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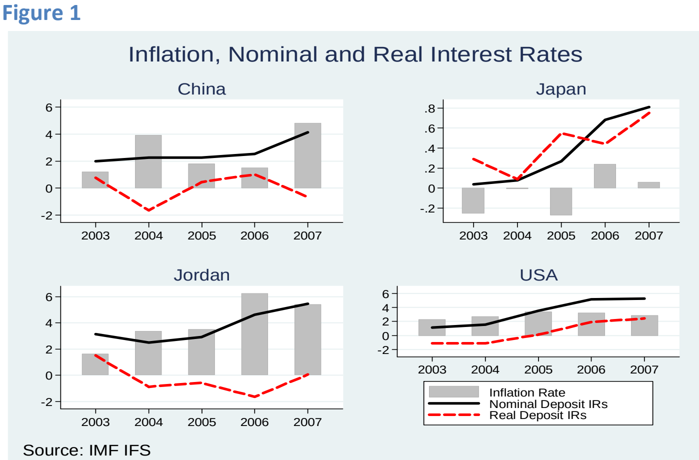
Oil Prices, Inflation and Real Interest Rates

Economic theory has it that oil and other commodity prices are inversely related to real interest rates[1]. That is; when real interest rates are low, commodity prices are high. Recall that real interest rates are simply nominal interest rates net of "expected" inflation (real interest rates=nominal interest rates- inflation). All else held constant, low real interest rates imply that it is better to keep the oil underground which would mean that the size of oil inventory becomes small, so oil supply will be relatively small and given demand, prices will be high. This simple analysis suggests that monetary policy plays a strong role in oil extraction. That is, when monetary policy is expansionary, interest rates would be low and inflation would be high causing real interest rates to nosedive & thereby reduce the incentives to extract oil and natural gas.

During the 1970's real interest rates were very low, close to zero due to the expansionary monetary policy that begot high inflation rates. Oil and commodity prices were also high during that decade. Now throughout the current period of high oil prices, real interest rates of many countries have been low too, less than one percent, Figure 1.

Figure 1



The problem, however, is that of causality: that is, if central banks pushed interest rates to higher levels, would that cause inflation to dissipate? Some analysts do not believe so. According to John Hussman, "if fed-controlled interest rates typically follow rather than lead, market determined interest rates, and they add little incremental power in explaining economic and market fluctuations once market forces are taken into account"[2] To illustrate, the recent actions by the Fed to cut interest rates in the face of financial crisis and in an effort to save Bear Sterns, despite its belief that inflationary pressures are building up illustrate the point.[3]

How about the role of oil fundamentals? Oil demand, particularly Asian demand, has been and is expected to remain strong. Currently global oil demand stands at some 87 million barrels per day but is expected to increase by another 30 million barrels per day (b/d) by 2030. The investment required to provide this petroleum could run to four trillion dollars or more[4]. Oil supply has been growing minutely however as mature oil fields in a number of OECD countries are experiencing steady output declines. As well, OPEC whose market share hovers around 40% of the total global supply has been producing at nearly maximum capacity levels[5]. Due to the implementations of sanctions against oil producers (Iran, Libya until recently) together with prolonged periods of sluggish investments in oil due to low oil prices during the 1980s and 1990s, new supplies are hard to come-by. There is evidence that with sluggish supply and rising demand that the oil peak theory might be perceived as "valid" thus reinforcing price pressures through speculation. Backstop technology is not anywhere in sight, including the role of bio-fuels and energy efficiency. On top of that, geopolitical tensions around the globe are putting a premium on prices as well.

Based on the above, a tight monetary policy that keeps inflation under control gives more incentive for oil suppliers to produce now rather than place a moratorium on the production of oil assets. However, speculation in the futures market could influence the future price of oil and hence affect the decision to produce as well. That is to say, if speculators push future prices to even higher levels in the short-term, producers might interpret this as signaling of sustained "permanent" future prices and hence decide to keep oil underground. While Saudi Arabia has announced it will increase production to cool off the market, the Shura Council is about to discuss a controversial proposal by a key member to curb oil production to serve reserves for better prices[6].

How Do Oil & Gas Dynamics Affect Our Region?

Profoundly! Aside from the oil & gas sectors, the sustained rise in oil prices buttress the so-called Dutch disease which has been proven to decelerate long-term economic growth, especially through reducing the productivity incentives. They also put tremendous pressures on governments to spend and follow expansionary fiscal policies. Investment is irreversible, once committed; investments have to be pushed forward. If oil prices were to decline because of an unexpected breakthrough technology or new discoveries, while project costs have already have increased, that would reduce the economic merits (returns) of these large-scale investments.

Our region has been involved in petro-dollar recycling for the third time in its modern history[7]. The recycled funds, together with

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[1] Frenkel, J. (2006): "The effect of monetary policy on real commodity prices" NBER, December.

[2] Hussman J.P (2008) "The Fed Policy Rate: Regret-Minimax" *Hussman Funds* June 9.

[3] Hussman, Op.cit.

[4] Rice Institute (2008):"The Global Energy Market: Comprehensive strategies to meet geopolitical and financial risks"

[5] CERI Commodity Report-Crude Oil, May 2008.

[6] *Econobrowser* June 8, 2008.

[7] Higgins M., Klitgaard T. and Lerman R. (2006) "Recycling Petrodollars" *Current Affairs in Economics and Finance, Federal Reserve Bank of New York,* Vol. 12 No 9, December.

