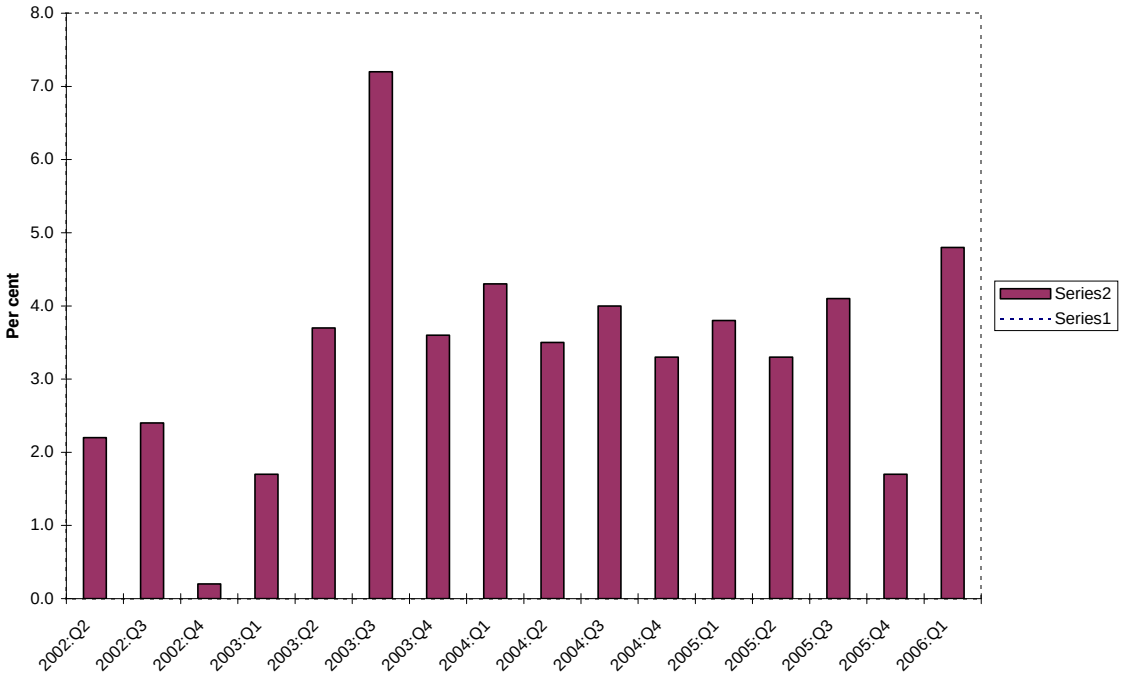
Global demand is estimated to rise by 1.6 million barrels per day in 2006 relative to 2005. Nearly a third of that growth is expected to come from China. This trend, combined with the uncertainty in West Asia resulting from the occupation of Iraq and the stand off in Iran over the nuclear issue, had created a situation where any destabilising influence—such as political uncertainty in Nigeria, the battle for control of Yukos in Russia, civil strife in Venezuela or fears of the impact of periodic hurricanes in the Gulf of Mexico—triggered a sharp rise in prices. According to reports, the energy consulting firm Cambridge Energy Research Associates estimates that output in Iraq is 900,000 barrels a day below pre-occupation levels; that in Nigeria is 530,000 barrels a day below normal; production in Venezuela is still 400,000 barrels below pre-strike performance; and the Gulf of Mexico remains short by 330,000 barrels a day—all adding up to a shortfall of more than two million barrels a day.

Exploiting these fundamentals, speculative forces have been keeping oil demand and prices high more recently. It is known that price trends in energy markets have substantially increased financial investor interest since 2004, resulting in speculative investments in the commodity. This has also affected the relative price of oil. According to the *New York Times* (April 29, 2006): "In the latest round of furious buying, hedge funds and other investors have helped propel crude oil prices from around $50 a barrel at the end of 2005 to a record of $75.17 on the New York Mercantile Exchange." According to that report, oil contracts held mostly by hedge funds rose above one billion barrels in April, twice the amount held five years ago. To this must be added trades outside official exchanges, such as over-the-counter trades conducted by oil companies, commercial oil brokers or funds held by investment banks. And price increases have also attracted new

investors such as pension funds and mutual funds seeking to diversify their holdings. While all this means that when price expectations change the outflow of hot money can drive oil prices sharply down, currently circumstances are in favour of a prolonged period of high oil prices.

