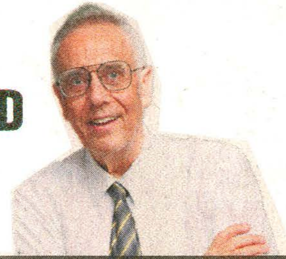
Publication: The Sunday Times, p C18
Date: 11 January 2015
Headline: Making sense of the oil economy

THE LAST WORD



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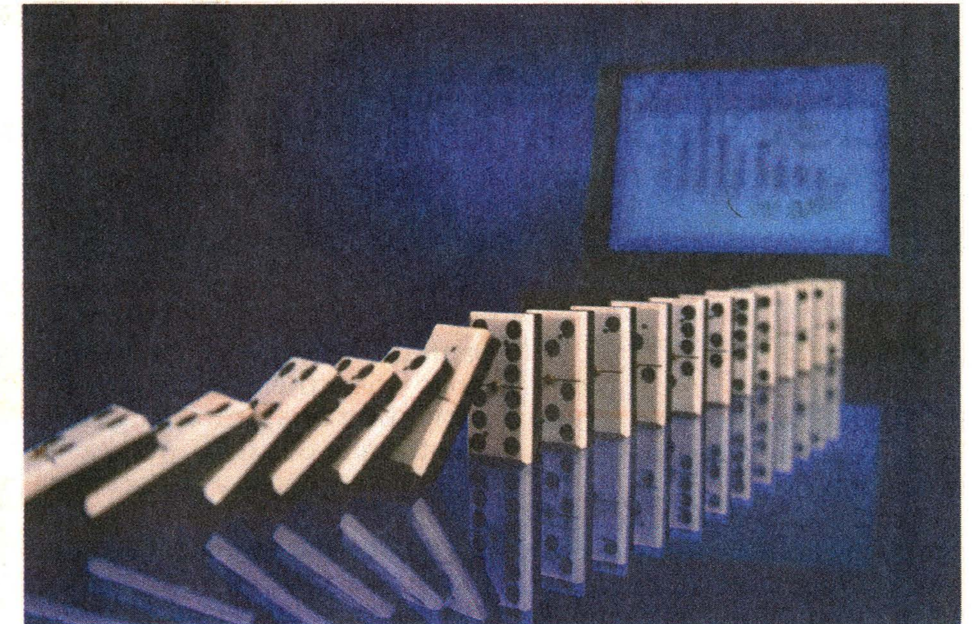
Making sense of the oil economy



WE have only just started the year and have already seen a year's worth of excitement, mostly because of lower oil prices.

What should we do now? For me, I changed our family's asset allocation from 100 per cent cash to 100 per cent stocks. Being in 100 per cent cash was foolish in the first place. I don't know why I did that. Don't you do it!

Now that I'm back in stocks, I hope to stay put for a few generations. As such, there is no need to follow rules about holding a certain percentage of safe assets based on age, since all fluctuations even out in the long run.

Oil makes life exciting

When it comes to oil prices, we have never seen anything like this: From over $100 to under $50 per barrel in only six months.

According to the authoritative US Energy Information Administration, the world uses about 92.3 million barrels of oil per day but it pumps more, around 92.8 million barrels. Half a million barrels per day may not sound like much, but it accumulates. Lower prices are the only way to work off the surplus and restore the supply and demand equilibrium.

In the past, the system worked differently. OPEC would hold a meeting and decide the only way to keep high oil prices was for the 12 OPEC nations to restrict their production, and they would cut production by, say, 10 per cent each.

The problem is Saudi Arabia would live up to its end of the bargain and the others wouldn't. Other countries would quietly keep pumping as before. Zero cuts.

Surprisingly, it worked because the Saudi cuts were huge and enough to single-handedly make OPEC successful. For its part, however, a production cut meant the Saudis had to give up customers. They might tell Japan, for example: "Our output cuts mean we can no longer supply the oil you need." Japan would then look elsewhere for its supplies, like to Iran, for example.

Now, for the first time, Saudi Arabia has said, "OPEC will trust free markets." For the first time, the Saudi's, like the other 11 OPEC nations, will not reduce its oil output.

What's the final impact? It seems obvious that winners will be oil consumers and losers will be exporters. And some will lose more than others, like producers which pump oil that is expensive to extract or refine like from Canada, Russia, Iran, Venezuela and Malaysia.

> *Quick* **Quote**
>
> **"Eighty per cent of success is just showing up."**
>
> Woody Allen, 79, comedian

Others, such as Saudi Arabia, produce a high-quality crude that is easy to bring out of the ground, so its costs are low and it can survive these low prices. Saudis also have enormous reserves which it can fall back on and so it doesn't desperately need the oil revenues. Abu Dhabi and Kuwait are in a similar position.

Add it up, and the world has more oil consumers than producers so, on net, lower oil will benefit the world's economies.

Surprisingly, the world isn't rejoicing. Stock markets have been in a funk showing no clear direction after a day of panic selling on Monday. Selling? Why not celebrating?

Yes, it's a mystery. Singapore seems to realise its good fortune but is ringing it in quietly.

Call for a bit of caution

On the demand side, we've still got two worries. One is Europe and the other is China.

In Europe, Greeks vote on a new government on January 25 (in two weeks). Its anti-austerity party says "enough is enough". Greece has unemployment rates of 28 per cent (ours is 2 per cent) and voters are likely to vote for change. The new government will ask to renegotiate the tough terms of Greece's 2008 bailout. The European Central Bank will likely respond with: "Forget it."

Greece might then default on its debts and withdraw from the Euro, which would have been cause for panic in 2008, but now, it's a yawn. If Greece wants to drop the Euro and go back to its old currency, the Drachma, the world will let them. The harm is likely to fall on Greece.

The other concern is China. The data shows construction and manufacturing may be entering a slowdown. China is a growth engine the world has come to rely on but can we believe Chinese GDP data? Is China really slowing? No one is sure.

Two remedies: First, Central Banks, especially the European Central Bank (and Japan too) have decided that the safest thing to do is expand the money supply. That's right, print more money, and create inflation. It has been the favoured solution to problems since the Great Recession began in 2008, although inflation has remained surprisingly low through it all.

Second, countries have pushed their exchange rates lower, trying to make their exports cheaper. It works well because the US doesn't care if its currency is made relatively more expensive. The US exports less than 10 per cent of its GDP and if US exports become more expensive, so be it. The US is glad to help.

An adjunct professor at SMU, Dr Haverkamp contributes this column weekly to help our readers understand money matters better.

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