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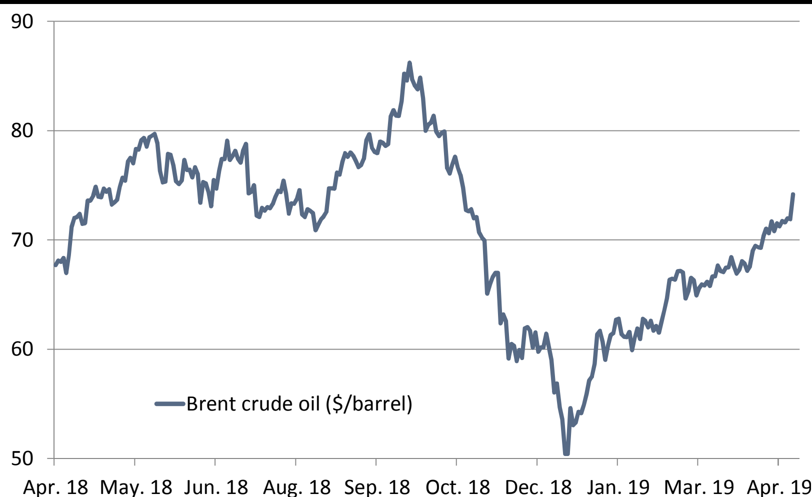
Economic consequences of the rising oil price

Back to mid-2018 levels: the oil price has rallied strongly so far during 2019



Daily data. Source: FT

- **Sustained gains in oil:** The price of a barrel of Brent crude oil has risen by c50% from the late-December 2018 low of c$50. International Energy Agency analysis points to a combination of supply and demand factors. On the supply side, US sanctions on Iran and Venezuela as well as lower OPEC and non-OPEC output relative to the H2 2018 surge have lowered production at the start of 2019. The fact that the rising oil price has mirrored the 2019 gains in equities highlights the demand-side element. The ongoing equity rally reflects market expectations that the global economy will escape its current soft patch, linked to worries about the US-China and US-EU trade skirmishes, the slowdown in China, and Brexit. We agree with this assessment and expect global industrial production and trade to recover in H2 2019 as long as none of the key risks go badly wrong.

- **No primary input matters more than crude oil:** Gyrations in the oil market can occasionally have large effects on real incomes and economic activity. This time, the impact will probably remain modest. Beyond the correction of the December trough, the additional 20% rise in the oil price since mid-February will likely contribute around 0.2ppt to headline inflation in the Western world in the coming months. The oil supply squeeze and subsequent rise in inflation could be a minor drag on real output growth in consumption-oriented advanced economies.

- **No need to worry:** When fundamentals are robust, demand growth tends to hold up when the oil price rises. Consumers can take a modest burden in their stride. Labour markets are in good shape on both sides of the Atlantic. Credit conditions remain favourable. Despite the recent rebound to just above the H1 2018 average of $71 per barrel, the current oil price is not high enough to throttle real demand growth and prevent a sustained rebound in global momentum linked to fading – mostly political – risks. We expect no more than a minor dent to real spending in oil-importing countries due to slightly higher outlays for oil imports now. Of course, a sudden rise in the oil price to, say, $100 per barrel, would be a cause for concern. But that seems unlikely.

- **Crude politics:** While demand-driven gains in the price of oil are usually manageable, as they reflect firmer global economic growth, supply-side driven shocks can be a different story. Rising oil prices due to geopolitical clashes are less easy to wear as they can also deliver an additional blow to confidence beyond the dent to real incomes. The end of the US waivers for purchasing Iranian oil is the most recent example. In our view, the Iranian troubles are unlikely to disrupt the global oil market much beyond the latest price uptick. The conflict is not new.

- **Higher price = more supply, eventually:** Global oil supplies are more price-elastic in the age of fracking than before. Many more oil sources become profitable as the price rises. Crude oil production is thus likely to pick up over the course of 2019. But the likely recovery in global industrial production – which is particularly crude-heavy on the input side – should prevent a swing back into the low $50 range, which would be a problem for producers. We expect the price of a barrel of Brent crude to trend towards the $60-70 range over the medium term. For the global economy, this balance between consumer and producer interests would be the Goldilocks zone.

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