OIL: MYTHS REALITIES AND CONJECTURES

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What has made oil prices shoot up in the last three months and why don't I expect it to cross $75 and stay there? After all, Goldman Sachs made the call this past spring that oil will touch $105 by 2007. First let's investigate what made it climb to the same lofty perch as in the mid-1960's.

The Middle East gets most of its imports from the EU but has to earn its living in dollars. Thus, because of the weak dollar, the purchasing power maintenance can explain the move from $25 to $40 at best. The rest is still a challenge. One can throw in the usual suspects—hurricane-related crude production disruptions in the Gulf of Mexico, a terror premium, bottlenecks in transportation capacity—but they will explain only part of the froth in the market, say the move from $55 to $65 a barrel. We still need to explain the move from $40 to $55. Hence, I decided to check the most prevalent thesis in the media that CHINDIA—the combination of the Indian consumer and the Chinese producer—is causing this pressure on limited global supplies.

Table A shows production and consumption of oil by major producers and consumers around the world. The first few columns display production of oil in 2000 and 2004 for the countries listed, and the net change in production over this time period. Similarly, the next three columns show consumption and net change. An interesting thing is that the US, the UK and VIN (Venezuela, Indonesia and Norway) all decreased production for a total

Table A

Who Can We Blame for High Oil Prices?

	Production (P)			Consumption (C)			NET *Change* in Supply
	2000	2004	DP	2000	2004	DC	(DP – DC)
US	7.73	7.24	-0.49	19.70	20.52	0.82	-1.31
Canada	2.72	3.09	0.36	1.94	2.21	0.27	0.10
Mexico	3.45	3.82	0.37	1.88	1.90	0.01	0.36
Japan	NA	NA	NA	5.58	5.29	-0.29	0.29
UK	2.67	2.03	-0.64	1.70	1.76	0.05	-0.69
China	3.25	3.49	0.24	4.99	6.68	1.70	-1.46
India	0.78	0.82	0.04	2.25	2.56	0.30	-0.26
Russia	6.54	9.29	2.75	2.47	2.57	0.10	2.65
Middle East	23.38	24.57	1.19	4.60	5.29	0.69	0.51
Africa	7.86	9.26	1.41	2.46	2.65	0.19	1.22
VIN*	8.13	7.29	-0.84	1.75	1.94	0.19	-1.03

* VIN – Venezuela, Indonesia, Norway

Source: BP Statistical Review of World Energy, June 2005 of about 2 million barrels per day. But this shortfall seems to have been made up by increased pumping in Russia, OPEC and Africa. Hence, there doesn't appear to be an oil shortage per se. However, this is only part of the story. When one factors in the demand side, one notices that China and US are the two entities that have shown solid increases in consumption during this time. India seems to be somewhat behind by the absolute metric of change in demand (of course, not in percentage terms). The last column is labeled as *net change in supply*, i.e. change in production less change in consumption. This is a metric designed to capture the pressure a country's demand puts on the oil market's clearing price.

By this metric, both China and the US are fighting for new oil supplies coming from non-OPEC sources. Furthermore, given the realities of existing pipelines, shipment logistics and historical contract relationships, excess oil from Russia and

Africa flows more easily to the US and Europe than to China. Thus, when China goes about looking for extra oil in the open market but can't find it from its historical OPEC suppliers, it is forced to bid higher on the spot market. This price signal is then interpreted as a "sustained" increase in demand by market participants who in turn bid up prices in the futures market for delivery three to six months down the road. Add to this mix the desire by US hedge funds to make a quick buck

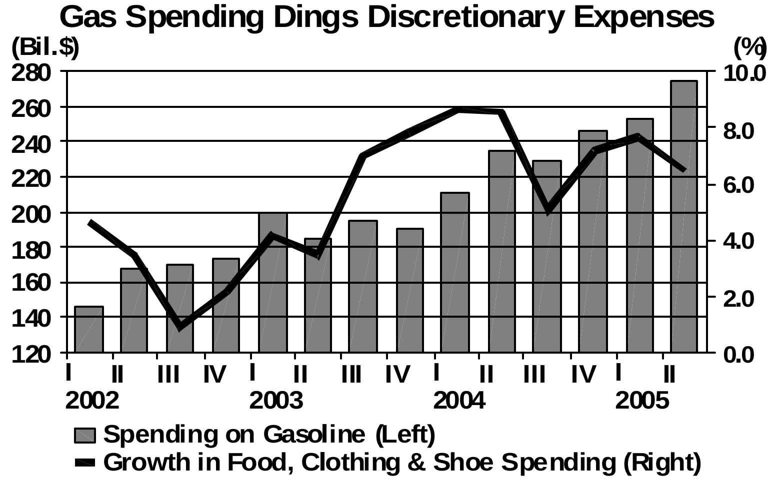
from speculation, and you can understand both the creep up in oil prices and the volatility of oil price futures. So how long will this schizophrenia last?

