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Buttonwood

Crude arguments

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Markets should worry about the surging oil price

NERVES, it is clear, are becoming increasingly frayed in financial markets. In general, the riskier and more generously valued the market, the edgier investors are. They are increasingly fearful about political stability around the world, following the bombings in Madrid, yet more tension in the Middle East and a disputed election in Taiwan. Perhaps even more concerning are worries about the sustainability of global growth. Goldman Sachs now thinks that the world economy will grow by 3.8% this year, not the 4.6% it had originally forecast. The main reason for this sharp reduction is the sustained rise in the price of a commodity long dismissed by most economists as having little impact on mature economies: oil.

That the rise in the oil price might be more than a temporary blip is best illustrated by the price of oil for future delivery. When the spot price of crude (that is, oil for immediate delivery) spiked in the past, notably on the eve of both Gulf wars, the forward price rose only slightly, mainly because the market expected the interruption to be short-lived. This time, not only is the oil price rising, but the forward price is going up sharply, too. On March 18th, the recent high, when West Texas crude rose to $37.93 a barrel, the price for delivery a year hence rose to $32.51, its highest ever.

Last week, the spot price of crude rose to its highest level (in nominal terms) since 1990. The proximate cause was an announcement in February by OPEC, the producers' cartel, that it would cut production by 1m barrels a day from the beginning of next month. But other factors are at work, too. There have been supply problems both within and without OPEC. Some of these problems are likely to be temporary, but then analysts have been saying this for months.

OPEC's desire to force the oil price up is almost certainly linked to the falling dollar. All crude is priced in dollars, and exports are thus worth a lot less because the dollar has plunged. Many think that this is one reason why OPEC is happy to see the oil price remain higher than its self-imposed band of $22-28. Possibly, too, Arab-dominated OPEC is rather less enthused by America's war in the Middle East than George Bush.

If oil supplies have been tight, demand has been expanding briskly, and in China—where else?—it has been growing at a breathtaking pace. China's rapidly growing economy will account for 40% of the 1.65m-barrels-a-day increase in demand expected this year by the International Energy Agency, according to David Fyfe, one of its analysts. Last year, China overtook Japan as the second-largest consumer of oil after America.

Many argue that the latest jump in oil prices is far more modest than it was in the two oil shocks of the 1970s. In real terms—that is, adjusted for inflation—the price is still a lot lower than it was then. Rich countries are, moreover, far less dependent on oil than they were, because they have become more efficient at making things, and anyway make fewer of them. And the rise in the oil price, as measured in anything other than the beleaguered dollar, has been comparatively trifling. All true, but Buttonwood can't help feeling nonetheless that many pundits have cried sheep once too often.

In Asia—whose economies are far more dependent on oil for growth than America's—there are, for a start, the risks of higher inflation, or lower growth, or both. Goldman Sachs thinks that Asian growth will bear the brunt of the oil-price rise. Since the region accounted for half of world growth last year (measured on the basis of purchasing-power parity), this is disturbing. To those who have been wondering what ill effects might come from Asian countries' attempts to hold down their currencies against the dollar, the rise in the dollar price of oil—and, indeed, of just about every other commodity—provides an answer.

China is already on the verge of overheating. But inflationary pressures are mounting elsewhere in the region. If companies do not or cannot pass on the rise in their input costs to consumers, they will either have to cut costs by sacking people (not a policy that finds much favour in China) or accept lower profits.

The effect of the rising oil price on America could be even more disturbing. America may be more efficient than it was, but it is far

from immune to higher prices. For consumers, the recent sharp rise in petrol prices—which hit an all-time high this week—is, in effect, an increased tax burden. And it comes just as the effects of Mr Bush's (official) tax cuts start to wear off.

But there is an indirect effect on consumption, too. Costs are rising for companies as the price of oil and other commodities goes up. In the past, this would have been inflationary: companies simply passed these higher costs on to consumers. But as Stephen King, the chief economist at HSBC, points out, that link seems to have gone, perhaps because of excess capacity at home, or because China's increasing presence in world trade pushes the prices of manufactured goods and labour down. As a result, wholesale prices have been rising much faster than the price at which companies are able to sell their wares.

To stop profits from falling, American companies must keep a tight lid on labour costs. As Mr King puts it, shareholders have been benefiting at the expense of those who work for them (though not CEOs, of course). A prolonged rise in the price of oil and other commodities would make this problem still more acute: America's jobless recovery is likely to stay jobless. This would eventually kill the recovery, since consumers in fear of their jobs are unlikely to carry on splurging.

Goldman Sachs now thinks the American economy will grow by only 2.75% (on an annual basis) in the second half of this year and the first half of next—a forecast it has revised down by three-quarters of a percentage point. It might, Buttonwood thinks, even turn out lower than that. Slower economic growth in turn bodes ill for stockmarkets and corporate-bond markets. And if markets tumble, consumer confidence will surely follow. The rise in the oil price, in other words, may leave nerves not so much frayed as in tatters.

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