RESERVE BANK OF FIJI ECONOMIC FOCUS

Higher Oil Price and the Economy

Crude oil is refined into various products such as unleaded fuel, gasoline, kerosene and lubrications. These products are the major sources of energy that drives the world today. At present, about 40 percent of the planet's demand for energy is met by crude oil related products.

Prices of crude oil are determined in the international commodity market and they are usually influenced by demand and supply conditions, as well as speculation or expectations about the future. Generally, when the world economy is experiencing good growth, demand for energy (crude oil) is higher and hence prices may rise. In times of an economic slowdown, demand weakens, often resulting in a decline in prices. Similarly, if buyers fear disruptions in supply in the future due to events like war, terrorism threats or labour strikes in a major oil-producing nation, they often try to stock-up oil inventories in advance. This causes an unusual increase in demand and leads to a rise in prices.

The Organisation of Petroleum Exporting Countries (OPEC) is mainly responsible for supplying crude oil in the market. About 11 countries are members of OPEC and Saudi Arabia is the largest oil-producing nation, followed by Iran, Venezuela and Iraq. There are other non-OPEC countries like Russia and Canada that supply crude oil. Oil prices are quoted in US dollar per barrel[1] - as it appears on television during the evening news bulletin. At present, the OPEC targets a price range between $US22-28 per barrel. In other words, if oil prices are higher than US$28 per barrel for a long time, then OPEC is likely to lift supply of oil to reduce prices. Conversely, if prices are below US$22 per barrel, then it is expected to cutback on supply to push prices upwards.

A persistent rise in oil prices can lead to a slowdown of economic growth and simultaneously raise the inflation rate. As prices of oil become higher, it costs more for firms to produce the same level of goods and services. Firms may pass on the increase in their cost of production to consumers by raising prices. Consumers may decide to buy less of the firms' products because of higher prices. This may lead to lower sales and ultimately the firm may reduce production and lay off workers. This will lower economic growth and raise unemployment.

There are also inflationary effects. The higher oil prices will directly raise inflation. The price of imported goods may also rise. This together with higher cost of domestic goods will add to inflation. The rise in inflation may therefore be higher than the impact of the higher oil prices itself.

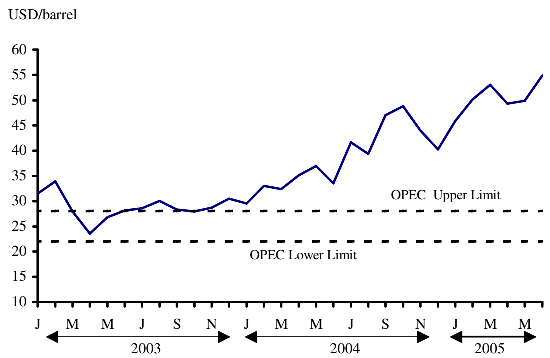
In summary, higher oil prices may reduce growth, lower corporate profits, raise unemployment and increase inflation.

It is important to note that these impacts only apply if oil prices remain high for a long period. The gains and losses stemming from temporary fluctuations in prices are often absorbed by firms and they do not have significant bearing on the economy.

So far this year, international crude oil prices have been higher than the US$28 per barrel - upper limit of OPEC's target band. Currently, oil prices are above the US$50 mark (see Graph 1) and this is mainly due to a combination of demand and supply side factors.

[1] circa 159 litres.

Graph 1. International Crude Oil Prices



Source: Bloomberg

The world economy is on track to grow by 4.3 percent this year, following a 5.1 percent growth in 2004. The strength of global economic activity has underpinned rising demand for oil. Strong performance by the US and China have also played a role in nudging up oil demand given that these economies are relatively intensive in their use of oil. In addition to rising demand, concerns about the security of oil supply, following disruptions in Iraq and interruptions in Nigeria and Russia have added upward pressure to oil prices.

In Fiji's case, domestic fuel falls in two subgroups within the CPI basket and has a weight of around 3 percent. Kerosene falls under the heating and lighting subgroup and has a weight of 0.6 percent, while motor spirit and diesel fall under the transport subgroup and have a combined weight of 2.4 percent. To some extent, the current inflation outcome in Fiji has been influenced by higher energy prices. So far this year, domestic fuel prices have risen by around 10 percent, directly contributing around 0.7 percentage points to the annual inflation rate.

Another point worth noting is that, fuel prices are regulated by the Prices and Incomes Board and this leads to a lag in the reflection of crude oil prices in domestic fuel prices. This time lag is around 2 months.

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