HIGH ENERGY PRICES AND THE WORLD ECONOMY

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Outline

• Rapid World Growth - expected to continue
  – Big risks from global imbalances, Oil, Geopolitical
  – How big is the oil impact?
  – The muted response
  – Implications for the Middle East

• Analysing an oil impact
  – The indirect tax analogy
  – Private sector response
  – Policy response
  – Past is a poor guide to the future

• Monetary policy
  – Policy response: different this time – so far

• Inflation response – key

• Anticipations and the private sector

• Implications
  – Simulations and forecasts
  – A new energy paradigm?
  – Security and foreign policy concerns
  – Climate change and the environment
  – The position of OPEC
  – Risks: oil supply and demand: other
World: GDP growth

Source: OEF

PPP exchange rates
Market exchange rates
Forecast
World: GDP growth

Source: OEF
World: Current account imbalances

Source: OEF
Oil price

Real
(1995 US prices)

Nominal

Source: OEF
Global: Oil intensity

Source: OEF
Oil consumption as a proportion of GDP

Source: OEF\BP
How big is the oil impact?

- Stylised impact: 3% OECD GDP
- Why is it muted?
  - Demand not supply?
  - Lower energy intensity?
  - More time to adjust?
- Response of inflation
- Policy reaction functions
- Past a poor guide to the future
The impact of an oil price change

- Sectoral balances
- The indirect tax analogy
- The inflation response
- Monetary policy: offsetting?
Sectoral balances identity

\[(S - I)_{\text{private}} + (T - G) = \text{B of P Surplus}\]

\[\Sigma \text{B of P} = 0\]

Financial Wealth

\[W = K + B + F\]

\[\Delta W = \Delta K + \Delta B + \Delta F\]

\[S = I + (G - T) + (\text{B of P})\]
Tax analogy

• The indirect tax analogy

• Could the oil impacts have been offset

• Example: UK 74 and 79/80

• Example: US early 1080s; the Volcker shock; oil or inflation?

• Budget deficits, interest rates and other offsets

• Lots of other similar macroeconomic impacts (tax changes, terms of trade movements, the exchange rate).
Monetary policy

- Inflation forecast targeting
- Maintains growth near potential if inflation under control
- Recent interest rate rises reflect rapid growth
- Oil prices secondary
- Deflationary effects of oil price rises will be offset if inflation does not come through
Official interest rates

(Source: Bank of England IR Aug 2006)

Chart 1.6 Overseas official and forward interest rates

Sources: Bank of England and Bloomberg.

(a) These are one-month forward rates. The US, euro-area and Japanese curves have been derived from instruments that settle on dollar Libor, Euribor and yen Libor respectively. These curves have not been adjusted for credit risk.

(b) Official rate refers to the Bank of Japan’s target for the uncollateralised overnight call rate.
Bond yields have risen in 2006

Chart 1.4 Nominal long-term interest rates

Sources: Bank of England and Bloomberg.

(a) Ten-year instantaneous forward rates.
Monetary policy

- Inflation forecast targeting
- Maintains growth near potential if inflation under control
- Recent interest rate rises reflect rapid growth
- Oil prices secondary
- Deflationary effects of oil price rises will be offset if inflation does not come through

- Effects of slowdown in US?
- Interpreting China’s policy. (Target growth 8 – 9% pa)
- Fiscal policy
- Expectations of growth and inflation. (Effects on private sector, financial markets)
Key issue: the response of inflation to oil price rises

- Prices
- Wages
- Expectations
US: Prices and earnings

% year

Average earnings

Consumer prices

Producer prices

Source: OEF
US: Inflation

Source: Datastream

CPI inflation

Core inflation

% year

1.0  1.5  2.0  2.5  3.0  3.5  4.0  4.5  5.0

1995  1997  1999  2001  2003  2005
US: Employment cost index

Source: Datastream
Eurozone: Inflation

Source: OEF
Germany: Prices and earnings

- Consumer prices
- Producer prices
- Average earnings

Source: OEF
Inflation: actual and derived from inflation linked bonds

**Chart A  CPI inflation**

Percentage changes on a year earlier

- United States
- Euro area
- United Kingdom
- Japan

**Chart B  Five-year breakeven inflation rates**

Per cent

- United Kingdom
- United States
- Euro area

Sources: Bank of England and Bloomberg.

(a) Implied instantaneous five-year forward inflation rates. UK and US rates are based on the difference between yields on nominal and inflation-linked bonds. Euro-area rates are based on inflation swaps. The instruments used are linked to RPI for the United Kingdom, CPI for the United States and HICP for the euro area, so the levels of the series are not directly comparable.
Summarising

• Inflation still muted despite oil price rises
• Policy responds to total situation, not just oil
• The indirect tax analogy: other evidence
• If inflation is under control, oil price impacts likely to lower interest rates (other things equal)
• The anticipation of growth stabilises private investment and consumption
• Interest rates have been going up largely because of rapid actual and anticipated world growth. (Eurozone, Japan, China and, of course, the US)
• Oil impact simulations based on the past probably worse than useless. (Most of the effect is via an interest rate response to inflation)
• Lack of feedback from oil has major implications for price forecasts, for spare capacity and for volatility

• Rising concerns over energy security reflect the likely continuation of rapid world growth. (Other risks point to lower oil prices)
• High oil prices raise serious environment concerns: coal, tar sands and nuclear
• There are many obvious risks