Lower oil prices are “good news” for the world economy

Lower oil prices are “good news” for the world economy, said the Executive Director of the International Monetary Fund (IMF) Christine Lagarde this week in the wake of OPEC’s decision not to cut production: “There will be winners and losers, but on a net basis, that is good news for the global economy,” said Lagarde during a panel discussion in Washington. Crude oil prices have fallen dramatically and lost about 30% since June, and currently stand at around 70 dollars a barrel, its lowest level in five years. They are poised to drop further still. Oil prices have risen to such an extent in the past decade that the public may have forgotten the concept of low oil prices being good for the economy. Indeed, high oil prices have always been considered a good predictor of future economic difficulties. The Yom Kippur War of 1973 and the Saudi led oil embargo, the Iranian revolution of 1979 and, more recently, the record increase in oil prices in 2008 have all paved the way for periods of great economic difficulties. The question is, then, why have people and the markets responded in a lukewarm or even concerned manner to what would normally have been the kind of news worth celebrating with expensive fermented beverages?

Some analysts had even warned that were oil prices to increase recorded they would have caused new problems to an already unstable international market. Compared to the difficulties 70s, mainly due to abnormalities in the supply, the current ones rely exclusively a problem of global demand, suggests the Nobel laureate economist like Paul Krugman. Since the amount of hydrocarbons present on earth is limited (but not as limited as the ‘peak oil’ preachers have led us to believe), rising imports from developing countries like China and India have created a difficult to eliminate imbalance. Nevertheless, high oil prices only benefit countries that have few other resources at their disposal. For most, they cause everything to be more expensive from food to cotton and any other commodity that requires transport. In fact, Krugman had warned in 2011 that high oil prices would hurt international economic recovery and generate yet another recession precisely because of excess demand for consumer goods and primary resources.

It comes as no surprise that Christine Lagarde says that the recent oil price collapse will benefit the major economies of the world and bring growth on the globe. “When you have a 30% decline …, this should result in a surplus (growth, note) 0.8% in most advanced economies which are oil importers,” a- she said. Of course, if she were addressing an audience in heavily oil reliant Russia, Saudi Arabia, Qatar and Kuwait, she would be speaking in less enthusiastic terms. Adding fuel to the fire, Lagarde spoke of ‘facts and figures’: the lower oil prices next year will push US GDP from 3.1% forecast last October to at least 3.5%. Similar benefits will come for the Eurozone, relieving a stagnant economic situation characterized by slow growth, low inflation and a high unemployment rate. Until the low oil prices, it seemed as if Europe was in a situation from which there is was no escape. Now, there is more impetus also for European leaders to take on structural labor market reforms along with a monetary policy that, according to Lagarde is “more aggressive and innovative”

Consumers are the big winners as the almost 40% drop in crude oil (and 35% for gasoline), will have an effect equivalent to a tax cut, because so much of their monthly budget (which is estimated as 4% for Americans and double that for Europeans) can now be directed to consumer discretionary spending. Saudi Arabia, OPEC’s undisputed leader, has been pursuing a tactic of bringing down prices up to render tar sands and shale oil, as well as renewable energy technologies, ‘inconvenient’ because of the latter’s much higher production costs than the traditional technologies employed in the traditional oil producing countries represented by OPEC and a few others like Russia. However, this strategy will not be very effective in the long term because, despite its efforts to discourage the growth of alternative oil and energy sources, OPEC will fail to disrupt investments in clean energy. Indeed, ‘green energy’ technology will be the target of 60% of the USD$ 5,000 billion worth of planned investments in the next decade, following the policy of the US, China and the EU to cut greenhouse gas emissions by promoting wind, solar, geothermal and other renewables – not to mention the dozens of thorium and traditional uranium powered nuclear reactors that China plans to build in the next decade. Green energy investments have been dictated by policy, which is hardly going to change course just because fossil fuels have become cheaper – for the time being – even if these same fossil fuels will still be an important source of the world’s energy mix for decades.