

## Oil Price Rises Increase Growth Uncertainties

Thomas D. Higgins, PhD, Global Macro Strategist,  
Standish Mellon Asset Management Company, LLC

April 2011

---

The collapse of political regimes in Tunisia and Egypt and the eruption of civil war in Libya have raised concerns about broader instability in the Middle East and North Africa and the implications for world oil prices.

---

### Executive Summary

Standish Global Macro Strategist Tom Higgins argues that the global economy can absorb the recent rise in oil prices. A sustained \$10 increase in the price of oil would trim growth only modestly, he says. Europeans seem more concerned than the U.S. about the spillover effect to core inflation, with the European Central Bank possibly raising interest rates this year amid concern over inflationary pressure. The worst effects of the oil price increases are likely to be felt in the far more energy-intensive economies of emerging Asia and Africa. While painful, the current price rises, he says, are tolerable for the global economy. However, given the continued geopolitical uncertainty in the Middle East and North Africa, he says that a further surge in oil prices could seriously undermine growth.

### Geopolitical Risk Returns to the Middle East

At the start of this year, forecasters highlighted three major risks to the global economy: the lack of a resolution to Europe's sovereign debt woes; fiscal problems at the U.S. state and local levels; and the potential for overheating in some emerging market economies. Popular opinion was that as long as none of these situations seriously worsened, the outlook for the global economy was relatively optimistic for 2011.

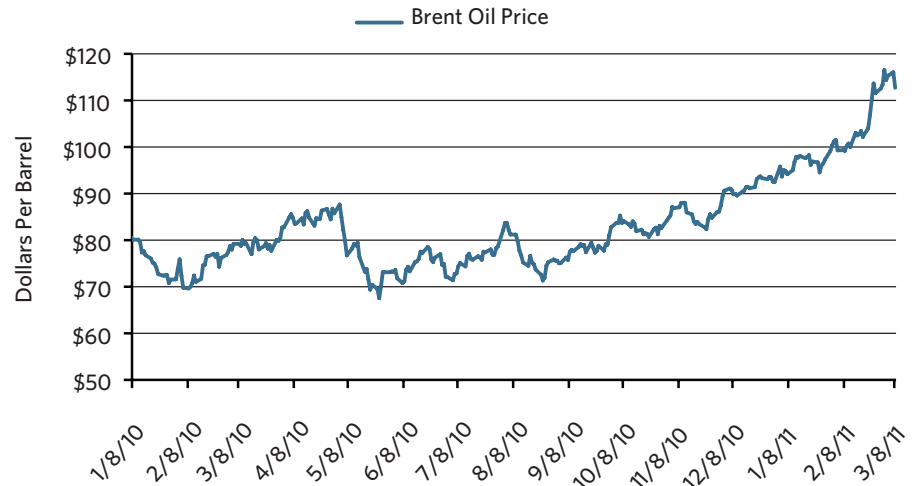
However, recent developments in the Middle East have altered this calculus. The collapse of political regimes in Tunisia and Egypt and the eruption of civil war in Libya have raised concerns about broader instability in the Middle East and North Africa and the implications for world oil prices. Brent crude prices have already jumped nearly 15% since mid-February to over \$116/barrel.<sup>1</sup> Empirical analysis suggests the global economy can absorb a shock of this magnitude, but this assumes oil prices are nearing a peak and the increase will prove temporary.

The repercussions may be more severe if unrest spread to other oil producers, such as Saudi Arabia or Iran. Supply disruptions of this order could pose a serious threat to the global economy. We are closely monitoring the situation, but it is very difficult to judge the probability of such an outcome.

<sup>1</sup> Reuters, March 22, 2011.



**Figure 1 - Tensions in Middle East Have Put Pressure on Oil Prices**



Source: Bloomberg as of March 8, 2011

The U.S. economy is roughly half as oil intensive as it was during the oil crises of the mid-1970s.<sup>2</sup> This is due to a combination of increased energy efficiency and the transition toward a more service-based economy.

