GLOBAL
ECONOMICS FOCUS

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CAPITAL
ECONOMICS

Are lower oil prices good or bad for the world economy?

- This *Focus* addresses two of the biggest concerns which have undermined confidence in the global economy and markets this year: worries over China and the further slump in the oil price. While recognising the many risks, **we remain more upbeat than most on the prospects for China this year and still believe that the positives from lower oil prices will eventually outweigh the negatives**.

- The latest economic data are still consistent with global GDP growth of around 3%, rather than the sharp downturn that many fear has already begun. That said, there are clearly pockets of weakness. China's growth, even on the official data, is the slowest since 1990. However, our own in-house measure suggests that the worst of China's slowdown is now in the past. Indeed, **it was never likely that China could maintain double-digit growth as incomes caught up with those in the West. Some slowdown was both *inevitable* as the economy matured, and *desirable* as part of rebalancing away from investment towards consumption**.

- The other major concern is the slump in the oil price. But it would be wrong to interpret this as an indicator of weak global activity. **Demand for oil has continued to grow at a fairly rapid pace and actually *accelerated* in the second half of 2015**. Instead, the main driver has been booming supply.

- Nonetheless, whatever the initial causes, large falls in oil prices might themselves have major economic consequences. The main impact, of course, will be to make oil producers worse off and consumers better off. The net effect might normally be expected to be positive, or at least neutral. However, the global economic impact of the recent slump in oil prices appears to have been negative, or (perhaps more accurately) has been interpreted as such by the markets. We suspect that there are a number of factors at play here. In particular, **the speed and extent of the slide in oil prices has added to the uncertainty about the global economy (including China). The costs to producers have also been proportionately much larger than the benefits to consumers**.

- However, this analysis also allows us to draw some more positive conclusions. A partial recovery (or at least stabilisation) in oil prices should ease some of the anxiety about the health of the global economy and financial system. Many of the negatives may also simply be a matter of timing. **Oil producers have generally been quicker to adjust their spending, but eventually this should still be outweighed by increases in spending by consumers on other goods and services**.

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Are lower oil prices good or bad for the world economy?

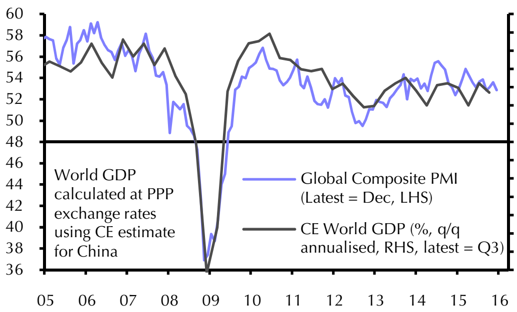
This is an adapted and extended version of a presentation given at the Capital Economics Commodity Forum in London on 19th January.

Confidence in the global economy and financial markets has, of course, been shaken this year by two developments which are at least partly related. The first is heightened concerns over growth in China and the potential fallout for the rest of the world, which have been exacerbated by uncertainty over the outlook for the renminbi. The second is the further slump in the prices of key industrial commodities, led by oil. This *Focus* puts these two developments in perspective and, in particular, addresses the question of whether cheap oil is good or bad for the global economy.

No sign of sharp downturn

It may help to begin with a snapshot of the state of the world at the end of 2015. One of the best measures of overall activity is the global composite PMI, compiled by Markit. As Chart 1 shows, **the global PMI has weakened a little, but it was still consistent in December with world GDP growth of around 3%**. Early survey results for January point to a similar (or only slightly lower) reading this month.

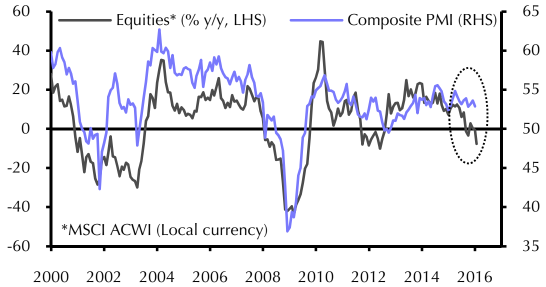
CHART 1: GLOBAL PMI & WORLD GDP



Sources – Thomson Datastream, Markit, Capital Economics

What's more, **it is hard to square the slump in global financial and commodity markets with the incoming economic data**. Chart 2 illustrates this by comparing the level of the composite PMI and the year-on-year change in the price of world equities, measured by the MSCI index.

