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Oil price shock threatens to topple financial dominoes

by William Engdahl

On April 1, crude oil prices hit their highest level in 10 months, with the world benchmark grade of oil, North Sea Brent crude, trading at $14.89 per barrel. Four weeks earlier, it fetched $11 per barrel. The question at this point is: How high is the price of oil likely to rise in the coming months? The answer could well determine if the world will undergo new shocks in the financial markets—the stock and bond markets, as well as in the currencies—of the Group of Seven (G-7) industrial nations, foremost among them those of the United States.

Since March 12, when the oil ministers of five of the major oil-exporting countries, led by Saudi Arabia, Mexico, and Venezuela, met in The Hague and agreed to broad terms for further oil-output cuts, the third attempt since March 1998, world oil prices have slowly begun to rise. Then, on March 23, the Organization of Petroleum Exporting Countries (OPEC) held emergency talks in Vienna, in an effort to ratify the preliminary deal of the five, to try to stop what had been a 50% fall in world oil prices since the beginning of the global financial crisis which broke out in Asia in October 1997.

Following those talks, OPEC ministers announced plans to cut another 1.7 million barrels per day (bpd) from their combined oil exports, bringing OPEC output down to 22.9 million bpd. Saudi Oil Minister Ali al-Niami, the spokesman for the OPEC producers, told the media that, unlike the two previous attempts by OPEC to cut supply to end a huge glut on world markets, this time he was confident that OPEC members would adhere rigidly to the quotas. "I'm telling you that compliance is going to be at its highest. Never has an agreement been signed so quickly," he said. The Saudi minister forecast that oil prices would reach at least $18-19 per barrel by the autumn.

Price may double

"The Vienna OPEC meeting represents a serious attempt to correct the decline in oil price," noted a senior spokesman for the Nicosia, Cyprus-based *Middle East Economic Survey,* an oil journal with close links to the Persian Gulf oil states. "The price decline had gotten so painful for the producing countries that the consensus is they must act. This meeting is far more serious than the previous two," he said. According to the spokesman, the crucial period will be April, May, and June. "The crucial issue is of credibility, after the failures of the past two attempts," he said. "If OPEC reaches the agreed 22.9 million barrel level, which is to begin April 1, and manages to hold it through May and June, then we're in a new ballgame. Then the huge excess stockpiles will begin to disappear and prices will respond accordingly." Some oil analysts forecast that prices could go as high as $20-25 per barrel by year end, which would be almost double its recent lows.

Indeed, there are compelling reasons why this OPEC action may hold. Unlike the oil price collapse of early 1986, when North Sea Brent briefly fell below $9 per barrel, the price collapse this time has been far more serious. In 1986, the crisis was over as soon as OPEC members agreed to new quotas demanded by Saudi Arabia, and prices recovered within months. This crisis has proven far more enduring, lasting well more than a year. The prime cause has been the collapse of economic growth in Asia, which had been the fastest-growing oil market. That crisis spread to other emerging markets during 1998, and by the beginning of this year, began to affect growth in the G-7 economies as well, particularly Germany and Italy. The collapse of oil revenue has turned the situation of nations such as Indonesia, Russia, and Venezuela into economic and fiscal catastrophes. Last year, OPEC oil revenue fell $50 billion from the levels expected at

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the start of the year.

Barring creation of a New Bretton Woods financial system tied to government support for long-term infrastructure and industrial investment to reverse the worsening world depression, which would boost oil demand, OPEC is reduced to cutting supply in the desperate hope that the price will rise significantly. Ironically, this emergency OPEC action designed to rescue its members from fiscal crisis, could detonate financial market shocks later this year that would plunge the global economy into collapse.

Expecting the unexpected

"Today financial markets still believe the price of oil can only go down, not up," said George Andersen, chief economist of a leading European bank. "The record highs in the Dow Jones and NASDAQ stock markets are tied to unbelievably low inflation. The lead indicator of future inflation is oil prices. If now we have an upward spike in oil, that will shatter the financial markets. This market is very, very sensitive to any spike in inflation."

