Oil at US$100: worrisome but not disastrous
10 reasons why there is no need to panic

Oil prices crossed the US$100 threshold for one barrel, reaching unheard of levels that until recently were consistent with the most pessimistic scenarios (war in Iran, major hurricanes in the Gulf of Mexico, etc.). These high prices do raise some concerns. In particular, high gas and heating oil prices will surely make a dent in household income. Net oil importing economies and those that do not have access to other forms of energy will be the hardest hit. However, the recent behaviour of the global economy shows that the consequences of high prices will not be anywhere as dire as they were during the oil shocks of 1973 and 1979.

Rather than discuss the causes behind these high prices, this Economic Viewpoint will present 10 reasons why there is no need to panic.

1) THE NATURE OF THE SHOCK: SUPPLY VERSUS DEMAND
Aside from geopolitical risks, the price trend in recent years has been largely driven by booming global demand (graph 1), currently at 85 million barrels per day. Beyond the enormous needs of industrialized countries, the frenetic growth of emerging nations translates into strong demand for energy. In fact, in the last decade, the world’s daily oil needs have increased by 12 million barrels.

In contrast, the two oil shocks of the ‘70s were sparked by a sudden drop in supply. The first was in 1973 when the Organization of Arab Petroleum Exporting Countries (OAPEC, consisting of the Arab members of the Organization of Petroleum Exporting Countries [OPEC] plus Egypt and Syria) decided to place an embargo on countries that supported Israel during the Yom Kippur War. The second was in 1979 during the Iran revolution and the Iran-Iraq war when Iran stopped exporting oil.

OPEC’s influence must also be taken into account. Comprised of mostly Arab countries, OPEC accounted for 50% of the world’s oil supply in the ’70s. After dropping to 29% in 1985, the figure today is 42%, a hefty proportion given that these countries hold two thirds of the world’s oil reserves. Still, solidarity within the cartel is not nearly as strong today. As more member countries join the cartel and divergent interests appear, the harder it becomes to impose production quotas. Consequently, the risk of a unanimous OPEC decision to significantly cut output is less likely.

2) GRADUAL PRICE ADJUSTMENTS
Price is not as important as a change in price. A brief shortage on the market that sends price surging in a short period of time causes more damage to economies that no longer have access to the resource. On average, prices rose 250% between 1973 and 1974 and 125% between 1978 and 1979 (graph 2). In recent years, the increases have been under 50% although prices tripled between 2000 and 2005. However, the solid

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economic performance of the past few years shows that price hikes spread out over several years have less impact on the economy.

3) OIL DEPENDENCE IS FALLING: INDUSTRIALIZED NATIONS ARE CONSUMING LESS ENERGY

The oil crises of the ‘70s sparked a movement away from oil dependence. The development of alternate sources of energy, along with advances in mass transit and energy efficiency, has reduced consumption on the businesses and consumer sides. As well, the knowledge and service industries (less energy hungry) carry more economic weight than in the past. Since the ‘70s, Canada and the U.S. have become much less dependent on oil (graph 4). Before the 1973 crisis, the U.S. needed some 1,500 barrels to generate $1 million in GDP. In 2006, it needed less than 700. In light of the recent price hikes, it’s safe to say that our dependence on oil will continue to decrease and thus provide the economy with some measure of immunity against price fluctuations.

4) INFLATION IS UNDER CONTROL: THE CREDIBILITY OF CENTRAL BANKS

When the first oil shock hit, the central banks cut interest rates to offset higher unemployment and lower investment. In a supply shock situation, this fuels inflation. And higher inflation has an impact on inflationary expectations and hence on the process of setting prices and wages, making it even more difficult to control spiralling production costs and consumer prices.

Economists and central banks learned their lesson from the 1973 crisis and limited their intervention when oil was choked off again in 1979 (graph 5).

Today, the primary focus of most of the world’s central banks is to keep inflation in check, which they have done, along with inflationary expectations (graph 6), despite the increases in oil prices. Right now, inflationary risks are a big concern, but there is no reason to believe that they won’t achieve their targets going forward.
5) OIL PRICE HIKES ARE NOT BEING PASSED ON TO GOODS AND SERVICES: GLOBAL COMPETITION GETTING STRONGER

The increases in the price of oil are by and large not spreading to other goods and services to the same extent as in the past (graph 7).

