

Inflated Oil Prices –again?

Comment By: SAMIRUL ARIFF BIN OTHMAN

Just as the U.S. and global economies show signs of sustained recovery, they now face a new danger; rocketing oil prices. Pundits say that the U.S. economy can still absorb the new cost. In Malaysia the baseline used by investment analysts to forecast growth for this year was definitely less than \$100 US Dollar a barrel.

So what happened? To be fair, oil prices had been rising for months (analysts whose concerns about chaos in the Middle East & North Africa (MENA) have put a "fear premium"), but they jumped as violence gripped Libya. Some 750,000 barrels a day of Libyan crude oil have been lost; Saudi Arabia claims to have replaced all of that supply. But Libyan and Saudi oil are not interchangeable. Libya's crude oil is known for its high quality and is easily refined into high-demand petroleum products. Only 25 percent of global crude is of similar quality; the loss of Libyan crude represents about nine percent of that pool. Saudi oil is an imperfect substitute for Libyan supply.

We could try to use the laws of supply and demand to explain changes in oil prices. Increased demand will raise prices and increased supply will lower prices. Higher prices will decrease demand and provide an incentive for producers to increase supply.

However, exceptions can be found regarding the expected effects of demand and supply. For example, higher prices have not had a substantial impact on the demand for oil. Theoretically, the demand for oil should change as a result of consumers' sensitivity to fuel price changes. This change has not occurred because the price elasticity of demand for oil is low. An increase in oil price will not reduce the demand for oil because oil is a necessity.

Contrary to the laws of supply and demand, the increase in oil price has not increased supply. It is not an actual lack of oil supplies, but rather problems that are due to supply disruptions. For example, in 2005 oil supplies from the Gulf of Mexico were disrupted as a result of devastating hurricanes. At this point in time, the political situation in the MENA region warrants attention.

Recently, demonstrations have erupted in Bahrain, a small island-monarchy that is less than 30 miles away from Saudi Arabia's Eastern Province, the site of most Saudi oil production and reserves. Similarly, Oman has witnessed mass protests. The specter of political turmoil in the Gulf countries raises fears over the disruption of oil supply at the Strait of Hormuz, through which about one-third of the global seaborne oil trade flows, carried by 30 large tankers a day. More than 75 percent of all oil consumed in Asia travels this route.

Other economic factors have also played a role. For example, the price of oil is impacted by the behavior of market investors and market traders. Their perceptions of "geopolitical risk" also have an impact in terms of keeping oil prices high. It doesn't matter if oil supplies are actually low or if threats to oil supplies actually exist. The mere perception of a possible threat to oil supplies can lead to an increase in trading, thereby driving up the price.

One way to appreciate the ripple effect of elevated oil prices is that high oil prices could harm European economies, many of which are net importers of oil and gas. Some have not fully recovered from the financial crisis and face heavy debt loads. In the midst of their slow, grinding recovery, a spike in oil price would deal their economies with yet another setback. Additionally pricier oil would also push up inflation in Europe, where it already exceeds official targets, and in countries with surging food prices, like China, Brazil and India.

In response these countries might then have to raise interest rates to cool inflation. This, in turn, would slow growth in Asia. One dark sinister possibility is that oil prices will keep rising until they reach \$150 or more. In that scenario, another global recession is the definite outcome.

An early resolution to conflicts that are causing supply disruptions in the MENA will definitely bring oil prices back down.

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