Economic Growth and Oil

The IMF's World Economic Outlook (WEO)[21] announced that the global economy has continued its strong expansion, and the outlook for continued and solid growth remains favorable, despite higher oil prices and more frequent natural disasters. Global growth is estimated at 4.8 percent, 0.5 percentage points higher than projected last September 2005.[22] Buoyancy of activity in China, India and Russia accounts for two thirds of the upward revision to global growth in 2005. In addition, global industrial production has picked up significantly since mid-2005, the service sector continues to be strong, and global trade growth is close to double-digit levels. At the same time, consumer confidence is strengthening as reflected in forward-looking indicators such as the Business Confidence Index and the Consumer Confidence Index.[23]

Global growth is aided by global financial stability and downward pressures on prices, which has allowed accommodative macroeconomic policies. In major industrialized economies, inflation appears to be contained, while global interest rates continue to be low, corporate earnings are strong and merger and acquisition activity will support global stock markets in 2006. Risks on the downside would be continued inaction in addressing increasing global imbalances. Another risk concerns a slowdown in emerging economies that are being hit by the continued high rise in oil prices which has already caused some inflationary pressures in these markets.[24]

The principal challenge for global policy makers is to make sure there is an orderly and timely resolution of global imbalances. The U.S. current account deficit continues to rise, matched by large surpluses in oil exporting countries, China, Japan, and a number of other Asian countries.[25] This requires strengthened policies to rebalance demand across countries, and a realignment of exchange rates over the medium term, in particular a depreciation of the US dollar and appreciation of currencies in countries with current account surpluses.[26]

In vulnerable emerging economies, a number of risks require attention. First despite lower consumption demand, comfortable inventory levels in the United States, and the easing from Hurricane Katrina-related high prices, uncertainties about future supply (given geopolitical uncertainties in Iran and Iraq, and supply threats in Nigeria) continue to drive price increases. In addition, the impact of higher prices on the global economy has been more moderate than expected, in part because inflationary expectations have remained well anchored. However, the pass-through may prove to be incomplete, especially if the market is treating the energy problem as transient.

Thus high and prolonged volatile oil prices, as well as expectations of further rises, pose challenges that could be aggravated by: (i) increased global activity leading to a rapid growth in oil consumption (2.9 mbd in 2004 over 2003, or 3.7 percent) the largest in the past 20 years; (ii) limited investment in exploration and digging of wells since the mid-eighties and limited refinery capacity; (iii) structural changes in demand in China due to electricity shortages and increases in transport demand; (iv) fears of oil supply disruptions; and (v) speculation about price movements emanating from uncertain expectations regarding future structure and fundamentals of the global oil market.[27]

Second, though the impact of Hurricane Katrina on crude prices has passed through, it has clearly increased short-term risks relating to US refinery capacity.[28] Third, the persistence and pervasiveness of global current account imbalances jeopardizes global growth. In the US in particular, the high current account deficit increases the vulnerability of the economy, with repercussions on global growth.[29]

Fourth, the engines of world growth continue to be the United States, and "other emerging market and developing countries" including China and Japan. However different, trends of growth in these countries present competing forces to the outcome of global growth. Growth in the US, as discussed, is still strong. Growth in Japan is well established but flat, while China is pursuing less expansionary policies to facilitate a soft landing. Nevertheless its economy is still booming and shows no signs of cooling.[30] As European growth is still dependent on export demand, it remains vulnerable to domestic and external shocks,[31] and a slowdown in Japan (or China) would adversely impact the Euro region.[32]

In the meantime, China as an "emerging giant" matches the US as a driver of global growth, and has

