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GLOBAL ECONOMIC & MARKET OUTLOOK

Eurobank EFG

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Focus Notes

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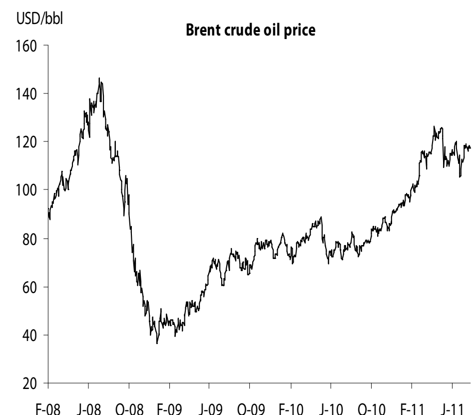
Elevated oil prices: a drag on global growth over the course of the year

- Factors such as increasing concerns over global economic activity, tighter monetary conditions and worries concerning the European debt crisis exert downward pressures on oil prices in the short term.
- However, tight supply and demand dynamics are expected to limit downside risks, since they keep oil prices at historically relatively high levels and leave the oil market rather sensitive to potential supply disruptions from geopolitical or other kinds of risks.
- We estimate that current levels of oil prices (about 40% higher than 2010), should they persist, will shave 0.5-1.0% off global economic growth over the next 1-2 years.

Oil prices to remain elevated over the course of the year

Since mid-2010, prices of oil have risen significantly, mainly on the back of strong gains in global demand and disruptions to global supply. Brent crude oil prices have soared above US$ 125/bbl in early April, a rise of about US$ 60/bbl over the past year (e.g. more than 80%) (Figure 1). Roughly one fourth of this increase (US$ 15/bbl) constitutes a heightened risk premium in the oil market. This is attributed to the escalation of the turmoil in the Middle East in early February and. The steady increase in oil prices has been followed by a sharp correction in early May (Brent fall over US$ 10/bbl in a one week period), due to a sting of disappointing economic data that raised concerns over weaker global growth prospects. Accordingly, additional disappointing economic news could remove an extra portion of the risk premium, bringing oil prices further down. Specifically, increasing concerns over the outlook of global economic activity, tighter monetary conditions, particularly in emerging markets and worries concerning the contagion of the European debt crisis to the US and Japan, are factors that maintain nervousness in the market, thus exert downward pressures on oil prices in the short-term.

Figure 1



Source: Bloomberg

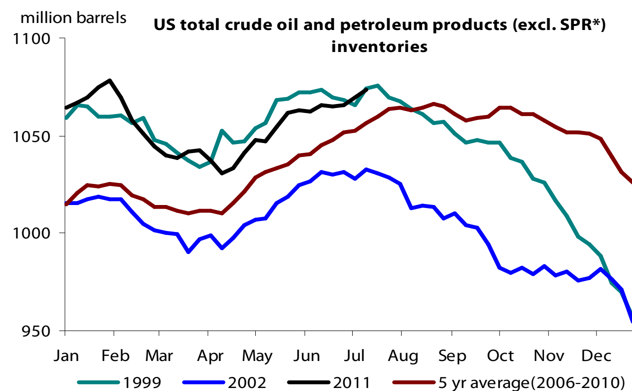
However, tight supply/demand dynamics, which are expected to persist this year, limit downside risks on oil prices, since they provide a floor upon price dips and keep oil prices at historically relatively high levels. On the supply side, non-OPEC oil production has proved disappointing since the beginning of the year. According to the latest US Energy Information Administration's (EIA's) forecasts, non-OPEC oil production, which accounts for about 60% of world oil supply, is projected to increase by 540

thousand bbl/d (1.0% y-o-y) in 2011. This represents the lowest annual increase since 2008 in terms of both absolute and percentage change. Meanwhile, OPEC's production has been dented by the disruption in Libyan's oil supply, which accounts for about 4.5% of OPEC's total production, in the wake of the civil war. EIA forecasts that OPEC crude oil production will decline by about 300 thousand bbl/d in 2011 and assumes that about one-half of Libya's pre-disruption production will resume only by the end of 2012.[1] Meanwhile, the IEA's decision to release 60 million barrels of oil from their emergency stocks over 30 days to help alleviate global oil supply disruption[2] has had only a temporary impact on oil prices. Brent crude oil is now trading above $117 a barrel, higher than before the announcement of the IEA's emergency reserves release. Indeed, the re-filling of the US Strategic Petroleum Reserves (SPR) is likely to add new pressures on crude oil prices in the future.

