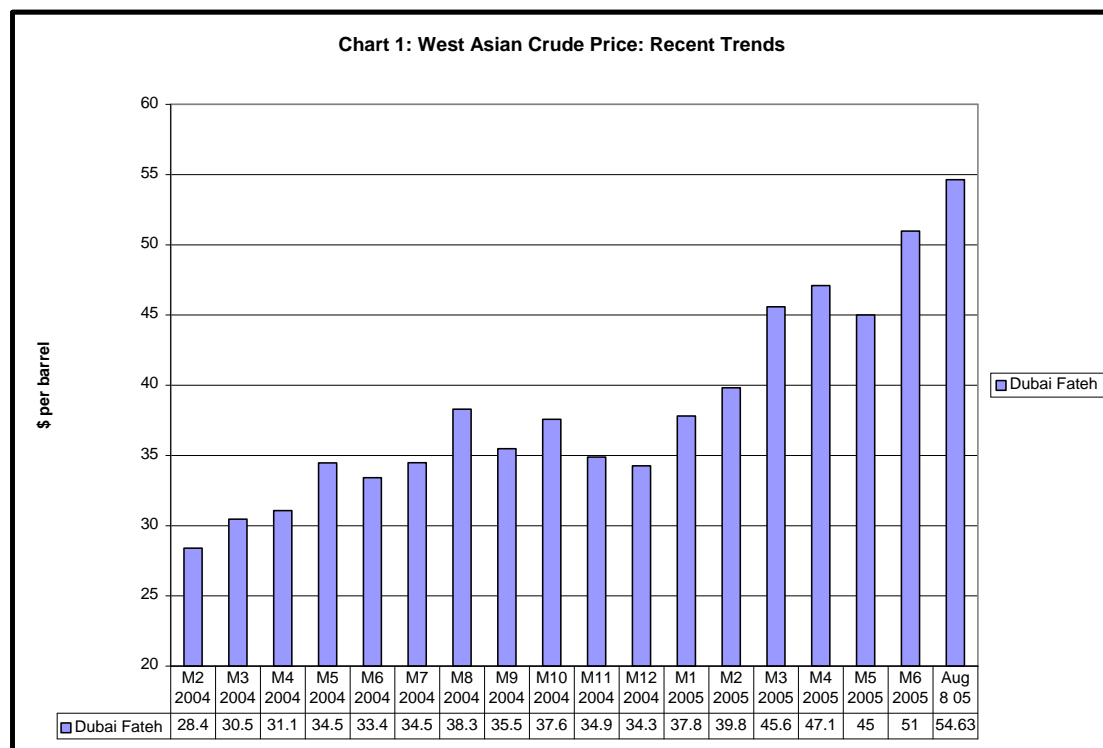


Awaiting the Oil After-shock

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Nothing seems to hold back world oil prices. Taking one of many internationally traded varieties of relevance to developing Asia, the price per barrel of Dubai Fateh crude averaged \$28 in February 2004, around \$35 between May and December 2004, nearly \$40 in February 2005, crossed \$45 in March and \$50 in June and stood at \$55 in mid-August. Other varieties like American light crude have crossed the \$65-per-barrel mark in international markets in recent weeks.



The fundamental reason why prices have risen so dramatically is that demand—especially driven by growth in the US, China and India—has outstripped the capacity of the industry to pump out crude and refine it. Global demand is estimated to have risen by 2.7 million barrels per day in 2004, the highest since 1976. Nearly a third of that growth came from China, where oil consumption soared by around 16 percent in 2004. On the other hand capacity has not been expanding to meet this growing demand. As a result, surplus capacity in the oil producing system is limited. Spare capacity in 2004 is estimated to have fallen to 1 million barrels per day (b/d), its lowest level in 20 years. Saudi Arabia, the country which sits on the largest share of global reserves and which was responsible for increasing availability when supplies were tight in the past, is also nearing its limits. Given the nature of the industry, supply can adjust only with a considerable lag, since investment requirements are large and involve substantial gestation lags. Investment has not kept pace with demand partly because of the low oil prices of the 1990s, when the average real price of oil was half that in the 1980s (Chart 2).

