Martin Wolf: How oil adds to the economy’s fragility

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Hurricane Katrina is at the very least a significant political event. But is it also an important economic event? “In itself, no,” is the answer. If the storm proves economically important, it will be because of its effect on oil prices. But do high oil prices still matter?

The US has, for the moment, lost about 10 per cent of its refining capacity. The reduction in the output of gasoline is 1m barrels a day, which is 10 per cent of US consumption. According to Goldman Sachs, this raised prices of gasoline by 40 per cent. In response, 2m barrels of oil a day will be released from the strategic reserves of the advanced country members of the International Energy Agency over 30 days. A large part of the oil to be released from outside the US is to take the helpful form of refined products.

In addition to the disruption in supply of crude oil and refined products, the hurricane has also interrupted economic activity throughout the affected region. Adding up these two effects, Goldman Sachs predicts a reduction in the growth of US gross domestic product by between half and one percentage point between the third and fourth quarters of this year. Overall, however, the direct economic impact on the US economy is modest.

Turn, however, to the impact of today’s tight oil market on the world economy. Here we have to register a puzzle. As Jean-Philippe Cotis, the chief economist of the Organisation for Economic Co-operation and Development, noted yesterday: “Oil prices have soared by about $20 since the finalisation of our Economic Outlook projections in May, reaching new peaks, in nominal but also in real terms. Their cumulative run-up over the past two years matches, in absolute terms, the large shocks observed in earlier decades.”

Deflated by US consumer prices, the price of a barrel of oil is now higher than at any other time over the past 35 years, except during the shock that followed Saddam Hussein’s invasion of Iran (see chart). Deflated by US export prices, the price of oil is higher than at any time since 1970.

A rule of thumb from an International Monetary Fund study of five years ago is that a $10 rise in the price of a barrel of oil lowers global growth by 0.5 percentage points for four years. Since the price has now risen by $40 since the beginning of 2002, global growth should have fallen sharply. The first and second oil shocks of the 1970s generated global recessions (see chart). But this time the economy seems to be sailing through. Why is this? And can it last?

To answer the first of these two questions, we need to identify the mechanisms through which high oil prices generate economic slowdowns. These are three: aggregate demand; inflation; and profits and performance of the corporate sector.

Big rises in oil prices shift income from consumers to producers (and so from net importing countries to net exporters). The numbers here are big. A $40 increase represents a transfer from consumers to producers of $1,200bn a year (about 3 per cent of global GDP, at market prices). The shift in income from oil importing countries to oil exporters is $700bn a year. Opec members alone gain as much as $400bn.

In the 1970s, the challenge of sustaining spending was known as “recycling”. Unfortunately, the recommended solution, which depended on encouraging developing countries to borrow, also helped generate the debt crisis of the 1980s. This time, fortunately, the US, an altogether more creditworthy prospect, seems to be prepared to borrow without limit. The resulting current account deficits are helping sustain global demand in impressive fashion.

Sustained low inflation has made it possible to adopt the needed expansionary monetary and fiscal policies. Not only has inflation remained very low, but underlying inflation has also been very stable, despite the rise in headline inflation (see charts). The credibility of low inflation has made it far easier for central banks to respond to slowing demand with expansionary policies.

The third impact of high oil prices is on profits and productivity. In the 1970s high oil prices squeezed profits and, for reasons never fully understood, triggered a deterioration in trend productivity growth, especially in the US. This time, however, profits have remained buoyant, while there is no sign of a slowdown in productivity growth, again at least in the US.

Thus, changes in the background macroeconomic conditions have made it far easier to accommodate high oil prices than in the 1970s and early 1980s. The principal explanations are the credibility of low inflation and the responsiveness of spending to monetary policy, above all in the US. Also helpful has been the arrival of China as a source of demand.
Can this buoyancy last? Probably, but not certainly. One risk is that relatively high headline inflation will start to feed through into wages and so into core inflation, particularly in economies now operating close to full capacity, such as the US.

Another risk is that reductions in the rate of growth of real disposable incomes caused by high oil prices will finally curb the astonishing willingness of US households to borrow and spend. Again, because the proportionate increase in prices of petroleum products is relatively high in the US (since the share of taxation in the price is negligible) and because household savings rates are so low, the US looks most vulnerable of the big economies. The role of rising house prices in sustaining borrowing and spending is another weakness.

Yet the US authorities would act aggressively if a slowdown were to be in the offing, unless inflation were on the rise. That is far less likely in the eurozone. Rising oil prices might be the straw that breaks the back of the eurozone’s weak recovery.

In the medium term, moreover, there is the risk of further price rises. Behind the buoyancy of prices is the dynamism of demand. This is going to continue. On present trends, global oil supply needs to rise each year by at least 2m barrels a day. Only if present prices were themselves high enough to curb the oil-intensity of global growth sharply would this change.

Against that background, any number of shocks could raise prices still further. The world economy is behaving like one of those cartoon characters that does not know it has run over the edge of a precipice. It may be over the edge, all the same.

Sources for charts: OECD; IMF

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