# Rising oil prices affect economic growth

## Global economic update: May 2011

**By Kevin Lings and Laura Jones, STANLIB economists**

As the price of oil rises above $100 per barrel, concerns increase around the effect this will have on global economic growth.

Disruption in the Middle East, the earthquake in Japan and now rising oil prices are creating instability in recovering markets.

### Impact of oil price on economic growth

The latest International Monetary Fund (IMF) report concludes that if current oil prices are sustained at around $100 a barrel, the impact on the global economy will most likely be relatively modest. Oil prices of over $100 a barrel would begin to hurt the global economy.

The increased energy prices have so far been smaller than in the past. For the year to date, the price of oil has gained 19.25%, with prices increasing from $95/barrel to over $113/barrel. According to the IMF, a general guideline is that a 10% increase in the price of oil reduces global GDP growth by between 0.2% and 0.3%.

If one follows this guideline, then the year-to-date increase in the oil price of roughly 20% will result in the decline of global GDP by between 0.4% and 0.6%. Higher oil prices will also put upward pressure on inflation.

### Japan's rebuild will fuel oil prices

The natural disaster in Japan, the world's third largest economy, will have an adverse effect on its economic growth, and this may in turn affect global oil demand. Japan currently imports 4.2 million barrels of oil per day but this may pick up dramatically as it works to restoring its economy.

### The inflation risks

Emerging markets are more susceptible to oil price increases, and economies such as China and India are more likely to be affected than some advanced economies like the US because emerging markets already have higher inflation rates. Oil price increases will have more of an impact in emerging markets that give more weighting to energy and food in their inflation baskets.

However, this does not mean that advanced economies will not be affected. Advanced economies such as the UK are struggling with high inflation rates and weak economic growth and will most definitely be affected. This will result in even weaker economic growth, placing additional upward pressure on inflation.

## Consumer spending could slow down

If the oil price is sustained at $100-plus, there is a real risk that the current expected pace of global economic recovery will slow down.

One of the main ways an oil supply shock can hurt growth is through the effect of energy prices on the consumer. Increased oil price spur inflation, which reduces real disposable income and leads to a fall in consumer spending.

If inflation around the world surges and growth is dented, the rise in inflation would have a direct and immediate effect on individuals' consumption. As consumption generally accounts for 60% of GDP, the overall effect will be quite dramatic.

## Fear driving the oil price

Oil price movements are not only a function of supply and demand but are sometimes also driven by fear. The 'fear factor' materialised when political unrest broke out in North Africa and Tunisia and then migrated to the east into the neighbouring countries of Egypt and Libya. This affected basic supply and demand as oil production started to decline.

With unrest now moving closer and closer to the world's biggest oil producer, Saudi Arabia, it's easy to understand why markets are feeling uneasy.