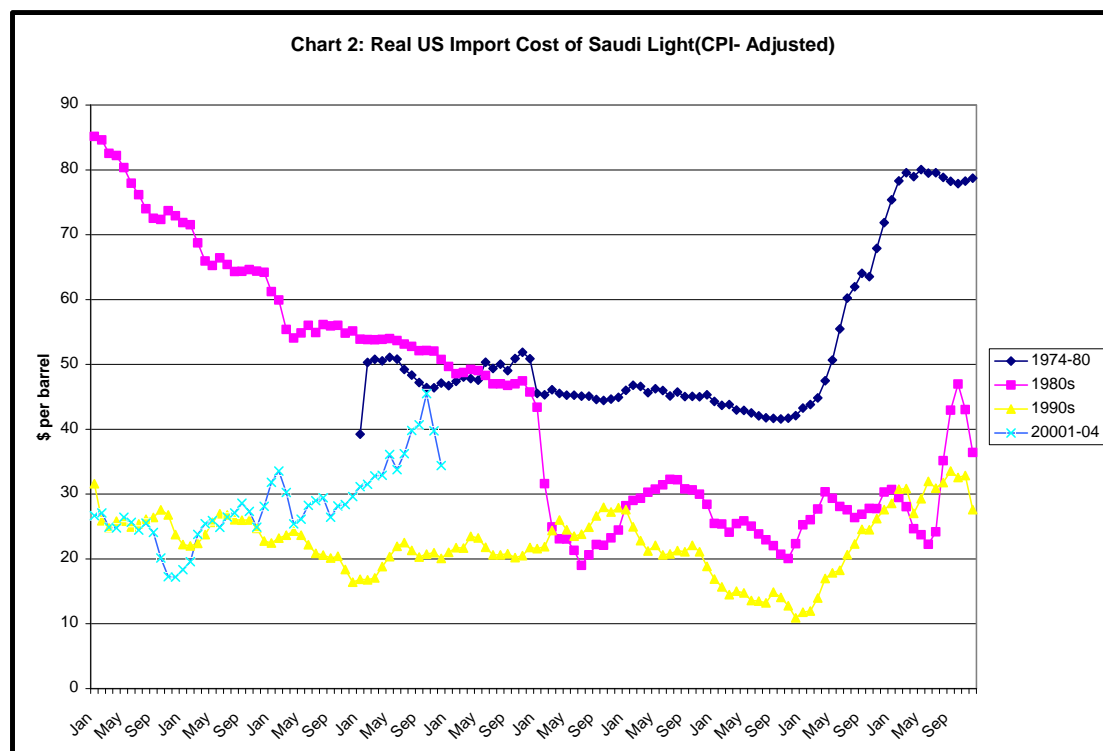
The other reason why supply is inelastic is that much of the oil that was discovered in non-traditional locations after the oil shocks, as in the Arctic and offshore in many countries, has

already been exploited. Thus the world's dependence on traditional sources of "easy oil" has increased.

The effects of medium term excess demand on prices have been aggravated by a number of factors that have increased uncertainty. The most important is, of course, the continued occupation of Iraq by the US and its allies and the strong resistance of the Iraqi people to that occupation. The inability thus far of the US army to contain the armed struggle, despite the use of violence even when it endangers civilians, has reduced exports and led to expectations of uncertain future supplies from Iraq. In addition, the war has precipitated terrorist attacks in the world's largest oil producer, Saudi Arabia, which have affected oil supplies, even if temporarily. So long as the threat of such attacks remains, supplies are uncertain and prices are buoyant.

The net result has been that any development that affects or could affect supplies from any other country triggers a price increase. This could be political uncertainty in Nigeria, the battle for control of Yukos in Russia, civil strife and oil industry strikes in Venezuela or fears of the impact of Hurricane Dennis on US oil supplies. All of these have in the recent past substantially affected prices at the margin and even led to a spike in prices.

The upward pressure on prices that result from these developments has been further exaggerated by speculative investments by financial investors in oil markets. It is known that price trends in energy markets have substantially increased financial investor interest during 2004. This has also affected the relative price of oil. It is widely known that capacity shortfalls in both extraction and refining are greater in the case of light sweet crude oil. For example, the little excess capacity available with Saudi Arabia is in heavy crude that is harder to refine into the cleaner fuels demanded by rich countries. This places a premium on light (low specific gravity) sweet (low sulphur) grades, whose supplies are relatively inelastic.



