Petrodollars ahoy!

Since emerging market stocks are currently in the tight grip of a bear hug, the imperative of parking huge oil surpluses could well trigger a bull charge

ALOK SHEEL

Why are commodity and oil prices rising…and rising? The most commonly cited reason is sustained unprecedented global growth rates in recent years and, in particular, the demand from China and India. Speculation is cited as a secondary reason. Following the financial crises in OECD countries and the sharp slide of the dollar, commodities, particularly oil, are considered a relatively safe haven. But why commodity markets are scaling historic highs well after recessionary fears have crystallised, and quite out of proportion to the fall of the dollar, is mystifying. Even as economists animatedly debate the issue, and global stock markets seem to have emphatically rejected it, some segments of the market appear to have bought into the decoupling hypothesis.

Rising oil prices are making biofuels increasingly attractive, leading to a strong linkage between oil and food prices. Since oil-exporting countries are also major food importers — and vice-versa — part of the oil boom surplus may ultimately be delusory. The net financial windfall is nevertheless likely to be huge. A back of the envelope calculation indicates that at the current global oil consumption of 86 million barrels a day, a price increase of $60 per barrel translates into a windfall of roughly $1.9 trillion. This amounts to over 10 per cent of global exports of goods and services, or more than twice the current account deficit of the US. To this must be added the relatively small windfall in other natural resources, such as coal, gas, iron ore, copper, aluminum, and so on.

A tsunami of petrodollars has been generated and the first waves are already striking global financial markets. Where will this money be invested? Since the absorptive capacity of oil-rich economies is limited, booming oil prices have in the past vastly inflated global liquidity, laying the seeds of subsequent financial crises. While the US Fed shares part of the blame for driving excess liquidity by keeping short-term interest rates low, as Alan Greenspan pointed out in his memoirs, *The Age of Turbulence*, the Fed has little control over long-term interest rates, which are now mostly driven by massive cross-border capital flows.

During the oil boom of the 1970s, petrodollars were recycled through the banking system by extending cheap debt at low floating rates to Latin American countries. When floating interest rates rose, Latin American countries went bust over a decade of lost growth. The Latin American debt crisis has an eerily familiar parallel to the excessive liquidity-driven subprime housing mortgages at teaser rates. The villain of the piece this time around is the double whammy of rising interest rates and falling housing prices.

Oil surpluses were only partly responsible for the excessive liquidity associated with the subprime crisis. The major portion was accounted for by trade surpluses of east Asian countries, especially China, on the back of manufacturing exports to OECD countries, and excessive leverage associated with financial innovation. With oil hovering above $100 a barrel, and showing no signs of declining, and asset securitisation on the wane, petrodollar surpluses are overtaking manufacturing exports as drivers of global liquidity.

During the first oil price boom, petrodollars were mostly invested in the currency in which payments were made through the banking system. How and where will the surplus be invested this time around? Past experiences of oil boom indicate that petrodollars have always been controlled by a handful of risk-averse entities that parked money in dollars, and which appreciated over the years despite growing US current account deficits. The recent sharp decline of the dollar, and also the current financial turmoil in western financial markets, have made the dollar lose much of its past lustre.

A defining characteristic of the current boom is the important role likely to be played by mostly authoritarian regimes that control much of the foreign hard currency reserves. These sovereigns have also moved to increase their direct control over natural resources over the past few years. The investment decisions, therefore, are likely to be more strategic, often ignoring risks that ordinarily deter commercial investors. China, for instance, is channelling huge amounts into resource-rich but conflict-ridden countries in Africa. Some of the surplus is being recycled to acquire stakes in the western financial system by bailing out troubled western banks through sovereign wealth funds. However, the likely resistance of OECD governments to such takeovers, and also the sliding dollar, may well mean that emerging markets could be the likely final destination of much of these surpluses. Since debt markets are less well-developed in emerging markets, equity would appear to be the natural choice. Since emerging market stocks are currently in the tight grip of a bear hug sparked by fears of a global recession, the imperative of parking huge oil surpluses could well trigger a bull charge in the foreseeable future.

The global imbalance generated by the oil price hike of the 1970s eventually had a calamitous fallout on Latin America, where the surpluses were recycled. The global imbalance created by developing country trade surpluses is at least indirectly linked to the current financial turmoil in America, where most of these surpluses eventually ended up. The impact of the debt crisis was particularly severe and protracted in Latin America because the borrowed money did not result in any productivity gains. Continuing technology-led productivity improvements may partly offset the damage arising out of the subprime crisis in the US.

It is difficult to divine how the emerging global imbalance deriving from the current oil price and commodity boom will play out, but if much of it flows to Asia, we may be reasonably certain where future financial bubbles and crises might occur. Investment and productivity are of course rising in Asia, but domestic savings are rising even faster, making huge external injections destabilising and an invitation to financial crisis via the familiar route of asset price inflation. This asset price inflation could, of course, fuel a consumption boom in developing countries, as it did in the US, which could help unwind global imbalances.

However, given the extent of financial exclusion in both China and India, where only a thin upper crust invests in such assets, the social gains from such a consumption boom may be limited. The social gains from a tradables-led consumption boom are likely to be more widespread, but few emerging markets are inclined to overcome their mercantilist mindset to let their currencies appreciate.

The writer is a civil servant. The views expressed are personal