### The Impact of High Oil Prices

Estimating the impact of the rise in oil prices on the global economy is a three-step process for us: 1) determining the magnitude of the increase; 2) figuring out whether that increase is temporary or permanent; 3) assessing the effects on economic activity. We can evaluate the effect on global economic activity by looking at the oil intensity and foreign oil dependence for different countries and regions. Oil intensity is defined as how many barrels of oil it takes to produce a unit of gross domestic product (GDP).

The U.S. economy is roughly half as oil intensive as it was during the oil crises of the mid-1970s.<sup>2</sup> This is primarily due to a combination of increased energy efficiency and the transition toward a more service-based economy. The International Energy Agency (IEA) estimates that a sustained \$10 increase in the price of oil would shave about 0.3 percentage points off U.S. output. This would lower the Bloomberg consensus forecast for U.S. GDP growth from 3.2% to 2.9% in 2011. The IEA also estimates that higher energy prices would push up headline inflation as measured by the consumer price index (CPI) by roughly 0.5 percentage points, which would raise the Bloomberg consensus from 1.9% to about 2.4%.

Yet, we believe the effects on U.S. core inflation, which excludes food and energy prices, are less clear. In recent years, there has been less pass through of oil price shocks to underlying inflation. We believe this may be partly due to the weakening of the labor union movement in the United States, which has reduced the ability of workers to insist on pay raises to compensate for higher energy prices. Union membership has declined from 20.1% in 1983 to 11.9% in 2010.<sup>3</sup> In any case, given the Federal Reserve's focus on core inflation, it has tended to view higher energy prices as more of a disinflationary shock that acts as a tax on consumption rather than a transmission mechanism for broader inflationary pressures.

<sup>2</sup> "Analysis of the Impact of High Oil Prices on the Global Economy," International Energy Agency, May 2004. All further references to the effect of oil price rises on GDP growth are taken from this same report.

<sup>3</sup> Bureau of Labor Statistics, Union Members Summary, 2010.

---

We believe the worst effects of higher energy prices would likely be felt in the emerging market economies of Asia and Africa. These areas tend to have a higher level of oil intensity than developed markets because they tend to be more manufacturing-based.

---

The European Central Bank (ECB), which focuses on headline inflation, does not share the Fed's view. Instead, the ECB worries the increase in commodity prices will eventually be passed through to core inflation.<sup>4</sup> As a result, the central bank is reported to be contemplating hiking interest rates as soon as its April 2011 meeting to combat price pressures. Such a move could aggravate any pull back in consumer demand associated with higher oil prices. The IEA estimates that a \$10 rise in the price of oil subtracts around 0.5 percentage point from eurozone output. This would reduce the Bloomberg consensus forecast for eurozone GDP growth from 1.6% to 1.1% in 2011. The eurozone would be more negatively affected than the U.S. because the region is more dependent on foreign oil, receiving roughly 83% of its oil from abroad, compared with only 50% for the United States.<sup>5</sup>

We believe the worst effects of higher energy prices would likely be felt in the emerging market economies of Asia and Africa. These areas tend to have a higher level of oil intensity than developed markets because they tend to be more manufacturing-based. The IEA estimates a sustained \$10 increase in the price of oil subtracts 0.8 percentage points from output in Asia and twice that amount for Africa. Higher energy prices are also likely to exacerbate inflationary pressures in these regions as markets have already begun to price this into the forward curves.

By contrast, the impact of higher energy costs may be more muted in Latin America, given large oil reserves in countries such as Mexico and Venezuela. For some oil exporters in the Middle East and Russia, a sustained increase in oil prices may even have a positive impact on output. However, we believe the net effect on global economic growth would almost certainly be negative. Indeed, the IEA estimates that a sustained \$10 increase in the price of oil would subtract 0.5 percentage points off global growth. This would reduce the International Monetary Fund forecast for global growth from 4.4% to 3.9% in 2011.