[21] IMF. April 2006. World Economic Outlook: Globalization and Inflation.
[22] IMF. September 2005. World Economic Outlook: Building Institutions.
[23] IMF. April 2006. World Economic Outlook: Globalization and Inflation.
[24] IMF Managing Director Statement to the Development Committee, September 22, 2005.
[25] IMF. April 2006. World Economic Outlook: Globalization and Inflation.
[26] IMF. April 2006. World Economic Outlook: Globalization and Inflation.
[27] IMF. September 2005. *The Structure of the Oil Market and Causes of High Prices.* SM/05/359
[28] IMF. September 2005. World Economic Outlook: Building Institutions. GRAY/04/2076
[29] IMF Managing Director Statement to the Development Committee, September 22, 2005.
[30] *Soaring Chinese economy defies slowdown fears.* Financial Times, October 21, 2005, p. 4.
[31] IMF. April 2006. World Economic Outlook: Globalization and Inflation.
[32] Statement by Mr. Shaalan on World Economic Outlook. August 30, 2004. GRAY/04/2076

growing influence on relative prices and incomes in the world economy. The prices of China's exports continue to fall, and as the biggest consumer of many imports, Chinese demand is having a significant impact on the world prices of oil, aluminum, coal, steel and copper. With respect to oil, assuming that the rise in oil prices has been mostly driven by strong Chinese demand (and not an interruption of supply), the impact of higher oil prices on inflation has been more than offset by cheaper Chinese exports of other goods,[33] coming from the world's third largest exporter. Thus the overall impact has been that the downward pressure by China's exports has more than offset the upward pressure from its imports of raw materials,[34] including oil, for the time being.

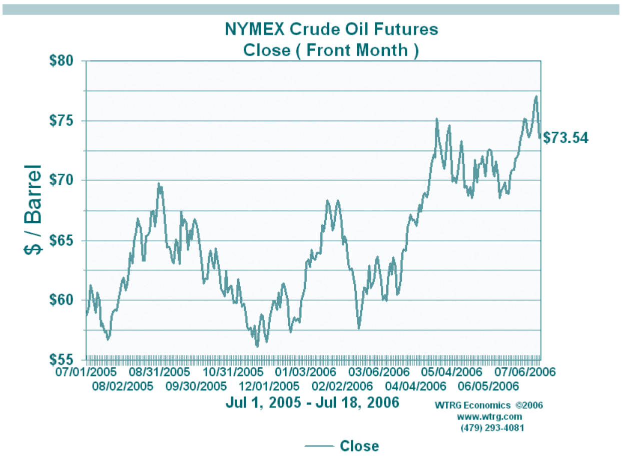
Not only have China's exports diluted the inflationary impact of high oil prices, but its policy of buying US Treasury bonds to hold down the Yuan has pushed down American bold yields, making it easier for the US government to continue to borrow at cheap rates and maintain robust economic growth.[35] Nevertheless, the rate of profits growth in the US could slow and high commodity prices could cause a spike in inflation. Stresses in the bond market could take place if interest rates rise more than expected or a slowdown in US consumer spending knocks equities.[36] A trigger for a correction in surging commodity prices including oil – a sharp economic downturn – does not appear to be on the horizon.[37]

However, even if the rest of the world went into a slowdown, Chinese demand for metals and commodities would still support high prices in the medium term. China has gone from accounting for some 7-10 percent of world demand of the main base metals in 1993 to 20-25 percent in 2003. By 2010, China will very likely account for more than 30 percent. Thus even if demand is falling in the rest of the world, if China continues to grow at current rates, it would make up for declines elsewhere. In addition, the size of global inventories of metals are at their lowest levels in decades, especially in the face of the lack of new projects to increase supply in both the oil and mining industries. Finally, tighter environmental standards in developing countries will also make it difficult to add new capacity.[38]

The question becomes: will risks of oil supply shortages continue in tandem with increased demand for oil? How will the persistence of demand/supply imbalances affect global inflation and growth? Will economic growth in the US remain solid after Hurricane Katrina? Will inflation rates remain at their current levels or will the US see rising price pressures? America's inflation rate almost doubled over the past year to 4.7 percent in September, its highest since 1991, and higher than when the former Chairman of the Federal Reserve Board, Alan Greenspan, took office in 1987.[39] Will fears about inflation continue to be inspired by expectations of permanent high energy prices, and feed into other prices and wage demands? Will US monetary policy continue to tighten to dampen inflation and excess liquidity in the housing market? These are all questions that have no easy answers given the "broad range of views in the outlook."[40]

