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ECONOMIC REPORT

OIL'S WELL IF IT ENDS WELL

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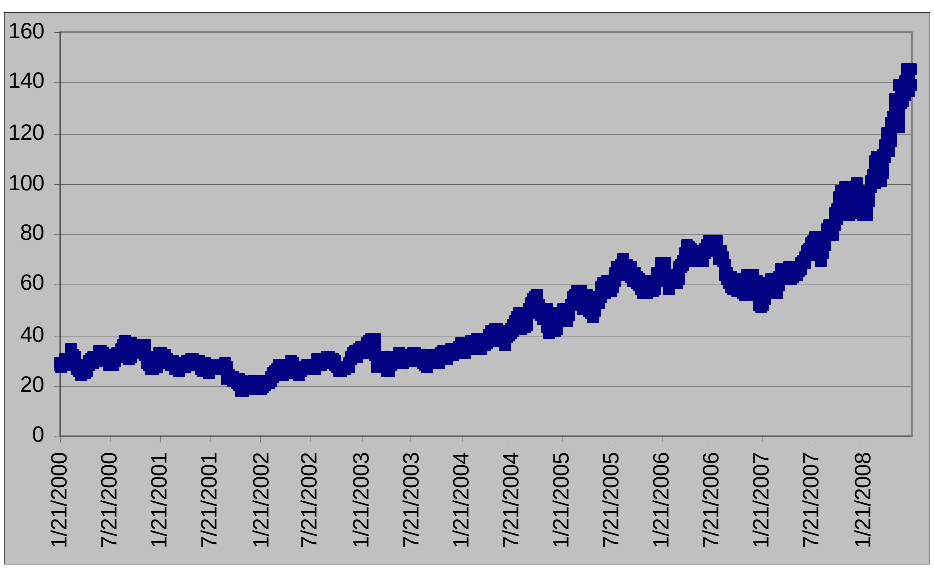
Oil prices have surged by nearly 50% since June 2007. Many reasons have been reported in the media for explaining this dramatic rise. These include oil supply shocks, weakening dollar, the world reaching 'Peak Oil' and geopolitical risks. This paper will try to go through the plethora of reports, allegations and finger pointing in order to clear the mist surrounding this dramatic price hike.

UNRELENTING RISE – WHY?

Oil prices are trading well above the $130 a barrel mark, with high volatility and frequent changes in investor sentiment. Speculation has become strong and oil markets jump or fall at every news, ranging from Nigerian strikes to US dollar performance. Evidence that speculation has become commonplace can be attained from the Commodities Futures Trading Commission, which released data indicating that speculators who controlled around 37% oil future contracts in 2000 now control 71%. Therefore with so many people betting on prices to rise in the financial community, it is difficult to say let alone predict when oil prices will come down and sentiments shift.

Recent reports in the financial market suggest that the prime reason for oil price going through the roof is high demand, specially from developing countries like China, India and South East Asia, combined with a lack of supply from oil producing nations. This is allegedly creating shortages in the demand-supply equilibrium thereby driving prices up. Basic economic theory supports this stance, high demand for any commodity results in less supply and raises competition amongst buyers, resulting in price going up. To add to this if there is insufficient supply to meet demand, extra pressure is put on an already strained equilibrium. This creates conditions for aggressive price hikes witnessed in the last one year.

However, while the economic explanation of such a situation can rightly predict a dramatic price hike, recent data does not support this popular hypothesis of demand-supply disequilibrium.



Oil Prices January 2000 - Present
Source: Bloomberg

OIL'S WELL IF IT ENDS WELL

DEMAND LULL

In reality demand from developing nations pales in comparison to demand from developed nations, specially the US which is the world's largest consumer of oil at approximately 83 million barrels a day. The disparity in oil demand is vast, US demand is larger than the demand of the next top four countries namely China, Japan, former USSR and Germany combined. Keeping this in mind, the IEA's (International Energy Agency) recent report claiming that oil demand in the US will decrease in 2008, is set to lull world oil demand.

China and other Asian countries whom have been singled out as the main reasons for so called 'soaring demand', showed a combined increase in oil demand of 2% in the first quarter of calendar year 2008 compared to last years average. World oil demand increased by 0.06% for the same period.

How can the price of oil increase if demand is fairly flat?

Acknowledging that world oil demand has gone up by 0.06%, this increase does not however, justify the 50% increase in price of crude oil from June 2007 to June 2008. It also does not justify recent claims by Goldman Sachs that a 'super-hike' in oil price will take crude oil to $200 a barrel.