We believe such an outcome for global growth would be disappointing, but tolerable. That would change quickly if civil unrest were to spread to Saudi Arabia or Iran. The Saudi Kingdom sits on top of approximately one-fifth of the world's proven oil reserves, and is the largest oil producer and exporter in the world.<sup>6</sup> Iran accounts for an additional 10% of the world's proven reserves and is the second largest producer in the world.<sup>7</sup> We believe that scenario is a low probability event. Saudi Arabia's King Abdullah has promised \$36 billion in benefits to his population and Iranian leaders have taken a more hard line approach with protesters.<sup>8</sup> Nevertheless, investor anxiety about the geopolitical situation in the Middle East implies oil prices could remain elevated for some time. We believe investors need to keep a close watch on new developments that might adversely affect the price of oil.

---

4 "Oil Chaos Could Divide Fed, ECB on Inflation Strategy," *Reuters*, February 27, 2011.

5 CIA World Factbook, 2009.

6 "Independent Statistics and Analysis," The Energy Information Administration, January 2011.

7 Ibid.

8 "As Protesters Roil Neighbors, Saudis Quash Rallies," *Associated Press*, March 11, 2011; "Iran Cracks Down on Protesters," *Financial Times*, March 1, 2011.

BNY Mellon Asset Management is the umbrella organization for BNY Mellon's affiliated investment management firms and global distribution companies. BNY Mellon is the corporate brand of The Bank of New York Mellon Corporation. • The statements and opinions expressed in this article are those of the authors as of the date of the article, are subject to change as economic and market conditions dictate, and do not necessarily represent the views of BNY Mellon, BNY Mellon Asset Management International or any of their respective affiliates. This article does not constitute investment advice, is not predictive of future performance, and should not be construed as an offer to sell or a solicitation to buy any security or make an offer where otherwise unlawful. BNY Mellon Asset Management International Limited and its affiliates are not responsible for any subsequent investment advice given based on the information supplied.

Past performance is not a guide to future performance. The value of investments and the income from them is not guaranteed and can fall as well as rise due to stock market and currency movements. When you sell your investment you may get back less than you originally invested. • While the information in this document is not intended to be investment advice, it may be deemed a financial promotion in non-U.S. jurisdictions. Accordingly, where this document is used or distributed in any non-U.S. jurisdiction, the information provided is for use by professional investors only and not for onward distribution to, or to be relied upon by, retail investors. • Products or services described in this document are provided by BNY Mellon, its subsidiaries, affiliates or related companies and may be provided in various countries by one or more of these companies where authorized and regulated as required within each jurisdiction. However, this material is not intended, and should not be construed, as an offer or solicitation of services or products or an endorsement thereof in any jurisdiction or in any circumstance that is otherwise unlawful or unauthorized. The investment products and services mentioned here are not insured by the FDIC (or any other state or federal agency), are not deposits of or guaranteed by any bank, and may lose value. • This document should not be published in hard copy, electronic form, via the web or in any other medium accessible to the public, unless authorized by BNY Mellon Asset Management International Limited.