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those from China and Japan, by way of purchase of US T-bills, are helping to prevent further deterioration in the U.S. trade balance and in the process helped support the dollar and prevented harsher declines in its relative value against other currencies.

Our region has been involved in petro-dollar recycling for the third time in its modern history[8]. The recycled funds, together with those from China and Japan, by way of purchase of US T-bills, are helping to prevent further deterioration in the U.S. trade balance and in the process helped support the dollar and prevented harsher declines in its relative value against other currencies.

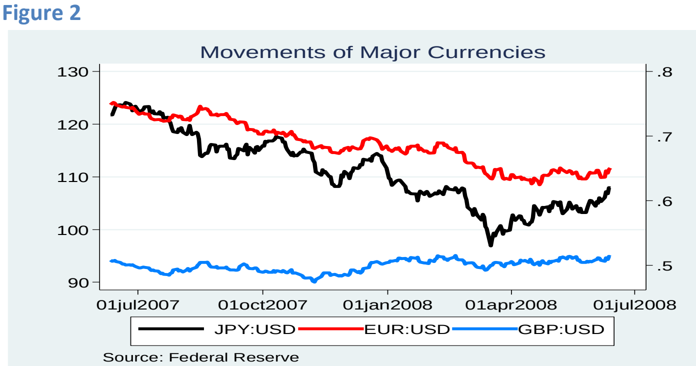
As well, rising commodity prices have increased inflation and production costs. We noted in an earlier issue how Saudi Arabia, seeks to ensure adequate grain supplies through outsourcing; i.e. growing grain in Taiwan and other countries. Contractors find it increasingly difficult to implement projects and often request additional financing from banks. With the greenback on the sliding scale and dollar-denominated loans out-of favor, until recently anyways, the costs of loans (bps) have risen in GCC countries[9]. If interest rates rise, as a way to help the greenback recover and/or to fight inflationary pressures, the costs of funds would accordingly rise.

At a somewhat luxury level, as the summer season approaches and tourist from the GCC countries head towards the UK and Euro zone countries, they will find it increasingly expensive to switch local currency into the Euro or GBP. If demand is completely inelastic, outside tourism will cost more and cause larger fund leakages outside the region, especially that aviation (flight) costs are likely to rise as well.

Global Developments[10]

The US Federal Reserve's chairman's statement that US economic fears are fading along with the anticipation of a vote on Euro reform caused the dollar to record its biggest weekly gain against the Euro in three years.

Figure 2



After last week's rise, oil prices dropped on news that Saudi Arabia is stepping up production to near record levels at 10 million barrels per day. The high energy and food prices are leading investors, once again, to return to gold as an inflation hedge.

Table 1 Selected Commodities

	Week ending 6/8/2008	Week ending 6/15/2008	Change
Oil WTI ($/bbl)	138.55	**134.87**	(2.66%)
Gold ($/oz)	890.50	**866**	(2.75%)
Natural Gas	12.715	**12.500**	(1.69%)

Source: WSJ

Markets in the US and Europe recorded small losses over the week despite rising on Fridays. On the other hand, markets in Japan tumbled hard over inflation fears with corporate goods prices rising at their fastest pace in 27 years[11]. In our region, active trading in the ASE boosted the index to new records above the 10000 mark.

Table 2 Selected Market Indices,

Index	Week ending 6/8/2008	Week ending 6/15/2008	Change
Jordan	9851	**10590**	7.50%
KSA	9,661.48	**9,688.45**	0.28%
Morocco	14,546.34	**14,399.63**	(1.00%)
S&P500	1,360.68	**1,360.03**	(0.05%)
NIKKEI	14,489.44	**13,973.73**	(3.56%)
FTSE100	5,906.80	**5,802.80**	(1.76%)

Sources: Bloomberg and Official Markets

DID YOU KNOW?

- Scientists at the Los Alamos National Laboratory in New Mexico have built and tested a new computer cluster called the IBM Roadrunner that is the first to achieve a petaflop of sustained performance. "Flop" is an acronym meaning floating-point operations, or mathematical calculations, per second. One petaflop is equal to 1,000 trillion calculations per second. To put the computer's speed in perspective, it has roughly the computing power of 100,000 of today's most powerful laptops stacked 1.5 miles high, according to IBM. The cost: $100 million [USDE web page June 9 2008].
- Today more than 20 states, own sovereign wealth funds with total assets that are estimated to range between $13.7Tr according to Standard Chartered and $17.5Tr according to Morgan Stanley [AB Corporate Communications based on Aljarida, June 13/14 08).
- Sustainable oil prices have helped Algeria, which produces oil and gas, to grow robustly in recent years. Investments are on the rise, with at least $20bn worth of contracts on the horizon. International banks are keen to get involved [MEED May 23, 2008].

INFORMATION

AB Weekly Economic Monitor provides weekly review of information and regional development. The weekly is authored by Dr.Sulayman Al-Qudsi, Chief Economist, AB Plc. Jordan

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[8] Higgins M., Klitgaard T. and Lerman R. (2006) "Recycling Petrodollars" *Current Affairs in Economics and Finance, Federal Reserve Bank of New York,* Vol. 12 No 9, December.

[9] MEED 5 June 2008.

[10] Reuters and Bloomberg

[11] Financial Times