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Don't forget the upside of 'lower for longer' oil

It's time to remember the fundamentals — low oil prices will boost the global economy

by Michael Heise

For weeks, markets have been mirroring the oil price. Investors consider slumping oil prices as evidence of lacklustre global demand. They are not convinced lower energy costs can lift global demand, as they have done in the past. It is time to go back to fundamentals. Lower oil prices will deliver a boost to the global economy. This time is not different.

Countries that are net importers of oil make up the bulk of the world economy. For them, lower oil prices translate into higher real incomes, which should increase private consumption. Of course, falling oil prices have drastically reduced earnings of oil producers, who have since been forced to slash investment spending. Also, aggregate demand in oil-exporting countries is declining — albeit not in proportion to falling oil revenues, as governments use their cash reserves to smooth the downturn.

Such economic effects were also visible in the mid-1980s, when Opec's attempts to gain market share brought the oil price crashing to $10 per barrel. It took some time for the price collapse to work through the system. Eventually growth accelerated to varying degrees in virtually all industrialised countries between 1987 and 1990.

The demand stimulus from lower oil prices is usually reinforced by a positive supply shock — a mechanism that economists like Michael Bruno and Jeffrey Sachs proved back in the 1980s. These supply-side effects are not immediate. It takes time before lower production costs affect prices and production plans.

I cannot see why these laws of economics should be defunct in 2016. True, the fiscal surpluses in oil-producing countries have been eroded after years of lavish public spending. Oil producers have, however, also built up huge sovereign wealth funds. Most of these funds are replete enough for governments to cushion the economic blow of low prices, at least for a while.

I would also expect the supply-side effects to kick in due course. The use of oil in global production has decreased since the mid-1980s, especially in rich countries that have shifted to less energy-intensive manufacturing and services. At the same

time, however, there has been a massive build-up of production capacity in emerging markets, which is often rather energy-intensive. China's net oil imports amount to 2 per cent of GDP. In Taiwan the figure is 7 per cent, with most of the other emerging Asian countries somewhere in between. Their economies will benefit from lower import prices.

Overall, the direct economic impact of cheaper oil may be somewhat weaker than in previous cycles. But this time around, central banks have been reacting forcefully to the perceived deflationary threats of lower oil prices. Expansionary monetary policies are reinforcing the positive demand and supply effects.

I reckon that the global growth impact of falling oil prices in 2014 and 2015 will be at least three-quarters of a percentage point. Part of this effect has already taken place and has helped to mitigate other strong headwinds for growth, especially in emerging markets. But the larger part is still to come.

Another long-term impact of low oil prices will be seen on capital markets. With lower oil revenues, the savings glut in oil-producing countries is about to disappear, and the global supply of capital will decline. At the same time, many emerging markets, above all China, are shifting their growth models towards consumption and away from savings and investment. Over time, these shifts in the supply of capital should push up rates of return globally — a welcome step back towards normality.

The key question for me, therefore, is not whether the laws of economics are defunct, but whether the oil price will stay low (say in the $25-50 range) for long enough for these laws to be set in motion. Under current circumstances, this looks likely.

Forecasting oil prices remains fiendishly difficult. Only a couple of years ago, many respected analysts predicted oil supply to peak and the oil price to stay extraordinarily high as a result. That turned out to be wrong. Not only supply and demand determine the oil price but also new technologies, financial market speculation, geopolitical tensions and the not always transparent political objectives of large producer countries.

So for us economists, the safest way to ponder the impact of oil prices is through scenarios based on different price assumptions. If you assume that the oil price stays lower for longer, expect good news for economic growth and financial markets.

Michael Heise is chief economist of Allianz SE

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