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Oil Price and its Impact on Global Economy

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Abstract— The report highlights the fluctuations occurring in the commodity market relating to crude oil prices. It highlights the reasons behind the major fluctuations being seen in crude oil prices as well as price fluctuation relating to oil that have occurred in the past. Thus, the report also highlights the significance of the free fall in crude oil prices being seen in the present upon the global economy as well as economies of countries that have a great degree of dependency upon the income generated through the export of crude oil. The report also discusses predictions about the future trends in crude oil prices and whether the prices have bottomed out and will stabilize in future whether the volatility in prices shall continue to remain. Thus, a conclusion has been drawn based upon the findings made with regard to crude oil.

INTRODUCTION

The price of oil largely refers to the spot price of say a barrel which acts as a reference price for buyers and sellers of crude oil in the market. The oil prices are different in different markets due to factors such as specific gravity or API and its sulphur content, its location i.e. its proximity to refineries etc.

The most major fluctuation in prices of oil dates back to 1973 which was largely due to shift in demand for crude oil. The demand for crude oil directly depends on the expansion of the global economy. The rise in prices can also be attributed to increase in demand for crude oil due to expected shortages in its stock in the future. The oil supply largely depends on discovery of oil geographically, tax implications of extraction of oil, its cost of extraction, cost and availability of technology and political situation of the country. Although the oil prices largely depends on the demand and supply as discussed above, but according to some, it also is affected by speculation in the futures market.

Oil, just as other commodities, is marketed. Oil futures as well as natural gas futures are widely traded today.

A major rise or even a decline in oil prices can have a major political and economic impact. Lower oil prices lead to greater trade globally. Further, lower oil prices can have a positive impact on global violence. Oil-rich states become more dependent on foreign investments thereby engaging more in international cooperation (Mers, 2014).

RECENT DEVELOPMENTS IN OIL PRICES

Prices of oil in the world market have fallen rapidly since 2014. It has fallen by about 50 per cent since June 2014. The situation of forward prices is such that indicates that in the future prices will not return to the levels of recent years. Lower oil prices results in reduction of inflation both directly and directly when production costs for other goods fall. The respective results are different for both oil-producing as well as oil-importing countries (Baffes, 2015).

Whether the low oil prices will be permanent or not can be said to be a critical factor in determining the development of global economy. The forward pricing today, indicates that though the oil prices will rise, but not as significantly as in recent years. It can be said that if the price largely depends on the production by OPEC. If the production is reduced, the price of oil will rise. Lower oil prices would lead to lower investments in production of oil in turn reducing the production capacity and thus supply of oil. A fall in price of oil due to reduced demand will not have the same positive impact on the global economy as a fall in price due to increase in its supply. The reason behind it is that a fall in price due to demand is a symptom of worsened growth prospects. The extent of the effects of fall in price also depends on how the countries adjust their fiscal and monetary policies as a response to the change in prices (Baffes, 2015).

IMPACT FOR FLUCTUATION IN OIL PRICES

The fall in prices of oil will have a significant impact on inflation in countries where the oil related products form a large part of CPI. The prices as well as the wages in a country are also indirectly affected by the fall in oil prices. The consumer prices in a country are also to a great extent impacted by the level of oil-related taxes. This can be gauged by the fact that the impact of oil prices is significantly greater in the United States as compared to in euro area and Sweden due to the United States' lower-volume based specific taxes imposed on petrol that are independent of the price.

Decrease in inflation is significantly expected to be temporary because of the positive effects on the real economy resulting in increase in the inflationary pressures. Presently however, there is a complicated situation in many economies because of the fact that inflation is already very low in the first place. The Central Bank's tolerance for negative inflation can be low in the situation where the inflation is far below target. There is an increased expectation for fall in household corporate inflation expenses as a result of fall in prices of oil. This may result in a more forceful reaction from the monetary policy. (Monetary-policyreport, 2015)

EXPECTED FUTURE TRENDS

Recently, the Organization of the Petroleum Exporting Countries bought about a cut in its forecasts for global growth of oil demand and the economy of the world stating that the lower prices of oil were offset lower consumer needs resulting in the loss of large countries such as Russia and Brazil. According to

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OPEC, the overall negative impact of fall in oil prices since mid of 2014 has outweighed benefits in the short term, although lower oil prices are generally considered as a boon to the industry, consumers as well as the global economy. The organization lowered its global forecast from 3.4% to 3.2% apart from decreasing its oil demand growth forecast by 10000 barrels a day for the current year. According to it, due to the after effects of the great recession the possibility of a rise in consumer spending is limited. (Faucon, 2016)

Today, the world has an excessive supply of oil to the extent that it can be said to be drowning in it. The greatest contribution to its production can be attributable to Saudi Arabia. It is thought that Saudi Arabia wants to capture the market by driving out the higher cost producers from the industry including some firms that have boosted to produce oil in the United States from 5m barrels a day in 2008 to over 9m now. In the past, cheap oil has bought down the economy of the world. The reason is that the consumers tend to spend more of their savings than the producers do. It hold much truer in today's scenario. The American consumers have been saving more than what was expected of them. Oil producers, having spent extravagantly when prices were high are now tightening their belts. Russia recently announced a 10% cut in public spending after the latest drop in crude prices. Similarly Saudi Arabia is also decreasing its budget to deal with the deficit of 15% of GDP.

The possible financial impact of decrease in prices of oil is hard to assess. Out of the $650 billion rise in emerging market corporate debt, most of it has been in oil and commodity industry. In the clutch of emerging markets prone to trouble, oil plays the dominant role. As a result of falling GDP, the government of Russia could soon face budgetary crises. On the other hand, Venezuela having inflation of 140% has declared an economic state of emergency. In the same way, other countries which are oil producers are prone to a weaker cycle of growth, imported inflation, falling currency and tighter monetary policy. The interest rates were increase in December by countries such as Colombia & Mexico. In order to boost its industry, Nigeria is desperately trying to ration its dollars.

The rich countries are also not spared by it. There is an increase in the yields of corporate high yield bonds from 6.5% to 9.7%. Central Banks of rich countries fear that continuous low inflation will give rise to static and falling prices resulting in raising real interest rates.

The drop in oil prices proves to be advantageous to countries like India & China. Whereas the oil dependant economies get a reason to embrace reform offering the oil importers such as South Korea, a chance to tear up the wasteful energy subsidies or raise taxes to curb deficits or boost inflation. The world economy is still coping with the aftermath of the financial crash. (The Economist, 2016)

CONCLUSION

The decline in oil prices has significant financial, policy and macroeconomics inflation. If allowed to sustain, it will support activity and reduce inflationary, external and fiscal pressures in oil importing countries. On the other hand it would adversely affect the oil exporting countries by weakening their external and fiscal positions as well as reducing their economic activity. Low prices of oil significantly affect the sentiments of the investors about oil exporting and emerging market economies thereby leading to substantial volatility in the financial market. Similarly, decline in oil prices present a significant window of opportunity to bring about a reform in fuel subsidies and energy taxes which are substantial in many developing countries and bring about a reform in to diversify oil-reliant economies. (Prospects, 2015)

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