

VAKIFBANK GLOBAL ECONOMY WEEKLY

Oil Prices: Economic Recessions, Inflation Fear and Food Price Linkage?



T. Vakıflar Bankası T.A.O

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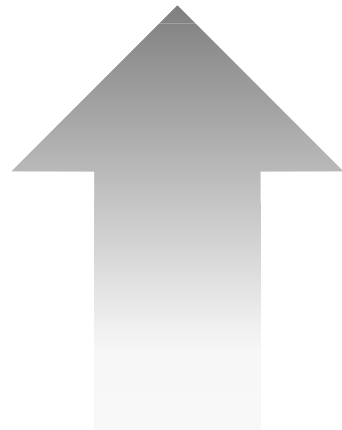
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Vakıfbank Economic Research



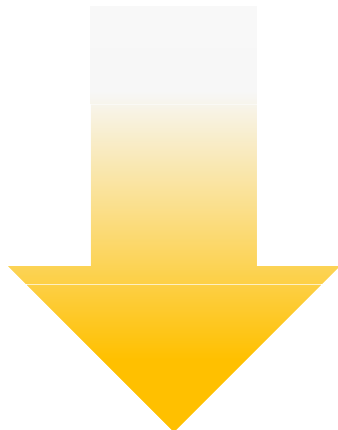
Political risks and strong expectations on growth has supported upward movements in oil prices...

 The price expectations for 2011 has increased.



Increase:




- Global Growth
- Regional Conflicts
- Weather Conditions



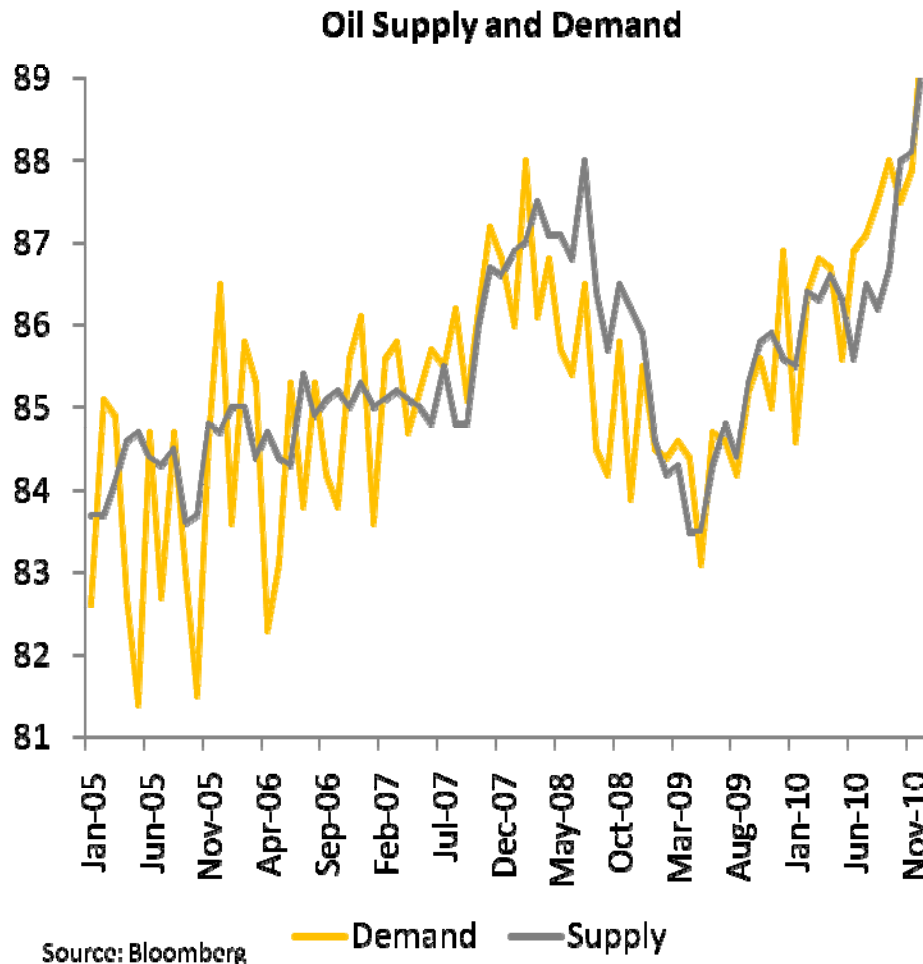
Decrease:







- Production increase of OPEC
- Macroeconomic risks
- Interest rate increases



-  With the beginning of the recovery period after the last crisis, oil demand has been the most important reason behind in oil price rise.
-  Increasing economic performances of the developing countries, particularly China, has put pressure on oil prices through rising oil demand.
-  Although, the contractionary monetary policies of Central Bank of China has lightened the pressure of the oil demand, it hasn't created a significant fall in expectations of the high oil prices in the near future.

Oil demand is higher than supply, thus oil prices are increasing...



