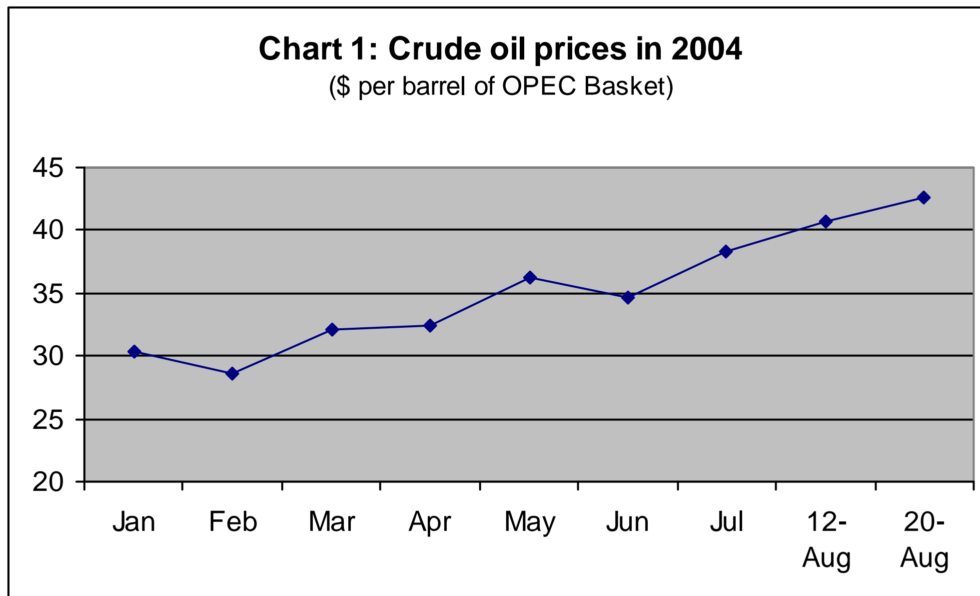
Oil Prices and the World Economy

C.P. Chandrasekhar & Jayati Ghosh

The past months have witnessed soaring oil prices in international markets, which have come on top of increases in the previous three years. In the third week of August world trade prices of crude oil nearly touched $50 per barrel before settling somewhat lower. But further increases are not ruled out in the near future.

While crude oil prices have been rising since March this year, thus far the month of August has seen the most rapid increase, as Chart 1 shows. The most recent increases have been driven by a number of factors. The most important factor, of course, is the continued resistance of the Iraqi people to the US military occupation. The inability thus far of the US army to contain the armed struggle of the militia of Muqtada al Sadr and others despite using blatant violence even against civilians, along with the growing sabotage of oil facilities and destruction of oil pipelines in Iraq, has reduced exports and led to expectations of uncertain future supplies from that country.



In addition, the threats of terrorist attacks in the world's largest oil producer, Saudi Arabia, are growing and also have been increasingly

realised in recent months. The nervousness this has created in world markets has not been neutralised by OPEC's promises of boosting production. More recently, the travails of the giant Russian oil company Yukos have also contributed to rising oil prices.

Normally, some of this supply uncertainty would be considered as inevitable and would have only a marginal effect on markets. At present, however, these factors, as well as other potential issues such as instability in Venezuela or strikes in Norway, or indeed any changes in any oil-producing country, can have substantial effects on prices at the margin and cause sudden price spikes. This is because world demand for oil rules very high at present. In consequence, current oil production is extremely close to current capacity, and there is little margin for major increases in supply in the near future.

World demand for oil has been fuelled not only by growth in the US, but also by strong demand from other countries. China's imports of crude oil have increased by more than 40 per cent since the beginning of 2004. This is not all for current consumption – rather it reflects stockpiling by the Chinese government, a shift from holding excess dollar reserves to holding oil reserves.

Even the US government is continuing to add to its Strategic Petroleum Reserve, rather than depleting it in order to reduce oil prices. The Bush administration has made it clear it would not intervene to release any of these stocks unless the oil prices goes to levels of $55-60 per barrel before the November elections.

Market analysts do predict that the current high levels of OPEC production (which was 29.8 million barrels per day in July, only 0.5 million barrels below total OPEC crude oil production capacity) are likely to push prices below $40 per barrel by the last quarter of 2004. Nevertheless, it is unlikely that 2005 will witness a sharp decline in crude oil prices, simply because world demand is expected to continue to grow and keep inventories tight. Global oil demand is currently projected by the US Department of Energy to exceed 2 million barrels per day this year as well as in 2005.

So if oil prices do continue to rise, what are the implications? Some observers have already sounded the alarm bells. OPEC itself has predicted that the global economic recovery could be in jeopardy in prices remain at

current levels (around $40 per barrel) for the next two years. An OPEC report projects that this would reduce growth in Europe and the US by between 0.2 and 0.4 percentage points.

