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Oil prices approach previous highs – what this will do to the world economy and to financial markets

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1. In the January edition of the **Monthly Bulletin, the ECB has a box on the “Factors accounting for the rise in oil prices”** (pages 11-13) which gives some important insights into the dynamics of the oil market. The price of Brent, the benchmark for European consumers, has gone from \$30 a barrel in January 2004, two years ago, to an all-time high of \$67.5 in September 2005. This was followed by a 15% decline, but since mid-December prices have trended up again and are now at \$63.
2. The combination of a rapidly **growing world economy and capacity constraints in oil production and refining has put a floor under the oil price**. At some point, the oil price inflation itself will cause, or contribute to, a worldwide recession, followed by a price decline. As long as world economic growth remains in the order of 4 ½% per year, however, it is likely that the oil price will rise further and reach new record highs.
3. The ECB analysis shows that during the period from 1997 to mid-2004 the relationship between the quantity and the price of oil was significantly different from what it has been more recently. Previously, the regression line was much flatter: for each 2½ million extra barrels per day of supply or demand, the world market price of oil had risen by \$5; nowadays, an equally large increase of demand would push it up by \$21. In other words: **if tomorrow Iran should decide to withhold 2½ million barrels a day from world markets this would immediately raise the oil price to \$84** - demand and supply are not elastic in the near-term, and the adjustment has to come via the price mechanism.
4. **Assuming that oil consumption will continue to expand at a rate of 1 ½ million bpd and year, as it has over the past eight years, it would take less than 4 ½ years for the oil price to hit \$95 a barrel. So it does not actually need a political crisis to drive prices significantly higher**. Such a scenario is not as far-fetched as it seems because the world economy does not yet show signs of slowing down. Quite the opposite, the growth engine is firing on all cylinders: The euro area, the eternal laggard, has visibly gained momentum recently, Japan grows by almost 3% these days, China is still going strong, India is taking off, and America’s slower growth in Q4 has probably been a one-time event; the January employment numbers suggest a new acceleration of output growth is just around the corner.

5. **Imbalances are clearly getting bigger**, and with them the risk of a violent correction, but since the world's growth is supply driven, ie by high savings and investment and a growing labour force, rather than demand, the dynamic if precarious equilibrium may be sustainable for yet some time. Since inflation is well under control in such an environment, monetary policies will be only moderately restrictive and are thus unlikely to trigger a recession.
6. The demand for oil is not only strong because GDP growth is strong, it is also because **growth is driven by the demand for goods rather than services which distinguishes the present expansion of the world economy from earlier instances**. Large emerging economies play a dominant role today. Since they are only in the early stages of their catching-up process, their focus is still on consumer hardware, capital goods and infrastructure, all of which are energy and commodity intensive products.
7. The above has been an exercise in extrapolation which is usually synonymous with bad economics. **When demand for oil is as strong as I have assumed and prices are pushed up so high various market reactions can be expected**. Households will reduce their energy consumption by driving and heating less, firms will increase the energy efficiency of their production and distribution, there will also be a shift to non-oil energy sources whose relative prices become increasingly attractive, and there will be, last but not least, more exploration and drilling and generally more investment in the energy sector, all of which will have a moderating influence on the oil price.
8. Yet, as mentioned earlier, in the near-term neither the demand for oil nor the supply of oil are very elastic because it takes time to adjust to the new set of prices. **Especially on the production side there are constraints these days**. It has been a long time that a major oil field has been discovered, and several of the old ones in Saudi Arabia, Kuwait and Mexico have passed their depletion midpoints, as have America's. Russia, Nigeria or Venezuela are in no position to fill the gap. And new fields are typically smaller and more expensive to exploit. Investors are nevertheless paying premiums for oil exploration stocks these days. The bottom line is that **for the foreseeable future producers will remain in a very strong position and that the oil price will be on an upward trend. Oil price forecasts will be revised up significantly**.
9. What will these developments do to the world economy and to markets? Assuming everybody is paying \$63 a barrel and that output is 84mn barrels a day in 2006, the **total annual oil bill amounts to \$1,932bn, or to about 4 ½% of world GDP, up from less than 2% only two years ago**. An oil price increase to \$84 - say as a result of further tensions in the Middle East - is the equivalent of 1½% of world GDP and would thus be another major demand shock, coming on top of the one we are experiencing since early 2004.
10. The effects on the real economy can probably not be shrugged off so easily any more. Few of the oil producing countries can translate their additional revenues one to one into more imports from oil importing countries, ie from the OECD and the large emerging markets in Asia. They are so-called low absorbers. **The world savings rate can thus be expected to rise, and overall demand to slow down**.
11. **On balance a new rally of oil prices will have disinflationary effects even though in the first round headline inflation is likely to rise. Bond investors seem to see things the same way and are content with very low real yields – they do not follow the arguments of the**

Fed and the ECB that rising interest rates are the order of the day. Flatter, not steeper yield curves are probably ahead if oil prices continue to rise.

- 12.** In such a scenario, it would be surprising if those low risk premiums on **emerging market debt** can be maintained – except where the debtors are net oil exporters, such as Russia. **As to equities, a new round of oil price hikes means that the clear winners will be energy stocks, producers of energy saving equipment, including fuel efficient cars, and all stocks for which energy is not an important input.**