

# Why Oil Prices Will Hover at \$120 for Next Decade

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The commodity super-cycle in which commodity prices reach ever-higher highs and fall only to higher lows is not over. Despite the euphoria around shale gas — indeed, despite weak global growth — commodity prices have risen as much as 150 percent in the aftermath of the financial crisis. In the medium term, this trend will continue to pose an inflation risk and undermine living standards worldwide.

For starters, there is the convergence argument. As China grows, its increasing size, wealth and urbanization will continue to stoke demand for energy, grains, minerals and other resources.

For example, the U.S. consumes more than nine times as much oil as China on a per capita basis. As more of China's population converges to Western standards of consumption, demand for commodities will remain on an upward trajectory.

Of course, not all commodities are equal. For example, although the case for copper seems

straightforward, given that it is a key input for wiring, electronics and indoor plumbing, a strong bid for iron is not as obvious, given the Chinese infrastructure boom that already has occurred in the last two decades.

Worst-case estimates have China's real gross domestic product growing around 7 percent per year over the next decade. Meanwhile, the supply of most commodities is forecast to grow by no more than 2 percent annually in real terms. All else being equal, unless China's commodity intensity, defined as the amount of a commodity consumed to generate a unit of output, falls dramatically, its demand for commodities will be greater this year than it was last year.

As long as China's commodity demand grows at a higher rate than global supply, prices will rise. The rapid economic growth that China's leaders must sustain to lift large numbers of people out of poverty — and thus prevent a crisis of legitimacy — places a floor under global food, energy and mineral prices.

To be sure, intensity of use has fallen for some commodities, like gold and nuclear energy. But for others, such as aluminum and coal, it has risen since 2000. In the case of copper and oil, declines have slowed markedly or stalled at high levels. As the composition of China's economy continues to shift from investment to consumption, demand for commodity-intensive consumer durables — cars, mobile phones, indoor plumbing, computers and televisions — will rise.

There is also the issue of the so-called reserve price, the highest price a buyer is willing to pay for a good or service. The reserve price places a cap on how high commodity prices will go since consumers are no longer willing or able to purchase the good or service.

For oil and many other commodities, the reserve price is higher in emerging countries than in developed economies. One explanation for the difference is accelerating wage growth across developing regions, which is raising commodity demand, whereas stagnating wages in developed markets are causing the reserve price to decline. By implication, if nothing else, global energy, food and mineral prices will continue to be buoyed by seemingly insatiable emerging-market demand, which commands much higher reserve prices.

Ultimately, emerging economies' absolute size and rate of growth both matter in charting commodity demand and the future trajectory of global commodity prices, with per capita income clearly linked to consumers' wealth. If people feel rich and enjoy growing wages and appreciating assets, they are less inclined to cannibalize other spending when commodity consumption becomes more expensive. They just pay more and carry on.

Of course, upward pressure on commodity prices also stems from supply-side challenges. It is not just that global supplies of resources are increasingly scarce, but also that supplies are increasingly falling into inefficient hands.

Around the world, governments are taking greater control of resources and imposing policies that hamper global production and ultimately force prices higher. Following the recent fracas surrounding Argentina's nationalization of YPF, Australia's 2012 mining tax on iron and coal companies is a stark reminder that such tendencies are not limited to emerging-market politicians.

Such price increases can prove particularly inflationary in countries that import commodities. And they can be disastrous to exporting economies, which risk rapid currency appreciation and thus a loss of competitiveness.

Of course, technological advances such as hydraulic fracturing, or "fracking," in the shale-gas industry, could increase supply and therefore lower prices. But mounting environmental challenges and the limited availability of commodity substitutes suggest that a reprieve on commodity prices is not near.

There is a perennial temptation to focus on, even to overemphasize, the short-term, tactical drivers of commodity-price movements at the expense of giving longer-term, structural factors their due. While short-term factors — for example, political instability, weather-related disruptions and speculative activity — are important determinants of prices, they tell only part of the story.

The economic fundamentals of supply and demand remain the key factors in driving the direction of commodity prices and determining whether the commodity super-cycle will persist. In practical terms, this means that oil prices, for example, are more likely to hover near \$120 per barrel over the next decade rather than \$50. We are unlikely to see a \$20 barrel of oil ever again.

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