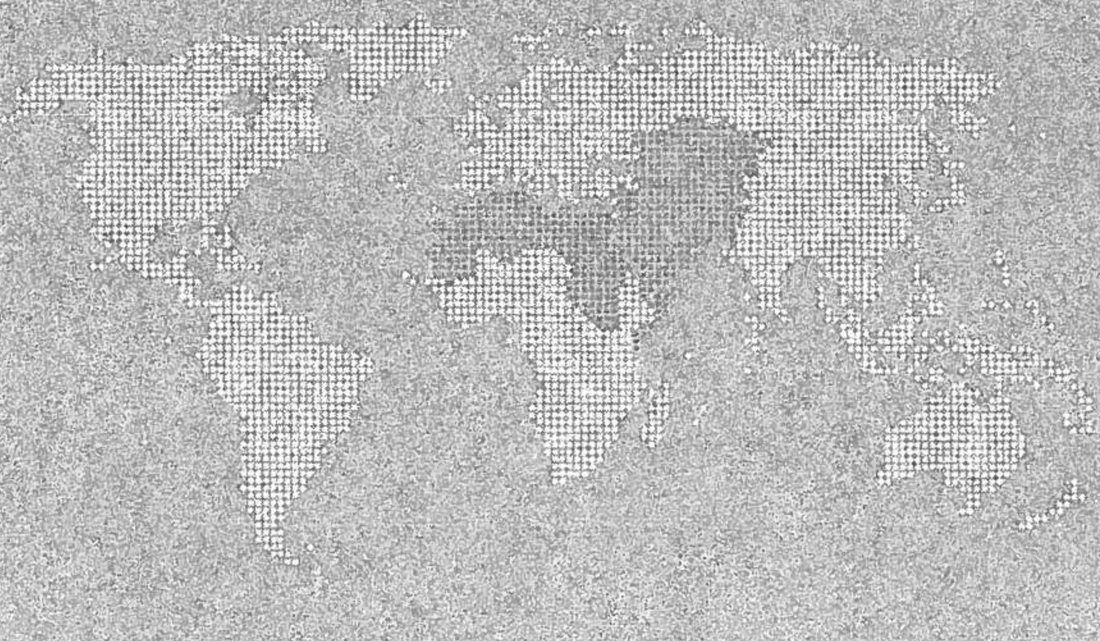
World Economic and Financial Surveys

Regional Economic Outlook

Middle East and Central Asia

MAY 08

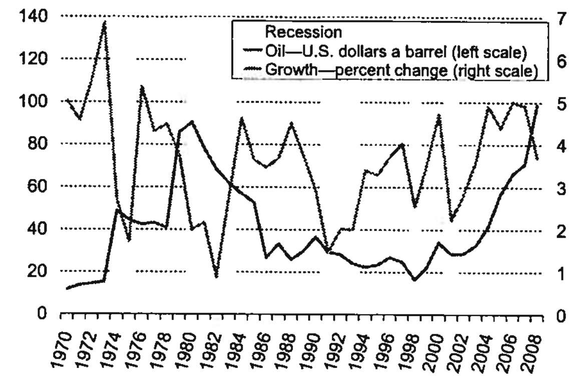


INTERNATIONAL MONETARY FUND

Box 7. Oil Prices: Fundamentals or Speculation?

Oil prices have continued to break records in 2008 (at over US$100 a barrel, and reaching a historical high of US$119 a barrel on April 22), even while it is widely believed that the U.S. economy is sliding into recession. At these levels, are oil prices being driven by fundamentals or by speculation?

Figure B7.1. Real Oil Prices and World Growth



Sources: Data provided by country authorities; and IMF staff calculations.

Since 1970 there have been five global recessions (with world economic growth falling to about 2½ percent a year or less). The first two (1974–75 and 1980–82) were associated with large prior hikes in oil prices (reflecting supply shocks). As Figure B7.1 shows, real oil prices did not immediately fall when the recessions began.[1] Oil prices remained quite firm one year into each of the recessions, and did not fall significantly until world economic growth had clearly recovered. By contrast, the following three recessions (1991–93, 1998, and 2001) were associated with declines in real oil prices at the outset (although these declines were not particularly large). Why the difference? It is possible that the Organization of Petroleum Exporting Countries (OPEC) had greater market control in the 1970s than it did during the 1990s. As a result, it was easier to prevent falls in oil prices (as demand weakened) in the 1970s than it was in the 1990s.

