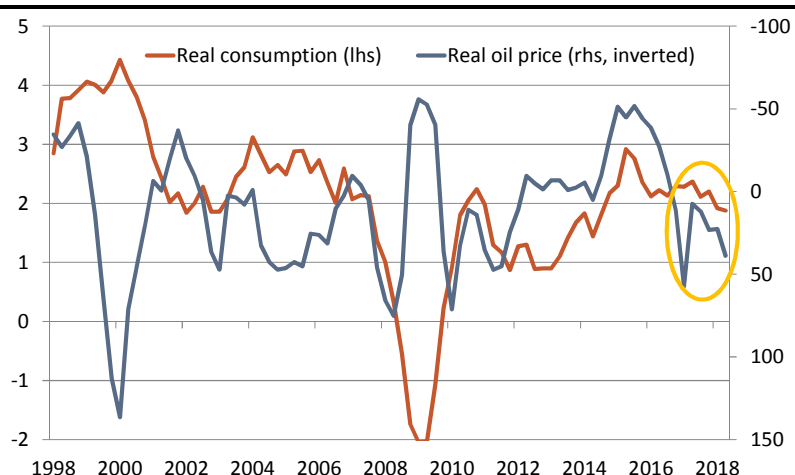


11 May 2018

How much of a headwind is the rising oil price?

Annual % change in G7 real consumption and real oil prices



Quarterly data. Source: EIA, OECD, BEA, Berenberg calculations. Oil price is \$ spot price of a barrel of Brent crude oil adjusted using the US GDP deflator. Q2 nominal oil price assumption - \$70. Q1 and Q2 G7 real consumption growth based on Berenberg forecasts for G7 ex. Canada. Weights: US (54.8%), Japan (14.4%), Germany (10.2%), UK (7.8%), France (7.3%), and Italy (5.5%).

- No primary input matters more than crude oil:** Changes in the price of a barrel of oil can occasionally have large effects on real incomes and economic activity. The advent of US shale since 2013/14, which added to global oil supply and sharply lowered oil prices and global inflation, has been a major boon for households. Consumption typically makes up one-half to two-thirds of GDP for advanced countries. As our chart shows, the drop in the oil price helped to jump-start consumption growth and bolstered the global upswing that we are enjoying now.
- The end of cheap oil:** The oil price has trended up during the past 12 months, from c\$50 for a barrel of Brent crude to a current price of \$77. The rise towards \$70 was mainly due to strong global demand and an effective effort by OPEC to constrain its own production. In the past week, growing tension in the Middle East, centred on US President Donald Trump's decision to withdraw the US from the 2015 Iran deal, has pushed the oil price up further.
- Should we worry about the latest rise in the oil price?** No, at least not much. As past episodes illustrate (2000 and 2002 to 2006), when the economic backdrop is strong, demand growth typically remains resilient as the oil price rises. Yes, a sudden rise in the oil price to, say, \$100 per barrel, as some market commentators predict, would be a cause for concern. But that seems unlikely. A more modest rise to, say, \$80 or even \$85 a barrel, could shave a mere 0.2ppt from annual rates of consumption growth over the next year relative to a baseline scenario with oil around \$70 per barrel. As most major economies are currently growing above their potential rates, this is not a huge worry.
- Higher price = more supply, eventually:** As long as tensions between Saudi Arabia and Iran do not escalate far beyond the current proxy wars in Yemen and parts of Syria, and the Strait of Hormuz remains open, current events are unlikely to disrupt the global oil market severely. Other oil producers should be able to compensate for any potential decline in the c4% of global oil output that Iran currently supplies. As global oil supplies are more price-elastic in the age of fracking than before, prices may come down a bit towards the end of 2018, as the higher price makes more oil sources profitable and production rises. We thus expect no more than a modest dent to real consumption growth in oil-importing countries due to slightly higher outlays for oil imports now.
- When fundamentals are healthy, we can live with the occasional headwind:** The advanced world is in better shape now than it was before the financial crisis. There are few signs of excess. Consumption growth is driven by rising incomes rather than borrowing. Firms are investing more in response to stronger demand and capacity constraints. While we have to watch out for the potential tail risks from rising geopolitical tensions, a modest rise in the price of oil should not be enough to destabilise the momentum behind the current upswing much.

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