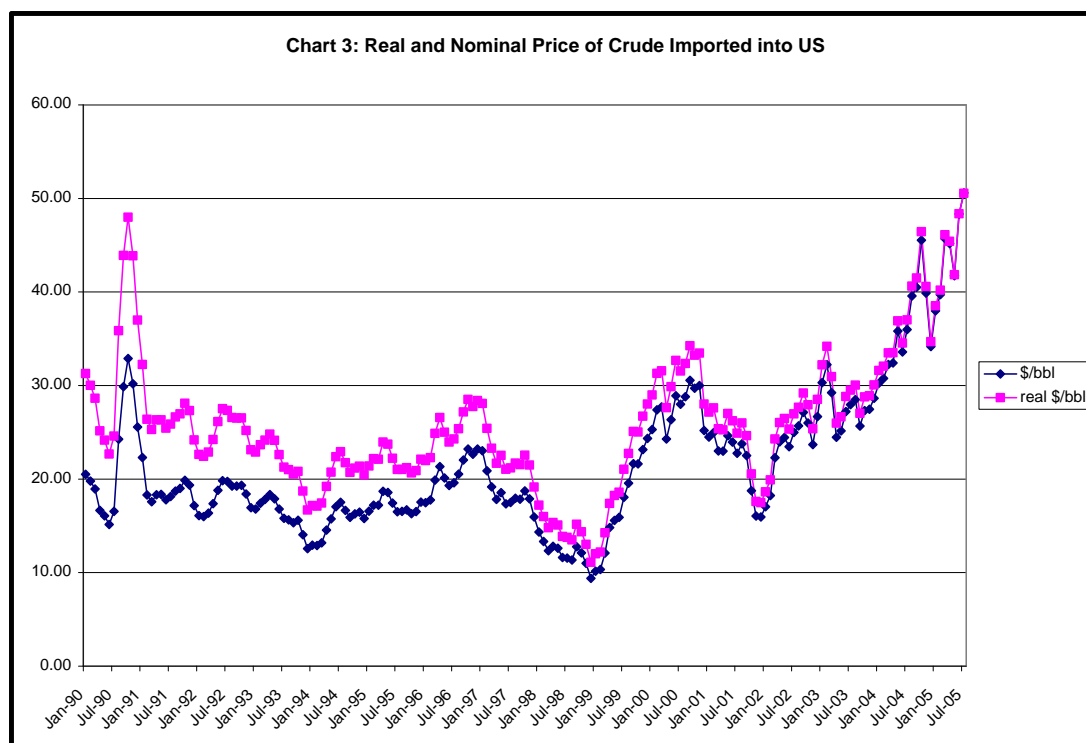
With investor interest focused for this reason on the light sweet grades during 2004 the spread between light and heavy grades rose during 2004. According to the Financial Times, in the first 10 months of 2004 West Texas Intermediate (WTI) rose 65 per cent, but heavier

sour oil blends rose by less than half as much. But as investors have discovered that excess demand is more generalised this spread has tended to decline more recently. The discount for Saudi Arabian oil relative to WTI rose from below \$6 a barrel to almost \$20 in October 2004. This year the situation has reversed. Saudi grades have gained by more than twice as much as WTI and the spread is back down near \$6.

The base for speculation seems even greater since the sharp price increases of recent times have not spurred inflation, curbed growth and forced a cutback in demand. The dissociation between the level of oil prices and the rate of global expansion only strengthens expectations of further price increases.

One explanation advanced for this lack of association between oil prices and growth is the fact that the real price of oil, which adjusts the nominal price increase to take account of changes in the prices of commodities other than oil, is by no means at a peak. Thus, in terms of 2005 dollars, the 1980 price of Arabian Light, which was \$35.69 in nominal terms, amounted to \$84.29. That is \$25 per barrel or 40 percent higher than today's price in real terms.

