

What's Happening to Oil and Food Prices?

With even Iraq's al Maliki asking for a US departure date, the U.S. should look to accelerate the arrival of the day it gets a much-needed economic boost from lower military expenditures.

Richard Vague 8/5/08

Gas and food prices have increased at an alarming rate. Blame is being laid at the feet of India, China, biofuels, speculators and a host of other supposed culprits.

But central to the real explanation is the Iraqi War—and the resulting weak dollar and risk premium in oil prices. Our economy can't get meaningfully better until we stop spending the massive sums we continue to spend in Iraq.

Supply and Demand

On the eve of the invasion of Iraq, oil stood at \$28 per barrel. It is now well over \$100 and has touched as \$140—an increase of roughly 4 times.

Oil Price Increase

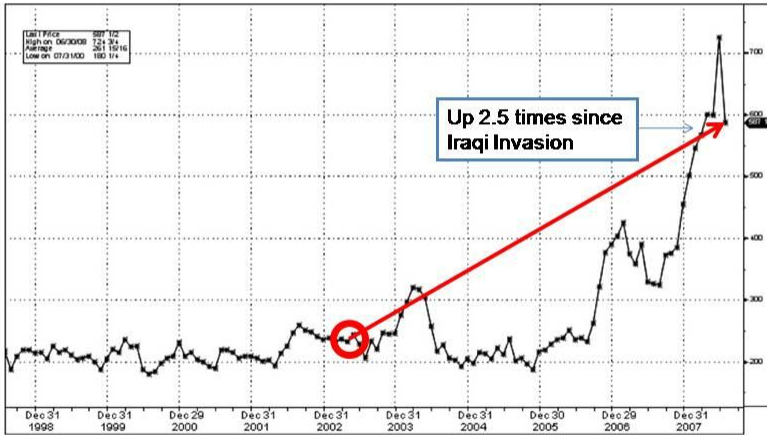


Note: Data in this presentation is as of 8/5/08

Food prices are also up in the post-invasion period. For example, wheat, corn, and soybean prices are up roughly the same amount as each other—2 to 3 times their pre-invasion levels.

(Corn prices have increased at a similar rate as wheat and soybeans, somewhat discounting the notion that biofuel production is the major contributor to this rise.)

Corn Price Increase



Wheat Price Increase

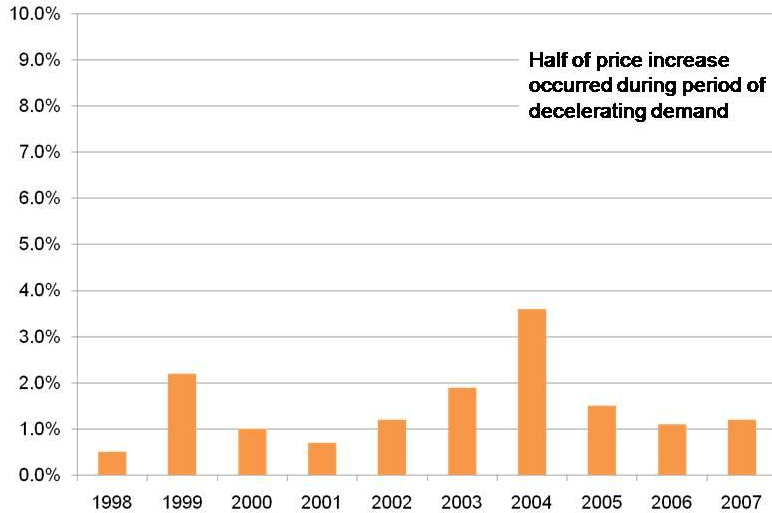


Soybean Price Increase



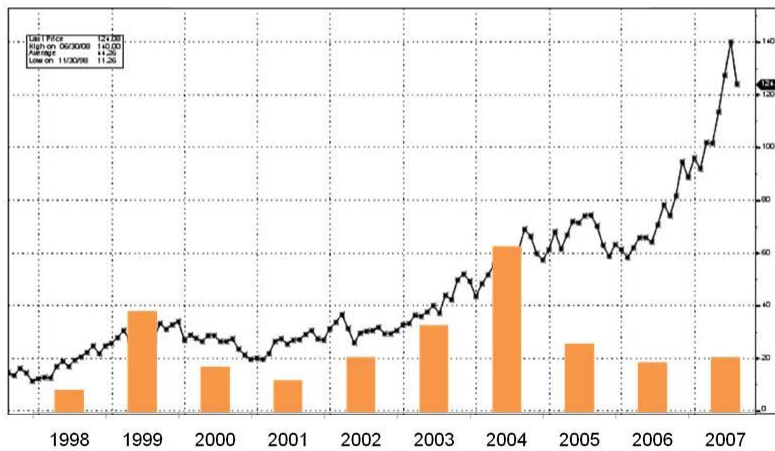
The most oft-cited reason for the rise in oil prices is the global rise in energy consumption. Proponents of this explanation will state that India's oil consumption was up 6.7% last year, and China's was up 4.1%. But in total, global oil consumption was only up 1.1% in 2007 as compared to 2006, and only 1.0% the year before that. America's consumption has actually declined over last two years, as has both Japan's and the European Union's. Japan's oil consumption dropped 3.5% in the last year alone. Note that the long car lines for gas in the 1970s were a result of our own price controls enacted at that time, not the lack of oil supplies. And current supply and demand characteristics for foods are not appreciably different than for oil. To put global demand characteristics in context, the global population growth rate itself is just above 1% per annum and has been decelerating slightly.

