- Column -

Tea Leaves

| by Coby van der Linde

Coby van der Linde is head of the Clingendael International Energy Programme (CIEP)

Only a year ago, oil traded for $57-60 per barrel. Since then the price of oil has climbed spectacularly, reaching $100 per barrel on January 2, and continuing its upward trend to $111 per barrel in early March. In the week that American interest rates fell another 0.75% and the Federal Reserve pumped more liquidity in the financial system to fend off more banking difficulties, the oil price quickly fell back to $101, indicating that part of the recent price rally was driven by the financial market rather than oil fundamentals. Despite the optimistic demand outlook in Asia, the continuing bad news about the US economy and warnings that the European economy would not escape the effects of the credit crisis must take some air out of the oil price. It is typical that in the current international economic turmoil, logic came only in hindsight. From the $111 high, oil prices fell by 10% in the space of a few days. These extreme price movements are creating difficulties everywhere, both in the OPEC offices and in the capitals of major consuming countries. Stabilising the national economy in an environment of major uncertainty over commodity prices, inflation, exchange and interest rate movements is very difficult indeed. It requires not only the insights supplied by the economic models that most government employ, but also the skills of a tea leaf reader.

The turmoil in capital and primary resource markets of the recent months is turning into a rollercoaster of inflation, interest rate changes and currency movements. When the dust finally settles it will also have fundamentally changed the competitive balance among economies. Inflation in China, Europe and the US is on the rise and higher commodity prices certainly play a role here. In China, the government controls oil product prices and that is creating problems for oil companies forced to sell petrol and diesel below the international market price. The gap is already very wide and unless the government promises to bridge this gap, Chinese companies might be tempted to redirect oil flows away from China, creating more scarcity. In the absence of subsidies to the oil companies, relaxing price controls could further spur inflation and add to the already ominous social unrest over food prices. The Chinese economy is experiencing some serious stresses and strains because of its rapid development, but now also has to deal with international uncertainties. The optimism about China pulling the world economy out of its current rut could be a grave mistake. China has a lot on its plate already, including political challenges, and is now for the first time experiencing some of the downsides of international integration. The oil-producing countries have finally been able to fill their pot of gold. Prices have been rising since 2003. Inflation and the depreciation of the dollar have challenged the value of their new riches but until recently they managed to increase oil prices in real terms. This might be much more difficult to maintain if demand is tapering off. Opec's reluctance to increase production is due to uncertainty over demand developments. Many Opec countries do not want to repeat their error in the Asian crisis in 1998, when they increased production only to see price levels plummet. The recent cry for more investment in new production capacity to accommodate new demand from countries such as China and India also met with reluctance because the new generation of oil fields are more expensive. These rising costs reflect the more difficult terrain, the remoteness of new developments and cost inflation due to equipment and personnel. Before committing to these investments, the real oil price has to improve. In addition, a study by consulting firm PFC Energy shows the oil price needed to sustain the external balance of Opec countries is around $55 a barrel for most, but substantially higher for countries such as Venezuela and Nigeria. Moreover, it is likely that Opec will tighten oil production when the real oil price comes under more pressure, and begins to slip below the level at which they can maintain their external balance. Much will depend on the value of the dollar, international inflation and how international growth will fare. This pretty much completes the circle: the current international economic uncertainties feed off each other. We'd be better off reading tea leaves after all.