NO SHOCK FROM THIS OIL PRICE SHOCK

Since OPEC agreed to cut petroleum output last March, the price of crude oil has jumped to above $27 per barrel in Februry 2000, up from less than $10 a year ago. This tripling of prices brings them to their highest level since the Gulf War in 1991, and elicits memories of the 1973 oil price shock when prices quadrupled, and 1979/80, when they almost tripled.

In addition to the production cutbacks already agreed last year, OPEC succeeded in convincing its members last March of the need to cut output further and, in particular, to adhere strictly to the agreed production quotas. Because of the marked supply reduction and a simultaneous demand revival, the following months saw an unusually steep increase in crude oil prices. The International Energy Agency (IEA) estimates that the entire demand for crude oil will be rising by 2.5% in 2000. The IEA also expects a partial loosening of the supply limitations, however[1], recently falling inventories notwithstanding.

Despite these hefty increases in oil prices, the economic consequences are likely to be much less severe than in the 1970s. There are several reasons[2]:

- First, the recent sharp rise in oil prices follows an equally sharp decline over the previous two years. Prices fell by more than half to their lowest level in real terms since 1973.
- In most countries the cost of crude oil now represents a smaller share of the price of gasoline than it did in the 1970s. In Europe, taxes now account for up to four-fifths of the price at the pump.
- Rich economies are much less dependent on oil than they were in the 1970s. For each dollar of GDP (in constant prices) they now use nearly 50% less oil than in 1973. Energy conservation, a shift to other fuels and a decline in the importance of heavy, energy-intensive industries have reduced oil demand. The OECD estimates that a $10 rise in oil prices increases the oil import bill of rich economies by a mere $^1/_4$ – $^1/_2$% of GDP. That is less than one quarter of the income loss in 1973 or 1980. Oil-importing emerging countries, to which heavy industry has shifted, have become more energy-intensive and thus may feel the effect of the oil price rise more acutely.
- Oil producers are much more likely to spend their extra oil revenues on imports from rich countries as most have large current account deficits in contrast to the 1970s when they had current account surpluses and therefore saved most of the windfalls.
- Finally, this time around – unlike in the 1970s – the oil price surge is occurring against the backdrop of low commodity prices. Non-energy commodity prices, which already fell by 14% in 1998 and another 8% in 1999, will just consolidate in 2000.[3]

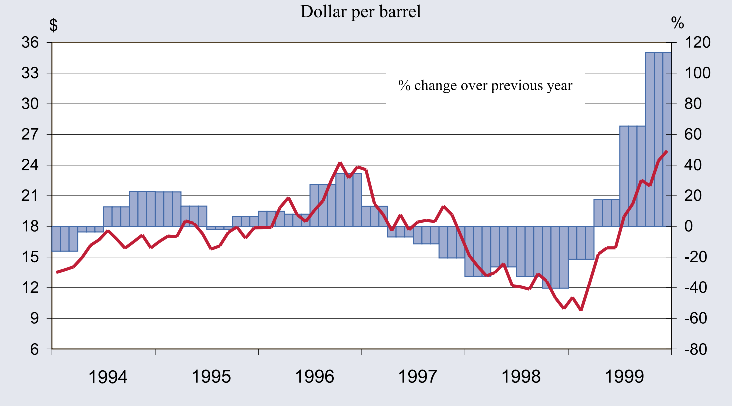
H.C.S.

1 See Hans-Dieter Karl, "AIECE-Prognose: Weltrohstoffpreise 2000/2001" *ifo Schnelldienst* 31/1999, November 9th 1999.
2 "Oil's pleasant surprise" *The Economist*, November 27th 1999.

3 See Hans-Dieter Karl, op.cit.

CRUDE OIL PRICE (BRENT)

Dollar per barrel



Source: ifo Institute.