CHART 2: GLOBAL PMI & WORLD EQUITIES



Sources – Thomson Datastream, Markit, Capital Economics

At this point, some will argue that falling asset prices are a leading indicator of economic weakness and may even be a factor causing a wider downturn. We will tackle this argument in more detail when looking at commodity markets. However, it does seem odd to conclude that corrections in equity prices (after an extended rally) are signalling a recession when there is so little evidence of this in the latest economic data themselves, including forward-looking indicators. Moreover, falls in equity prices rarely have as big an impact on the real economy as the headlines might suggest.

Panic over China still looks overdone

That said, there are clearly pockets of weakness in the world economy. It is impossible to discuss global prospects without dwelling on the recent developments in China, although for in-depth coverage we would point readers to our dedicated China service. (In particular, see our *China Economics Update*, "China, growth star", published on 25th January, and our latest *China Activity Monitor*, 27th January.)

Starting with the official China GDP data, growth was reported at 6.9% in 2015, which would be the slowest since 1990. Our own China Activity Proxy (CAP) suggests that the true growth rate has been much weaker – perhaps as low as 4.3% in 2015. However, while slow by China's recent standards, even 4.3% would still be a respectable pace of growth anywhere else. **Our CAP measure also suggests that the worst of China's slowdown is now in the past.** (See Chart 3.)

CHART 3: CHINA OFFICIAL GDP & CAPITAL ECONOMICS CHINA ACTIVITY PROXY (BOTH % Y/Y)

Sources – Thomson Datastream, Capital Economics

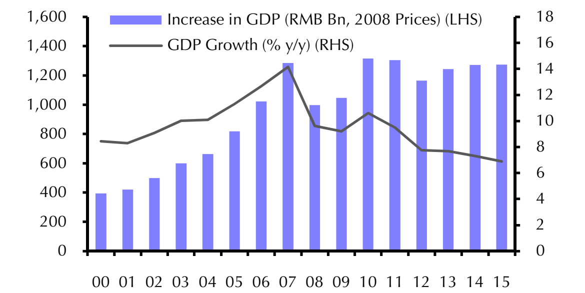
Indeed, much of the recent gloomy commentary about the impact of slower growth in China on the rest of the world misses a number of other key points:

i. It was never likely that China could maintain double-digit growth as incomes caught up with those in the West. **Some slowdown was both *inevitable* as the economy matured, and *desirable* as part of rebalancing away from investment towards consumption**;

ii. **China's slowdown is nothing new**. Growth peaked in 2007 and, after rebounding following the global financial crisis, had been on a clear downward trend since 2011. Crucially, this has not prevented advanced economies from picking up, or global growth from stabilising;

iii. In part this is because **the much larger size of China's economy now means that even much slower rates of growth can deliver big increases in demand from year to year and maintain a high contribution to global growth**. Indeed, on the official data at least, the increase in China's GDP in 2015 was practically the same as in 2007 (measured in renminbi at constant prices), even though the annual growth rate had more than halved, from 14.2% to 6.9%. (See Chart 4.) (The differences would be larger using our CAP estimates, but the essential point still stands.)

CHART 4: CHINA OFFICIAL GDP

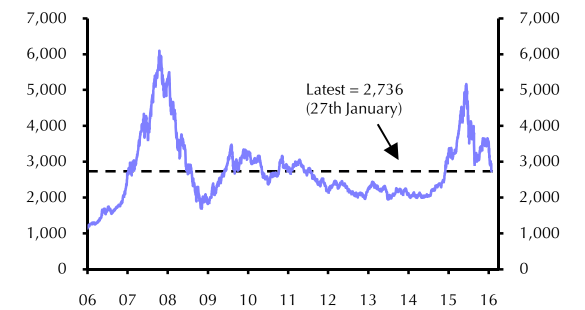


Sources – IMF, Thomson Datastream, Capital Economics

To be clear, **there are valid concerns over the medium-term outlook for China, especially the high and rising levels of debt**. Credibility has also been damaged by the recent botched interventions in the equity market and poor communication of changes in currency policy. Indeed, the renewed volatility in China's own financial markets has injected additional uncertainty worldwide.

Nonetheless, the recent swings in the Shanghai equity index have simply taken it back again to where it was in late 2014, ahead of what proved to be a relatively short-lived speculative bubble. (See Chart 5.) This is telling us little, or nothing, about the health of the real economy.