Oil Consumption Increase



When these consumption increase levels are juxtaposed against the graph of oil price increases over the last several years, the fact that half of the recent price increase has occurred in a period of decelerating demand becomes apparent.

Oil Consumption and Increase



With only modest increases in demand, some commentators have tried to explain price increases by suggesting that the world's current 85 million barrels per day represents an effective "ceiling" for oil production which current demand is straining against. But an annual 1% increase in global production is only 850,000 barrels per day, and the Saudis alone recently committed an additional 700,000 barrels a day, and have current capacity for more.

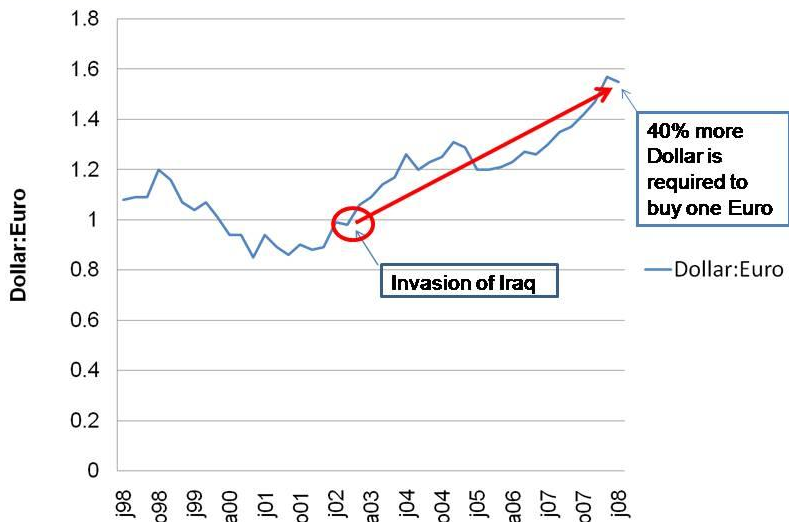
Why prices are up

Demand is in fact up globally for a wide range of commodities—including oil. But not at a level sufficient to support the tripling and quadrupling of prices seen in recent years. While we might speculate that current supply and demand trends would support an increase in oil prices from \$28 to \$50, \$60 or even \$80 per barrel, the idea that supply and demand alone accounts for the increase from \$28 to \$110 or \$120 or \$140 doesn't hold up.

And much of the discussion about oil prices has focused on our dependence on foreign oil. We support the idea of reducing our dependence on foreign oil—and oil generally—since it is likely over time to bring strategic, environmental and demand-side benefits. But again, our dependence on foreign oil is not different today than it was in 2003 when oil was \$30 per barrel.

So then why are prices up? The first place to look is the weak dollar. Since the invasion of Iraq, the dollar has declined markedly against the Euro—in fact, it now takes 40% more dollars to buy the same number of Euros as compared to the period before the invasion. On the eve of the invasion, oil was approximately \$30 per barrel and was approximately €30 per barrel. Since then, oil has reached roughly \$120 per barrel, but only to €80 per barrel. The difference? The decline in the dollar—notwithstanding Secretary Paulsen's dutiful protestations to the contrary.

Rise of the Euro vs. the Dollar



Oil Price in Euros



The second place to look is risk. The market price of oil began rising immediately after the invasion, and has continued to rise in part because of investor fears of a widening conflict and a disruption in supply resulting from conflict. This “risk premium” reflects such things as the current heightened tensions between Israel and Iran, and the rise of conflict in Afghanistan and

Pakistan. Senator Joseph Biden, chairman of the Senate Foreign Relations Committee, estimates that as much as 30% of the current price of oil can be attributed to this factor.

To this idea of a risk premium, we would add both the speculation and the hoarding that are now receiving wide-spread attention. While not causal, speculation and hoarding are typical behaviors when the price of an asset class rises, and exacerbate the upward pressure on prices. Added together, we believe that these factors together account for at least 20-30% of the current price of oil.

