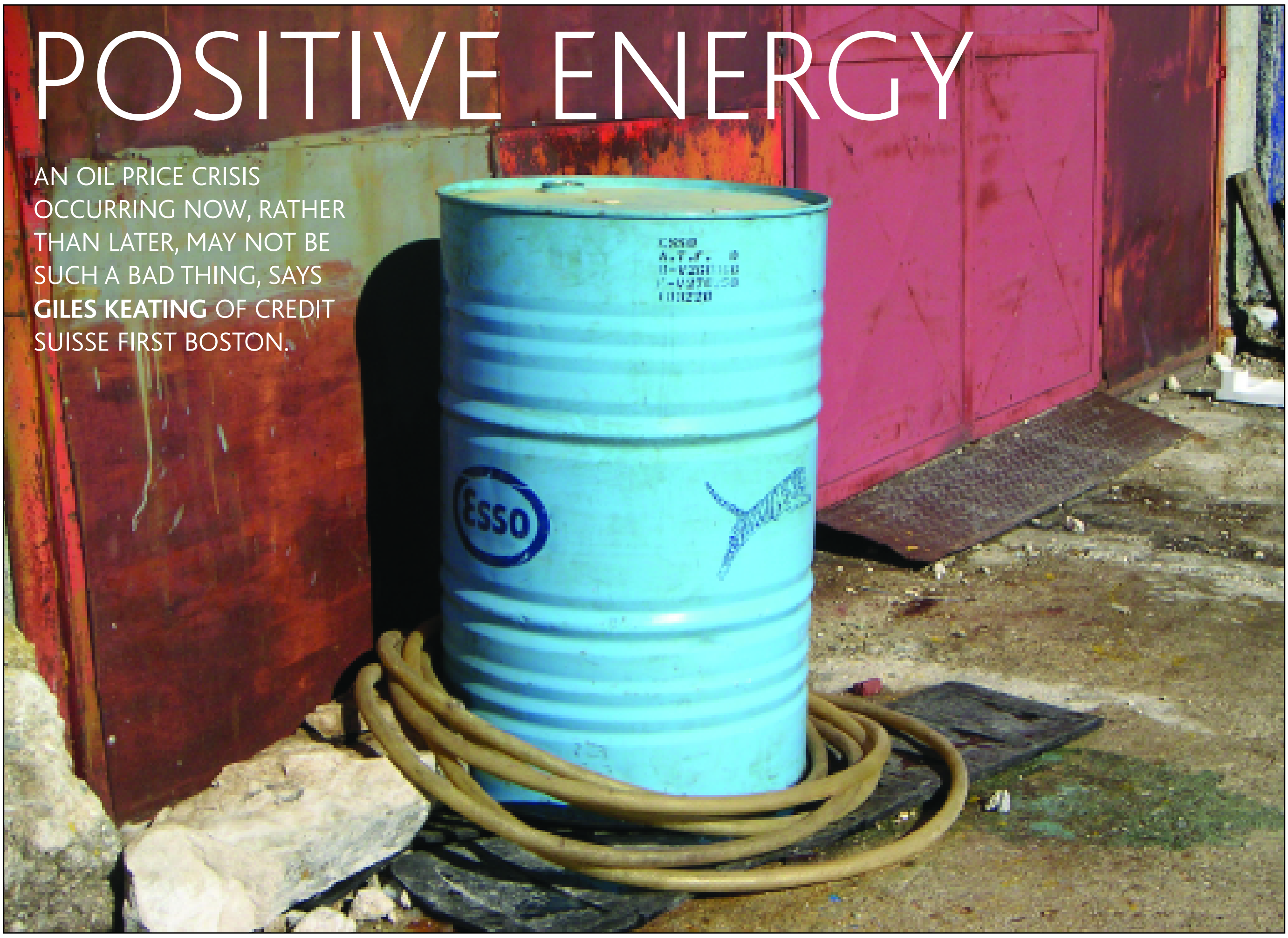
POSITIVE ENERGY

AN OIL PRICE CRISIS OCCURRING NOW, RATHER THAN LATER, MAY NOT BE SUCH A BAD THING, SAYS **GILES KEATING** OF CREDIT SUISSE FIRST BOSTON.



If there has to be a full-scale oil crisis, with prices at perhaps $70-$80-plus per barrel, then 2004 is probably one of the best years for it to happen. Of course, there would be short-term disruption to both the global economy and to financial markets. Econometric models suggest that within a year, inflation in the world's main economies would have increased by about 0.25%-0.5% for every $10 rise in oil prices, with GDP reduced by a similar amount. And many people fear the impact of large price hikes could be disproportionately higher than suggested by the models, if consumer and business confidence collapses, or financial discontinuities emerge.

PRICE RISES. The initial reaction of financial markets will almost certainly be highly negative, with both stock and bond markets falling sharply in anticipation of higher inflation and falling economic growth. Yet, the world in 2004 could prove surprisingly resilient to much higher oil prices.