Recent Trends in Selected World Commodities

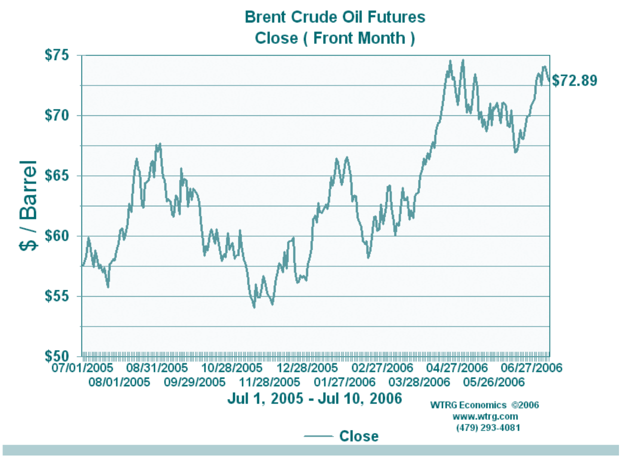
Oil prices rose in the first quarter of 2005 but declined as OPEC's expanded production came into the market. However, prices have risen again since the beginning of December and are at a new US dollar high. Analysts feel that the current spike reflects the near-capacity status of the refining industry.



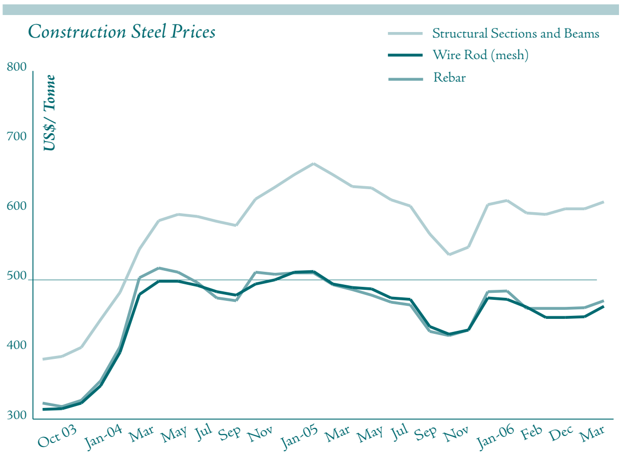
Without a more significant reduction in demand for oil, the current price trend could stimulate world inflation.

The current price is now higher than the historic high in real terms which occurred in late 1979 to early 1980. The price at that time reached almost $65/barrel in terms of 2004 dollars.

33 *How China Runs The World Economy.* The Economist, July 30th 2005.
34 *China And The World Economy*. The Economist, July 30th 2005.
35 *How China Runs The World Economy.* The Economist, July 30th 2005.
36 *What Does 2006 Have In Store?* Financial Times, December 30, 2005, P.11.
37 *Commodity Process: Supply Shortages And China's Appetite Keep Correction At Bay.* Financial Times, December 30, 2005, P. 24.
38 Ibid.
39 *Global Inflation - The Scourge Returns: Central Banks Cannot Ignore The Latest Spurt In Inflation.* The Economist, October 22-28, 2005, P. 18.
40 *Barclays Bank As Quoted In Crude Back At Levels Last Seen Before Pre-hurricane.* Financial Times, October 22, 2005, P. 12.

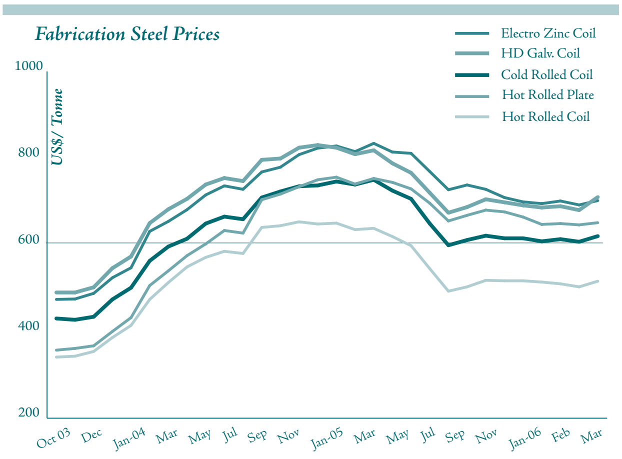


Steel prices overall declined between December 2004 – July 2005. They have been on an upward trajectory since August 2005. Analysts believe that strong demand will keep prices from waning.



