

CHAPTER III

THE IMPACTS ON DEVELOPED COUNTRIES

The impact as a result of increasing price of petroleum on the world is enormous. Speaking economically, the overview of oil impact on the world, would provide general perceptions and acknowledgement of most countries being economically and developmentally affected, meanwhile some being benefited by it. In fact, rapidly rising gasoline price has reshaped political landscape, for oil represent a new source of wealth and political supremacy. Nevertheless, it is clear that the global economy, as a whole, has appeared to be harshly hit by this oil's phenomenon.

In this chapter, the general background of oil impacts on economy in developed countries since 1970s until the recent crisis will be explored. Additionally, it will be particularly focused the case study of economic and development impacts of oil price increase during 2004-2006 upon the United States, European Union and Japan, the world superpowers or the so- called first world , whose economic and industrial development is high.

A. Background of Oil Impacts on Economy in Developed Countries

Generally the economy of this group is affected by inflation and economic slow down, but an effect is less significant as faced by the developing countries. Only moderate effect prevails, due to less reliance on oil as well as continuous accumulation of reserved crude. According to analysis by the International Energy

Agency (IEA), the effect of a sustained \$10/B increase in oil prices from \$25/B to \$35/B would lower world GDP, other things being equal, by at least 0.5% in the following year.

The economy of the first world society only experiences comparatively less harmful impact, because of their professional management of oil supply. Undergoing industrialization long ago, most of developed countries have fortunately and already been through since the early period of industrialization. Other reason is that the price, though higher than that in the third world, is nonetheless affordable and somehow comparatively cheap, as compared with inflation rate and purchasing power of those in the developing world.

In addition to that, it generates inspiration for great power to adopt strategic diversification of source and resource. For simplistic explanation, these states are embarked on their strategic journey in a discovery of energy beyond their frontiers. Not only the US and its great rival, China, but also India, Russia and Japan turned to be engaged in a quest for oil all over the world. Fights over resources have taken place outside their territories as exemplified by a long war in Iraq. Similarly politics of pipelines where these super powers compete with each other for the same reason, to ensure their energy security for the future prosperity of the nations. At this age, conflict has been not limited within the Middle East, but expanded into Africa and Central Asia.

B. The Impacts of Oil Price Increase during 2004- 2006
on Given Developed Economies

I. The United States

To understand individually the effect of rising oil price in developed country, the United States is the largest consumer of oil. It accounts for 25% of global daily consumption, but hold less than 3% of the world's proved oil reserves¹². Historically, oil production in the US has been in a gradual decline since 1970 and this decline is projected to continue¹³. At the same time, oil imports have increased steadily and now accounts for 58% of total US consumption and this trend is expected to continue.

Therefore, analyzing impacts of rising prices of oil upon the US economy should not be ignored. The US economy is in a better position to weather oil price shocks in the past because it is less "oil intensive". The US uses half as much oil to produce the same amount of GDP as it did in the 1970s. The rate of decline in oil use relative to the economy however has slowed in recent years as vehicle fuel efficiency has stagnated. In general, high oil prices would lead to a U.S. and global economic slowdown; but such a slowdown did not actually materialize. Such growth slowdown did not occur for several reasons: the oil and commodity price shock was driven by more by higher global demand rather than by a supply shock; U.S. and advanced

¹² BP p.l.c., "BP Statistical Review of World Energy," June 2005, pg 4-9.

¹³ Department of Energy Information Administration, Annual Energy Outlook 2006.

economies are less dependent on oil than in the 1970s and 1980s; the recycling of petrodollars - via high oil exporters current account surpluses and excess savings - kept global long rates lower than otherwise and thus stimulated consumption and investment demand in oil importing countries; monetary policy remained very easy in the G7 (in the U.S. until late 2004; in the Eurozone and Japan until very recently) thus helping growth; asset and housing bubbles driven by low short and long term interest rates sustained demand and investment in many advanced economies; in China and other countries high oil prices did not lead to higher oil/energy retail prices because of price controls; many oil importing countries - especially the U.S. - reacted to the oil shock as if it was only temporary, thus not adjusting consumption and savings to the higher oil price level; and, finally, in the US in 2002-2004 a very loose policy stance with easy money, easier fiscal policy and a weaker dollar stimulated economic activity.

On the inflation side, the spike in oil, energy and commodity prices did not lead to an increase in US and global core inflation rates. Again, the reasons are several: less structural dependence on oil and energy; globalization keeping non-oil import prices low; stable and credible low inflation monetary policies; sluggish growth of labor costs - in part due to globalization - that kept a lid on overall production costs.

II. Japan

Japan is another important developed country of major oil consumer affected by the rise of crude oil prices. Japan's dependence on imported crude oil reaches nearly 100% as for the statistic from Japan Economic Department of 2004¹⁴. Theoretically, the effect of a price rise on the Japanese economy and people's lifestyles should be extensive. However, the structural pattern of energy consumption in Japan differs from that of the first and second oil crises. During past crises, crude oil's share of energy consumption in Japan was nearly 80%, but this has now fallen below 50%. Moreover, Japan has taken steps to cushion the impact of a rise in crude oil prices through a strategic stockpile representing more than 150 days' consumption and raising the efficiency of energy consumption. The ratio of energy consumption to GDP, calculated by dividing energy consumption by real GDP, declined rapidly from the middle of the 1970s to the first half of 1980 and mildly after that until the beginning of the 1990s. Since then, it has been flat or risen slightly. Between 1973 and 2000 it fell 33%, reflecting Japan's increased energy consumption efficiency.

Furthermore, because crude oil transactions are based on the US dollar, the yen-dollar rate is reflected in the import price of crude oil in Japan. A strong yen partly or wholly cancels out a rise in crude oil prices, while a weak yen intensifies the effect of a price rise. The effect of the rise in crude oil prices so far has been cushioned by the exchange factor. Crude oil import volume is predicted to increase

¹⁴ Ono Mitsuhiro, "Rising Crude Oil Prices Affect the Japanese Economy," Economic Research Department, 2004, http://www.jetro.go.jp/en/stats/survey/pdf/2004_07_other.pdf

1.1% if Japanese economic growth increases one percentage point. Volume declines 0.18%, however, if the import price rises 1%). Indication is that crude oil import volume is not strongly affected by a rise in crude prices. These estimates were made from a static viewpoint, for instance, how an increase in crude oil imports would affect the Japanese economy under the economic structure. It is not an estimate of dynamic economic movement nor changes in final demand. Therefore, the results are more moderate than similar estimates by other institutes. According to an analysis of the effect of a rise in crude oil prices on the world economy,

III. European Union

According to the research¹⁵, similar to the U.S., all EU countries stand to experience higher inflation due to rising oil prices. While the U.S. has been successful in reducing its dependence on oil from a consumption-per-unit of output perspective, this is not the case in many other countries, where oil use is key to their developing industrial and transportation sectors. Moreover, for the U.S., the net import share of total oil consumption is above 50 percent, and this share is expected to rise steadily in the future. Other EU countries face the same prospect. Higher oil prices have direct and dramatic effect on the trade patterns between countries. Here, trade in oil is just one side of the story. As higher oil prices get translated into higher commodity prices, there are likely to be changes in the prices of non-energy exported and imported

¹⁵ Ronald Earley, "What has happened to the share of energy in the U.S. economy since the early 1970s?", in *Energy Price Impact on the U.S. Economy*, 2007, http://www.eia.doe.gov/oiaf/economy/energy_price.html.

goods which will affect trade beyond just the oil accounts. And the impacts, in general, are not so much different from those of the United States.