Without these factors, we believe that oil would be well below \$100 per barrel. A stronger dollar alone could very well bring prices down below \$100 per barrel.

Why is the dollar weak?

One key reason—easy money, or what the economists would call expansionary monetary policy. The U.S. last entered the trap of monetary inflation in dealing with the massive spending on Vietnam and the effects of the oil embargo. This period was the second worst for the US during the twentieth century, and combined both inflation and a recession—“stagflation.” It took Federal Reserve Chairman Paul Volcker and his tightening of the money supply--and the accompanying 20% interest rates--to overcome the inflation of that period. A robust economic period followed.

But more recently, the Fed has again been easing money. The fact that real short term interest rates have been negative for much of the last decade is sure evidence of this. The Fed has acted in this manner for a variety of reasons—for example, to help in withstanding the Internet crash of 2000. The main reason, however, has been to finance a trillion dollar war without raising taxes or interest rates. It should not have been unexpected, since from the beginning of time, kings and countries have used inflation to pay for wars.

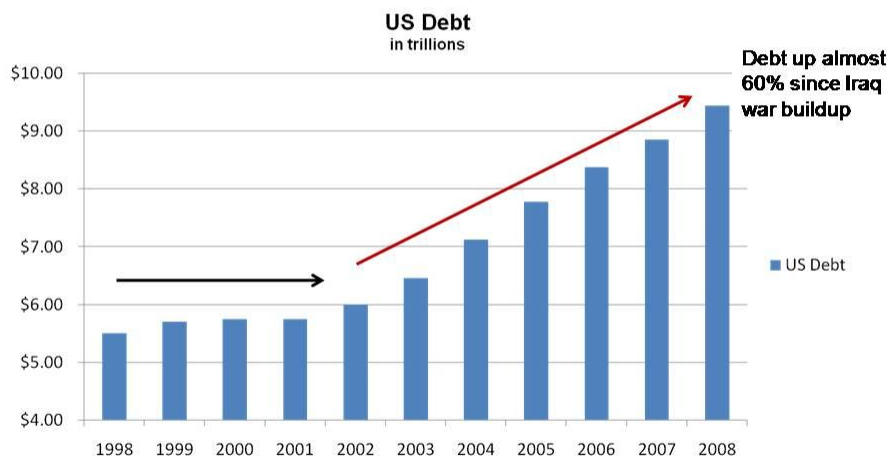
Some discount the idea of inflation, pointing to the low CPI and to the absence of wage pressure. However, CPI is a lagging indicator, often by years. And wages lag even further still. Once inflation manifests itself in these numbers, the chicken has long since flown the coop.

This war has been expensive, despite President Bush’s claims to the contrary. The lowest estimates put the cost of this war at roughly \$1 trillion, making it the second most expensive war in U.S. history in adjusted dollars--after World War II itself. And some estimates put the cost of the war at a far higher number. After properly accounting for expenses in other budget categories and emergency supplemental funding, we are likely spending well above the widely referenced \$250 billion per year on the “war on terror”. Whether \$250 billion or a higher amount, this is an enormous number—as measured against the \$13 trillion U.S. economy, or the \$3 trillion U.S. Federal budget. Some independent analysts have placed very high estimates on current defense spending taking into account emergency supplemental spending and defense-related expenses in other budget categories. For instance, Veronique de Rugy, a senior

research fellow at George Mason University , calculates total defense spending for 2008, including emergency supplemental spending and defense-related expenses in other budget categories, at close to \$1 trillion. In any event, it is larger today in inflation-adjusted dollars than at any point since the end of World War II.

Evidence of this war’s massive expense comes from total U.S. debt, which, since our invasion, has increased from just over \$5 trillion to almost \$10 trillion.

U.S. Debt



And when considered relative to our GDP, this war has been very expensive. One key difference from prior wars, however, is that in virtually all of them, taxes were raised or maintained to help finance the increased defense spending, and other Federal spending was curtailed. Going into this war, taxes were actually reduced--and our country was already carrying record debt--so the need to rely on money supply expansion to pay for the war was significantly heightened.

How do we reduce oil prices? How do we strengthen the dollar?

The cure for an over-expanded money supply and a weak dollar is more disciplined money supply growth—which normally results in higher interest rates. But raising rates will worsen an already perilous housing and banking crisis, and we are seeing rising unemployment as well. The Fed is between a rock and a hard place, in both its actions and its rhetoric. Thus far, the Fed has acted properly to ameliorate these problems by maintaining a low rate environment and

providing liquidity. But delaying the inevitable rate increase, however appropriate, will only make the period of reckoning more harsh when it arrives. And in the meantime, the more effective way to ease the pressure on financial markets would be to dramatically reduce our expenditures in Iraq. In other words—get most of our soldiers out.