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 The rapid expansion in economic activity and energy demand especially in emerging markets is starting to increase oil prices.
- 
 Oil demand is higher than its supply. This leads to oil price to increase.
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 Central Bank of China's contractionary monetary policies caused a little ease off in demand pressures, but future expectations haven't declined significantly.
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 With increased geopolitical tension on the horizon, oil prices might stay high.
- 
 Oil price estimates for the coming periods has been revised upwards.
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 In CBRT's latest Inflation Report, oil price forecast was revised from \$85 to \$95.

The high correlation between oil shocks and recessions doesn't imply that the oil shocks will definitely cause recessions...

OIL PRICE SHOCK AND GLOBAL RECESSIONS			
Gasoline Shortages	Price Increase	Key Factors	Business Cycle Peak
December 73 – March 74	51%	Strong demand, supply constraints , embargo	November 73
May 79 – July 79	57%	Iranian Revolution	January 80
November 80 – February 81	45%	Iran – Iraq War, controls lifted	July 81
August 90 – October 90	93%	Gulf War I	July 90
December 99 – November 00	38%	Strong demand	March 01
February 07 – June 08	145%	Strong demand, stagnant supply	December 07

Source:Hamilton J. **Historical Oil Shocks**, Handbook of Major Events in Economic History, 2011

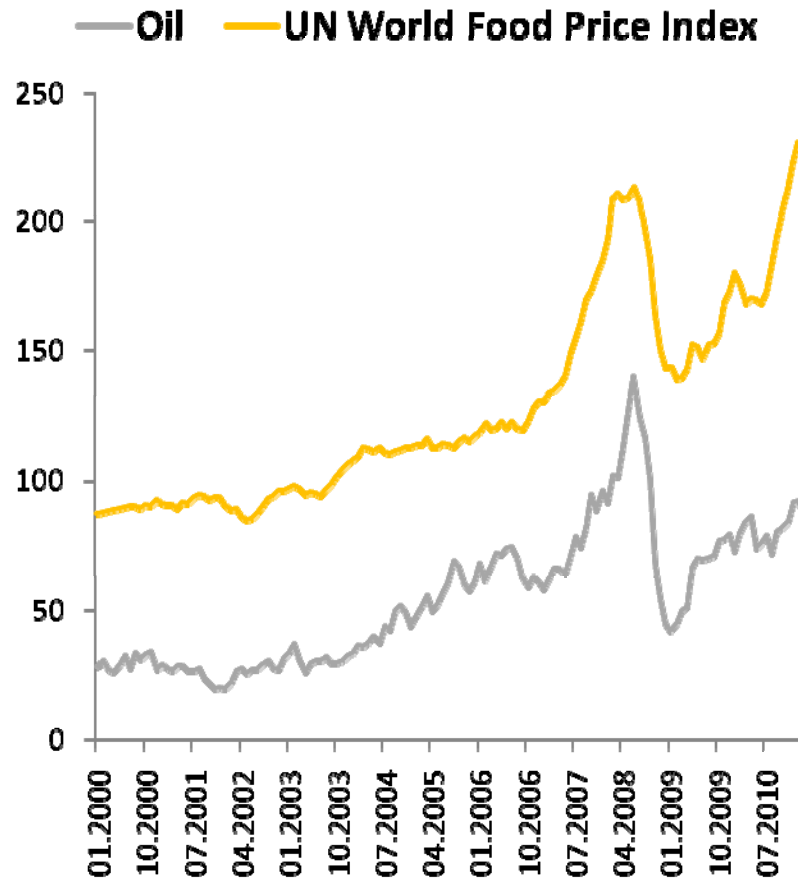
- ✔ The correlation between oil shocks and economic recessions appears to be strong.
- ✔ It indicates that the oil shocks are the most important factor in some postwar economic recessions.
- ✔ The recent re-emergence of oil prices rise to \$100 level has triggered the worries about the comprise of other macroeconomic problems. Since the recent rise in oil prices remains very low compared to the precedent samples, the possibility of another recession due to this hike is low whereas the rise in oil prices will increase inflationary pressure.

Oil prices have reached the highest level since 2008...



- ✔ Oil prices reached the highest levels since 2008 in January with the effect of political turbulence in Tunisia and Egypt.
- ✔ According to International Energy Agency's (IEA) 2008 data, Egypt supplies only 1% of global oil production. However, Egypt is home to the Suez Canal and the Suez-Mediterranean Pipeline which connects the Red Sea with the Mediterranean. Hence it caused the concerns about the oil flows but according to IEA, less than 1% of global oil supply is shipped through the Suez Canal.
- ✔ Thus, it can be said that contagion risk of political turbulence to bigger oil supplier countries in the Middle East is effective on the rising oil prices.
- ✔ Rising oil prices also increase inflationary pressures in the emerging markets but food prices should be watched in terms of inflationary risks.

There is a positive correlation (0.94) from oil prices to the food prices...

