Oil prices and the world economy

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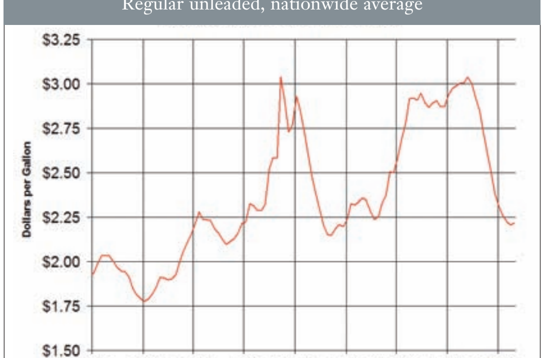
We live in unusual times. The world economy is growing very strongly. Global income per head has risen by 3.2 per cent per year since 2000, which is faster than its pace during the high-growth, post-war recovery era of 1950-73. That era ended with an oil price shock and a deep recession. Under the prod of higher prices, the world has since learned to use energy more efficiently, but oil is still the commodity with the tightest link to economic growth. Yet in the past few years oil prices have soared to record levels without derailing global growth. What accounts for this unprecedented combination of expensive oil and robust growth – and is it sustainable?

New dynamics in the oil market

While there are many factors that contribute to the recent run-up in oil prices, the key driver is unexpectedly high global demand, not suddenly constrained supply as in the 1970s. This fundamentally different pattern of causality accounts for the paradox of our high growth era, and also explains many other unusual features of the world economy today.

Since 2000, the global demand for energy has been growing at an annual average rate of 2.6 per cent, or about twice as fast as during the 1990s. Over 80 per cent of this increase has come from developing countries and they now account for more than half of the world's total energy consumption. This growth in energy demand is a direct result of the rapid economic growth that those countries are enjoying. Their income per capita has risen by 5.6 per cent per year since the millennium, compared to about 2.5 per cent during the 1990s. By comparison, income per capita growth in the rich countries has been around 2 per cent for many decades.

US retail gasoline prices, 2004-2006
Regular unleaded, nationwide average



The surge of energy demand from developing countries was not initially noticed as oil prices rose. The upward price trend began in May 2003, just as US President Bush declared military victory in Iraq. The previous peak of US$40 per barrel – touched briefly in 1990 during the first Gulf War – was breached in July 2004. Geopolitical concerns about supply disruptions from terrorism in the Gulf were blamed for the high 'risk premium' attached to oil prices. In a speech at Chatham House in November 2004, Saudi Oil Minister Ali Al-Naimi estimated this risk premium to be US$15 per barrel. Since then prices have continued to rise in fits and starts, topping US$75 per barrel in August 2006 and falling back somewhat since then.

The oil market has worked efficiently during this period, with no unmet demand caused by supply disruptions and with inventories maintained at near normal levels in the major importing countries. Oil prices still contain a sizable risk premium stemming from continuing tensions in Iraq, new threats from Iran and the worsening of Israeli-Palestinian relations. But these supply-side factors alone cannot account for the sustained run-up in oil prices over the past three years.

Oil price prospects

Because today's high oil prices are predominantly caused by strong demand in the developing countries, their economic growth prospects hold the key to the medium-term outlook for oil prices. Over the longer term – say, beyond 2010 – new energy supply sources will have an important moderating impact on the oil price.

The growth momentum of developing countries is now well-established, nearly a decade after the Asian currency crises of 1997. It is supported by closer linkages into the world economy through trade, foreign direct investment and the cross-border sourcing of services. These linkages have grown partly because of favourable conditions in the developed world. Interest rates have been low and consumer demand strong, especially in the United States, where imports from Asia have soared. But the emerging economies have also grown because of their own structural reforms and better macroeconomic policies. Budget deficits have been reduced and this has helped to keep inflation low. Since the Asian crisis the ▶

larger developing countries have been careful with foreign borrowing and have used their current account surpluses to build up large stocks of foreign exchange reserves as insurance against future shocks. The OPEC countries have been more cautious in spending their burgeoning oil revenues than they were in the 1970s. This time they have saved more of it and channelled more of their domestic spending into investment rather than consumption.

