

What Goes Up Must Come Down

There are widespread signs of demand destruction in the largest consumer of oil--the U.S.

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Just as the El Niño phenomenon is bandied about to explain away any weather disturbance, economic analysts these days impulsively attribute all major trends to the "Chindia" factor. However, the myth has again transcended the truth. And nowhere is this more apparent than in the discussion of oil.

China is indeed a trendsetter when it comes to most commodities, typically accounting for 25 to 30 percent of total demand in various base metals and bulk commodities. But on the oil front, the United States is still the 800-pound gorilla of that market; it consumes nearly 25 percent of the world's total output, compared with 9 percent for China. India is far from being a major player in the commodity arena, accounting for no more than 5 percent of global demand for any major commodity and just 3 percent of the world's oil demand.

To be sure, much of the incremental demand for oil in the past few years has come from the explosive growth in emerging markets such as China. However, over the past few months the uptrend in many commodities has been moderating. This suggests economic growth is coming off a boil, even in Chindia. Combined with increasing evidence of lower oil demand in the developed world, the implication is that the price of oil is really running on empty this year.

There are widespread signs that the surging oil price is leading to demand destruction in the largest consumer of oil—the United States. From reports of the sharpest ever year-over-year drop in miles driven, SUV sales falling off a cliff and cutbacks airlines are making to their flight operations, U.S. consumers are clearly coming under severe stress. Oil spending as a share of the global economy has risen to more than 7 percent, a level last seen in late 1979. What happened next is instructive: from 1980 to 1983, the consumption of oil fell by 10 percent, and it took another seven years for oil consumption to reach the 1979 peak level of consumption. The length of the cycles may vary, but in the end, oil, too, is a cyclical business.

In inflation-adjusted terms, the price of oil got back to the 1979 level only earlier this year after having risen by a factor of nine in the 1970s. The price of oil has again risen by 900 percent over the past decade and the global economy is at last at a choking point, where it just cannot withstand a higher oil bill. Various emerging-market countries from Indonesia to India are not able to sustain the ballooning oil subsidies any longer and have no choice but to pass on the cost of higher oil to consumers. Until late 2007 the rise in oil prices did not pose a problem for the global economy, as it largely reflected booming economic demand in the developing world and a steady situation in the United States. But over the past six months, the price of oil has risen at its fastest pace in recent history, even as economic demand has slowed.

All price setbacks in oil over the past three decades have been demand- and not supply-led. Still, the oil bulls are willing to ignore evidence of demand destruction and are instead obsessed with supply issues. While there may be some merit in the increasingly fashionable "peak oil" theory, which essentially postulates that the world will have consumed most of its oil within a 300-year period, there is no evidence that world oil production is peaking today. The crude-oil market is currently well supplied, and production is expected to grow by 1.5 to 2 percent this year.

The obvious question, then, is: why are oil prices rallying so violently of late? Well, because that is how markets typically behave at the final stages of a powerful bull run. Prices get disconnected from fundamentals and enter a blowoff stage as everyone wants a piece of the action. Financial flows into oil-dominated commodity funds in just the first quarter of this year exceeded the entire 2007 influx. The price of oil has more than doubled over the past year after rising steadily at an annualized rate of 35 percent in the preceding five years. The NASDAQ had a similar blowoff in the year leading up to the major top in March 2000. In another telling sign, currently six of the world's 10 largest companies by market value are energy firms. Back in March 2000, technology stocks occupied an identical position in the global top 10.

Of late, the world seems split between oil and non-oil nations, with all the producing economies booming while their consuming counterparts are threatened with oil-induced stagflation, meaning slowing growth and rising inflation. Over the past three years, net oil-importing countries have transferred more than \$3 trillion in wealth to oil-producing nations. At the current price of oil, the annual wealth transfer is nearly \$2 trillion. However, there is a limit to which the fortunes of the oil-producing and oil-consuming nations can diverge. With evidence of demand destruction mounting in oil-consuming countries, it will not be long before the term "peak oil" invokes images of a peak in both the price of oil and its demand, rather than fears that the world is running out of oil.

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