We took stock of the oil issue on May 28, presenting those elements that were likely to feed the price upsurge of crude oil and its potential effects on the US and Canadian economies. Since then, the price of oil has skyrocketed and nearly reached US$50 a barrel during the week of August 16. There are some new elements that must be taken into consideration and it has become necessary to revisit the subject to update the current situation in order to better evaluate the repercussions on the North American economy and financial markets.

Limited supply faces stronger than forecast demand

At this time, we have a better grasp of the world oil supply and demand for 2004 and 2005. In May, we knew that demand had grown significantly compared to the previous year. However, an analysis of the data since January indicates acceleration in demand (mainly in China and the US) that has been even more rapid than we formerly expected. In such a context, the fears of inadequate supply—already present in the spring—reared their heads again over the summer. While the oil supply adequately covers current needs, it is the fear of a breakdown in supply that is feeding the price hikes.

Any event liable to impair oil production, export or refining becomes a source of concern and feeds the fear of being short of oil. At present, these fears are winning out over reason. It’s a little as though a price were being assigned to each possibility of a breakdown in the supply chain and that the sum of these prices is being reflected in the price of crude oil. In a market such as the oil market, the links in the chain are many, which multiplies the sources of nervousness and speculation.

The security of the supply is put into question

To the already tight supply/demand balance, the violence in the Near East (Palestine-Israel) and the tensions that existed before now in the Middle East (since the conflict with Iraq) have been added other sources of concern. The issue of the security of installations in Saudi Arabia (the world’s No. 1 producer, with Russia on its heels) has been questioned since attacks were carried out on foreign workers in June. The active resistance of armed Iraqi groups to the American troops in place and to the new government has been manifested by acts of sabotage on oil installations (production sites, pipelines). In that country, production has been reduced from 1.8M b/d (barrels per day) in April to around 1M b/d during a few weeks in August. But the production has been on the rise for some days.

The epic surrounding the Russian company Yukos also has repercussions on the market. The Russian government is threatening to seize its largest oilfield in Siberia (1M b/d) for non-payment of income tax arrears. The situation does not seem to be on the point of being resolved and in its turn is generating a great deal of tension.

The political instability in Venezuela (No. 3 world producer), which showed up in questions as to the legitimacy of the head of the government, Hugo Chavez, has helped to feed concerns over oil supply. When Chavez’ leadership was contested in 2002, production was cut in half for several weeks and took a long time before getting back to normal.

The problem of supply rigidity

That said, Saudi Arabia’s excess capacity (1.3M b/d) might only become available in several months. In some cases, it would be necessary to re-open certain installations. Even if Russia were to decide to put more crude oil on the market, it remains limited by its transportation infrastructures, primarily by pipeline.
To this morass of uncertainty is added the rise in super tanker rates. The retirement from service of single-hull oil tankers makes things especially complicated. The current overcapacity in Asian shipyards is not allowing them to deliver new ships rapidly. This is creating a bottleneck for delivery of oil and refined products but, above all, limits the possibilities for transporting additional quantities as demand rises.

Last, the forecasts of the IEA (International Energy Agency), an authority on the subject, present an even tighter picture of the balance between world oil supply and demand. The estimate is whipping up negative expectations of a shortage of oil. Furthermore, it holds the view that winter will begin early in the Northern Hemisphere and will generate an additional demand for energy.

**Price, the measure of tension**

On the topic of price, WTI (Western Texas Intermediate) moved from US$35.15 per barrel in January to US$40.27 in May, then to US$38.04 in June and nearly reached US$50 on August 20. How far could it go? The US$50 mark that seemed like a far-off dream in May has nearly been reached. Could it hit US$60 per barrel? That is not impossible, although it would be short-lived given that at that price demand would start to fall off and the pressure on prices would have the same effect. This morning, WTI closed at $43.50 per barrel.

What do the next few months hold in store? Current conditions are likely not to change rapidly, which is why prices will remain high (around $40 and above) for some time. Among all of the possible scenarios, it seems that the most likely is that of a barrel of oil fluctuating around US$45 (WTI) in the third quarter and closer to US$40 in the fourth quarter. These assumptions are based on the gradual resumption of production at some of the installations in Iraq in the fourth quarter of 2004, a slight increase in the production of non OPEC member countries, a rise in production of at least 300,000 b/d in Saudi Arabia and a smooth settlement to the standoff between Yukos and the Russian government (no stoppage in production or exports). This prognosis presumes a slowdown in the pace of the US and Chinese economies compared to the sustained rhythm of the first half of the year. The moderate slowdown in both countries, the planet’s biggest consumers, is not, however, attributable exclusively to energy prices.

There is no cause for alarm for the time being. If we express oil prices from 1970 to the present on a fixed basis, say 2004 dollars, we see that the situation is not as catastrophic as it appears at first glance. The price of a barrel of oil is still far from the levels reached during the oil crises of the end of the 70s and beginning of the 80s. Remember that the developed economies were plunged into a severe recession at the time. In 1991, the price of oil also reached a high during the war in the Persian Gulf. Combined with other factors, this upsurge in the price of oil contributed to the economic difficulties in the United States at the beginning of the 90s. Not only is the current price of oil still very far from these highs, but the economies of the industrialized countries are less and less dependent on oil, which reduces their vulnerability to ups and downs in oil prices.