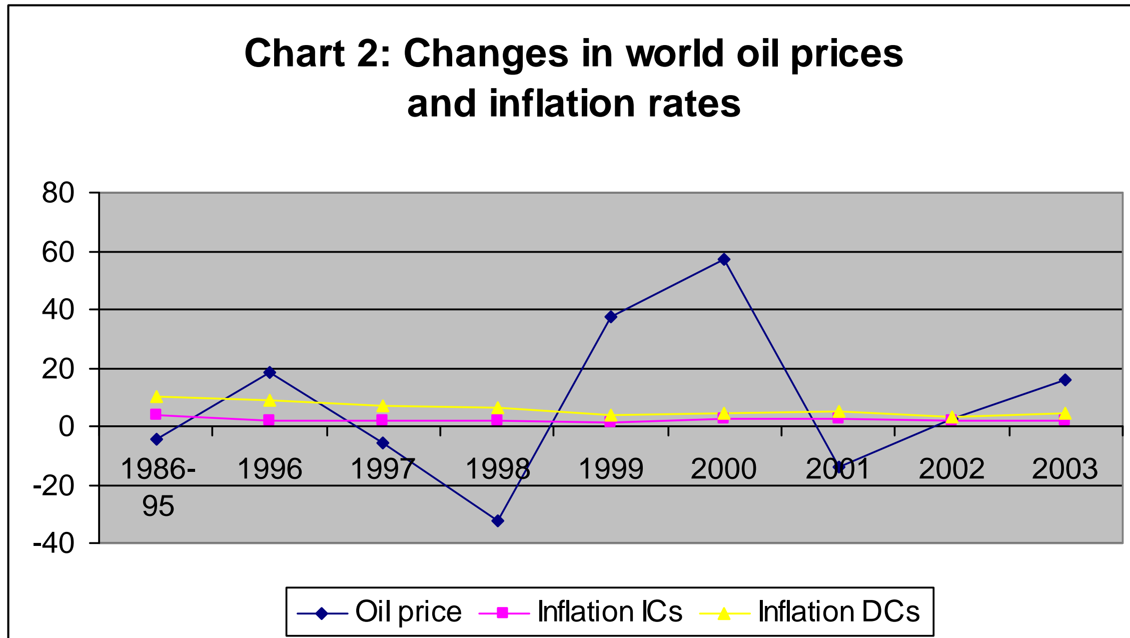
Asian economists have been even more pessimistic. Kim Hak-Su, the Executive Secretary of UN-ESCAP (the United Nation's Economic and Social Commission for Asia and the Pacific) has suggested that oil prices of around $40 per barrel would mean a 0.5 percentage point reduction of growth in the region, and $50 per barrel would mean a 1 percentage point reduction.

Such projections usually hinge around the perceived trade-off between growth and inflation, and are predicated on the assumption that oil prices increases will lead to more general inflation. Governments attempting to combat inflation will then embark upon contractionary fiscal and monetary policies, which will bring down inflation but also imply lower rates of aggregate economic growth.

It is correct to assume that governments across the world remain obsessed with inflation control, because the political economy configurations that have led to the domination of finance still persist. However, the prior assumption, that oil price hikes necessarily lead to higher inflation, may not be so valid any more.

Certainly it is true that for a very long period – in fact almost the whole of the second half of the 20th century – oil prices showed a strong relationship to aggregate inflation rates in the world economy. Between 1970 and 2000, for example, world trade prices and oil prices were strongly positively correlated and in the largest economy, the US, the Consumer Price Index inflation tracked movements in world oil prices.

However, there is evidence that such a relationship may be changing. Chart 2 indicates the annual percentage changes in world oil prices and average inflation rates in industrial and developing countries, especially since 1996.



Two things stand out quite sharply in this chart. The first is that oil prices were exceptionally volatile over this period, rising and falling dramatically. The second is that such fluctuations appear to have had little impact on aggregate inflation rates in either developed or developing countries. Rather, such inflation rates have been relatively stable and even fallen slightly compared to the earlier decade.

So what has changed in the world economy to cause such an apparently established relationship to break down? To begin with, it is worth remembering that even the currently "high" oil prices are still well below their real levels in the 1970s, when the oil price shocks generated stagflation. But there are other forces which have reduced the responsiveness of the general price level to energy prices.

The first important factor is the reduced dependence of the industrial economies upon oil imports, at least in quantitative terms. For the group of industrial countries in the OECD, net oil imports accounted for 2.4 per cent of GDP in 1978, but have since fallen continuously, to amount to only 0.9 per cent of GDP in 2002.

