# OIL PRICES AND ECONOMIC POLICY

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## Price developments

Oil prices have risen rapidly in recent years. In 2008 oil prices are expected to average at around $120 compared with $72 in 2007. In 2008 prices rose close to $150 a barrel in June-July 2008 before declining to around $120 a barrel in August. On the 19th of August 2008, oil prices were $113.7.

The increase in the price of oil is rooted both in supply problems (supply constraints, infrastructure problems, war, natural disasters, and political and social unrest in oil producing countries), and increased demand by fast rising economies like China and India. Although demand growth may decelerate with the slowdown in the US economy, supply conditions are likely to remain tight due to low spare capacity (below 3 million barrels/day in 2007 according to the International Energy Agency Statistics), and because geopolitical risks, such as Iran's nuclear program, violence in Iraq and Nigeria, and the looming threats of terrorism, prevail.

The impressive increase in the dollar price of crude oil (around 67% increase during 2007) is more moderate if prices are measured in euros, due to the

weakening US dollar. Nevertheless, the increase is still significant even when exchange rate developments are taken into account. In fact there is evidence that oil price hikes have been following the dollar weakness, as oil exporters have an incentive to maintain their purchasig power in other currencies by partly adjusting oil prices in response to changes in the value of their invoice currency.

**Effects**

Higher oil prices translate into higher inflation for various reasons. Firstly, they directly increase the price of energy. Second, higher energy prices increase the price of production and distribution. Thirdly, higher prices often translate into higher wage demands by labour unions (second round effects), which if materialized put further pressure on inflation. Recent studies that discuss in detail the effect of an increase in oil prices on the economy include Bodenstein et al. (2007), Elekdag et al. (2007), and Kilian (2007).

Food prices have been the most affected by the oil price hikes. They have increased through the direct effect of higher production costs, but also indirectly due to lower supply, as food crops have been replaced by biofluel production, in an attempt to find substitutes for oil fuel. More importantly, high oil prices increase the value of biofuels, and make their production more worth it for farmers everywhere. The sharp increase in food prices has deeply eroded the purchasing power of workers, and put serious pressure on wage negociations.

**Temptations**

All around the world, governments have been challenged to do something to curb the slowdown in growth, the increase in unemployment, and oil and food price inflation. As economists know, it is impossible for the government to tackle all these problems at the same time, with a shock steeming from the supply side of the economy. Nevertheless the pressure is there, and all sorts of measures have been proposed, the most favoured perhaps being oil price subsidies (or lower taxes). Although the debate is still on EU governments have promptly resisted to this temptation. Why?

If a supply shock is temporary, in theory the government could temporarily cushion the economy from the shock, through subsidies, as long as the policy is reversed as soon as the shock disapears. This policy entails several risks:

- Firstly, it is very difficult to reverse such a policy on time, and supporting demand is just likely to translate into a permanent increase in inflation.
- The second flaw is that such a policy may in fact transform a temporary shock into a permanenet one. When there is an inflation shock, it is lower demand and a slowdown in the economy that puts downward pressure on costs and restablishes the equilibrium (Blanchard, 2007). By giving out subsidies, the government maintains the level of demand high easing the pressure on production costs to go down, therefore costs of production and prices remain

high. In particular, as demand for oil remains high, this policy eases the pressure on oil producing countries to lower the price of oil.

- It is also very difficult to judge whether this particular shock is temporary or an ongoing trend, and subsidies cannot be financed forever, and therefore cannot be the right answer.
- Finally, another problem with subsidizing oil consumption, is that with a relatively rigid supply, by supporting demand with subsidies, governments are simply transferring money to oil producing countries, since the increase in demand will translate into higher prices when supply is limited: the consumer will end up paying more or less the same, while the producer takes the subsidy in the form of a price increase, while the quantity sold hardly changes.

**Answers**

The answer to a hike in oil prices has to be a reduction in the demand for oil. This is the only way to constrain oil producers from rising prices further. It is the invisible hand of Adam Smith, the market mechanism, or whatever one would like to call it. There has to be a slowdown in consumption, either through energy saving technologies, or with the use of alternative fuels.

What governments can do now is to direct resources to finding ways to allocate energy resources more efficient (through congestion charges, promoting the use of public transportation, etc), and to investment on renewable sources of energy (solar, wind, wave). As it has been observed biofuels may not be the right

answer. Biofuels are an easy way out of the debate for rich countries which have abundance of land, like the United States, but they use up a limited resource, land, which is essencial for the production of food crops. The overall costs and benefits of alternative energy sources must therefore be seriously taken into account. Countries must now think of a long run sustainable energy plan.

## References


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