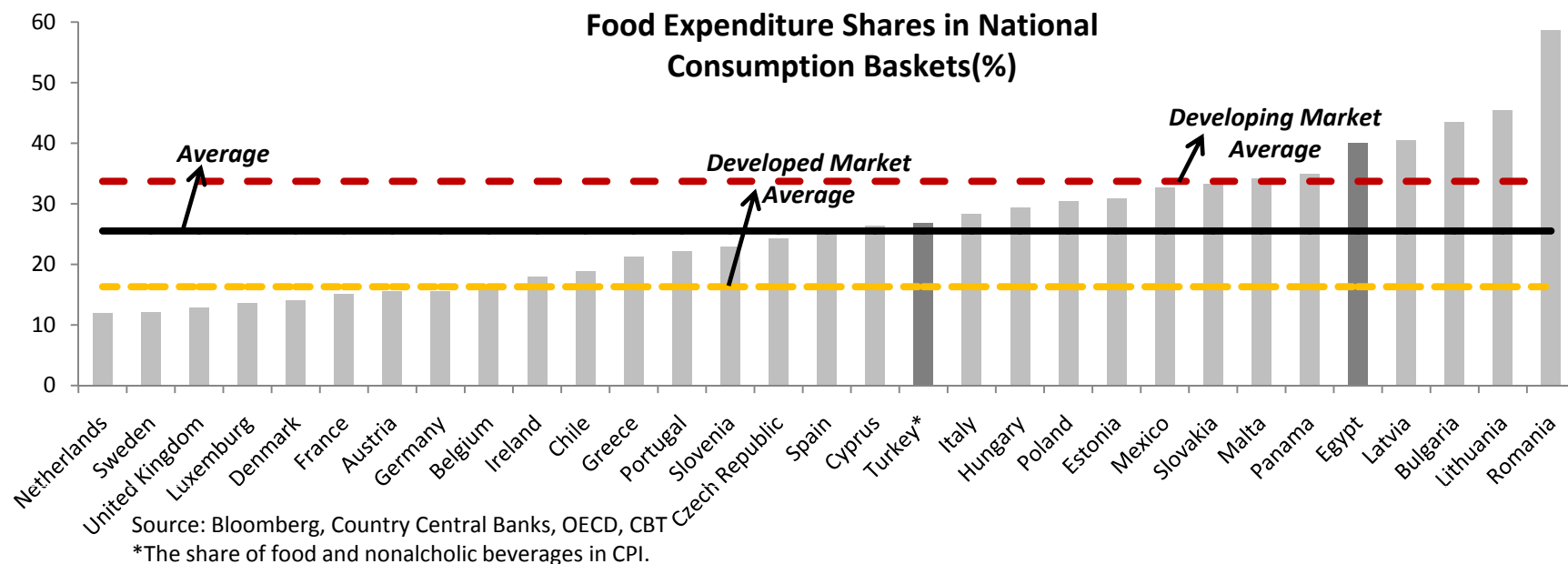


Source: Reuters, Bloomberg

- World food price index reached the highest level in January since the Food and Agriculture Organisation (FAO) started collecting food prices in 1990.
- New records in food prices will be possible in the future because of bad weather conditions in supplier countries and speculations about the stocks in Egypt which is an important cereal producer in the world.
- It can be seen in the graphic that oil prices and food price index move parallel. High correlation between oil and food price could be another factor that push up inflation risks in already overheating emerging economies

Increasing food prices and the political instability in Egypt lead to economic concerns worldwide...

- ✔ The dramatic swings in world commodity prices (especially wide fluctuations in food prices) in recent years have renewed interest in the issue of how monetary policy in small open economies should react to imported price shocks.
- ✔ The large weight of food in households' consumption baskets and its limited substitutability with other goods, food price fluctuations can have a sizeable impact on overall consumer prices as well as on terms of trade.
- ✔ Developing countries have higher food expenditure in national consumption basket than developed countries and, this shows that the food expenditures vary according to income levels of countries.
- ✔ According to recent surveys, the share of food expenditure in household expenditures is above 25% in countries with national income per capita under 10.000\$ and in Egypt (who has roughly 2000\$ per capita national income) this ratio is 40%.



Serkan Özcan
Chief Economist
+ 90 312 455 7087
serkan.ozcan@vakifbank.com.tr

Cem Erođlu
Senior Economist
+ 90 312 455 8480
cem.eroglu@vakifbank.com.tr

Ümit Ünsal
Economist
+ 90 312 455 8418
umit.unsal@vakifbank.com.tr

Naime Dođan
Researcher
+ 90 312 455 8486
naime.dogan@vakifbank.com.tr

Fatma Özlem Kanbur
Researcher
+ 90 312 455 8482
fatmaozlem.kanbur@vakifbank.com.tr

Senem Güder
Researcher
+ 90 312 455 8476
senem.guder@vakifbank.com.tr

T. Vakıflar Bankası T.A.O
Ataturk Bulvari No: 207
Kavaklıdere 06683 Ankara, Turkey
www.vakifbank.com.tr

Vakıfbank Economic Research
ekonomik.arastirmalar@vakifbank.com.tr

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