

## **1. Impact of Oil Prices**

Of all the factors that contribute or affect the economy, oil price remains a major influence in the world's economy today. Over the years of industrialization, oil has become the chief production input in the economy. Any changes in its prices will implicate a profound effect throughout the economy.

### **1.1 Inflation and Unemployment**

Oil, is used indispensably in many business production processes. When prices increase, the overall production cost is pushed up, making it costlier to produce. Producers will logically react by producing less, hence decreasing the output. Cost will be passed on to the consumer, making end products costlier, and contributing to a cost-push inflation.

Therefore as oil prices increase, inflation will follow in the same direction establishing a direct relationship.

Additionally, as the general cost of production rises, the reduced output from the producers will contribute in the rise of unemployment, specifically cyclical unemployment.

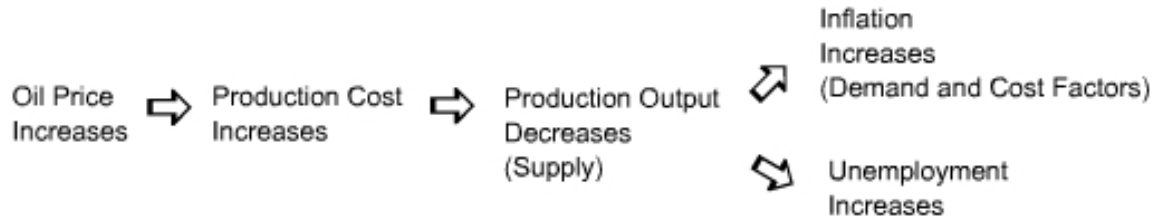
**Figure 1.1.1 The Impact of Oil Price Increase**

Figure 1.1.1 illustrates the flow of impact initiated by a change in the oil price. When price raise, output will decrease resulting in inflation from shortage of supply and raise in end-product cost. Unemployment will increase as production output decline equates to less work opportunities.

## 1.2 Consumption and Investments

High oil prices hurt both consumer and investor confidence. When oil prices increase, inflation sets in and reduces the real value of disposable incomes. This reduction in the real money and instability of oil prices will dampen consumer's confidence and influence purchasing habit. These changes would equate to less consumer spending directly lowering the economy's consumption.

Oil price increase affects investments by discouraging potential investors from investments and reduces its investments. Businesses and investors alike make investment decisions based on profit expectations. When the economy is volatile due to oil price change; they may respond intuitively by waiting until the market is more stable.

Moreover, with less consumption and higher input costs, the economy would seem less favorable for investments.

$$Y \text{ or } GDP = C + I + G + (X-M)$$

From this equation, we understand that Aggregate demand(Y) is based on

Consumption(C), Investment (I), Government Spending(G) and Net Exports (X-M).

From the study, we observe that two major factors are affected when oil price increase.

Declining Consumption and Investments will impact the aggregate demand or GDP.

It is evident that effects of oil prices change is a significant determinant of global

**Figure 1.2.1 Inflation effects on Consumption and Investments**



Figure 1.2.1 illustrates how inflation will affect a consumer's disposable income and reduce the consumption level in the economy. With a low GDP and Consumption, the potential in the economy seem less promising and investments duly decrease.

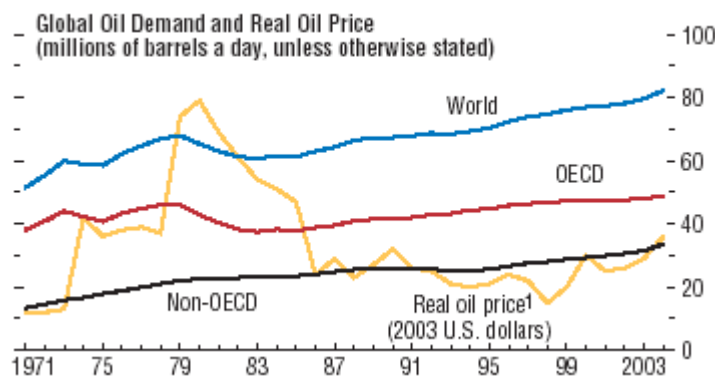
## 2. Factors affecting oil price

The main factor for affecting oil prices is based on basic economic theory of demand and a supply. In recent years, prices of oil have reached a soaring level due to the increasing strong global demand and concerns for its limited supply and production capacity.

There are many varieties of factors contributing to change in oil prices in the economy yet these are the three predominate reasons.

## 2.1 Demand

Consumption of oil and its related products has grown increasingly over the years with two major economies that accounts for most of it. The higher consumption rise was mainly attributed by a petrol consuming culture in America and China's booming economy.