The picture is not, of course, uniform. Oil importing countries such as Turkey and Hungary have seen current account deficits grow to uncomfortable levels, and much of sub-Saharan Africa still relies heavily on foreign aid. Even thriving countries such as China and India face formidable policy challenges with their banking systems and infrastructure needs. But the overall prognosis for continuing rapid growth in the developing world is good, and that implies high oil prices for the next few years, even if growth in the US and Europe slows under the influence of higher interest rates. A plausible range for Brent crude over the next five years would be US$50-70 per barrel.

The higher reaches of this range reflect the huge difference that still exists between the energy consumption in developing and developed countries. Oil consumption per person in China is less than one-fifth of that in the UK and only about 8 per cent of oil consumption per person in the United States. There are two cars for every 100 people in China today, compared with 50 in the US. Chinese leaders are determined not to replicate what they consider to be the wasteful energy consumption patterns of the west, but it is inevitable that oil usage per capita will rise as the size of their middle class expands and its demand for transport grows.

Compelling as this picture is of strongly rising energy demand in developing countries, it would be foolish to predict longer term oil price trends without considering the supply response. This is already evident. Increased investment is underway in Saudi Arabia and other OPEC countries, in Russia, and elsewhere in the non-OPEC world. Global investment in the oil and gas sector (including refineries) is so strong that costs in the sector have risen sharply and there is very little unused capacity in the supply chain for drilling rigs or oilfield services. All of this activity should gradually ease production and supply constraints over the next five years.

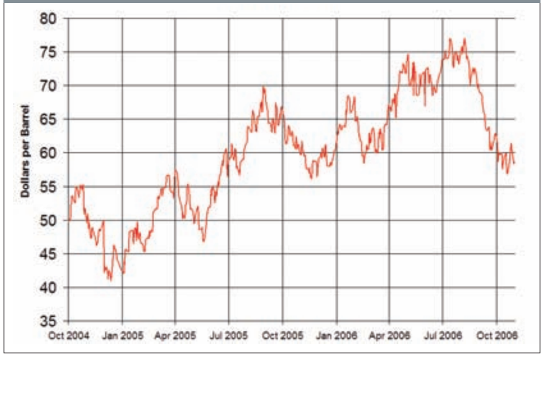
However, the major supply response will be beyond that horizon. The big energy story of the next decade will be the expansion of non-conventional oil and renewable energy supplies. Today's technology can produce liquid fuel from gas and coal for prices below US$40 per barrel of oil equivalent. With appropriate investments, heavy oil from Canada can be extracted for around US$30 per barrel. Biofuels in Brazil have replaced 40 per cent of its transport fuel requirements even after dismantling subsidies. The technologies for solar and wind generation of electricity are developing rapidly and governments from California to China are offering regulatory incentives to speed their adoption. In addition, green taxes and carbon trading regimes such as that adopted in Europe will provide an additional environmental spur for the development of renewables. Ten years hence, even with optimistic assumptions about world growth, it is possible to see oil prices held below US$40 per barrel (in today's money) by the cost of competing non-conventional and renewable supplies.

Noises off-stage

This benign view that the current conjuncture of high oil prices and strong global growth can continue through the five-to-ten year transition to lower prices and a more diverse energy supply mix is subject to at least three independent risks. The first is that geopolitical developments in the Gulf and/or Russia create an oil price spike serious enough to derail global growth. Current concerns about energy security reflect this risk. The second is that protectionist sentiment in the rich countries, fed by rapid out-sourcing and hyper-competitive imports from developing countries, leads to lower growth in world trade and a fall in FDI which results in a coincident global slowdown. This is another familiar risk, already on the radar screens of financial markets and world leaders.

The third risk is newer and more difficult to assess. Evidence is mounting that global climate change may be happening more rapidly than expected. This raises the probability of sudden adverse events – such as the stoppage of the Gulf Stream – that could cause massive economic and social disruption. In that case the world will need a much quicker and more painful cure for its "addiction to oil", as President Bush recently put it. The current period of high oil prices may be a blessing in disguise if the gradual, price-induced transition described above proves sufficient both to meet economic aspirations and to prevent environmental catastrophies. ■

Oil prices, 2004-2006
NYMEX light sweet



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