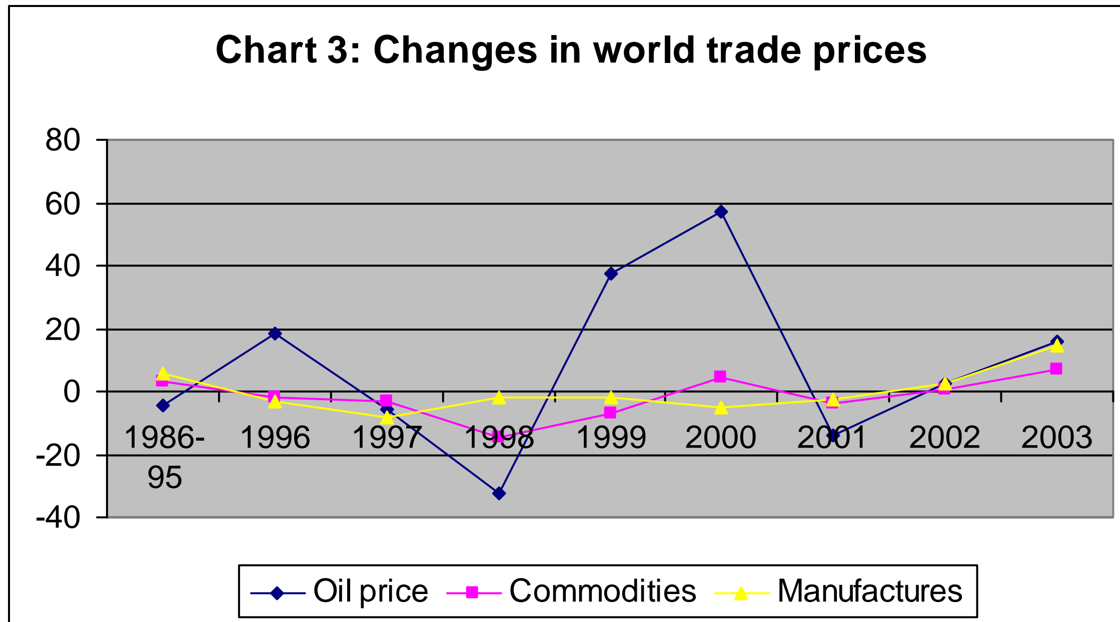
But the second factor may be even more significant. This is a distributional shift, whereby the burden of adjustment to higher oil prices is essentially borne by workers across the world and non-oil primary

commodity producers in the developing countries. This means that even though energy is a universal intermediate good, its price rise does not cause prices of many other commodities – and especially the money wage - to increase accordingly. This in turn enables aggregate inflation levels to remain low even though oil prices may be increasing.

It is well-known that the period since the early 1990s has been once of a substantial decline in the bargaining power of workers vis-à-vis capital in most of the world, and this has been reflected in declining wage shares of national income and real wages that are either stagnant or growing well below productivity increases. This provides a significant amount of slack in terms of the ability of employers to bear other input cost increases. In addition, this disempowerment of workers also means that such input cost increases can be passed on without attracting demands for commensurate increases in money wages in the current period.

Along with the working class, the peasantry and other non-oil primary commodity producers have also been adversely affected and been forced to take on some of the burden of adjustment. Indeed, even manufacturing producers from developing countries have been forced in a situation where intense competitive pressure has ensured that they cannot pass on all their input cost increases.

Chart 3 indicates the annual changes in the world trade prices of oil, non-oil primary commodities and manufactured goods. It is evident that the prices of other primary commodities have generally been more depressed, falling between 1995 and 1999, and barely increasing even in years when world oil prices rose sharply. Similarly manufactured goods prices also have hardly increased, and have also been falling in absolute terms over much of this period. Only in the period since 2001 is there some evidence of all three sets of prices moving together.



So does this mean that the oil price is no longer an issue of concern for those interested in the aggregate growth of the world economy? Not at all; in fact, such a conclusion would not only be unwarranted, it could also be extremely misleading.

It is clear from the preceding argument that the adverse impact of oil prices upon inflation can only be contained by suppressing and reducing the incomes of workers everywhere and peasants in the developing world. But there are limits to the extent to which such incomes can continue to be reduced, since such a process has already been under way for some years, and it cannot be intensified in most countries without causing social unrest and political instability.

This means that continuing high prices of oil are likely to place governments across the world in a dilemma. If they continue with the practices of the recent past of forcing the majority of the people to bear the burden, they risk losing legitimacy with the people. In any case these policies have become so unpopular and are meeting with more and more distrust and resistance. This is of special significance in those developed countries (including the US and UK) where elections are due in the near future. But it is also true of some developing countries (including India) where the balance of political forces may be shifting in some small degree in favour of the working class and peasantry after more than a decade of extreme tilt in the opposite direction.

So this particular strategy has its limits. However, the alternative strategy, of using contractionary monetary policies to bring down aggregate inflation, would also be extremely unpopular since it would add to unemployment and material insecurity which are already at high levels.

It appears that if governments are to take into account this requirement of popular legitimacy, they must be prepared to live with higher inflation in the medium term. How far this is compatible with the domination of international finance capital is something that remains to be seen.