

Box A: Oil Prices and Economic Performance

Oil prices have risen to their highest level for about ten years in recent months (Graph A1). At over US\$30 per barrel, oil costs about three times as much as it did at its low point in late 1998. That twenty-year low in oil prices was a result of a combination of an increase in the supply of oil from OPEC in early 1997, and a fall in demand for oil shortly thereafter as a result of the Asian crisis. An increase in demand as the world economy has recovered, and decisions by OPEC to reduce supply, helped to push prices higher during 1999. During 2000, ongoing growth in demand, concerns about the low levels of world oil inventories and limited global refining capacity have seen the price of oil continue to rise. In response to the rise, OPEC has increased its production quotas four times this year. At present, however, oil prices remain high and are over 60 per cent higher than their average for the past three years.

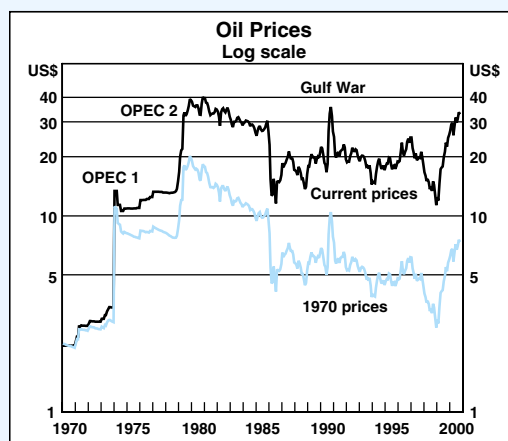
This rise, while very substantial, is not of the same order of magnitude as those seen in the oil price 'shocks' of the mid and late 1970s. Nonetheless, if oil prices remain high, they can be expected to put upward pressure on global inflation rates and to have some dampening influence on global economic

growth. The pressure on prices results from the direct impact on price indexes of the higher prices for household expenditure on petrol, and from the indirect impact on prices for a range of goods and services which embody transportation costs. The direct effect has added about 1 percentage point or so to CPI inflation over the past year in most countries, with further effects likely in the short term. The indirect impact may take somewhat longer to come through. It might be mitigated to some extent by a short-term compression of profit margins, or partly offset by other cost savings.

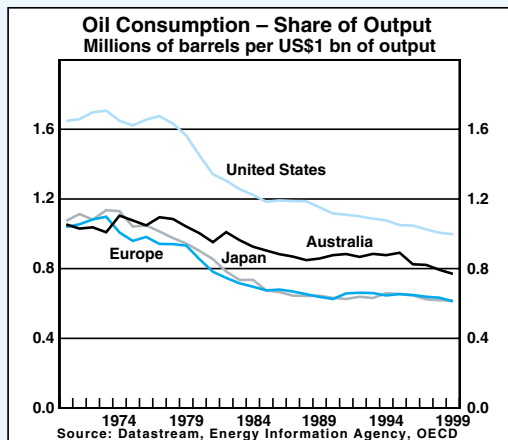
The effects on economic activity arise firstly because the rise in oil prices pushes up the cost of production. As such, it represents a reduction in the aggregate supply of goods and services that can be sustained at any given price level in the industrialised economies. Absent an offsetting demand expansion, this means that production will be lower, and prices higher, than otherwise. Moreover, since the rise in oil prices represents a loss of income to oil consumers, it is likely that aggregate demand in energy-consuming countries will be weaker than otherwise. This income is transferred to oil producers, who are then likely to expand their own demand for goods and services, providing some offsetting impetus to the contraction in oil-consuming regions. The net result of all these forces is that world economic growth is likely to be lower, and inflation higher, than would otherwise have been the case.

The recent rise in oil prices is smaller, in proportionate terms, than those which occurred in the mid and late 1970s episodes. For this reason, the impact on global growth and inflation should be considerably smaller than on those occasions, unless the price of oil were to rise much further. In addition, most advanced economies have become relatively more efficient in their use of oil,

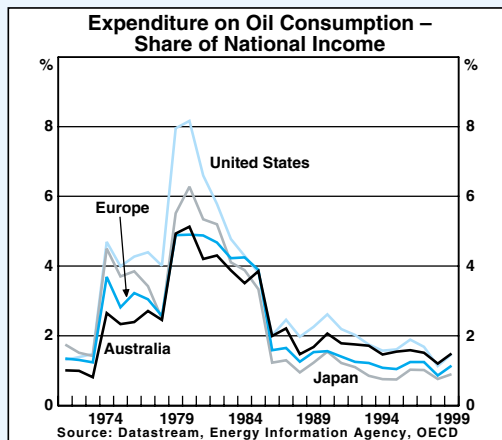
Graph A1



Graph A2



Graph A3



largely as a response to the earlier rises in oil prices. Graph A2 shows how the quantity of oil consumed per unit of real GDP has declined over time, so that although the price of oil remains much higher than it was prior to the OPEC 1 increase, the share of total income devoted to spending on oil has returned to pre-OPEC 1 levels (Graph A3).

The effects on individual economies and regions can be expected to vary, depending on the pattern of their production and the extent to which they rely on imported, as opposed to domestically produced oil. It is important to note that a number of developing economies have probably *increased* their reliance on oil as a result of rapid industrialisation over the past two decades.

In Australia’s case, the effects of rising oil prices are likely to be less contractionary than for most other advanced countries. While Australia has in recent years been a small net importer of oil, it is a substantial net

exporter of natural gas (Table A1), the price of which is linked to the price of oil. Hence there is a net transfer of income towards Australian producers from world consumers. All other things equal, this would tend to impart a stimulus to the Australian economy, though the transfer within Australia from energy consumers to producers might be a dampening influence in the short term. Should the price of oil remain high for some time, it is also possible that prices for other energy sources such as coal could increase, as has tended to occur in the past. √

Table A1: Australia’s Trade in Energy Resources
Year to June quarter 2000, \$b

	Exports	Imports
Petroleum	7.1	7.5
Gas	2.6	0.1
Coal	8.3	0.0