Oil : The Tipping Point

Martin Khor

When the international oil price hit a new high of US$142 a barrel recently, the alarm bells went off. The oil price is now six times higher than in early 2002.

However, in real terms (after adjusting for inflation and rising cost of other products), it has risen less. It is only 15% above its peak level of 1979.

Though the rising oil price has caused grumbling through the recent years, somehow, it seemed that many economies could absorb this trend quite well.

Not anymore. There are signs that at US$130 a barrel, the oil price has reached the "tipping point" at which it is deeply affecting economies as a whole, as well as undermining not only profits but the survival of companies and sectors.

"We may finally have crossed the line where the price of crude actually matters for most companies," according to a New York-based equity specialist, Peter Boockvar, as quoted in the *Los Angeles Times*.

"The economic outlook has been taken hostage by the relentless surge in oil prices," said Robert V DiClemente, chief US economist at Citigroup.

The oil price hike affects the economy in many ways. First, many industries are hit, especially those that use a lot of oil.

Airlines are one of the most affected. Profits have vanished in almost all US airlines, which are reported to be on the verge of insolvency. American Airlines is even charging passengers US$15 for a piece of luggage.

In Europe, British Airways is cutting back on flights, and warned that its operating profits would be wiped out if the oil price is above US$120 a barrel. Air France-KLM said that its profits are affected and it will raise fares soon.

The auto industry is also hit, as sales of cars that use a lot of petrol are hit in the US. With sales of sport utility vehicles plunging, Ford said that there won't be profits this year, and the situation at General Motors and Chrysler is rumoured to be even worse.

Second, the agriculture sector is also affected. Rising oil prices have increased the cost of fertiliser, the operation of agricultural machinery and transport. This has affected costs and net incomes of farmers in developing countries. It has contributed to the rapid rise in food prices, which in turn led to social unrest in many parts of the world.

Third, the higher cost of oil is winding its way into various parts of the production and distribution chains in many other sectors, causing inflation to rise across the economy in many countries.

This hits consumers in their pockets, reducing the volume of goods and services they can buy. The real pay of many workers goes down, causing a rise in poverty and social unrest.

Fourth, the slowdown in consumer spending is in turn slowing the sales of many products and services, which will affect the growth of the economy as a whole.

Fears of recession are growing in many countries. Indeed, memories have been revived of the situation of the 1970s, when the hike in oil prices led to "stagflation" -economic stagnation combined with inflation.

Fifth, in countries where there are controls on the prices of several oil products, the amount that the government spends on subsidies on oil products is ballooning.

The government faces a dilemma in these countries. If they cut the subsidies, the prices of oil products go up and there will be public grumbling and protests. Moreover, costs and prices in many sectors will shoot up, for example, bus and taxi fares.

And if they maintain the controlled prices at the same level, the subsidies will keep shooting up, increasing the public sector's budget deficit, or causing the government to cut spending in other areas.

There are a number of causes of the oil price hike. First, demand is outpacing supply, especially with high economic growth in some big developing countries.

Second, oil is a depleting resource, and the world has reached (or is fast reaching) the situation known as "peak oil", in which the global output has attained its highest level, and will go downhill after that, causing supply to lag more and more behind demand.

Moreover, as the best oil fields are exploited, more effort and costs are incurred to extract oil from fields that are of lower quality or more difficult to reach, and this contributes to higher prices.

Third, there is a frenzy of speculation in the oil market, not only because of a belief that prices will rise further but because speculative funds are searching for yield in oil and commodities after the collapse of confidence in the financial sector in particular, and the volatility in the stock markets generally. This speculation is the immediate cause of the price jump in recent weeks and days.

The oil price trend is expected to continue. The price of long-term oil contracts at one point went up higher than the spot price ($145 a barrel for 2016 delivery versus spot price $135) "as confidence that supplies can meet demand in the next 5 to 10 years crumbled", according to a *Financial Times*, report.

There are forecasts of the oil price hitting US$150 a barrel within weeks, and then the new threshold of US$200 will be in sight.

One positive point amidst the gloom is that this rising oil price is making renewable energy sources such as wind and solar more and more viable. Moreover, the high oil prices are inducing a reduction in the use of oil. Both of these have a positive effect in the fight against global warming. □□□

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