**What can we expect over the next few months?**

Insofar as there are no major economic upheavals and fears of attacks do not materialize, prices should remain high from now until the end of the year given the existing conditions. While it is dangerous to make statements about the price of oil, it seems to us reasonable to believe that oil prices will fall within a range of US$40 to US$50, with some possible forays above that mark. In light of the
information available now, prices could play on average around US$34 to US$38 next year.

**The effect on the US and Canadian economies**

While historically it remains relatively moderate, the rise in the price of oil risks upsetting US economic activity. Already, real GDP advanced less than its growth potential in the spring and the recent economic difficulties such as the weakness of real consumption in the second quarter and the decline in consumer confidence have been in part caused by the concerns raised by the hikes in the price of oil and, into the summer, of the price of gas at the pump. Paradoxically, in spite of the skyrocketing of the price of a barrel of crude oil, gas prices have declined slightly from their highs of the beginning of July. This lag between price variations has given the economy a bit of a break. But, if gas rises toward relatively higher levels than what Americans are finding at the pump today, the economic effect of the rise in the price of oil will be much more harmful. A hike in the price of gas acts like a growth tax on GDP growth and each penny more paid for a gallon of gas takes about US$1.4 billion out of consumers’ pockets.

Most of the economic simulations dealing with the effect of a marked increase in the price of oil on the growth of real US GDP show that an increase of 50% in the price of oil compared to a base scenario (around US$45 instead of US$30) would contribute to weaker real GDP growth by about 0.5% to 1.0%. As our scenarios forecast a decrease of about 20% in the price per barrel starting in the fall and in 2005, the economic effect could be less marked. But, for the second quarter of 2004, real GDP growth would drop from an average growth of 3.8% to growth of 3.4%. Our estimate of real GDP growth for 2005 would decline from 3.8% to 3.5%. Of course, the price of oil is not the only factor influencing the forecasts, but they do nonetheless play a leading role in the decline of growth levels compared to the economic scenarios published earlier this summer.

It is clear that the rise in the price of oil, especially if it manifests as an increase in the price of gas, will have direct consequences for total inflation in the United States. Even if energy accounts for only 7.1% of the Consumer Price Index (CPI), the significant fluctuation in energy costs directly affect the development of total CPI. On the other hand, compared to the situation in the 70s and 80s, the advance in the price of oil has very little effect on the price variation of non-energy goods since the US economy is proportionately less energy-consuming than 20 or 30 years ago. This means that the recent hike in the price of oil should not have too many repercussions on core inflation, which excludes food and energy, and inflationary pressure should remain relatively modest. US core inflation should advance by nearly 2% over the next few quarters.

In Canada, just like the American situation, the recent skyrocketing of crude oil prices has not yet begun to have an effect on energy retail prices. For example, the price of gas declined 3.5% last July. The price of a barrel of crude oil, however, rose by about 15% during the same month. Since the advance in crude oil prices continued to the upside for a good part of August, the upswing in prices on international markets will probably make itself felt in the next few months in consumer prices. So, we should expect a potential spike in the total Consumer Price Index. But this hike should be short-lived, meaning the time needed to absorb the sharp growth of the last few weeks. In these circumstances, we should look closely at developments in underlying inflation (CPIX), which excludes the most volatile elements such as gas. That said, we should expect the annual variation in underlying inflation to remain more or less stable over the next few months, at around 2%.

The sharp increase in oil prices will probably more likely be felt by Canadian consumers. Since gas and the other energy goods are quite inelastic in the short run (meaning that price variations do not have much of an effect on demand), the upswing in prices equates with a reduction in the disposable income of Canadians. So, we may be concerned about a slowdown in the pace of consumer spending. Canada might feel a twofold rather than a single effect from this phenomenon as US demand could also be reined in by the decrease in the disposable income of American households and our exports would then experience the negative effects.
On a different front, Canada is a petroleum producer and a net exporter of petroleum products. The sharp increase in oil prices, combined with the growth in world demand, is therefore beneficial for Canadian oil companies. Bottom line, the effects on the Canadian economy of an increase in oil prices are for that reason less harmful than we might imagine. According to a study by Canada’s Finance Department, an increase of $1 in the real price causes a 0.05% decline in real GDP after four quarters and 0.1% after eight quarters. Since the price of crude oil has increased by about CAN$10 in real terms since the spring, growth of Canadian real GDP could be reduced by nearly 0.5% over the next few quarters.

Impact on financial markets

The pressures caused by the skyrocketing of the price of oil on the economy and inflation in North America should encourage the US Federal Reserve and the Bank of Canada to exercise caution over the coming months. It seems clear to us that the effect of the rise in energy prices will be seen by the continent’s central banks as a growth risk rather than a risk leading to an uncontrollable rise in inflation. Weaker economic growth inevitably brings with it a lag between the progression of economic activity and the full use of its potential, thus reducing the pressure that strong demand might bring to bear on core inflation. For that reason, the Federal Reserve might opt to take a break in raising federal funds rates. Similarly, the Bank of Canada will exercise patience before starting to increase its key rates.

As far as the bond market is concerned, rates should continue—in the short run—to move within the range observed for the last few weeks. The uncertainties related to the price of crude oil and the outlook for a slower pace for the economy of our neighbours to the south are making stakeholders pessimistic. On the other hand, we still believe that on a horizon of several quarters, bond rates will be between 1% and 1.5%—depending on maturity—higher than current rates.

The current marked weakness in stock prices will also be a short-lived phenomenon. While the forecasted advance still remains modest for the next few quarters (between 5% and 8%, depending on the indices), the stock market should perform better once the uncertainties have slacked off and the fears of a prolonged pause in the US economy have faded.