A dramatic rise in the price oil, to which the world economy is most sensitive, could, according to Andersen and other financial market analysts, detonate a collapse of major stock and bond markets in the United States and Europe within the coming three months. This prospect, considered all but impossible by most market participants even two weeks ago, has become a distinct possibility since the March 23 OPEC meeting in Vienna.

One of the strongest factors pushing U.S. and European financial markets higher, especially in the United States since the collapse of the Long Term Capital Management hedge fund last October, has been the historic low inflation rate, which has enabled the Federal Reserve and European Central Bank to maintain dramatically low interest rates. That, in turn, has fuelled a speculative buying binge, especially in U.S. stocks, on cheap credit. Oil is by far the most influential commodity for determining inflation levels for bond markets. Were the price of Brent oil to rise to $20 per barrel in the coming two to three months, that shock would likely detonate a major crisis, first in the inflated U.S. bond and stock markets.

According to City of London bond strategist S.J. Lewis of London Bond Broking Ltd., "Were oil to hit $20 per barrel, [Federal Reserve chairman Alan] Greenspan and the Fed would be forced to raise interest rates or lose credibility entirely in the eyes of bond markets, and face a crisis in the dollar as investors fled the U.S." A rise in U.S. interest rates, in turn, would reverse expectations built into the present inflated stock and bond prices. In brief, it would likely trigger a panic sell-off. According to the economic model used by the Fed to determine the appropriate level of stock prices versus real economic growth, the U.S. market is 30% overvalued. Many American households continue buying at record levels based on the view that their savings invested in stocks would cushion them from any problems. Were stocks to plunge, consumer spending would follow with a vengeance.

While many Wall Street pundits argue that the milestone of 10,000 for the Dow Jones index of 30 industrial companies is just the beginning of a new era of unlimited rise, every serious indication is that the U.S. stock market has become the world's most colossal speculative bubble. At some point, that bubble will pop, and indications are that the pressures building for higher interest rates, because of fears of inflation over the price of oil, could be the trigger.

Detached from reality

According to every conventional indicator used to determine when stock prices have detached from underlying economic reality, the $12 trillion U.S. stock market is beyond the pale. Since the end of 1994, the price/earnings ratio in U.S. stock markets has doubled, from 14 to 28. The P/E ratio is widely used as an indication of an inflated stock market. The P/E for Standard & Poor's-500 stocks is at 26. That is, an average price 26 times a company's after-tax annual earnings. For decades the rule on Wall Street, before the explosion of the "new economy" mania several years ago, was that a P/E of 7.5 was considered "healthy."

The P/E for individual stocks is even more alarming. The company whose stock value, so-called market capitalization, is the largest in the United States, is Microsoft—at today's levels, worth $486 billion. It has a P/E of 68. The ten largest stocks on the S&P-500 have an average P/E of 48. America Online, an Internet company, has a P/E of 350. Its market capitalization is $147 billion. On March 31, Priceline.com, a company which has operated only 11 months and racked up losses of $114 million selling airline tickets over the Internet, went public with an IPO initial stock offering. By day's end, the share price had risen 400%, from $16 per share to $69, giving the company a larger market value than United Airlines, Continental Air, and Northwest Air combined. "Each new Internet IPO is nothing more than red meat to the mad dogs," said David Simons of Digital Video Investments. In short, the stock market is a bubble that could burst at the next major shock.

Commenting on the fragility of global financial markets, Lyndon LaRouche recently noted three decisive features of the current financial situation: 1) Japan entered its new fiscal year on April 1 with an unresolved $2 trillion bank bad loan problem, which is pushing the world's second-largest industrial nation into its worst depression since the 1920s; 2) Brazil's crisis is in no way resolved, but rather is spreading economic decline across Ibero-America; and 3) the Russian and eastern Europe crises, which the G-7 and International Monetary Fund are desperately trying to contain from default, are worsening.

A crisis in the U.S. dollar or a hike in Fed interest rates, either one a likely consequence of dynamics set off by OPEC's March 23 meeting, can begin to plunge Japan, Brazil, Russia, and, this time, the G-7, into collapse. That would bring OPEC and the world unintended consequences indeed.