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Oil prices

Running out of gas

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The world economy pays the price of expensive oil

IT IS a sign of remarkable times that the prospect of \$100 oil is greeted with relief rather than trepidation. The price of a barrel of crude, having burst through \$100 in February, peaked at \$147 on July 11th. Since then it has fallen by more than a quarter. Not everyone is cheering. The Organisation of the Petroleum Exporting Countries (OPEC) met in Vienna on September 9th to discuss how to respond to the recent slide in prices. Faced with demands from Iran and Venezuela to cut output, but mindful that high prices have encouraged a more frugal use of oil in rich countries, OPEC opted for a fudge. It kept its target at 28.8m barrels a day but agreed to abide more faithfully to that goal by curbing overproduction—leading to a cut in actual output of 1.8%.

The more hawkish countries want oil prices to remain as high as possible to fund their lavish budgets. But Saudi Arabia, OPEC's largest member, has exceeded its output quota over the summer to prevent further harm to its rich-world customers, already reeling from the credit crunch. That makes sense. Even countries such as Germany and Japan, that are not very dependent on borrowing, have suffered alongside those struggling in a sea of mortgage debt, such as America and Britain. The woes of the thrifty may have at least as much to do with sky-high oil prices as they do with collapsing credit markets.

In such circumstances, the recent fall in the price of oil (and food) should be a boon for hard-pressed consumers. It has not, however, fallen far enough for central bankers to be celebrating just yet. Inflation seems set to follow oil and food costs down, but some policymakers fret that it may not fall quickly to a tolerable level. Their concern is that high oil prices may have harmed the potential growth rate of the economy, as well as temporarily pushing up inflation. If so, sluggish GDP growth may not create enough slack in the economy to drive inflation down far.

That possibility was outlined by Athanasios Orphanides, of the European Central Bank's (ECB) rate-setting council, at the "ECB and Its Watchers" conference in Frankfurt, on September 5th. An increase in the relative price of oil raises the costs of energy-intensive production, making some plant and machinery unprofitable. An oil shock could even leave the economy with a smaller margin of spare capacity if it harms output more than spending. For this reason, policymakers need to be careful not to overstimulate the economy when an oil shock hits. Indeed one of the policy errors that led to the 1970s stagflation, said Mr Orphanides, was to overlook the effect of dearer oil on viable output.

A recent study by the OECD concludes that oil prices at \$120 a barrel could over the years reduce potential output by a total of as much as 4% in America, and by 2% in the euro area (which uses less oil for each unit of GDP). Because machinery is upgraded only slowly, this impact is likely to feed through gradually, initially shaving 0.2 percentage points a year off America's potential GDP growth.

Much depends on how other costs adjust. If firms can pass on part of the increased oil bill in lower real wages (through either higher prices or less generous pay deals), a larger chunk of the capital stock will remain viable. That may be happening in America, where hourly wage growth is well below inflation; the brunt of the oil shock has been borne by workers. In the euro area, by contrast, there are more signs that wages are picking up in response to recent inflation. Jean-Claude Trichet, the ECB's chief, has warned that the effect of dear oil on potential growth "should not be considered negligible". The bank's anxiety about it may prove a barrier to swift

Reuters



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