The Oil Drum: Europe
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What would $120 oil mean for the global economy?

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The pdf is a short report written by Robert F. Wescott and published in **April 2006** by Securing America's Future Energy. It was written when oil was ~$60 a barrel and addressed a scenario where the price of oil surged to $120 due to coordinated terrorist attacks on global oil transport infrastructure. Well, here we are, two years on at $120 oil (without the attacks) so it's worth revisiting the analysis in light of the conclusion:

> The main conclusion of this note is that $120 oil would have profound negative effects on the world economy and global financial markets.
> ...
>
> Such oil prices would almost certainly precipitate a global recession.

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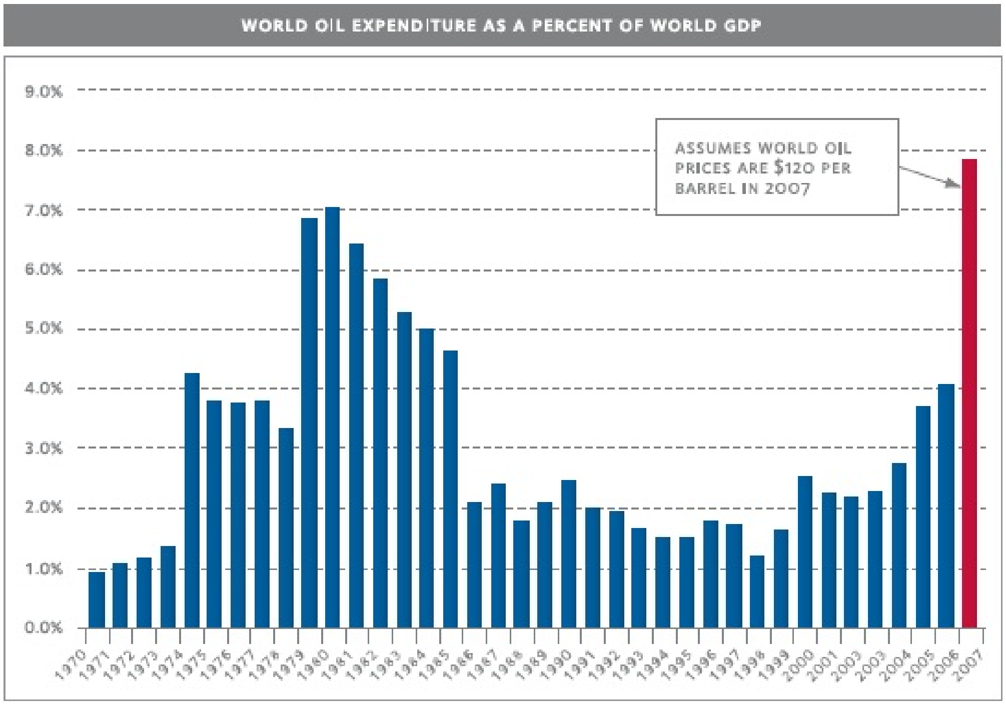
The scenario is not identical to the present situation, Wescott's terrorism induced $120 involves a rapid spike upwards however the analysis is based on the $120 price being sustained for a year. This long term high price is similar to today's situation.

The most interesting chart from the report shows world oil expenditure as a percentage of world GDP:



Wescott points out that historically this metric has been in the range of 1-3% and recessions have occurred when the expenditure exceeded 4%. $120 represents approximately 8% of world GDP, higher than at any time in modern history. Two studies are cited: The International Monetary Fund (IMF) suggesting a $5 increase cuts world GDP by 0.3% so it follows that the $60 to $120 doubling would reduce world GDP by 3.6% and the US Federal Reserve estimates that a $20 increase reduces GDP by 0.75%, which would result in a loss of 2.3% from the increase to $120.

With world GDP growth averaging 3.5% over the last 30 years we are clearly in the ball park of a global recession due to oil price, before even considering today's other difficulties in the credit and housing markets.

Wescott associated $120 oil with $5 a gallon gasoline in the US and $8-9 a gallon in Europe. In April 2008 the average price of a US gallon of regular petrol in the UK was $7.98 (April '08 national average [108.1p/litre] and assuming £1 = $1.95). In the US a gallon is $3.61 ([EIA]). How has he managed to be right on one count but off when it comes to the US? Current retail prices lag the oil price by several weeks and with low taxation the US price is more sensitive to changes in the oil price. Prolonged $120 oil is certain to increase today's US price by a larger proportion than the European price.

Wescott forecast that inflation would rise from 2-3% to 6-8% and that interest rates would increase to combat this pressure. It was noted that as growth slows the reverse decision may be taken to ease credit conditions. We seem to have skipped the first stage of increased interest rates and moved straight to cuts, in an attempt to break the "credit crunch".

Whilst a radical claim two years ago $120 now seems conservative. This week we have two new forecasts; in a major departure from previous downward predictions Daniel Yergin of CERA is [now suggesting $150] this year and Goldman Sachs are [talking about $200] within the next six-months to two years.

In conclusion, Wescott's paper makes some interesting observations and we seem to be on the trajectory he identified. However three things are tempering reality against the scenario presented:

- the value of the dollar has decreased somewhat so today's $120 is not as high in comparable

terms as Wescott's
- the rise from $60 to $120 has been a steady climb rather than the abrupt terrorism induced shock and
- we are yet to experience the full year of $120 that the report assumes.

The core prediction is one of global recession, history suggest that and whilst the Wall Street Journal article didn't use the 'r' world this paragraph requires little further analysis:

> "That would put oil at unprecedented price levels, even going back to just after the Civil War," said Stephen Brown, an energy economist at the Dallas Federal Reserve Bank. A sustained price of $150 a barrel, he estimates, would shave around 1.8% percentage points off U.S. economic output in the first year, and a further 1.5% in the second year. The U.S. economy in the first quarter grew at an anemic 0.6% annual pace.
>
> Wall Street Journal