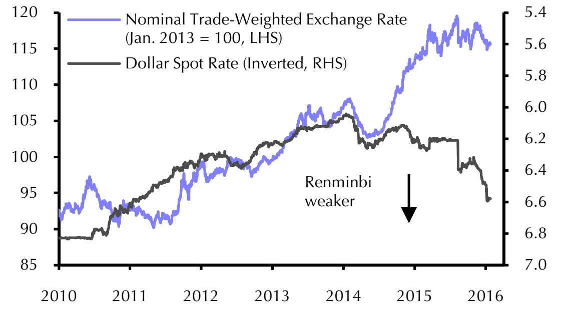
CHART 5: CHINA EQUITY PRICES (SHANGHAI COMPOSITE)



Source – Thomson Datastream

Similarly, the recent slide in the value of the renminbi against the US dollar needs to be seen in its proper perspective. (See Chart 6.) **Whereas the markets fear that China is actively targeting a large devaluation of the renminbi across the board, in reality the exchange rate has remained fairly stable on a trade-weighted basis**.

CHART 6: CHINA EXCHANGE RATES



Source – Bloomberg

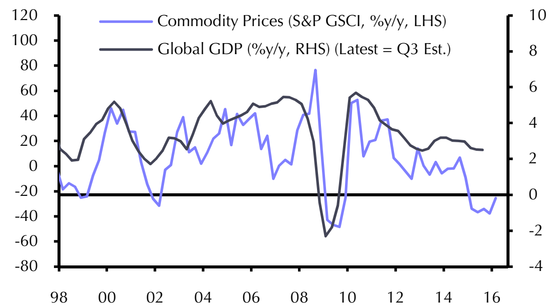
This at least is consistent with the official commentary on the topic and the fact that the PBOC sold over US$100bn of reserves to support the currency in December alone. (For a fuller discussion of the issues here see our *China Economics Update*, "How long can the PBOC hold on?", published on 7th January.)

Overall then, despite some genuine risks, China's economy is not collapsing. Our China Activity Proxy (CAP) suggests that growth has stabilised rather than continued to slow and we remain more upbeat than most on the prospects for this year. Nor is there much to justify fears that the turmoil in China's equity or currency markets will cause major problems in the rest of the world.

What are commodities telling us?

The other major source of concern is the slump in commodity prices. Indeed, **a casual glance at Chart 7 might suggest that the world economy is at imminent risk of recession**. The last time that commodity prices fell this much was in the wake of the global financial crisis.

CHART 7: COMMODITY PRICES & GLOBAL GDP



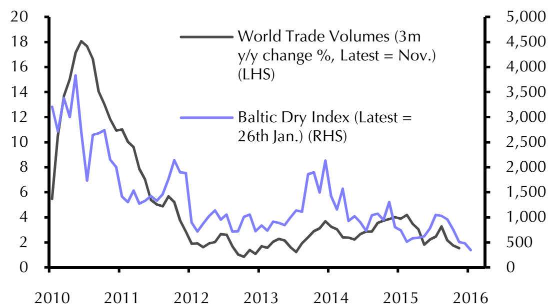
Sources – Thomson Datastream, Capital Economics

However, even taking this chart at face value, the picture is more nuanced. For a start, the global financial crisis and subsequent recession in 2009 were preceded by a *surge* in commodity prices. What's more, there have been several periods when lower commodity price inflation has been associated with a pick-up in global growth (as, for example, in 2006-7).

Similarly, we are wary of reading too much into the weakness of the Baltic Dry Index (a composite measure of the cost of shipping dry bulk commodities, such as iron ore and coal, by sea). While sea freight costs may be a helpful guide to the balance of supply and demand for certain commodities, there are other, much better indicators of the health of the global economy. Indeed, the BDI only covers dry bulk commodities. Overall shipping costs are actually recovering – helped by rising (not falling!) demand for oil.

Admittedly, the BDI has a pretty good track record as an early indicator of world trade and, at face value, suggests that volumes remain soft at the start of 2016. (See Chart 8.) It is also relatively timely and observable daily, and should be less vulnerable to the speculative pressures that can distort other financial variables.

