The Opec oil price still matters (just not as much as before)

Larry Elliot (*The Guardian*, 27/11/2014)

The oil cartel has been weakened by non-cartel producers and alternative energy sources such as shale

A cursory glance at the history of the oil price since the second world war tells its own story. There are booms when the price of oil is low and busts when the cost of crude rises. Four spikes in oil since 1973 have been matched by four recessions over the same period.

The so-called postwar golden age is also the story of a flatlining oil price, which remained at around $2 a barrel during that period. Five Middle Eastern nations formed the Organisation of the Petroleum Exporting Countries in 1960 but it was more than a decade before Opec bared its teeth.

Then, in the autumn of 1973 the cartel responded to Israeli successes in the Yom Kippur war by announcing an oil embargo of the west. The price of crude rose almost five-fold within six months, raising business costs and threatening living standards. Stagflation – a period in which inflation and unemployment both rose – followed.

A brief and fragile recovery in the mid to late 1970s was quickly extinguished when the start of the Iran-Iraq war resulted in a further doubling of oil prices. And a second, even more painful, recession.

But the slump in the west meant demand for oil fell. Producers could no longer sell all the crude they were pumping and with the key producer – Saudi Arabia – ensuring that global output remained at high levels, the price fell to below $10 a barrel by the mid-1980s. Business costs fell, consumers were spending less on filling up their cars and heating their homes. The late 1980s recorded a colossal boom that was already running into inflationary problems when Saddam Hussein invaded Kuwait in August 1990. A third oil spike was accompanied by a third global recession.

As in the 1980s, producers could not make higher prices stick. And as the price of crude subsided so growth in the west picked up. These were the years in which Bill Clinton

balanced the US budget and when the UK embarked on a long period of uninterrupted growth that lasted from 1992 to 2008.

By then, though, the global economy was gripped by a fourth oil shock. With the cost of a barrel of crude peaking at almost $150 a barrel, policymakers faced a familiar problem: inflation was rising even while their economies were shrinking, only with the added complication that the banks were on the brink of meltdown.

So what are the conclusions of this brief history lesson? It is clear that oil matters. Although economies in the west have become less oil-intensive over the past few decades, that has been offset by the thirst for energy in developing countries such as China and India.

Opec has less clout than it once did, partly due to the importance of non-Opec producers such as Russia and partly because of the shale revolution in the US. Members of the cartel have different interests, with Saudi Arabia better placed to deal with lower prices than Venezuela or Iran. But Opec still matters: witness the fall in oil prices as it became clear that there would be no production curbs emerging from the current meeting in Vienna.

Finally, there are winners and losers from falling oil prices just as there are from tumbling interest rates. Producing nations suffer while consuming nations benefit. The net effect, though, should be positive for growth since producers are more likely to save than consumers.

There are two provisos, however. The first is that lower prices stick. The second is that falling oil prices do not lead to a period of outright deflation from which countries find it difficult to escape.