My view is that the oil market is ready for a correction. As China achieves its goal of orderly moderation in its runaway investment spending and our own Greenspan manages to cool the ardor of local home builders, the resultant drop in global demand will self-correct this problem. Trust me, a sustained $3 plus a gallon of gasoline at the pump will make even lead-foots like me drive conservatively. This force is very strong but it takes while to register. Mind you, car discounts only delay the inevitable. **Figure B**, meanwhile, shows that people's discretionary spending has already been affected by high oil prices. This graph charts gasoline spending by consumers in nominal terms from national income accounts. Since late 2002, of the extra $120 billion on gasoline spending that the consumer had to find to feed its oil habit, about 1/3rd has come out of spending for clothing, shoes and food. Recently, this category's growth acceleration has stopped in its tracks, as the graph clearly shows. The rest has come out of savings, drawing down home equity credit lines, less spending on recreation and the ongoing transfer of auto shareholder's wealth to the consumers via numerous discount schemes. Either way, people have been able to finance this habit much more easily here than I can say for Europe, where high gasoline taxes raise prices exponentially at the pump and crimp their consumption spending.

Now, let's not get the idea that higher fuel taxes will solve our problem and cause a quick correction in the market. High taxes at European levels would not only

Figure B

Gas Spending Dings Discretionary Expenses



lead to resentment (or a second revolution if ever implemented) but fill the coffers of local and state governments, who will fritter them away any which way they can. I remember in the heyday of the dot-com boom, the City of Santa Monica redid their perfectly good sidewalks as the city had the money budgeted for the work.

China's bid to buy UNOCAL got a lot of bad press for all the wrong reasons. The charge was that CNOOC was a front for the Chinese military, which is correct, but then again what major Chinese enterprise is not? The paranoid claimed that if China were to get their hands on precious oil supplies, it would allow them to hold the US hostage in the event of a future conflict between these two countries. This is sheer nonsense—but trust politicians to exploit this skewed point-of-view to the hilt for a few lousy anti-foreign votes. China needs a stable supply of oil to feed its voracious production machinery to supply goods that the West consumes. These poor guys are just watching out for their production ability like any capitalist company.

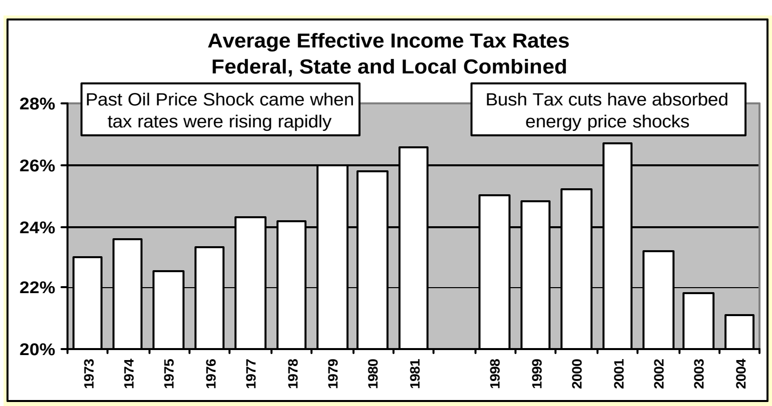
Did anybody even think that this motive will also make China more of a model state, one interested in global peace to ensure oil supplies? This line of thinking might be more productive than berating and threatening them for Taiwan at every opportunity. The Chinese have simply learnt from Japan's futile attempt at exploration to find domestic supplies after the OPEC oil-embargo in the 70's. If China is unable to buy existing oil companies due to political opposition in the US, it will go to the last frontier, which is Africa. Note also from table A that Africa has increased its net supply at a rapid pace over the last few years. Sudan, as its internal political fratricide abates, is pumping out almost half a million barrels of crude oil! Nigeria is ramping up its capacity and so are South Africa and Angola. This numerical fact explains my amazement when Bush stood with Blair and other G-8 leaders and pledged to increased financial aid to Africa. He gets unjust criticism for pandering to the Saudis whereas the new game in town is the African continent.

And let's not forget Russia. The West is chummy with Putin—Bush's soul mate—and the Chinese have swallowed their disgust at this neighbor's liberalization efforts and warmed up to them.

Another factor that helps consumers weather the current oil-storm is the break in mortgage payments over the last four years since the FED began their reflationary campaign. More importantly, inflation is not a problem this time as it was in the 70's. **Figure C** shows, courtesy of my mentor Prof. Larry Kimbell, effective tax rates in the 70's climbed sharply when inflation led to a bracket creep. This time, whether you liked them on not, Bush administration's tax cuts eased the oil-tax burden. Unfortunatley, no new tax cuts are on the horizon but neither is another fifty percent run up in the price of oil.

Figure C

But Tax Cuts Have Eased the Oil Price Shock this Time



Source: Prof. Larry J. Kimbell, November 2004