

“Oil Price Volatility and Financial Management”

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**Global Finance Forum on Oil Price Volatility,
Economic Impacts and Financial Management
George Washington University
March 10, 2008**

Good Morning, it's a great pleasure to be invited to speak at your opening session. I'm sure you're going to have an excellent two days of discussion.

The Power of Globalization

We live in extraordinary times.

With the focus on real time financial prices and quarterly profit announcements, it's not surprising that the emphasis of markets, policy-makers, and the media is on the slowdown of economic activity in the industrial world. Their questions are all about the extent to which output growth will decelerate in response to tighter credit conditions and attempts by households to rebuild savings and strengthen their balance sheets.

A related issue is to what degree a slowdown in the US will be transmitted to the rest of the world through the usual trade and financial linkages including changes in investor risk appetites. There's considerable debate on the degree of decoupling from the US economy and whether increases in energy and food prices will translate into broader inflationary pressures. Even the word “stagflation” is creeping into the lexicon of some analysts.

At the same time, it's important that we do not lose sight of the powerful global forces that are driving economic convergence and causing global poverty to decline more rapidly than ever before.

A global productivity shock has helped generate the strongest and most broadly based global growth for 40 years. Globalization is transforming people's lives. Millions of people are escaping poverty because of the global transfer of skill enhancing technologies and the catalysts of investment, trade, and migration. Deeply engrained, these forces will prosper through shorter-run downturns in the global economy. Asia is now a powerful pole for global economic growth, and developing countries are receiving large resource rents since they produce 60 percent of global crude oil production and more than two-thirds of lead, zinc, and copper production. Their overall terms of trade have improved by 14 percent since 2004.

We live in a world where many developing countries are benefiting from a favorable demographic window of rapid labor force growth and declining dependency ratios.

Global capital flows are accelerating rapidly. For example, private net cross-boarder capital flows and household remittances to developing countries have doubled over the past three years and now total in excess of US\$1 trillion – about ten times the level of annual official development assistance. Trade flows have expanded at twice the rate of industrial production and developing countries' foreign exchange reserve now total US\$4.6 trillion - an increase of 90 percent in SDR terms over the past three years.

It's important to keep these powerful structural forces in mind as well as the current economic conjuncture when focusing on the oil markets.

Developments in Oil Markets

Oil prices have more than quadrupled since 2002. In real terms, they are higher than the peak reached in 1980. Oil price volatility in recent years has been much higher than in the 1990s and the implied volatility of traded options from Brent Crude suggests that future volatility will continue.

The reasons for the supply demand imbalance are well known. The more interesting question is whether the forces shaping the demand and the supply curves will shift. Some big variables are in play.

On the demand side, the energy intensity of production in OECD economies has diminished markedly since the 1970s. Greater efficiency and substitution into alternative energy sources will help to moderate oil demand, but Chinese demand for oil is currently increasing by 15 percent a year. The IEA projects global energy demand to rise more than 50 percent between now and 2030 - with China and India accounting for almost half of this increase.

On the supply side, there's limited excess capacity in oil producing countries and many potential new sources of supply carry considerable political risk. With the lack of net investment in oil refining capacity over the past two decades and the long gestation periods in installing new refining capacity, these supply constraints will be costly to rectify. The IEA estimates that US\$20 trillion needs to be invested in the energy sector over the next 25 years to secure sufficient supplies.

There's been considerable debate over the role that oil speculators and traders might have played in exacerbating volatility and inducing upward pressure on prices. Some of this sentiment may date back to concern about the role that Enron's energy traders played in manipulating the market for natural gas on the West Coast. I'll be interested to hear the conclusions of this debate as my general impression is that increased speculative activity in futures markets result from the high level of oil prices and uncertainty about forward prices, not the other way around.

Challenges for Economic Management

Whatever its sources, high and volatile oil prices present challenges to governments in managing the terms of trade impact and its consequences for traditional macro-policy instruments, and regulatory and distribution policies.

Oil producers have often struggled with the effects of exchange rate appreciation on traditional export industries and the ensuing deterioration in governance - often characterized by growing corruption. While GDP per capita in resource-rich countries increased by 50 percent in the four decades to 1998, per capita income growth for resource-poor countries was four times higher.

