Financial Times (London, England)

August 18, 2004 Wednesday
London Edition 2

SECTION: MIDDLE EAST & AFRICA; Pg. 6

LENGTH: 743 words

HEADLINE: Too much money to blame for rising price of oil, economists claim

BYLINE: By ANNA FIFIELD

DATELINE: LONDON

BODY:

As oil prices continue to set new records, markets, manufacturers and motorists alike seek to apportion blame.

Sometimes it is violence in the Middle East, sometimes it is Venezuela's political troubles, or surging Asian demand, or Russia's crackdown on oil company Yukos.

But while few would dispute the role of supply disruptions in pumping up the price of crude this year, a small but influential group of economists thinks that a price fluctuation of this magnitude is determined less by supply and demand for oil, and more by that for money.

They think interest rates have much greater influence on commodity prices than is widely assumed, and blame loose monetary policy in particular for the current high level of oil prices. If true, their contention underscores the unpredictable consequences of monetary policy and provides a powerful argument in favour of tightening monetary control.

Mervyn King, the Bank of England's governor, has defended central banks from the charge that their lax policies have fuelled the oil price rise. But he conceded that aggressive rate cutting may have contributed to the rise in commodity prices, including oil.

"I think there has been an expansion of money and liquidity around that does lead in general to an increase in asset prices, of which commodities prices are one," Mr King said last week. "But that has, of course, been a deliberate response by the monetary authorities to the situations in the economies which they each face."

Since 2001, the US Federal Reserve has cut interest rates 13 times, and left its main rate at a historically low 1 per cent for a year before two rises - in June and last week - took it to 1.5 per cent. Japan's ultra-loose monetary policy, meanwhile, shows no sign of changing.

While conventional economic wisdom says that supply and demand factors are what drive changes in oil and other commodity prices, the influence of monetary policy cannot be overlooked, some analysts say.

Eric Barthalon, chief economist at Allianz Dresdner Asset Management, has tracked a correlation between US public debt held by central banks - a measure of overall global liquidity - and the oil price. Meanwhile, the ratio of global reserves to world trade, another measure of global liquidity, has risen for two years at the fastest rate since the 1970s - the last era of oil shocks - according to data collated by the International Monetary Fund.

"Whenever you print money in excess of the needs of the real economy, you create a situation where people try to spend it, to get rid of excess liquidity," said Mr Barthalon. "We are in a situation where the US current account deficit is not financed by foreign private savings but by global money creation - money is being created out of thin air." This tends to be spent on the likes of oil and steel, he says. "The markets that are most likely to react the fastest are commodities markets. And in creditor countries like China, the economy is booming and so is the demand for commodities."

Economist Jeffrey Frankel of Harvard's Kennedy School of Government has argued that changes in oil prices are at least partly the result of real interest rates - nominal interest rates adjusted for inflation. "If short-term (real) interest rates are low then speculators borrow in US dollars and go long in other things, in this case in commodities, so this could explain some of the big run-up in prices," said Mr Frankel.

Over the past two years, Nymex crude oil futures have risen by more than 50 per cent, setting a record close to Dollars 47 last week. Meanwhile nickel prices have more than doubled, while steel is up by about 60 per cent and gold by 25 per cent.

Stephen Roach, chief economist at Morgan Stanley, thinks the world is now seeing a commodities bubble. "Central banks have been biased towards excess accommodation in the last four years, and that has left the environment ripe for bubbles," Mr Roach said.

Although Mr Roach thinks exuberant Chinese demand was driving up commodities prices, he lays some of the blame on the monetary authorities. "A key proponent of rising commodity prices has been investors and speculators and hedge funds in particular, searching for a return in a low return environment." Mr Roach says there would be a "sharp reversal" in commodity prices as China's economy slowed, but Mr Barthalon says foreign exchange reserves growth means the annual average price of oil could rise by 15-20 per cent over the next two years.

LOAD-DATE: August 17, 2004