This observed pattern suggests that it would take a global recession to bring about a major decline in oil prices. Currently, the IMF is projecting a decline in world growth to 3.7 percent, which means that oil prices should not be expected to fall sharply if they are being driven solely by economic growth ("fundamentals"). Even if the world does go into a recession, history suggests that the effect on oil prices could be lagged, depending on how much discipline OPEC is able to exert.

It is hard to explain current oil prices in terms of fundamentals alone. The recent surge in the oil price (from US$80 to over US$100 a barrel) seems to go well beyond what would be indicated by the growth of the world economy. Producers and many analysts say it is speculative activity that is pushing up oil prices now. Producers in particular argue that fundamentals would yield an oil price of about US$80 a barrel, with the rest being the result of speculative activity.

It is difficult to get a direct measure of speculative activity. It is true that open positions in oil futures more than doubled in size over 2003–07. Net long noncommercial positions at the New York Mercantile Exchange briefly reached new highs in mid-2007, after which they declined. Yet prices have stayed high even as these speculative positions were unwound. Moreover, there is evidence that changes in net long noncommercial positions generally follow price changes rather than lead them. So this line of reasoning would imply that speculation is not the cause of recent increases in oil prices.[2]

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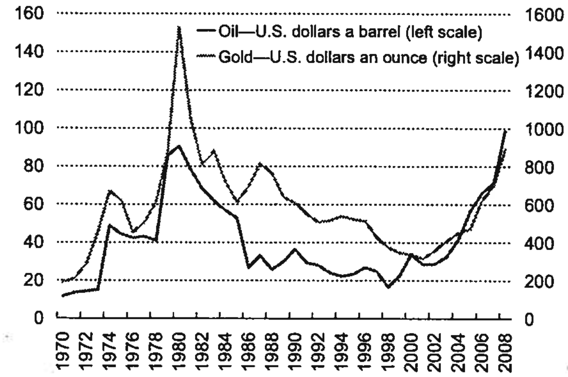
[1]Real oil prices are defined as the nominal price deflated by the U.S. consumer price index (CPI).

[2]It should be noted that the distinction between commercial and noncommercial positions in oil futures is difficult to make. Total positions may be a better indicator of speculative activity.

Box 7 *(concluded)*

Another way to get a sense of speculative activity is to compare movements in the real price of oil with the real price of gold. This relationship has been surprisingly close for a long period of time (Figure B7.2). Gold is well known to be a highly speculative commodity, driven by factors other than derived demand. One could reasonably argue that this relationship, which has continued in 2008, is evidence of speculative behavior in oil. If the oil price does fall significantly in the near term, it may reflect more the unwinding of speculative positions in both gold and oil than indicate that a recession is under way.

Figure B7.2. Oil and Gold Prices Deflated by U.S. CPI
(Base year = 2007)



Source: IMF, *World Economic Outlook*.

In summary, it appears that speculation has played a significant role in the run-up in oil prices as the U.S. dollar has weakened and investors have looked for a hedge in oil futures (and gold). As financial market conditions settle down, fundamentals should take over and oil prices should come down further from the highs recently observed. How far they will come down will depend on how the world economy is doing, and if history is to be a guide, they will come down slowly. ■

recession. Growth in emerging markets and developing countries is projected to slow to 6.7 percent from 7.9 percent in 2007, reflecting efforts to prevent overheating in some countries as well as trade spillovers and some moderation in commodity prices. Inflation is expected to remain high in the first half of 2008, but should decline gradually thereafter, as commodity prices stabilize and slack in some countries emerges.

Risks to the baseline projection, however, are significantly to the downside, with the greatest risk coming from the still-unfolding events in financial markets and their potential impact on global activity. The recession in the United States could be more severe if the correction in housing prices and ensuing deterioration of households' net worth are more pronounced.

There is also a risk that the credit crunch might intensify, as both engines of credit creation—the banking system and the securities markets—are being impaired at the same time. Similar housing price corrections in other countries in Europe, although likely to be less pronounced, could also weigh down global growth. Continued inflationary pressures also pose downside risks as they may constrain policymakers' room for maneuver. Emerging market economies would be affected more substantially if the advanced economies were to experience a major downturn or if the rise in sovereign spreads and the retreat in equity markets were to intensify. Emerging markets that rely on short-term cross-border borrowing to finance large current account deficits are also more vulnerable to persistent turbulence in financial markets. ■