Fortunately, sensible governance arrangements based on frameworks similar to those adopted by Norway and the State of Alaska are beginning to emerge in several developing countries. The goal is to convert non-renewable resource endowments into permanent sources of investment income using diversified asset strategies and strict budgetary or stabilization rules. It's good to see that these experiences will be examined in the conference.

We have seen considerable international interests in the operation of sovereign wealth funds. These funds currently manage assets of around US\$2.5 trillion and some projections suggest that this could reach US\$12 trillion by 2015. The G7 has called on the IMF, World Bank, and OECD to develop a code of conduct for these funds, including provisions on institutional structure, risk management, transparency, and accountability. Although some of the political rhetoric has become highly inflammatory, there are some important issues here. For example, given that these are state-owned investment vehicles, would it be appropriate for them to take an aggressive speculative position like George Soros's hedge fund did in shorting sterling in 1992?

Financial Market Instruments

If used responsibly, commodity hedges and other risk management building blocks can help enormously in managing balance sheet risk. Hence, it's pleasing to see that financial market instruments and strategies are being examined.

Governments are keen to manage their balance sheet risks. They do so through a range of mechanisms, e.g. by being conscious of the currency exposure of their assets and liabilities, by building up foreign exchange reserves, privatizing assets, and adopting sound principles of fiscal management – including managing contingent liabilities. In the energy field, risk management may involve liberalizing energy markets, diversifying energy and fuel sources, restraining demand, managing inventories and creating incentives for energy efficiency.

In 2000, the World Bank introduced several hedging products to help developing countries manage their balance sheet risks. With these products, countries have the opportunity to manage exchange rate, interest rate, and commodity price risk in their

IBRD loan portfolios. We can also use these instruments to transform their non-IBRD portfolios.

In using derivative products, it's essential that users understand their pricing characteristics. We have recently seen how competitive pressures drove investors to take on greater risks in their search for high yield. We saw dominant institutional investors investing in complex structured products with risk and return characteristic that they did not fully understand – even more so when market liquidity began to dry up with corresponding uncertainty on how to value underlying cash flows.

The Effects on Developing Countries

But even with efficient financial markets, there remains a critical challenge for many developing countries. One of the cruel ironies today is the connection between rising energy and food prices. This coupling can have devastating implications for global poverty and food security. Higher energy prices have increased fertilizer and transport costs and stimulated bio-fuel production. In the US, for example, a quarter of the maize crop – representing over ten percent of global output – went into bio-fuel production this year. Together, higher energy prices, drought, and rising demand have led to a 75 percent increase in the price of staples since 2005. Just last week, rice prices soared to a 20 year high.

Just as the poorest on this planet are the most exposed to the effects of climate change, they are also highly vulnerable to the effects of rising fuel and food prices. Food and energy prices usually represent over 70 percent of the consumption basket of the poor. The long term consequences are considerable. Poor households will cut back on food consumption and education – and girls will invariably be the first withdrawn from schooling. Reliance on traditional fuels will increase with obvious environmental consequences.

This leads to an important point. The catalyst of globalization will only be sustainable if it can create opportunities and benefits for all.

Today, given the recent revisions to purchasing power parities, well in excess of over a billion people live on less than \$1 a day. The benefits of globalization are by-passing many of the poorest who are in danger of becoming politically and socially disenfranchised and disconnected from global society. We have seen how their exposure to higher food prices recently led to riots in West Africa and South Asia.

A world where a large proportion of the population remains trapped in extreme poverty and unable to share the benefits and opportunities of globalization, carries unacceptable costs in terms of human suffering, economic losses and political tensions, and has important potential implications for security within countries and across borders.

Conclusion

In concluding, even though we have concerns about the current slowdown in the industrial economies, globalization and the catalyst of trade, investment, technology, and labor mobility, are boosting productivity growth and delivering millions of people from poverty.

In many respects, “drami” or “the endless knot” – one of the eight lucky signs of Buddhist philosophy, illustrates the challenges of globalization. It symbolizes how citizens of the world – across countries and over time - are connected in a web of mutual interdependence.

Globalization and interdependence and how to manage the risks around these will feature strongly in your discussions over the next two days. I wish you a very productive and successful dialogue.

Thanks very much.