To put things in perspective world oil demand increased by 1.58% on average from 2004 to 2005 but prices remained stable. Also on July 15th 2008, OPEC downsized its demand outlook in 2008 for the fourth time this year, adding demand would continue to decline in 2009. This was in addition to a report published earlier claiming that world oil demand will decrease by 3.7% in the next 20 years.

Demand is on the decline because of high oil prices around the world, specially the US. A major decrease will occur when countries start removing oil subsidies on account of widening trade and current account deficits. Pakistan has announced that it will remove all subsidies on oil by the end of 2008. It remains to be seen how much of an impact this will have on oil demand not only in Pakistan but around the world, as governments pass on higher oil prices to the population.

High oil prices have also stimulated investment in renewable green sources of energy. According to a UN report, global investment in renewable energy went up to an all time record of $148 billion in 2007, jumping by 60% compared to 2006. the report called this the 'green energy gold rush' and pointed out the clean energy industry was maturing and attracting many investors from around the world. In addition, the next US president is expected to make renewable energy and energy efficiency a political priority. These steps by the US, which is a leading consumer of carbon fuels, and by other nations around the world will replace oil demand with clean renewable sources of energy. This will further decrease demand for oil in the future if not the short term.

DEMAND LULL… continued

Economic theory therefore does not support oil prices going up since current as well as future demand is in reality stable/decreasing but not increasing. In open transparent markets oil price should be going down. Taking this into account and that demand side pressure on the price of oil is nominal, we now turn to the supply side to look at reports that supply shortages are driving the rally in oil markets.

SUPPLY GLUT

Unpredictable supply is seemingly creating market irregularities, which is lowering market sentiment and increasing prices. Border tensions between Ecuador and Columbia, insurgent attacks in Nigeria and Iraq and weather related disruptions in the North Sea and Australia have reportedly made supply of crude oil questionable. These supply shocks are cited to justify volatility in oil markets.

However, it must be noted that Saudi Arabia agreed to produce an extra 300,000 barrels a day in June and another 200,000 barrels a day in July to curb prices. Although this increase may not be enough to bring prices down, it can comfortably cover for the sudden supply shocks mentioned above, smoothing out any inconsistency in oil supply.

To add to this, the IEA reported that total world oil production rose to 87.47 million bpd in February, up from 87.29 million bpd in January, thanks to higher volumes from the Americas and former Soviet Union.

Thus, there is no supply crisis to justify such a price bubble. On the contrary, there are several massive oil fields due to begin production this year that will boost supply. In April Saudi Arabia's Khursaniyah oilfield began pumping oil at 500,000 bpd. Also Khurais oilfield is expected to further increase Saudi Arabia's oil production by 1.2 million bpd by 2009.

Long term expansion projects are also in the pipeline, Saudi Arabia is in the finalizing stage to increase drilling activity and increase investments by 40% to boost production. Brazil's Petrobras is in the early phase of exploiting what it estimates are newly confirmed oil reserves offshore in its Tupi field that could be as great as or greater than the North Sea reserves. This casts doubt on the 'Peak Oil' theory, which argues that oil production has pumped half of all reserves and the world is now on the down slope of cheap oil and abundant quantity.

SUPPLY GLUT… continued

Contrary to media reports world oil supply is outpacing demand both in the short and long term, with inventories in many countries including the US increasing. According to the May 7th Energy Information Agency (EIA) monthly report on inventory, stockpiles of oil climbed by almost 12 million barrels in April, up by nearly 33 million barrels since January. Also MasterCard's May 7th US gasoline report showed that gas demand fell by 5.8% and refiners were reducing refining rates dramatically to adjust to the falling gasoline demand. They were now running at 85% of capacity down from 89% a year ago. The refiners today are clearly trying to draw down gasoline inventories to bid gasoline prices up.

Markets are well supplied with oil and with flat demand, market fundamentals point toward decreasing oil prices. Despite this prices have reached new highs every month and displayed extreme volatility never witnessed before, a phenomenon that can only be explained if we discount for speculation. The answer therefore lies in policies which allow uncontrolled and unregulated participation in future markets.

BEWARE, SPECULATORS ON THE PROWL

As mentioned earlier, speculators have increased their share of oil futures from 37% in 2000 to 71% now. Dollar weakness and a slowing world economy have prompted investment not only in oil but in almost all commodities including food.

