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Prepare for a new era of oil shocks

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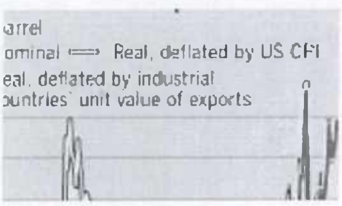
By Martin Wolf

Oil prices are up. Barack Obama is to blame. Drilling in the US is the solution. This is the mantra from the president's opponents. All presidents tend to get the blame for high fuel prices. But with the price of gasoline nearing $4 a gallon, Mr Obama is getting it by the barrel load.

This may be good politics. But it is absurd. Oil, unlike natural gas, is a globally traded commodity, whose price is set in world markets. In 2010, the US produced 7.8m barrels a day, 9 per cent of the world's supply. Unlike Saudi Arabia, the US lacks spare capacity: it is a price taker. Responding to his critics, Mr Obama said: "We are drilling more. We are producing more. But the fact is, producing more oil at home isn't enough to bring gas prices down overnight." These remarks are correct, except for the last word. Producing more oil would have next to no effect on oil prices.



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Moreover, if there is a specific cause for the rise in oil prices, it is the tightening of sanctions on Iran, which Republicans support. If, as many desire, military action is taken, the impact on oil prices and the world economy will be far greater.

In the longer run, a big reduction in US demand, still 20 per cent of the world's total, might make an appreciable difference to prices. Moreover, the relative wastefulness of US oil use, compared with other high-income countries, would make such a reduction quite easy to achieve. The best way to make this happen would be to raise prices, via higher taxation. But that policy is deemed un-American. It is a policy fit only for European wimps.

Yet, despite the absurd politicking, we should be concerned about the economic impact of high oil prices: a rise of $10 in the price of oil shifts $320bn a year from higher-spending consumers to lower-spending producers, within and across countries. The 15 per cent rise since December 2011 would shift close to $500bn. The real price of oil is also very high, by historical standards (see chart). Further rises would take the world into uncharted territory.

In short, higher oil prices are a threat. So what is going to happen?

In a recent note, Goldman Sachs argues that a 10 per cent rise in oil prices tends to lower US gross domestic product by 0.2 percentage points after one year and by 0.4 percentage points after two. In the European Union, the impact is smaller: a reduction of 0.2 percentage points in the first year, but no further reduction thereafter.

Since the actual rise has been 15 per cent since December, the impact on US and EU GDP would be a reduction of 0.3 percentage points over the first year – appreciable, but not calamitous. Such a price rise would lower US household incomes by about 0.5 per cent. Moreover, crossing the threshold of $4 a gallon might be significant when confidence is fragile, as it is now.

Goldman also suggests the factors that would determine the size of any adverse impact.

The first is whether the rise in prices is caused by demand or a shock to supply, with the latter being more disruptive. The answer, it suggests, is that demand is now the principal cause of higher prices, though the tightening of sanctions on Iran would be more important. The Paris-based International Energy Agency, in its latest monthly report, even qualifies this view. It agrees that "there may be no actual physical supply disruption at present deriving from the Iranian 'issue'. But there are ongoing non-OPEC outages totalling around 750,000 barrels a day".

The second factor is how much spare capacity exists. The answer: not much. Inventories in high-income oil markets are low (see chart). Saudi Arabian production is now at 30-year highs, which suggests limited spare capacity. Moreover, the growth of world oil supply has been persistently slow, at just below 1 per cent a year over the past decade, despite generally high oil prices. Thus, capacity is structurally tight. That explains the level and the volatility of prices over the past decade. With potential global economic growth at 4 per cent a year, oil supply growing at 1 per cent and the lack of easy alternatives to oil as a transport fuel, supply is likely to become tighter.

A third factor is what is happening in other commodity markets. Here the news is good: natural gas prices have been falling, while agricultural prices have not been so much of a problem this year. This should limit the inflationary impact.

A final consideration is the monetary response. Here the news remains favourable. Central banks are likely to ignore movements in commodity prices, particularly ones whose impact is contractionary, provided they see no pass-through into wages. They are right to do so.

In all, Goldman concludes, the price increase is a "brake", not a "break", in growth. But Fatih Birol, the IEA's chief economist, warns against too much complacency. He notes that the EU's net imports of oil will cost 2.8 per cent of GDP at present prices. against an average of 1.7 per cent between 2000 and 2010. Given the frailties of the EU economy, the dangers are evident.

Furthermore, in this stressed oil market, further spikes in prices are quite possible. A war with Iran may be the most frightening possibility. But danger is always present, given the political instabilities in places where oil is produced. Moreover, the world is going to remain stuck in this danger zone, given the soaring demand for oil from rapidly growing emerging countries. The IEA suggests that Chinese sales of private light-duty vehicles will reach 50m a year by 2035, even under an energy-efficient scenario. The implications of such growth in vehicle fleets are quite obvious.

The world will be vulnerable to high oil prices and repeated shocks, so long as supply is stagnant, demand buoyant and unrest likely – in short, so long as it remains as it now is. For the US, the best response would be to lower the oil-intensity of its economy, to reduce vulnerability to these shocks. Higher prices would help deliver this. But why does it let all the revenue go to foreigners? It makes far more sense to tax imports and keep some of it, instead.

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