Last week my colleagues spent some time in the US talking to international policy-makers including officials at the IMF, the World Bank and the UN. The consensus at these organisations was clear: we should all get used to oil at $150 per barrel, because the price has been driven their by “fundamentals”. The problem with the message that they received on their trip is that it was delivered by the same organisations who were arguing in 2002 that a price of $20 to $25 per barrel was the ‘fundamental’ level for oil prices. So what fundamentals have changed between then and now to justify a seven-fold increase in the oil price?

China and other emerging economies have grown rapidly. But rapid growth was in the consensus forecast back then, and it was well known that this growth would be highly oil intensive. Perhaps China’s average growth rate has exceeded the consensus forecast by a percent or two per year over the period? But that’s not enough to increase the oil price seven-fold. Geo-political risks in the Middle East and elsewhere have deteriorated. But again, such deterioration was widely expected back then. And Iraq, for example, continues to pump oil at the rate of 2 to 2.5 million barrels a day, very close to the level preceding the invasion in 2003. Developed economies also grew rapidly after 2002, probably more rapidly than the consensus forecast called for. But that rapid growth is grinding to a halt now, and yet the oil price remains elevated.

Fundamentals have not changed, or at least not by enough. The view we heard was, to paraphrase:

“We thought it was fundamentals back then, but we were wrong. But don’t worry we’ve got it right this time.”

Somehow, we don’t find that assurance persuasive. We all suffer from a tendency to ascribe to ‘fundamentals’ those aspects of the current conjuncture that we do not really understand: its called post-hoc rationalisation … and economists tend to be particularly good at it! Whether it is the value of housing or the rate of unemployment or productivity growth, large unexplained components make us feel uncomfortable. We’re much happier arguing that the current level is close to its fundamental level, even if that means acknowledging that we must have been wrong about that in the past.

There are at least three reasons – fundamental reasons, I might add – to argue that oil prices should fall back over the next few years.

First, developed economies are in or about to enter a downturn or outright recession. So far the impact of high oil prices on oil consumption across the OECD has been very slight compared to the experience of previous oil shocks. That is because the previous shocks were associated with global recessions, and we have not seen that, yet, this time around. But developed economies will slow sharply this year, and a recession cannot be ruled out, which could spill over into emerging markets as well.
Second, oil producing economies - because of their subsidies on domestic fuel consumption - have been major contributors over the last few years to global growth in demand for oil. But fiscal problems and increasing inflationary pressure in those economies suggests that the subsidy regime might not be sustainable, at least not as it currently stands. If it were to be relaxed, the impact on oil consumption in those economies and, by extension, global oil consumption, could be pronounced.

Third, our analysis indicates that 2009 would have to see a larger contraction in the supply of oil than that which occurred back in 1974 for the current price of oil to be maintained. That is possible, but it is an extreme assumption to say the least.

In our view, the risks to oil prices are skewed to the downside over the next two or three years. That is fortunate, since the impact of high oil prices on inflation has not yet peaked. In the UK, we would not be surprised to see CPI inflation breach 5%. And in the UK and the US, inflation expectations are threatening to slip their anchor.

One straw in the wind is the recent resignation of former Fed governor Fred Mishkin. It was Mishkin who argued for the exceptionally aggressive loosening of monetary policy in the US, to offset the ‘tail risk’ of a credit-crunch-induced slump. However, his argument had two elements: cut hard and quickly to ease the credit crunch and, when credit market conditions start to improve, hike hard and quickly to prevent inflation expectations from rising.

Markets were slow to believe that the Fed loosening would be as aggressive as it turned out to be. They have finally caught up – but they have not priced in the aggressive hikes in interest rates that would be consistent with the other part of the Mishkin plan: market forward rates imply that the short rate will return to ‘neutral’ (around 5%) only gradually over the next five years. Mishkin’s plan would see that happen by the middle of 2009.

Markets are probably right that the hikes won’t happen the way Mishkin planned. The problem for the Fed is that the US economy is in recession, and there is a presidential election in the offing. The idea of returning interest rates to neutral as rapidly as Mishkin might wish is anathema, since it would imply prolonged weak growth and rising unemployment.

Mishkin is well aware of this risk, as his recent speech (“Global Financial Turmoil and the World Economy”, delivered at the Caesarea Forum of the Israel Democracy Institute on July 2) made clear:

“The central banks in most parts of the world are at a crucial juncture: we must all be vigilant to keep inflation expectations anchored and inflation low.”

Perhaps he resigned because, as the official explanation states, he was keen to return to academia (it’s a nice place to be). Perhaps the current policy environment was just not challenging enough to keep him interested, or perhaps there is a paper that he has been itching to finish for the last decade or so.

More likely, I fear, he resigned because he knows that policy makers would rather take the pain in future than take it now, even if it means the pain is greater when it finally comes.
After all, if and when the inflation chickens come home to roost, policy makers can always say:

“We were wrong back then. But now we’ve got it right.”

That line won’t be any more plausible in two or three years’ time than it is today.