A notable trend witnessed in recent months has been the indirect relationship between dollar strength and oil price, an increase in dollar strength decreases oil price and vice versa. Therefore, oil futures have acted as a safe haven for investors looking to hedge themselves against the weakening greenback and a deepening recession.

Oil price today is not determined by market fundamentals but by speculators and hedge funds investing in unregulated futures markets. The London ICE futures and New York NYMEX futures exchanges are pivotal in this process. US energy futures traded in ICE are not regulated by the Commodities Futures Trading Commission. This bodes well for financial institutions that are given a free hand to speculate in unregulated markets where the demand pricing of final goods is inelastic.

Another policy encouraging speculation in oil is the margin rule which determines what percent of cash a futures contract investor in oil has to put up to bet on oil prices. Current NYMEX regulation allows a speculator to put only 6% cash of the total value of oil futures contracts from their own pocket. Therefore investors can borrow 94% for investing purposes, creating a leverage of 16 to 1, increasing volume in commodity speculation.

Therefore, commodity speculation is arguably the investment of choice at the moment. The weakening dollar and ever deepening recession in the US economy has left fewer opportunities for investment elsewhere. Hedge funds and investment banks have been major investors in commodities as they look to hedge against the dollar decline. Capital controls on banks which recently did not give enough allowance for commodity speculation, now allow greater freedom.

The US economy continued to slow in June with declining home prices, skyrocketing oil prices, increasing inflation and mounting job losses crushing consumer sentiment. Labour Department's report released on July 3 showed payrolls decreased by 62,000 workers, a decrease for the sixth straight month. This raises concerns that reduced spending will further slow the economy, as the impact of Federal tax rebates fades.

This shows the US economy is currently not showing signs of turning around. Therefore banks and hedge funds have little choice than to invest in commodities which have shown reasonable returns, acting like a beacon of hope amidst a backdrop of deteriorating market conditions.

CONCLUSION

Some market participants have predictably tried to shift blame of high oil prices to OPEC nations for failing to meet demand. However, it is abundantly clear that market fundamentals of demand and supply are not the reason behind the record oil prices.

A slowing global economy, weakening dollar and investors looking to hedge themselves are the core reasons for investment in unregulated commodity exchanges. It seems like this price bubble will only burst when recessionary conditions begin to fade. However, falling home values, increasing inflation, high job losses and falling consumer sentiment in the US may combine to worsen the recession and slow the world economy in short term. Due to this oil prices this year and the next are expected to remain on average, above the $130 mark.

ECONOMIC SNAPSHOT

Fiscal Year 2007-08															
	Units	April	May	June	July	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May
Inflation															
Headline Inflation	%	6.9	7.4	7.0	6.4	6.5	8.4	9.3	8.7	8.8	11.9	11.3	14.1	17.2	19.3
Core inflation	%	5.2	4.7	5.1	6.0	6.0	6.1	6.5	6.9	7.2	7.8	8.1	9.3	10.8	12.3
Food inflation	%	9.4	11.3	9.7	8.5	8.6	13	14.7	12.5	12.2	18.2	16	20.6	25.5	28.5
Non-food inflation	%	5.2	4.7	5.1	4.9	4.9	5	5.4	5.9	6.3	7.3	7.8	9.4	11.2	12.5
T-bill (Wgt Avg)															
3 month	%	8.69	8.69	8.69	8.69	9.05	9.05	9.05	9.05	9.09	9.09	9.38	9.59	9.59	9.59
6 month	%	8.9	8.9	8.9	8.9	9.12	9.12	9.12	9.21	9.29	9.29	9.61	9.86	9.86	9.86
12 month	%	9.08	9.10	9.16	9.16	9.39	9.39	9.39	9.4	9.49	9.44	9.87	10.13	10.13	10.13
External Sector															
Export	Mln US$	1,446	1,540	1,583	1,434	1,475	1,463	1,593	1,524	1,500	1,634	1,591	1,833	1,862	1,954
Import	Mln US$	2,159	2,190	2,373	2,423	2,206	2,150	2,555	2,864	2,910	3,316	2,909	3,549	3,406	3,241
Trade balance	Mln US$	(713)	(650)	(790)	(989)	(731)	(687)	(962)	(1340)	(1410)	(1637)	(1637)	(1716)	(1,544)	(1,287)
Remittances	Mln US$	513	537	505	495	489	516	580	505	479	557	502	602	590	584
Forex Reserves	Mln US$	13,661	13,778	15,182	15,723	16,106	16,145	16,354	15,807	15,589	14,657	14,031	13,232	12,362	11,258

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