However, the fact that in absolute terms today's real price of oil is far short of its historic peak does not detract from the fact that recent increases in that price have been dramatic and that the real price of oil is at a 15-year high (Chart 3). So the persistence of growth and demand for oil is indeed puzzling. It suggests that the expectation that rising nominal oil prices would trigger contraction in government spending to smother inflation, as happened at the time of the second oil shock at the end of the 1970s, has not been realised. One reason for this could be that the impact of oil price increases on the balance of payments is immediately debilitating because of the greater access to foreign exchange of the big spenders. Many countries have been able to finance a rising oil import bill without much difficulty. For example, China keeps sucking in oil despite higher prices because of the consistently high increase in its export earnings; India manages because of large IT-related revenues and capital inflows; some other developing countries are able to stay afloat because of remittances from migrant workers; and the US pulls through because of capital flows that finance its burgeoning trade deficit and make it the world's largest debtor nation.



Thus the fact that the world is awash with liquidity that can be accessed in the form of foreign revenues, debt, portfolio investments or foreign direct investment by countries that are better off has helped ensure that a sharp contraction of the kind triggered by the second oil shock has not occurred. The resulting persistence in strong demand for oil has contributed to buoyancy in prices because supply too has not been responsive to price increases.

These features of the global oil scenario have two implications. First, it is likely that prices are likely to remain high for some time to come even if the era of cheap oil is not altogether over. Second, as and when specific developments threaten to affect or actually do affect oil supplies from any existing location, a further spike in oil prices is a real possibility.

But already there are signs that things may change. To start with, not all countries are in a position to cope with the current price of oil. Many poor countries cannot access foreign credits with the ease that characterizes the more developed even among the developing. But that is not all. Even some of the more developed countries in developing Asia have been badly affected in 2005, when prices have continued to rise and the discount on the West Asian varieties they import has fallen sharply. Asia, which imports 70 per cent of its oil from the Middle East, has received a larger oil shock this year than last. Countries are finding it increasingly difficult to maintain retail fuel subsidies. Thailand abandoned subsidies in August, while other governments, such as India's, have raised prices despite opposition. In the event growth and oil demand are likely to fall.

Thus the hike in oil prices is bound to have an adverse effect on the global system soon. What is not certain is the nature and location of that adverse effect. Fears of a global recession arise because the already high US trade deficit is widening sharply. Clearly, if prices rise further, global growth could indeed stall. Even the otherwise optimistic IMF believes it would. To quote the **World Economic Outlook** released in April: "In the past, a permanent \$5 a barrel increase in oil prices has been expected to lower global GDP growth by up to 0.3 percentage point; in practice, the impact over the last year has been less than feared, partly because higher prices have in part been a consequence of strong global

growth, and partly reflecting the greater credibility of monetary policies (so that interest rates have not had to be raised to ward off second-round inflationary effects). The impact of further sharp increases, however, could be more marked, especially if they were to adversely affect confidence or inflationary expectations; there would also be a greater danger of negative supply-side effects over the longer run.”

However, that projection hinges on the perceived trade-off between growth and inflation, and is predicated on the assumption that oil price 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.

But, there is evidence that this relationship may have changed. Though oil prices have been exceptionally volatile recently, 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? 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 one per cent of GDP.

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. These prices do not rise in tandem with oil prices and in some cases have declined. This means that even though energy is a universal intermediate good, its price rise does not cause prices of many other commodities to increase anywhere near proportionately. 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 one 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 workers, agriculturalists 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 adversely

affected in a situation where intense competitive pressure has ensured that they cannot pass on all their input cost increases.

Thus, even if growth persists despite rising oil prices, the distribution of the benefits of that growth is likely to be extremely unequal. But even growth is likely to be unequally distributed. In the case of the poorer, oil importing developing countries, the effects of higher oil prices are already adverse and can get worse. These countries have much smaller volumes of remittance incomes from abroad and cannot access large capital inflows. Thus they have to adjust to rising oil prices by squeezing demand through contractionary policies that reduce domestic incomes and increase unemployment. This is the only way they can deal with their balance of payments difficulties.

So long as these sections are forced to bear a disproportionate share of the burden, the current oil shock may not seem a big problem. But if for some reason they cannot be called upon to do so, a global recession may be inevitable.