Beyond the work of the central banks, growing global competition explains this situation. In a highly competitive environment dominated by cheap goods and services from Asia and India, businesses think twice before passing on higher costs to consumers for fear of losing market share. Of course, if oil prices remain high, consumers will eventually feel the pinch, but price adjustments are now being made much more slowly, which is less destabilizing for the economy.

6) WAGES ARE NOT INDEXED: NO INFLATIONARY SPIRAL IN SIGHT

Unlike the ‘70s, wages today are not systematically indexed to the cost of living. During an oil shock, indexed wages drive up the production costs of companies that are already directly feeling the effect of energy price hikes (graph 8). This causes an inflationary spiral: prices go up because of high oil prices, wages go up because of high prices, prices rise again because of high wages, etc. The current trend against wage indexation has been made easier by the fact that central banks have been successful in containing inflation and by the fact that higher prices have largely not spread to other goods and services. Together, these three elements help ward off hikes in energy prices.

7) CORPORATE BALANCE SHEETS ARE LESS AFFECTED BY ENERGY PRICES

Higher labour and energy costs adversely affected corporate balance sheets during the previous two oil shocks (graph 9). A sign that times have changed, business profits continued to grow despite the oil price increases that took place between 2000 and 2006.

Low profitability often goes hand in hand with a reduction in hiring and investment. Unemployment went up and non-residential investment fell when profits dropped in the mid ‘70s and early ‘80s. However, the picture has changed dramatically in the past few years (graphs 10 and 11). Unemployment has remained low and non-residential investment has continued to grow despite the fact that oil...
prices have gone up. However, this situation could change if the U.S. economy continues to be dragged down by the housing slump and tighter credit conditions following the liquidity crisis.

8) MITIGATING EFFECT OF FOREIGN EXCHANGE
To some extent, the recent hikes in oil price reflect the greenback’s depreciation on the foreign exchange market. Oil prices sometimes adjust to changes in foreign exchange rates to maintain the purchasing power of oil exporters. When oil prices are converted into other currencies, the recent price hikes are not quite as high. Consequently, the impact on these economies is proportionately less. Since the beginning of 2007, the price of a WTI barrel has increased 88% in U.S. dollars versus 69% in euros and 55% in Canadian dollars (graph 12).

9) A BETTER UNDERSTANDING OF SUPPLY SHOCKS: THE SUPPLY SIDE POLICIES
In the past, governments and monetary authorities would stimulate demand when the economy slowed and unemployment rose. These policies are effective for an aggregate demand shock but not for a supply side shock. An expansionary monetary policy only fuels inflation. Expansionary fiscal policies, already less effective in global economies, essentially lead to the same result. Governments now prefer to address the supply issue directly with policies designed to trim business costs and boost productivity, which offsets higher energy costs. This can be achieved through education, training, R&D and public infrastructure investment policies or business tax assistance programs.

10) PRICES SHOULD NOT REMAIN THIS HIGH INDEFINITELY
Barring an armed conflict between Iran and the U.S., prices should drop in the longer term. Strong demand pushes prices up but also stimulates oil exploration and development, which until now was difficult because of high extraction and refining costs. Reserves increased after the second oil shock, keeping prices down for many years. High prices also put a crimp in demand. The first two oil shocks sparked a move to reduce our dependence on oil, and today’s high prices will only propel us further in this direction. Ultimately, demand will fall, which combined with an increase in supply, will drive prices down (graph 13).
CONCLUSION
While worrisome, the price hikes of the past few years have not really slowed the economy and for the same reasons, the impact of a barrel close to $100, or $30 more than last year, will be limited. We’re still a long way from the increases of 1973 and 1979. To be comparable, the price would have to triple from last year, i.e. to about $180 a barrel. And even then, the impact would not be as severe because of the 10 reasons explained in this Economic Viewpoint.

Prices could jump unexpectedly if Iran and the U.S. enter into an armed conflict or if Iran restricts access to the Strait of Hormuz (see following map). Over 30% of the world’s oil flows through this strait, which connects the Persian Gulf to the Oman Sea.

Lastly, countries will feel the impact of a price hike differently based on foreign exchange movements and on their individual economic situation. For example, in the U.S., where consumers are already suffering from the mortgage crisis and tighter credit conditions, a jump in energy prices could be the straw that breaks the camel’s back.

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