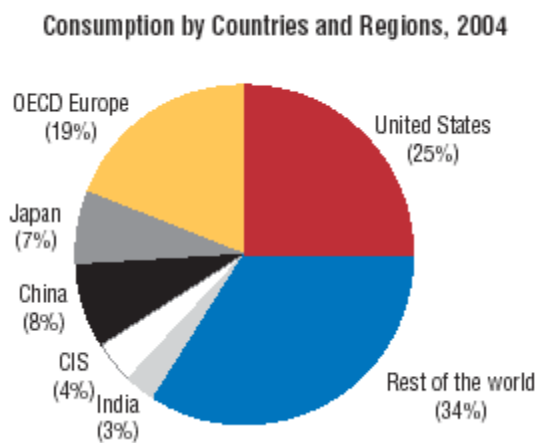
Sources: International Energy Agency; U.S. Department of Energy; and IMF staff calculation

An oil exporter until just a few years ago, China is now the world's fastest growing major importer of oil. Energy demand from China seems to have gone berserk. In the last decade, its oil demand increased by a huge 140 per cent and this year alone it increased by a whopping 20 per cent. Historically, no other country had a 20 per cent rise in demand in a single year. (Vinish Kathuria, 2004)

China's mounting economic expansion has contributed to the growth in demand for oil. Its demand, primarily driven by the phenomenal growth of the Chinese economy is continuously increasing. It is abundantly clear is that world oil production can not continue to increase at the same pace. The geological and engineering realities of oil

production guarantee that the rate of increase in Chinese oil demand will of necessity be restrained, through some combination of a slowing of Chinese economic growth and the energy conservation incentives that are an inevitable consequence of higher oil prices.

There is little sign that demand from industrialized countries is flagging. In the US in particular, the gas-guzzling Sports Utility Vehicle (SUV) still dominates the car market. Some projections suggest that over the next quarter of a century, demand could soar from the current 90 million barrels a day to as much as 140 million. (CNN.com)



Sources: International Energy Agency; U.S. Department of Energy; and IMF staff calculation

This embedded oil culture, habits and the increasing growth for developing countries would continue to increase the demand for oil and remain to be a major reason for increasing oil prices. Over time, we can expect the emerging economies to consume a lot more oil than the industrial world a fact that cannot be disputed due to the sheer

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population numbers in developing countries. This excess demand will most probably be tackled not by increased supply, but by significantly higher prices.

## **2.2 Supply**

One of the most important economy resources is oil. As all resources alike, they are scarce and oil is especially limited even more. Currently, only few countries in the world have oil fields to produce oil. With the worlds demand for oil continue to increase strongly and supply invariably tight, any serious supply disruption would push prices yet higher. The two major dynamic of oil supply are the Diminishing Oil Capacity and OPEC.

### **2.2.1 Diminishing Oil Capacity**

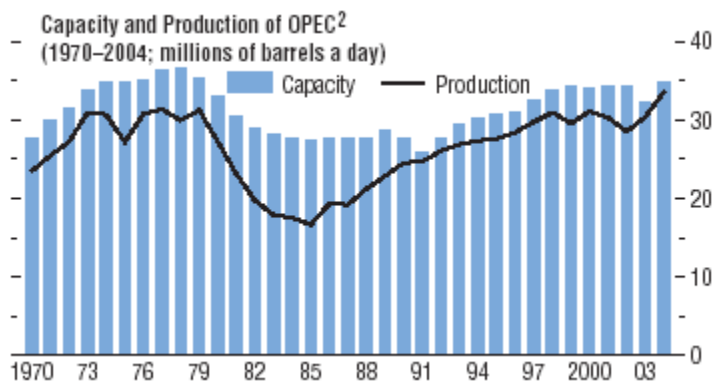
Expected growth in oil production output is not likely to provide for the increasing worldwide demand. Oil is a limited commodity that is depleting and the world's spare oil production capacity is regressively diminishing, estimated to remain low. Additionally, Oil companies have not replaced production with exploration-related investment. Essentially, this lack of oil supply could be due global oil production peaking or peaked.

### **2.2.2 The Organization of Petroleum Exporting Countries (OPEC)**

Oil price reflects much more than the usual supply and demand dynamics. People's demands for oil, but suppliers produce a fixed number of barrels of oil to maintain a technical shortage and derive higher profit.

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As the main supplier of oil, how OPEC plays the market is crucial. The organization accounts for about half of the world's crude oil export, works as a cartel intended specifically to control output decisions and to maintain and stabilize world oil prices. Because of their capacity to adjust production level, they possess a great deal of influence on the price of oil. OPEC would deliberately understate or conceal their true production capabilities for strategic reasons. They would introduce production cuts to control the balance between production supplies and demands accordingly and therefore selling oil at their preferred price levels.