As far as oil demand is concerned, the shift in global demand towards the emerging world, which account for almost half of global oil demand, is a long-term factor for upside pressures to oil prices. Specifically, oil prices have proved particularly sensitive to the strength of Chinese demand. The resilient strength of the Chinese economy continues to give a boost to both consumer and industrial demand growth. In addition, severe drought conditions have resulted in low levels of hydro power, a substantial source of Chinese electric generation, leading to increased demand for diesel in order to fuel electricity shortfalls. Given that the summer is a period of strong power consumption, we do not expect tightness in the Chinese power market to abate short term. EIA's latest forecasts suggest that China's oil consumption will increase by 7.6% y-o-y in 2011, which is the second largest annual growth rate since 2006. Increased demand for oil is also stemming from Japan in the aftermath of the Tohoku earthquake, since the latter forced the shutdown of oil refineries and nuclear power plants in Japan. A boost to Japan's oil demand is expected during the period of reconstruction which is more likely to take place mainly over the end of the year and in 2012. Following Japan's earthquake, Germany has decided to close its nuclear plants, suggesting that the ongoing substitution of more conventional sources of energy for nuclear power will constitute a long-term factor for upside pressures to oil prices. In the meantime, in the absence of further shocks to the global economy, oil demand may be supported by a reacceleration of economic growth in advanced economies later in H2 2011, since the easing of economic activity in H1 seems to be temporary.

With global economic activity expected to continue to support oil demand and global oil production expected to lag behind, the oil market continues to operate with a significant deficit (the worst deficit since 2007). As a result, inventories and OPEC spare capacity fall. According to EIA's estimates, OPEC's surplus capacity will fall from 4 mbbl/d at end-2010 to 3.5 mbbl/d at end-2011 and 3.1mbbl/d at end-2012. Since global oil demand outpaces global oil supply, we believe that an inventory draw in Q3 is very likely. Should this occur, it would be counter-seasonal in the sense that US total petroleum inventories are usually built in Q3 rather than drawn, so that the market can meet the increased seasonal demand in the winter ahead (Figure 2). The path of inventories so far in 2011 is similar with that of 1999 and 2002, when inventories were drawn in Q3, and oil prices spiked in the winter ahead. This implies that tight fundamentals created during the course of the year are leaving the oil market rather sensitive to potential supply disruptions from geopolitical or other kinds of risks.

Figure 2



* Strategic Petroleum Reserves (SPR)

Source: EIA, Ecowin

The impact of high oil prices on the global economy

The sharp oil price increase over the past year constitutes a major risk for the global economy. Overall, an oil price shock affect the global economy mainly through the terms of trade channel, transferring income from oil importing to oil exporting countries. Higher oil prices result in increased production costs for businesses and reduced disposable income for households, weighting on economic activity. The purchasing power of households is reduced, thereby avoid or reduce spending on durable goods and services. From the producer perspective, high oil prices lead to increased input costs and a simultaneous decrease in demand for their products, thus limiting profit margins and resulting in a potential reduction of production and investment. The vulnerability of each individual country to higher oil prices depends mainly on whether the country is a net oil importer, its oil intensity[3] and its flexibility to substitute less

[1] *EIA Short-Term Energy Outlook, July 2011*

[2] *This is the third time IEA member country stocks have been used as a collective action globally. The first time IEA member countries mandated a stock release was at the time of Iraq's invasion of Kuwait in 1990/1991. The second stock release of IEA's history was on 2 September 2005, after* Hurricane Katrina damaged offshore oil rigs, pipelines and oil and gas refineries in the Gulf of Mexico.