This naturally has raised concerns about the possible impact of the phenomenon on global economic performance. The immediate area of focus is on the impact it would have on the tenuous and quirky global imbalance in which, despite a rising current account deficit on it balance of payments, capital keeps flowing into the US to finance that deficit. That capital flow, in turn, through its effects initially on stock values and subsequently on interest rates and the housing market, has increased the book value of the wealth held by Americans, encouraging them to indulge in a debt-financed spending spree. In the event, the US economy is growing at a remarkable (even if not healthy) rate. According to advanced estimates released by the Bureau of Economic Affairs on April 28th, US GDP grew by 4.8 per cent in the first quarter of 2006. This is not only better than the 3.8 and 4.3 per cent growth rates recorded in the corresponding quarter of the previous two years, but amounts to a remarkable turn around of the incipient deceleration in quarterly growth rates from 4.1 to 1.7 per cent between the third and fourth quarters of 2005. What is more, the quarterly GDP growth rate has been above 3.5 per cent in 9 out of the last 16 quarters (Chart 3). Not surprisingly, Ben Bernanke, the new governor of the US Federal Reserve, recently told the US Congress that though high energy prices were a cause for concern in themselves, "the prospects for maintaining economic growth at a solid pace in the period ahead appear good."

Chart 3: US Quarterly GDP Growth Rates



What could possibly explain this resilience of US economic growth despite the fact that the US is not insulated from the effects of rising oil prices. One factor, often offered as an explanation is the reduced dependence of the US on oil. As *The Economist* recently put it: "In 1980 America used a little over 17 million barrels per day (bpd) to produce GDP worth $5.2 trillion (in 2000 dollars). By last year oil consumption reached 20.7 million bpd, but GDP had more than doubled to $11.1 trillion. As for consumers, they are not especially dependent on petrol either. According to the BEA, in 1970, Americans spent 3.4 per cent of their consumer dollars on petrol and oil. By 1980 that rose to 5 per cent. Yet in 2005, after a year of steadily appreciating oil prices, that number was 3.3 per cent."

But this in itself is only a partial explanation, since it is not just direct US consumption of oil which is the issue. Rising oil prices shift the distribution of global surpluses, generating reduced current account surpluses or current account deficits in oil importing countries and large surpluses in the oil exporters. From the point of view of the US, the immediate impact would be a worsening of its already widening current account deficit. Between 2002 and 2005, the ratio of the current account deficit of the US to its GDP rose by 1.56 percentage points from 4.54 to 6.1 per cent. During that period the oil trade balance worsened by 0.92 percentage points of GDP, from 0.89 to 1.81 per cent. Thus oil did contribute significantly to the worsening of the current account deficit.

As is well known, the US depends on flows of capital from the rest of the world to finance its current account deficit. This process has been facilitated by the large current account surpluses that have characterised many countries, especially in Asia, including Japan, China, Taiwan and India. These countries, recording current account surpluses that reflect an excess of domestic savings over investment have invested these surpluses in dollar-denominated assets, especially US Treasury securities. The consequence of such flows have been two-fold: initially a boom or buoyancy in US stock markets, and subsequently a boom in the housing market because of the depressing effect on US interest rates that large capital inflows have had.

If increases in oil prices reduce these surpluses and reduce the confidence of investors from these countries in dollar-denominated assets, we should expect a slowing of capital flows into the US and a consequent unravelling of the tenuous global equilibrium that delivers high growth to the US. Thus, if US growth remains robust, driven still in large part by consumer spending, then it must be true that the above reversal of capital flows is not being realised.

Evidence collated by the recently released *World Economic Outlook* (April 2006) of the IMF suggests that this is indeed the case. Three factors according to the IMF have facilitated this. First, a sharp rise in the surpluses of the oil exporting countries that, as expected, compensated for any decline in surpluses elsewhere in the world. According to the IMF, oil-exporting countries' export revenues have increased significantly over the past two years, with OPEC revenues estimated at about $500 billion in 2005. Even during 2002-2004, well before the recent surge in oil prices, the cumulative current account balances of net fuel exporters, increased by close to 90 per cent from $415 billion to $782 billion. This trend would have only strengthened since.

What is noteworthy is that unlike in the case of the 1970s the savings which come from these increased surpluses have to be recycled ***to the US*** rather than ***through the US*** to oil importing developing countries. This is because, those countries for varied reasons, but especially a deflationary fiscal stance have been characterised by current account surpluses, whereas the US is characterised by current account deficits. This makes the recycling process, which could occur through two channels, much simpler. One would be increased global demand from the fuel exporters, which favours countries outside the US that are more competitive. This would further increase their current account surpluses which would then be invested in larger measure in the US, to finance the latter's deficit. The other would be, for savings to increase disproportionately in the fuel exporters, and the direct investment of these financial savings in US paper and banks deposits. On the surface it appears that deposits with the banks have been important, but this is partly because flows into US paper including Treasury Bills can occur through third country agents, such as those in London. Whatever be the route, the impact would be to continue to finance US deficits, to sustain thereby the US dollar and to keep interest rates depressed in the US, allowing for the continuation of the debt financed boom for the time being.

The losers would be the developing countries without surpluses on their current account. They would experience a worsening of their deficits that would have to be financed by high cost capital flows from the US and elsewhere. In the event they would have to reduce their demand for dollars, if they have to manage their balance of payments, by curtailing growth. In sum, once again the structure of the global economy, in which the US remains the global financial hub, seems to be working in a way that places the burden of the redistribution of global income in favour of one section of the developing world (the oil exporters) on other developing countries (the poorer oil importers), rather the developed countries.