Sources: International Energy Agency; U.S. Department of Energy; and IMF staff calculation

OPEC today barely produces more crude oil than it did in 1977. It held its output quotas below the level it had set in early 1998 until April of 2005. Yet by year-end 2005, OPEC's net oil import revenue will have more than doubled over a 3-year period, reaching an estimated \$430 billion, up from \$193 billion in 2002. (Jim Saxton, 2005)

### 2.3 Political Uncertainty and World Events

Price of oil is heavily affected by political uncertainty and world events. Over the years, peoples' perception over the increasing lower supply of oil, have surfaced with regularity. Recently, risk have risen with fears of supply disruptions arising from the sabotage of Iraq's oil export infrastructure, attacks on oil workers in Saudi Arabia, the uncertainty over the future of the Russian oil company and threats of supply disruptions in Nigeria and Venezuela. The impact of speculation on oil prices is harder to quantify, but may also account for some of the volatility. (OECDObserver.com)

The world's major oil consumers remain dependent on the Middle East for their oil. Recent violence in Iraq and Saudi Arabia has again raised fears about an interruption to supplies. Any substantial attack on Saudi oil facilities would be a major event for world oil markets. The country is the world's biggest oil producer and, by far, the biggest exporter. Analysts also view political tension in non-Middle East states Nigeria and Venezuela as having the potential to disrupt exports and drive up world prices. And there have been worries that a dispute between Russia's government and the country's biggest oil company, Yukos, will lead to the shutdown of a good deal of Russia's production. (BBC.com)

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### **3. Government policies (Counter Oil Prices Increase)**

Government policies response to oil price increases should target on these two main objectives. They are tasked with the responsibility to stabilize prices and to maintain and

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improve employment. Oil shocks impact is extensive throughout the economy, which the government cannot totally eradicate the impacts, but it can minimize them.

### 3.1 Expansionary Polices

The government of the of the affecting economy will lower or maintain interest rates encouraging an increase in money supply to the public. This increase of supply would induce more spending, in an apparent effort to stimulate economic growth and tackle the decrease in economy's output and unemployment. This is policy mostly use to reducing effect of low consumption and to stabilize unemployment rates. This effect is quite immediate with the lowering of interest rate, delaying the impact of the consumer's real income. However in the long run, the consumer's excess money and demand for goods and services will contribute to even higher inflation.

**Fig 3.1.1**

#### **Expansionary Polices**

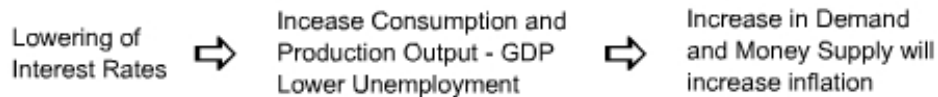


Figure 3.1.1 depicts how the Expansionary Policies can encourage more consumption by lowing interest rates, stimulating economic growth and reduce unemployment. The increase Demand (Consumption) will however inflate prices even more

### 3.2 Contraction Policies

Contraction polices targets exclusively on countering the initial impact of the on inflation.

This approach would exclusively employ to reducing demand enough to stabilize inflation rates. With inflation likely to rise, monetary authorities will worry about a price-

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wage spiral, and will therefore tighten monetary policy by increasing short-term interest rates which acts to dampen down spending to fight the inflationary pressure. In a long run, we would expect to see slower economic growth which will affect the economy's output and unemployment.

**Fig 3.2.1      Contraction Policies**

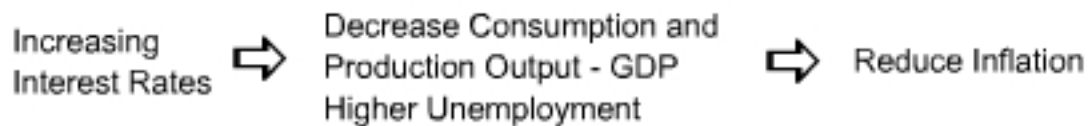


Figure 3.2.1 depicts how the Contraction Policies can reduce inflation by increasing interest to dampen consumption. The problem is the decrease of consumption will further stunt economic growth and increase unemployment.

Depending on which concern is more critical at the point of implementation. Based on the two polices, the government can focus on stimulating the market and reduce unemployment or control inflation. In reality and in best interest of the economy and the people, these polices will be implement at a timely manner to be able to minimize the impact of the oil price increase.

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#### **4. Conclusion**

On most cases in the economy, when the price of a commodity increases, the fluid market will intuitively respond by either finding other alternative or reduce spending which will decrease its demand. However in the oil reality, the rigid structure and the backbone of

the world economy is based highly around the function of oil. It has become one indispensable resource which our global economy and modern society require, and without any competent viable alternative to substitute.

Efforts are making inroads to reduce the dependency on oil and seeing progress. With oil prices surging and increased talk of global warming, capitalists are putting increasing support and investment to into alternative-energy companies. Hybrid car markets, particularly for low petrol consumption. Hydrogen economy that promises to replace and eliminate all of the problems that the fossil fuel economy, and finally, ethanol energy, alternative substitute for fuel, all reinforcing upward pressures on crude prices. But as of now, crude oil still remains to be the driving force the economy business function and its overall oil prices continue to be an important determinant of the global economy.

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