In Australia, this document is issued by BNY Mellon Asset Management Australia Limited (ABN 56 102 482 815, AFS License No. 227865) located at Level 6, 7 Macquarie Place, Sydney, NSW 2000. Authorized and regulated by the Australian Securities & Investments Commission. • In Brazil, this document is issued by BNY Mellon Serviços Financeiros DTVM S.A., Av. Presidente Wilson, 231, 11th floor, Rio de Janeiro, RJ, Brazil, CEP 20030-905. BNY Mellon Serviços Financeiros DTVM S.A. is a Financial Institution, duly authorized by the Brazilian Central Bank to provide securities distribution and by the Brazilian Securities and Exchange Commission (CVM) to provide securities portfolio managing services under Declaratory Act No. 4.620, issued on December 19, 1997. • Investment vehicles may be offered and sold in Canada through BNY Mellon Asset Management Ltd., a Portfolio Manager and Exempt Market Dealer. • In Dubai, United Arab Emirates, this document is issued by the Dubai branch of The Bank of New York Mellon, which is regulated by the Dubai Financial Services Authority. • In Germany, this document is issued by WestLB Mellon Asset Management Kapitalanlagegesellschaft mbH, which is regulated by the Bundesanstalt für Finanzdienstleistungsaufsicht. WestLB Mellon Asset Management Holdings Limited is a 50:50 joint venture between BNY Mellon and WestLB AG. WestLB Mellon Asset Management Kapitalanlagegesellschaft mbH is a wholly owned subsidiary of this joint venture. • If this document is used or distributed in Hong Kong, it is issued by BNY Mellon Asset Management Hong Kong Limited, whose business address is Level 14, Three Pacific Place, 1 Queen's Road East, Hong Kong. BNY Mellon Asset Management Hong Kong Limited is regulated by the Hong Kong Securities and Futures Commission and its registered office is at 6th floor, Alexandra House, 18 Chater Road, Central, Hong Kong. • In Japan, this document is issued by BNY Mellon Asset Management Japan Limited, Meiji Seimei Kan 6F, 2-1-1 Marunouchi Chiyoda-ku, Tokyo 100-0005, Japan. BNY Mellon Asset Management Japan Limited is a Financial Instruments Business Operator with license no 406 (Kinsho) at the Commissioner of Kanto Local Finance Bureau and is a Member of the Investment Trusts Association, Japan and Japan Securities Investment Advisers Association. • In Korea, this document is issued by BNY Mellon AM Korea Limited for presentation to professional investors. BNY Mellon AM Korea Limited, 21/F Seoul Finance Center, 84 Taepyungro 1-ga, Jung-gu, Seoul, Korea. Regulated by the Financial Supervisory Service. • In Singapore, this document is issued by The Bank of New York Mellon, Singapore Branch for presentation to professional investors. The Bank of New York Mellon, Singapore Branch, One Temasek Avenue, #02-01 Millenia Tower, Singapore 039192. Regulated by the Monetary Authority of Singapore. • This document is issued in the UK and in mainland Europe (excluding Germany), by BNY Mellon Asset Management International Limited. BNY Mellon Asset Management International Limited, 160 Queen Victoria Street, London EC4V 4LA. Registered in England No. 1118580. Authorized and regulated by the Financial Services Authority. • This document is issued in the United States by BNY Mellon Asset Management.



## BNY MELLON ASSET MANAGEMENT

The Alcentra Group  
Ankura Capital Pty Limited  
Blackfriars Asset Management Limited  
BNY Mellon ARX  
BNY Mellon Beta Management  
BNY Mellon Cash Investment Strategies  
The Boston Company Asset Management, LLC  
The Dreyfus Corporation  
EACM Advisors LLC  
Hamon Investment Group  
Insight Investment  
Mellon Capital Management Corporation  
The Newton Group  
Pareto Investment Management Limited  
Siguler Guff & Company LP  
Standish Mellon Asset Management Company LLC  
Urdang Capital Management, Inc.  
Urdang Securities Management, Inc.  
Walter Scott & Partners Limited  
WestLB Mellon Asset Management

BNY Mellon holds over 90% of the parent holding company of The Alcentra Group. The Group refers to these affiliated companies: Alcentra, Ltd and Alcentra NY, LLC. Only Alcentra NY, LLC offers services in the U.S. • Ankura, Insight Investment and WestLB Mellon Asset Management do not offer services in the U.S. This presentation does not constitute an offer to sell, or a solicitation of an offer to purchase, any of the firms' services or funds to any U.S. investor, or where otherwise unlawful. • BNY Mellon holds a 20% interest in Siguler Guff & Company, LP and certain related entities (including Siguler Guff Advisers LLC). • BNY Mellon Beta Management is a division of The Bank of New York Mellon, a wholly-owned banking subsidiary of BNY Mellon. • BNY Mellon Cash Investment Strategies is a division of The Dreyfus Corporation. • Hamon's services are offered in the U.S. by Hamon U.S. Investment Advisors Limited. BNY Mellon holds a 19.9% interest in Hamon Investment Group Pte Limited, which is the parent of Hamon U.S. Investment Advisors Limited. • The Newton Group refers to the following group of companies: Newton Investment Management Limited, Newton Capital Management Limited, Newton International Investment Management Limited, Newton Capital Management LLC, and Newton Fund Managers (CI) Limited. Except for Newton Capital Management LLC and Newton Capital Management Limited, none of the other Newton companies offers services in the U.S. • BNY Mellon Asset Management International Limited and any other BNY Mellon entity mentioned above are all ultimately owned by BNY Mellon.