One important factor is that many companies have stronger balance sheets compared with two years ago, cutting back investment and deleveraging after the excesses of the previous upswing. Indeed, in 2004, we are at the stage of the cycle in which boards are just initiating or considering new investments for the next upswing but generally have not yet got large-scale expenditure underway. The cashflow drain from higher oil prices will hardly be welcome and will cause many spending projects to be postponed. But its impact on corporate health should be far less than a similar shock in, say, 2000-2001, when it would have hit highly geared companies that had undertaken major investments which were starting to come on stream, forcing them into a deep economic downturn. That could have triggered widespread bankruptcies and defaults, which are difficult to counter even with aggressively expansionary monetary policy.

Another important reason the impact of high oil prices would be restrained in 2004 is that a substantial amount of spare capacity exists in the global economy. This is left over from the excess investment in the US from 1998-2001, in China over the period since 2001, and in Europe and Japan from the prolonged period of sluggish or falling domestic demand seen over the last decade.

Faster world growth since late 2003 has started to erode some of this slack and bottlenecks have emerged in certain areas, notably steel and other metals and, at the opposite end of the value chain, flat screens for PCs and TVs. But, at the overall macro level, actual output is well below its potential level, helping to dampen inflation.

ADVERSE EFFECTS. If there is not a major oil crisis in 2004, this favourable output gap will continue to narrow, disappearing perhaps by the end of 2005 or in early 2006. By then, corporate balance sheets will also have become more highly leveraged. As a result, an oil crisis taking prices to $70-$80-plus at that time would be far more adverse for the world economy than one that occurs this year.

Moreover, the existence of this slack provides the Federal Reserve, and the world's other major central banks, with considerable policy

flexibility. Since higher oil prices tend to simultaneously increase inflation and reduce output, they always create a dilemma for monetary policymakers. Should interest rates be raised to counter the inflation, or cut to sustain output?

If the Federal Reserve is faced with much higher oil prices in 2004, it can afford to lean towards protecting output, rather than tackling inflation. This might not necessarily involve outright cuts in rates, which are, after all, already very low, but it could imply postponing, perhaps for a considerable time, the rate increases that had been planned. This would help US consumers, who, unlike companies, are at a peak level of leverage. It would also have the effect of offsetting any adverse effect on equity and bond prices from the oil price rises. After an initial down-period, it could even trigger a new asset price bubble. In the UK, the Bank of England would face a particular dilemma, with the housing market perhaps less affected by soaring oil prices than other parts of the economy. On balance it, too, would probably slow the pace of rate hikes, allowing house prices to reach yet further highs.

LOWER PRICES. There is another, very different, kind of reason why an oil crisis in 2004 might not be such a bad thing. The real price of oil, averaged through all its ups and downs, has been on a downwards trend over the last decade, despite growing demand from China and concerns over Middle East instability, in part as new sources of supply have come on stream, notably from Russia's resurgent oil industry. Like drug users, oil consumers have responded to the lower price by becoming even more hooked. In the US, this is epitomised by the popularity of gas-guzzling sports utility vehicles, and in China, by a development programme that beats the western model of energy intensity, exemplified by the way previously bicycle-based urban transport is rapidly being replaced by car mobility. In Europe, it takes a different form, with cash-strapped governments over the last decade taking advantage of a downward creep in oil prices to crank up their own revenue take from petrol taxes.

Much higher oil prices now, as opposed to later, would help to break this cycle of dependency at an earlier and less disruptive stage. US consumers will have to revert to more sensible cars, China will have to accelerate its metro-building and impose city-wide road tolls, and European governments will have to accept that fuel taxes do not provide a bottomless pool of revenue for funding re-distributive social programmes.

ALTERNATIVE ENERGY. Importantly, the move to viable alternative fuels will be given new impetus. By far the most obvious of these are biomass-based fuels, which can be used in existing diesel vehicles without modification and which are already on sale widely in Germany and in small quantities at some supermarket petrol outlets in the UK. They are 100% renewable and their emissions are modest. The agricultural produce from which they are made could be imported from farmers in many of the poorest developing nations. This would help to offset the current trade regimes that exacerbate poverty by penalising such imports, while also reducing dependence on oil supplies from politically unstable regions.

The main disadvantage of biomass fuels is that their pre-tax price can be between about one-third and three-quarters as much again, compared with oil-based fuels. But that problem would disappear if oil prices double, and would probably be eroded anyway over time as research and development (R&D) and economies of scale help to cut costs. Despite all these advantages, UK Chancellor Gordon Brown is committed to increasing the tax on biomass faster than the general level of fuel duties in this autumn's round of fuel tax rises.

An oil crisis would not be good news, but if it happened now, the impact is likely to be less disruptive than if it had occurred two years ago, or compared with its happening later, at the peak of the economic cycle. In terms of the long-term impact on relative demand for various fuel types, the sooner a crisis occurs, the better.

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