This savings would be a powerful antidote to high prices, deficits and a host of other ills. In fact, it will be impossible for our economy to get appreciably better without it.

What about speculators—aren't they to blame?

Speculators almost always pile on when there is a dramatic upward movement in the prices of any asset. They add to the price pressure by doing so. Speculators are known for pushing prices beyond where they would otherwise go, but as one economist has said “there is a tendency for rational investors to sit on the sidelines and allow an overly enthusiastic market to go unchecked for a while,” and as George Soros said, there will come “a moment of truth, when reality can no longer sustain the exaggerated [price] expectations.” In other words, watch out. Keynes said “profiteers are a consequence and not a cause of rising prices” and most likely a large number will get burned as prices descend. Our view is that within the next few months or years, as investors gain visibility into a curtailment of defense spending, as the Fed finally moves to strengthen the dollar, and as we experience the decline in global economic activity that accompanies excessive commodity price run-ups, there will likely be a significant money-making opportunity for an equally large group of speculators as commodity prices tumble.

So where are we?

Wheat, corn and soybean prices have tripled since the invasion of Iraq due to a combination of supply/demand factors and an expansionary monetary policy. We strongly believe it is more the latter than the former. Publisher and monetarist Steve Forbes maintains that “inflation accounts for at least half of the price of oil today. We are not running out of the stuff.” And as John Maynard Keynes wrote in 1919, the process of inflation “engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose.”

Even if you think that easy money is the lesser factor, it is still the case that oil prices will not decline all the way from \$140 to \$60 or \$50 or \$40 simply by increasing supply. Easy money—monetary inflation—will still have to be addressed. In contrast, oil will very likely re-attain those price levels if an increase in supply is accompanied by actions that increase the strength of the dollar—especially Congressional actions that reduce spending on the war and Federal Reserve actions relative to the money supply.

Additional Discussion

Some added comments on inflation:

Monetary inflation occurs when money supply growth is in excess of GDP growth—though recently monetary supply growth has been increasingly hard to measure and detect. Monetary inflation is one of the regular strategies used for centuries by kings and countries to finance war or reduce debt. In the days when coins predominated, the edges of coins were clipped and those clippings were used to mint new coins. The unsuspecting recipient of the clipped coins was getting less gold or silver than he bargained for. In fact, one of the keys to making monetary inflation work for the government over the short term is for the recipient to be unaware of that lost value.

During the ascendance of paper money, extra money was simply printed—as in the U.S. Civil War. With monetary inflation, price increases occur even if there are no changes in supply or demand—simply because there is more money chasing the same amount of goods, so more dollars must be spent to buy the same goods. Today, in the era of electronic money, this money supply growth is accomplished by Fed “open market” operations and rate management. Advocates of the gold standard do so because it ties monetary growth to an external standard, thus prohibiting the government from printing extra money at its pleasure.

Why do kings and countries inflate their currencies? So they can spend—especially on war—without raising taxes, and can pay back existing debt with cheaper dollars.

One last note on inflation. Some portion of the world’s additional demand stems from our inflationary monetary policy. Many countries peg their currencies to the U.S. dollar—directly or indirectly. So as we have expanded our money supply, they have had to respond in kind to preserve this “peg.” The result has been easy money in their own countries and a short-term stimulant to their own economies—which has itself helped drive up global demand. For many of these countries, this has created significant internal inflation, especially in food prices, and created pressure for these countries to “de-peg” from the weak U.S. dollar.

A comment on deficit spending:

This war will end up costing well over a trillion dollars—perhaps considerably more. An expenditure of this size is not a terrible thing in and of itself. It is the fact that this amount has been spent on war instead of other items that would have produced a higher economic return—like US domestic infrastructure, technology, education, research or a host of other items.

Here’s a simple example of the difference. Let’s say you were given \$100,000 and could choose to spend it on either redecorating and landscaping your home or investing in diversified stocks and bonds. Redecorating would certainly create a short-term stimulus for the interior designers

in your area, but investing in a diversified portfolio would provide a return for years to come. We don't want to trivialize the horror of war or the importance of the military—we simply want to make the point that some expenditures can be viewed as investments to an extent that others simply cannot.

Summary and other considerations

Energy and food prices are up. Significantly.

If these high prices persist, there may well be talk of government intervention to reduce demand or increase supply—price controls, stimulus programs and more. As ever, none of these things will have the intended effect, and may just as likely have an adverse effect.

With the weak dollar, there may also be public outcries as foreign investors snap up U.S. assets such as real estate and corporations. There may even be renewed talk of the theories of Thomas Malthus.

But this will all miss the point. We have weakened the U.S. dollar and economy by financing a massive war on the cheap. And things will only truly get better when we significantly reduce this military spending and act to shore up our dollar.