Source: http://www.meps.co.uk/World%20Carbon%20Price.htm

In late 2003, early 2004, and late 2005, the rising price of steel was frequently mentioned as evidence of impending world inflation. However, prices started stabilizing since September 2005.



Source: http://www.meps.co.uk/World%20Carbon%20Price.htm

Textile Production and Trade

On January 1, 2005 all quotas were removed from trade in textiles in accordance with WTO agreements. Since then, there has been a rapid rise in selected textile imports from China into the EU and the US, the world's two largest textile markets. On May 13, 2005 and again on May 18 the United States announced that it had reintroduced textile quotas for various categories of textiles including cotton trousers, shirts and cotton blend underwear. Shortly thereafter, the EU advised China that it would do the same for t-shirts, flax and other categories of textiles unless exports were restrained. On June 9, China agreed to restrain the growth of selected categories of textiles to the EU, thus avoiding the re-imposition of quotas. Thus far, no similar agreement has been reached between China and the US.

Preliminary data for the first ten months of 2005 indicate that the predicted migration of the production of textiles to China and India is taking place. US trade data for January - October 2005 shows an overall 47.6 percent increase in total textile imports during this period compared to its correspondence in 2004.[41] However, China and India expanded their exports to the US by 67.9 percent and 25.3 percent respectively while there was an actual decline in the value of textile exports to the US from Mexico, Hong Kong, Canada, South Korea, Taiwan, the Philippines, Mauritius and South Africa. Similarly, EU data for the first quarter of 2005 show as much as a 32 point upward shift in China's market share in selected textile categories compared to the first quarter of 2004.[42] In almost all cases where China has gained market share, the prices of the textiles has declined from 15 to 47 percent.

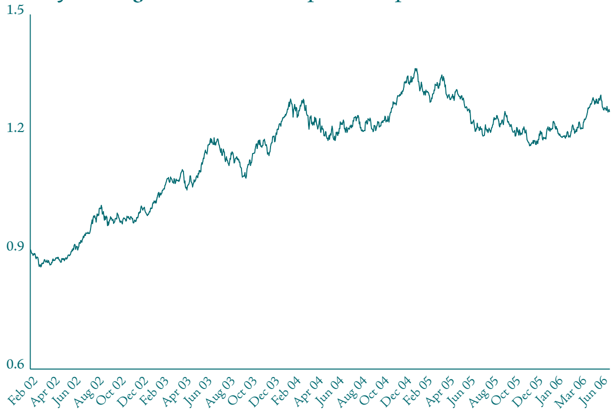
The consequence of this shift is that a number of countries are reporting a decline in exports and employment in textile production as the more labor intensive components of the industry are being taken over by Chinese suppliers. Countries that previously had relied heavily on textile exports now face a potentially formidable challenge to rapidly diversify exports in order to sustain overall growth and employment.

[41] http://www.census.gov/foreign-trade/statistics/country/sreport/china.xls.
[42] "Trade Developments", Nathan Associates Inc, www.nathaninc.com, April 2005.

Foreign Exchange Rates

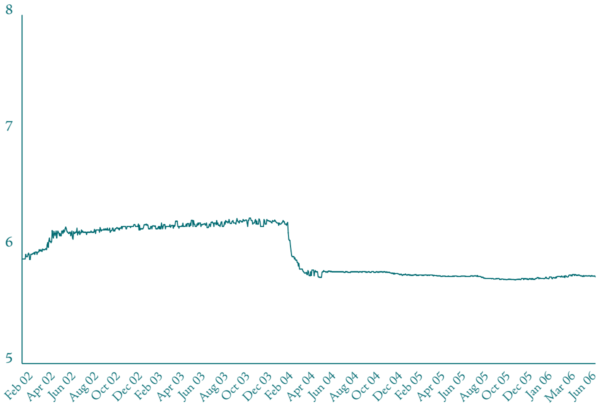
Since early 2002, the U.S. dollar has depreciated by some 37 percent, matched primarily by appreciation of the euro.

Daily Exchange Rates: US Dollars per 1 European Euro



The Egyptian pound has steadily and slowly appreciated against the dollar since January 2005.

Daily Exchange Rates: Egyptian pounds per 1 US$



Its performance against the Euro has been more volatile, but has overall appreciated.

Daily Exchange Rates: Egyptian pounds per 1 Euro