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## ECONOMIC NEWS UPDATE

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David O'Reilly has made a big bet -- big not only by Las Vegas standards, but by the standards of the swashbuckling oil industry. The Chevron CEO bet more than \$18 billion that oil supplies will be tight and prices will stay high when he bought Unocal, after the Chinese authorities yielded to political pressure and withdrew CNOOC's higher, competing bid. He is betting that the fabulously successful boss of Exxon Mobil, Lee Raymond, is wrong to be optimistic about the future growth of world oil supplies. In O'Reilly's corner are some experts who say that we have discovered just about all of the big fields that exist; in Raymond's corner is the International Energy Agency, which reminds us that demand might slow and prices drop.

Little wonder that my colleague on The Sunday Times, David Smith, says this is "a nervy time for the global oil market." One reason is that economists can make informed guesses about the future demand for oil, and experts can make equally good (or bad) guesses about supply prospects, but no one can accurately appraise the risks of supply interruptions. It is those risks that

are adding a risk premium of indeterminate amount to the current price of oil.

Start with Saudi Arabia, a country in which a medieval regime sits on the world's largest oil reserves. Authorities in Washington at one time calculated that there was a 50:50 chance that the regime would survive the next ten years. They have now shortened that probable survival period to five years. The Saudis say they have stamped out the domestic terrorists who went on a bombing rampage, but they would say that, wouldn't they? A country in which the unemployment rate among young men is 25%, real income per capita has fallen by somewhere between one-half and two-thirds in the past decade, thousands of profligate princes keep the budget in chronic deficit, dissent means an extended visit to an unpleasant prison, and Wahabbi preachers favor Bin Laden's brand of Islam is hardly a risk-free supplier.

Then there is Venezuela, every bit as important a source of oil imports for the US as Saudi Arabia. Its president, Hugo Chávez, is spouting a particularly virulent form of anti-

Americanism: he calls us the most evil empire in the history of the world and is preparing to repel an invasion that he imagines -- or says he imagines -- President Bush is preparing to mount from his ranch in Crawford. He is using his oil revenues to fund Fidel Castro's regime in Cuba and narcoterrorists in Colombia, and is attempting to divert supplies from the US to China and his Latin American neighbors. Worse still, he has stuffed the national oil company with political cronies, with the inevitable result of massive inefficiencies that have kept Venezuelan production below potential levels.

Add problems in other important sources of oil. Russia has stifled much-needed investment in its industry by confiscating Yukos and jailing its executives. Iran is heading towards a confrontation with the EU and the US that might result in sanctions -- if the EU acts on its threats -- that will inhibit its ability to produce and sell oil. Iraq remains in turmoil, unable to protect its pipelines and other routes needed to get even its terror-restricted output to market.

Possible political- or terror-induced disruptions to the smooth flow of crude to market are not the only source of worry. Underinvestment in the infrastructure has left refineries short of capacity, and increased reliance on production from platforms far offshore makes production vulnerable to hurricanes, as BP found when its drilling platform, 150 miles offshore in the Gulf of Mexico, tipped under the force of hurricane Dennis

In the face of these uncertainties, our politicians have demonstrated an unwillingness to develop policies to reduce the nation's massive dependence on imported oil, preferring

instead to pass an energy bill that is long on gifts to a variety of special interests, but short on any measures that will reduce gasoline consumption.

All in all, not a pretty picture. And one that Federal Reserve Board chairman Alan Greenspan has very much in mind as he shapes US monetary policy. Greenspan knows that despite high oil prices, consumers have been disinclined to abandon the malls or the auto showrooms. He knows, too, that business investment is picking up: business outlays for equipment rose by 11% in the last quarter. So, despite high oil and petrol prices, the Goldilocks economy seems to be getting a bit too hot for the comfort of a central banker.

Until now, most analysts were pleased that the growing economy and high oil prices had not triggered inflation. But revisions to the price measure most relied on by the Fed now show that inflation last year was higher than the 1.6% originally reported. It was, instead, 2.2%, a bit above Greenspan's ideal, primarily because prices in the service sector are rising at an annual rate of around 3%. Unlike manufactured goods (apparel, autos), services (haircuts, dry cleaning) are not subject to international competition.

So as Greenspan prepares to exit the scene, he sees an economy that is growing rapidly, a labor market that is tightening, an intractable trade deficit and a dollar that is weakening, house prices that are in his view "frothy" in some areas, and fiscal policy that is loose and getting looser. He also faces his now-famous "conundrum" -- the failure of long-term interest rates to keep pace with the increases he has mandated in short-term rates.

So he will want to continue raising interest rates, not only to the

“neutral” level that neither heats nor cools the economy, but to a level that will actually cool things down. But high oil prices make it more difficult to decide just what to do, since they can act as a drag on economic growth as well as a source of inflationary pressure. That’s called stagflation -- not the legacy that Greenspan cares to leave as he gives up life at the Fed.

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## **THE SUNDAY TIMES**

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