

China and the Market for Crude Oil

CHINESE ECONOMY EXPANDING AT BREATHTAKING PACE

Chinese GDP has grown at an average rate of around 9.5 per cent per year since the economic reform process started in 1978. Yearly fluctuations have been rather large, but no significant set-back has been seen. The most recent difficulty has been overheating of the economy resulting from excessively rapid growth last winter and this spring.

GDP growth in the last quarter of 2003 stood at 9.9 per cent, slowing only marginally in the first quarter of 2004 to 9.8 per cent and 9.6 per cent in the second quarter. The government expects third quarter growth to come out at 9 per cent. Industrial production has expanded much faster than GDP, as evident in the figure

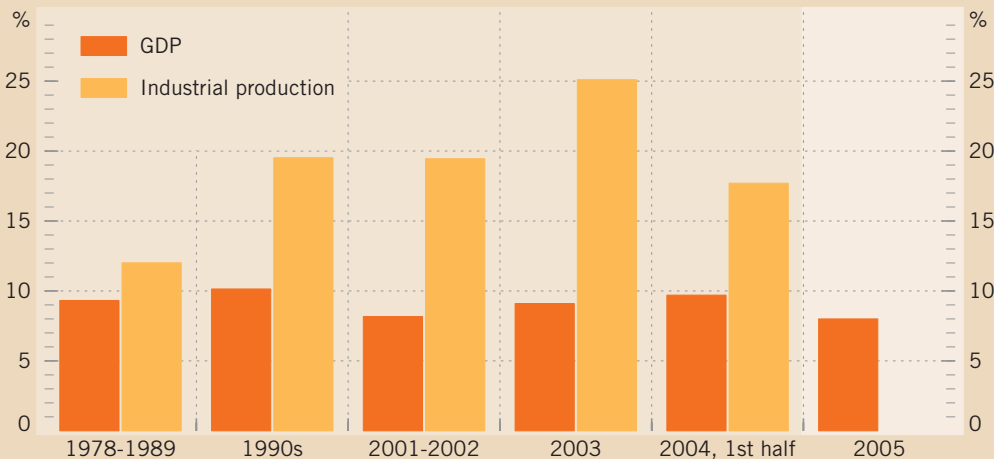


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below. In the first half of this year, it grew by 17.7 per cent while slowing to 15.5 per cent in July. Growth has been driven by investment activity especially in the automobile, steel and cement industries.

Average Growth in Chinese GDP and Industrial Production Since 1978



Sources: CHNS1, CHNS2.

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MEASURES TO COOL THE ECONOMY HAVE BEEN INTRODUCED

Economic overheating has led the government impose direct restrictions to cool the steel and cement markets. In addition, attempts to moderate demand have been made by restricting lending to these sectors. On the other hand, the government is encouraging investment especially in the country's infrastructure in order to prevent a crash in the economy.

However, it is still not obvious that growth has clearly slowed. Indeed, the second quarter figure was "inflated" by the low base of comparison last year due to the SARS epidemic. However, the government revised last year's second-quarter growth figure upwards by more than one percentage point, which suggests that growth was still robust in the second quarter of this year. In the third quarter of 2003, growth was not biased downwards so much, making it a better basis of comparison. Reliable information on quarter-to-quarter changes in GDP is very difficult to obtain. However, indirect information can be drawn from the commodity markets as they are very sensitive to changes in Chinese demand. The very strong Chinese growth pulled many commodity

