CAZENOVE
CAPITAL MANAGEMENT

December 2014

WHAT WILL BE THE IMPACT OF LOWER OIL PRICES ON GROWTH?

Strategy and economics

Richard Jeffrey - Chief Investment Officer

Pick up almost any business publication or newspaper and you will read someone's deep thoughts about the oil price, plus a multitude of predictions about where it will go next. $20 per barrel is the lowest I have come across. That the collapse in the oil price has been one of the more dramatic moves in markets during 2014 hardly needs saying. I have no doubt that there are a few people who will claim that they saw it coming, but in reality such sudden moves in asset prices are unpredictable. Some economists may have got the direction right, but few will have dared predict the extent of the move. The Treasury carries out a monthly survey of economists' forecasts. A year ago, the average price for Brent crude in 2014, as projected by 12 City economics teams, was US$109 – compared to an average price in 2013 of… US$109 (and US$111 in both 2011 and 2012). In fact, the average price for 2014 looks as if it will be just a fraction below US$100. By July this year, the month in which the slide in the price began, the expected average price for the year had fallen to US$107. Perhaps we should have done, but most of us never saw it coming.

The problem when trying to assess trends in commodity prices is that the market is inherently unstable. This is due to relatively unusual supply and demand conditions. On one side, near-term demand for oil is relatively price inelastic. This means that changes in price do not result in huge shifts in the quantity consumed; but it also means that changes in the quantity of oil available can lead to substantial moves in the price.

During 2014, world growth looks likely to have been slightly faster than in 2013. However, outside the US, a number of larger economies have lost momentum during the second half of the year. As a result, world energy demand will not have increased significantly during the period.

In itself, dull world growth would probably have resulted in the persistence of a relatively flat oil price. But the real change in the market has been a shift in the supply curve. This has been brought about by rapidly rising US oil production, as it ramps up its exploitation of oil shale reserves. Almost certainly, it is this development that has triggered the recent instability. Indeed, in combination with the unwillingness of OPEC countries to constrain production, rising US output has been more than sufficient to outweigh the impact of concerns that may otherwise have become evident from geopolitical events in both Europe and the Middle East.

Falling energy costs are good for consumers of oil and bad for producers. Inasmuch as oil consumers, in aggregate, have a higher propensity to consume than oil producers, this is not necessarily a zero-sum game, and will probably result in a modest short-term boost to world growth. It is interesting to consider this in the context of the US, which is now both a large consumer and producer, albeit it is still a net oil importer. In the short-term, the more significant near-term impact of lower energy prices will be on households, with reduced energy bills resulting in higher consumption of other goods. While this should benefit domestic industry and boost output, some of the stimulus will be lost to imports. Further ahead, the consequences could be rather more ambiguous. If prices remain sufficiently low to deter further exploitation of shale reserves, net oil imports will eventually start to rise and there will be less capital investment. In addition, there will be lower employment within the domestic oil industry and reduced profitability. While the slack in the economy would eventually be taken up within other sectors, the medium-term impact of a prolonged slump in the oil price could be negative to the US, before becoming more neutral thereafter.