CHART 8: BALTIC DRY INDEX & WORLD TRADE VOLUMES



Sources – Thomson Datastream, CPB

Nonetheless, **the BDI has essentially flat-lined since 2012, so weakness here is little new. World trade has also been sluggish for several years and yet the global economy has still been growing at a decent pace**. (For more discussion on this point see our *Global Economics Update*, "Is the Baltic Dry Index a useful economic indicator?", published earlier today.)

What's more, the level of the BDI also depends on the supply of cargo ships. The BDI could surge in the coming months even if demand picks up only slightly, simply because the pipeline of new cargo ships has dried up and more of the existing bulk fleet has now been scrapped or converted to tankers for carrying oil and LNG.

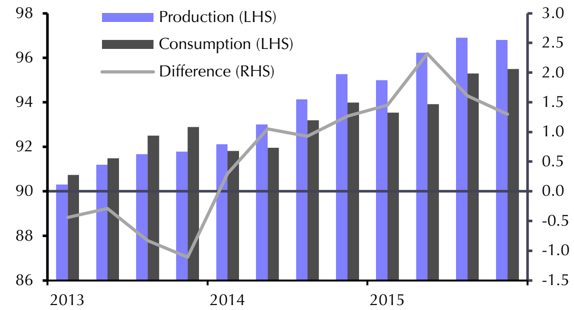
There are also other special factors to take into account. The BDI is based on *dollar* prices and is therefore another casualty of the strength of the US currency. It is also vulnerable to distortions caused by the Chinese New Year (the BDI often dips to its lows for the year ahead of the holidays).

Finally, the big picture is that the prices of the commodities that are commonly shipped as dry freight are also now at multi-year lows. The BDI may therefore not be telling us much that cannot already be observed from commodity prices themselves.

Rather than generalising then about the wider economic impact, it is important to understand *why* commodity prices are weak. The key driver of the slump in the main commodity indices over the past year has, of course, been the collapse in the oil price. But it would be wrong to interpret this as an indicator of weak global economic activity.

As Chart 9 shows, **demand for oil did falter in the first halves of both 2014 and 2015. But it has continued to grow at a fairly rapid pace over the last few years as whole, and actually *accelerated* in the second half of last year**.

CHART 9: GLOBAL OIL PRODUCTION & CONSUMPTION



Source – IMF

Instead, the main reason for the fall in oil prices has been a surge in the supply of oil, which has outpaced demand in each of the last eight quarters, resulting in a large accumulation of stocks and further downward pressure on prices.

In this context, while the headlines tend to focus on the dry freight index, measures of *overall* shipping costs have already been recovering. Data published by the shipping services company Clarksons show that average daily revenues for oil tankers rose by an average of 73% last year (as demand picked up in response to lower crude prices), more than offsetting a 28% fall for bulk carriers. Admittedly, **increased demand for oil is still being outpaced by rising supply, but this provides another reason to be wary of interpreting the current weakness in oil prices as a signal of a sharp slowdown in the global economy**.

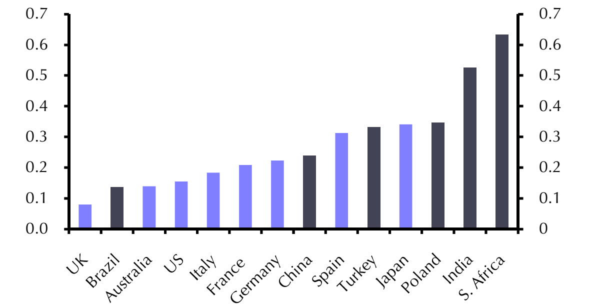
Are lower oil prices good or bad?

Nonetheless, whether the initial causes are higher supply or lower demand, large falls in oil prices might themselves have major economic consequences. The main impact, of course, will be to make oil producers worse off and consumers better off. The net effect of this transfer of income on global demand should therefore largely depend on the relative propensities of producers and consumers to save or to spend.

In the past, **oil producers have typically been large net savers**, reflected in the big current account surpluses run by Middle East economies and non-OPEC producers such as Russia and Norway. **This means that a transfer of income from oil producers to oil consumers, who are more likely to spend on other goods and services, should boost global demand**. At worst, the impact on the world economy might be expected to be neutral, with the losers balancing the winners.

