

Oil prices over US\$100 a barrel! Is it the final nail in the U.S. economy's coffin?

Despite the expected U.S. economic slowdown, oil prices have continued to defy gravity. Tuesday, crude jumped US\$4.50 a barrel, crossing the US\$100 mark (Graph 1).

Graph 1 – Oil prices back above US\$100 a barrel



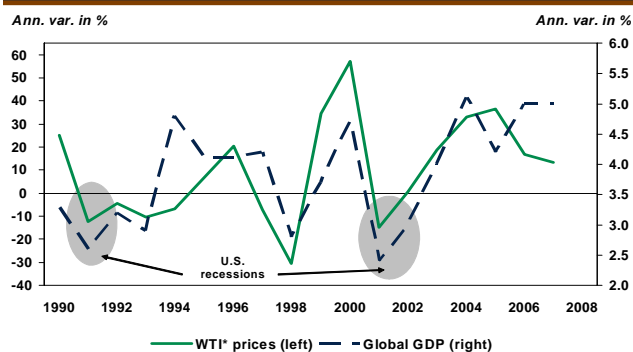
Sources: Datastream and Desjardins, Economic Studies

In and of itself, oil's move to US\$100/barrel is not enough to cause the U.S. economy to slow sharply.¹ Skyrocketing oil prices since 2002 primarily reflect the substantial increase in global demand over the last few years (Graph 2). But, with several shocks already in place (property price correction, subprime crisis, liquidity crunch and tightening credit conditions), oil's steadily elevated prices are not reassuring in the least. For one thing, this is an additional factor that could tip the U.S. economy into a recession. The real estate and stock market wealth losses incurred in the last few months are weighing heavily on households' purchasing decisions; the increase in gas and heating oil prices means that another piece of the household wallet is being chopped off. It is also an additional cost for businesses. For another, it

¹ For further details, see *Economic Viewpoint* of January 3, 2008, "Oil at US\$100: worrisome but not disastrous".

could throw a monkey wrench into inflation expectations and disrupt the work of the monetary authorities. The markets reacted immediately, with 10-year bond rates reaching 3.90%, a rise of nearly 0.5 % since the January 22 low.

Graph 2 – Higher crude price reflect robust global demand



* West Texas Intermediate.

Sources: Datastream, International Monetary Fund and Desjardins, Economic Studies

Oil has shot up by almost US\$13 a barrel in the last few weeks, mainly due to fears surrounding the global oil supply, technical factors, and an increase in "speculative demand".

The Venezuelan government's threat to cut oil shipments to the United States and the possibility that OPEC (Organization of Petroleum Exporting Countries) could decide to reduce production quotas at its March meeting gave oil prices their initial push last week. This week, the temporary (as long as six months) closing of a Texas refinery due to a fire, and signs that the conflict between Nigeria's government and the rebels could get worse helped oil cross the US\$100/barrel mark.

All in all, supply concerns appear exaggerated, and are not really enough to justify the recent increase in crude prices. The threat that OPEC will cut quotas is not very credible, unless crude prices plummet back toward US\$90. Some OPEC

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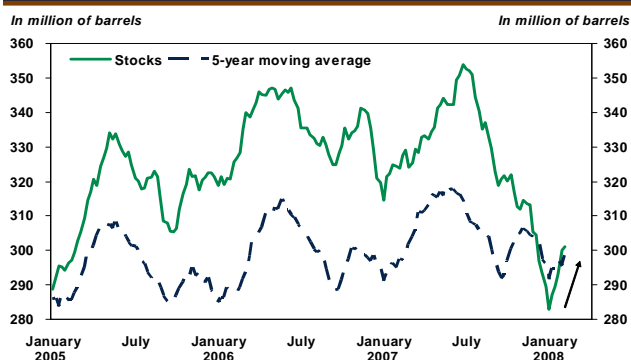
NOTE TO READERS: The letters **k**, **M** and **B** are used in texts and tables to refer to thousands, millions and billions respectively.

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sources have already intimated that, at the moment, the most logical decision would be to keep quotas unchanged. Venezuela's government has also changed its position. Only Exxon Mobil, which is demanding compensation for the loss of its operations in Venezuela, is under threat of losing its access to the country's oil. A temporary problem with a refinery should not have a major impact on crude prices, either, especially as U.S. gasoline inventories are very high. Lastly, the news from Nigeria is a little more worrisome, but markets had already been expecting numerous problems in this very unstable country.

The increase is especially surprising as the fundamental factors that usually influence oil prices have been evolving in the direction of a price decrease in the last few weeks. Clear signs of slowing by the global economy and the risks of recession in the United States have made most international organizations revise their growth outlooks for oil demand downward for 2008. This should translate into a better balance between supply and demand for oil in the next few months, and an increase in inventories. Signs of this can already be seen. After tumbling in the second half of 2008, U.S. crude inventories have shot up since the year began (Graph 3). Weekly statistics (to be published on Thursday instead of Wednesday this week because of President's Day) should show further sizeable increases in U.S. inventories. The stocks of all OECD (Organisation for Economic Co-operation and Development) countries also jumped markedly in January, indicating that global demand is beginning to slow.

Graph 3 – U.S. crude inventories are rising again

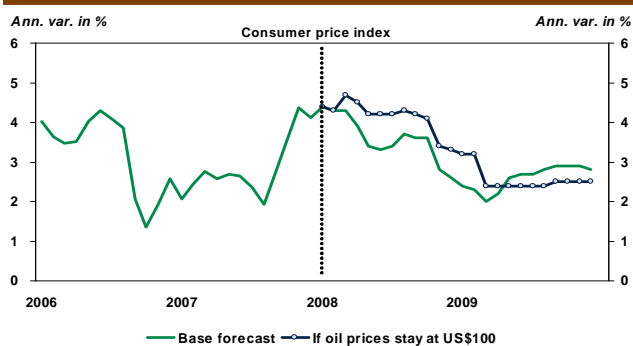


Sources: Energy Information Administration and Desjardins, Economic Studies

In our opinion, the current increase is primarily speculative, with investors wanting to arm themselves against an acceleration in inflation or further U.S. dollar depreciation defying the fundamental factors and increasing their positions in oil. Technical factors, especially the closure of a number of short positions and the expiry of the March futures contract, could also have magnified the price increase.

While further volatility can be expected in these uncertain times, a gradual descent around US\$85, a value more in line with the economic fundamentals, should be anticipated. If prices stay close to \$100 throughout 2008, our estimate for total U.S. inflation would go up by about 0.5 of a percentage point (Graph 4). Our forecasts, however, are looking for a gradual slide by inflation towards 2.0% by the second half of 2008. Under these circumstances, inflation expectations will stay well anchored and the U.S. Federal Reserve will be able to keep its focus on kick-starting the U.S. economy.

Graph 4 – U.S. inflation should slow during the rest of 2008



Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

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