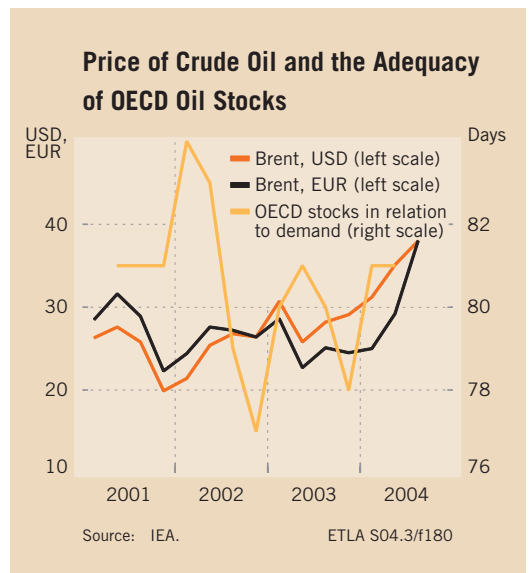
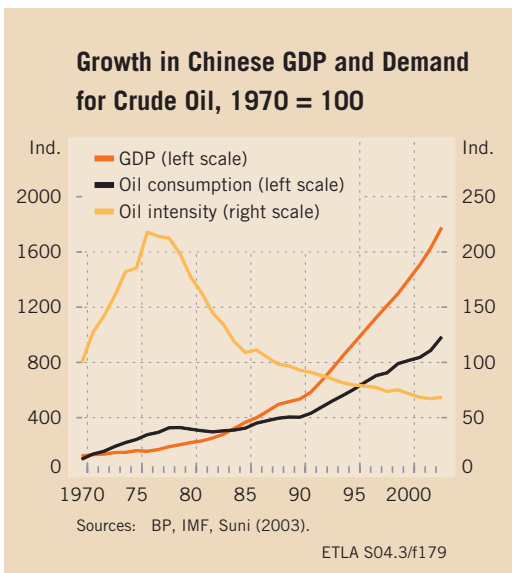
prices up steeply till the early summer, after which many prices started to fall quite rapidly. However, in late summer prices began to rise sharply again.

The government has continued restrictive policy this autumn. If government attempts to cool the economy are not successful, there is a danger that even stronger measures will be introduced which could lead to a hard landing in the economy.

THE MARKET FOR CRUDE OIL VERY UNSTABLE

The price of crude oil has fluctuated considerably during the summer. At the end of August, the price reached 45 dollars per barrel (Brent) for a while. In nominal terms, oil has not been this expensive since the early 1980s. In real terms, the price of oil is still less than half of its level back then.

Pushed forward by China and the USA, the strong growth of the global economy is behind the tightening of the market for oil and many other commodities. The demand for crude oil has risen to a level unanticipated by producers. Investment in oil extraction has been insufficient and it takes time to increase capacity,



which is now almost in full use. As the situation in the Middle East is very unstable, terrorist strikes against oil targets are common, the situation in, e.g., Russia, Venezuela and Nigeria is problematic, and recently hurricanes have disrupted offshore oil production in the Gulf of Mexico. As a result speculators' interest in the oil market has also grown.

According to many estimates, the "normal" market price of crude oil is slightly above USD 30 per barrel, which means that there is a considerable risk premium in the price. ETLA's September forecast presumes, however, that the price of oil will remain at around USD 35 per barrel both this year and in 2005, assuming the risk related to the availability of oil is reasonably contained.

The situation in oil inventories has improved during the year, as consumers have been buying oil in order to guarantee availability in uncertain times. This has raised the price of oil. On the other hand, it will allow for a decline in prices towards ETLA's forecast.

The possibility of considerably higher prices is large unless risks are brought under control, however. On the other hand, if certainty over the availability of oil increases and demand cools off faster than expected, oil prices will decline more than what has been forecasted.

HIGHER DEMAND IN CHINA HAS RAISED THE PRICE OF CRUDE OIL

China's rapid growth has been intensive in raw materials and therefore China's significance in the commodity markets has risen rapidly. Despite a fast improvement in energy intensity, use of oil remains inefficient. Compared with the European Union, China uses three times more oil in relation to GDP. China became a net importer of crude oil in 1993. Last year China surpassed Japan in oil imports and became the world's second-largest oil importer after the USA.

Growth in imports has been rapid regardless of the improved energy efficiency in China during the past few years. According to the IEA, China's oil production increased by 11.1 per cent last year. This year the IEA expects that growth will accelerate further despite efforts to contain economic growth.

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