Indeed, these positive effects should be sizeable. To illustrate this, Chart 10 shows the benefit from a $10 fall in the price of a barrel of oil for net oil consumers. The calculation here simply multiplies the number of barrels of oil consumed in 2014 (netting off production where appropriate) by $10, and expresses this as a share of GDP. This is not necessarily the same as the potential boost to GDP itself, which will depend on many other factors including currency movements, the degree of pass-through to local consumers and the extent to which they adjust their spending on other goods and services. But this analysis does provide a guide to which economies might be expected to benefit the most. This group includes some major emerging economies, picked out in black, including China and India. (Note that Brazil and Australia should also be net beneficiaries from lower oil prices, but in these cases the boost could be more than offset by falls in the prices of other commodities.)

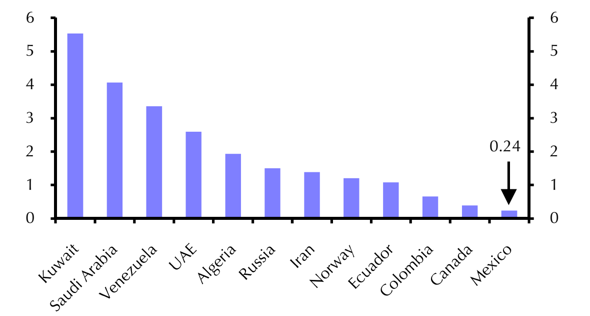
CHART 10: BENEFIT FROM $10 FALL IN OIL PRICE TO NET OIL CONSUMERS (AS A % OF GDP)



Sources – BP, Thomson Datastream, Capital Economics

Chart 11 shows the corresponding calculations for a selection of net oil producers.

CHART 11: COST OF $10 FALL IN OIL PRICE TO NET OIL PRODUCERS (AS A % OF GDP)



Sources – BP, Thomson Datastream, Capital Economics

However, the global economic impact of the recent slump in oil prices appears to have been negative. Or, perhaps more accurately given the lack of any real evidence of a widespread downturn, it has been *perceived* to be negative by the markets and by many commentators. Why should this be?

We suspect that there are a number of factors at play here too:

i. **The speed and extent of the slide in oil prices has itself added to the uncertainty about the global economy**. Rightly or (more probably) wrongly, the fall has been interpreted as evidence of a collapse in demand and fuelled fears about a hard landing in China in particular;

ii. **The costs to producers have been proportionately much larger (relative to their incomes) than the benefits to consumers**. (Note the different scales in Charts 10 and 11.) This concentration of losses relative to the more diffuse benefits is one reason why producers appear to have cut their spending more quickly and by a larger amount than consumers have increased theirs;

iii. This asymmetry has compounded the negative impacts on financial markets. **Energy companies may only account, for example, for 20% of the US junk bond market, but the fear is that there will be widespread defaults throughout this sector, rippling through the financial system as a whole**. Similarly, the impact on the 20% or so of the FTSE 100 accounted for by commodity producers is far more visible than the potential benefits to the remaining 80% who are not;

iv. **Pressure on oil producers to sell assets accumulated in Sovereign Wealth Funds has also soured the mood in financial markets**, even though this selling might actually boost the global economy if the proceeds are used to support local spending;

v. The additional downward pressure on headline inflation from lower energy costs has revived fears that vulnerable economies may slip into a more damaging period of *deflation;*

vi. A common theme is the magnitude of the declines. **Small falls in oil prices are more likely to be positive for the world economy than large ones, where the asymmetric nature of the impacts becomes more important**.

However, this analysis also allows us to draw some more positive conclusions. A partial recovery (or at least stabilisation) in oil prices should ease some of the anxiety about the health of the global economy and financial system. The downward pressure on headline inflation will unwind too.

Many of the negatives may also simply be a matter of timing. Producers have generally been quicker to adjust their spending, but eventually this should be outweighed by increases in spending by consumers on other goods and services.

On balance, then we continue to expect an extended period of lower oil prices to boost global growth over the next few years, even if this process may take longer than originally anticipated.

Indeed, **our central scenario for oil prices is a relatively benign one for the world economy**. There are a number of risks which could cause oil prices to slump to as low as $20 per barrel in the first half of this year. However, our forecast is that the prices of Brent and WTI will stabilise around current levels of $30 over the next few weeks, before rebounding to $45 by the end of the year, as both supply and demand respond to the previous sharp falls. (See our *Energy Focus* "Oil prices – how low can they go?", published on 26th January.) **This could even be described as a "Goldilocks" scenario: prices high enough to keep the main producers afloat, but low enough to provide a significant boost to spending on other goods and services**.