The Telegraph

Even a fall in the oil price is bad news for the eurozone

Lower oil prices will accentuate the move to lower inflation which is already under way

"Lower oil prices should visibly reduce the prices that consumers pay for fuel and heating" Photo: Alamy

By Roger Bootle

7:50PM GMT 16 Nov 2014

157 Comments

This weekend the leaders of the so-called G-20, the world's 20 largest economies, have been pontificating in Brisbane, Australia, about the state of the world economy and what can be done to make it better. These gatherings amount to much sound and fury but signify, if not quite nothing, then very little. Meanwhile, the ineluctable economic forces that really do shape the world and its prosperity quietly do their work, for good or ill.

At the moment, one of those forces is promising to do far more to raise global prosperity than any international agreements or treaties ever could, namely the sharp drop in the price of oil.

Much of the world's economic history over the past 70 years can be told in relation to movements of the oil price. After 1945, there was a long boom characterised by rapid economic growth, relatively low inflation, stability, exchange rate fixity and full employment. This came to an end in 1974 when the oil price rose from $2.5 per barrel, where it had been pretty much throughout the post-war period, to $15. This brought the world into an altogether new state: inflation rose sharply, exchange rates gyrated, growth faltered and unemployment soared. The era of stagflation was born. Another sharp hike in oil prices in 1979-80 brought another inflation spike and another economic downturn.

Economic recovery in the 1980s owed much to the subsequent sharp fall in oil prices. Since then, they have been up and down, again with significant impacts on the economy. Most importantly, they rose to $143 per barrel just as the world was entering the financial crisis of 2008-9. The reason why the world economy was so weak in the following years is that it had been hit by a double whammy – the worst financial crisis since the 1930s and a huge rise in commodity prices, led by oil. So the news that last week oil prices fell to $78 per barrel, the lowest since 2010, was highly significant. Moreover, there is a good chance that they will fall much further.

Mind you, it is important to recognise that movements in oil prices can be both cause and effect. Other things equal, weaker economic growth reduces the demand for oil and hence tends to lower its price. Lower prices originating in this way aren't so much good news as a mitigating factor to what would otherwise be bad news.

Yet sometimes oil prices can fall because more oil becomes available, or available more cheaply. This is a supply shock. Both demand and supply elements are at work now but the current low prices seem to be mainly the result of a favourable supply shock, partly associated with the US fracking boom.

There are two reasons why such a price shock can be advantageous. First, oil is a significant input into all sorts of production, including, by the way, other commodities. So lower oil prices make it economically feasible to produce more GDP with existing technology and factors of production.

The second reason concerns the demand side and is probably more important. As oil prices rise, this transfers real income from oil consumers to oil producers. This sounds like a zero sum game – what is lost by some is gained by others – but the gainers and losers are very different animals. By and large, the big oil-producing countries in the Middle East, as well as Norway and Russia, do not spend all their oil revenues but instead tend to build up financial reserves. By contrast, the oil consumers do tend to spend a high proportion of their income. So, when oil prices fall, this transfers income from non-spenders to spenders. Higher aggregate demand is the result. This could now be a powerful factor helping to lift the world economy.

Lower oil prices should visibly reduce the prices that consumers pay for fuel and heating but, over and above this, they will also bring unobserved benefits as they filter into the cost base of all sorts of production.

So they will accentuate the move to lower inflation, which is already under way. (The recent fall of the pound, though, will operate in the opposite direction.) Unlike lower inflation that originates from domestic sources, there is no need for this reduction in prices to drag wages down. In other words, lower oil prices allow real wages to rise.

The UK position is slightly different from other European countries because we are an oil producer. Nevertheless, we are net gainers from lower oil prices. First, although we export considerable amounts of oil, we are net importers. (There are different sorts of oil so it is not unusual to be both an exporter and an importer.) Second, as a country with a substantial involvement in the world economy, we benefit considerably from the improvement to the overall economy that follows from lower oil prices.

The UK Government's financial position is a different story. It receives various sorts of tax revenue from oil. So lower prices will reduce the tax-take – at a time when the Chancellor needs all the revenue he can get. But the sums are no longer substantial. The overall revenue from North Sea oil production is now only about £5 bn, or less than 1pc of total tax revenue. (Tax receipts from the consumption of petrol and related products total about £27bn but most of that comes from fuel duty and will be unaffected.)

There is a European dimension to all this. Lower oil prices will also benefit the economies of the eurozone through the mechanisms described above. Indeed, much lower oil prices might be just about the only thing that can lift the eurozone economy from its current torpor. But there is also a threat that does not apply to the same extent to other countries.

As I have pointed out before, the eurozone is perilously close to deflation, that is to say, a point at which overall consumer prices fall. That may not sound so bad. Indeed, often it isn't, but it is downright dangerous in an economy saddled with as much debt as the eurozone now is. Deflation raises the real burden of debt and therefore increases the chance of a debt disaster, involving a sovereign default and leading to a new banking crisis.

Isn't it funny? When it comes to the eurozone even something that should be extremely good news ends up being dangerous. That tells you that there is a really serious problem.

They cannot say they weren't warned.

Roger Bootle is executive chairman of Capital Economics.
roger.bootle@capitaleconomics.com