[3] *Oil intensity indicates how much oil a country uses to produce its goods and services. High oil intensities indicate a high price or cost of converting oil into GDP.*

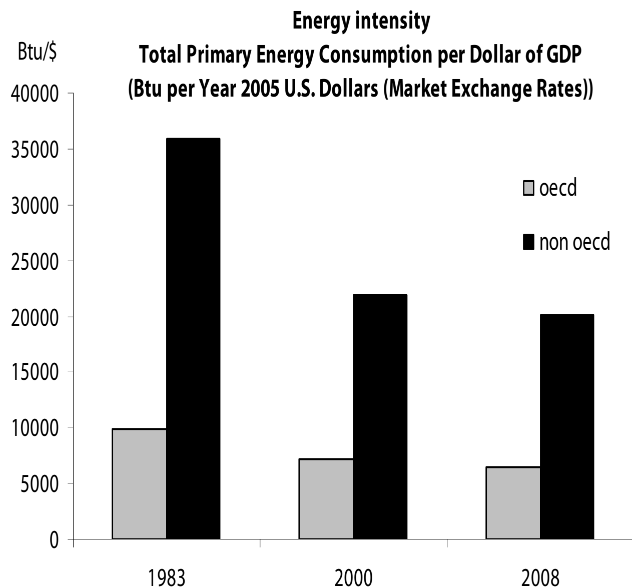
expensive sources of energy for oil. Meanwhile, high oil prices will have a greater adverse economic impact on oil-importing emerging economies than on advanced economies. This is because oil accounts for a larger part of total consumption and overall incomes are lower in these countries. Moreover, energy intensity in emerging economies is higher compared to advanced economies (Figure 3).

There are several studies that estimate the size of the negative impact on economic activity and inflation of oil shocks.[4] Indeed, researchers argue that the negative effect of oil price shocks on growth has fallen significantly through time, since countries have gradually reduced their energy intensity (Figure 3). The results of the above empirical studies indicate that a 10% increase in the price of oil will cut approximately 0.2% off global growth. Therefore, we estimate that current levels of oil prices (about 40% higher than 2010), should they persist, will shave 0.5-1.0% of global economic growth over the next 1-2 years. Apart from economic growth, higher oil prices have also a key impact on inflation. According to IMF (2000)[4], a permanent 10% increase in crude oil prices raises core inflation after one year by 0.2% in the US and Euro area, 0.3% in Latin America, and 0.4% in Asia.

As far as Euro area is concerned, according to the European Central Bank[5], a 10% increase in oil prices reduces Euro area's real GDP by 0.24% over a horizon of three years. The impact of high oil prices would be greater in Belgium, Germany, Italy and Greece compared to the rest countries in the region (Table 1). Regarding inflation, a 10% increase in oil prices leads to a rise in the Euro area HICP inflation of about 0.45% in the third year, with the corresponding impact on Greece being the third largest in the region after Slovakia's and Slovenia's (0.65% versus 0.90% and 0.82%, respectively). In Greece, the increase of the existing tax on heating oil, as part of the austerity plan, is likely to amplify the economic effects of high oil prices on the real economy.

To sum up, we believe that oil fundamentals will remain tight enough over the course of the year to sustain oil prices at current levels, although further downside in the short-term cannot be ruled out. Increased concerns over the long-term supply environment of the oil market will continue to be a major factor adding to upside risks to oil prices. Consequently, elevated oil prices will most likely remain a drag on global growth and inflation over the remainder of 2011. Furthermore, another abrupt increase in oil prices triggered by an additional shock to the global economy would have a severe impact on the global economy, as there is not much room for economic policy to accommodate an oil shock. The fiscal stance in several economies is already overstretched, while monetary policies still loose.

Figure 3



Source: EIA

Table 1

Effect of a 10% oil price increase in real GDP in the Euro area countries

(cumulative percentage deviation in 3 years from baseline scenario, annual averages)

	Year 1	Year 2	Year 3
Belgium	-0.09	-0.30	-0.40
Germany	-0.16	-0.33	-0.37
Italy	-0.07	-0.25	-0.36
Greece	-0.03	-0.13	-0.34
Spain	-0.04	-0.21	-0.25
Portugal	-0.05	-0.11	-0.20
Malta	-0.27	-0.26	-0.16
Cyprus	-0.03	-0.08	-0.15
Slovakia	-0.10	-0.14	-0.14
Austria	-0.07	-0.09	-0.07
Slovenia	0.01	-0.01	-0.06
France	-0.01	-0.02	-0.05
Ireland	0.00	-0.03	-0.05
Luxembourg	0.00	-0.03	-0.03

Source: ECB

[4] *International Energy Agency, 2004, "Analysis of the impact of high oil prices on the global economy",*
IMF, 2000, "The impact of higher oil prices on the global economy",
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[5] *ECB, 2010, "Energy markets and the euro area macroeconomy".*

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