OIL AND THE ECONOMY

The 2011 oil shock

More of a threat to the world economy than investors seem to think

THE ECONOMIST

The price of oil has had an unnerving ability to blow up the world economy, and the Middle East has often provided the spark. The Arab oil embargo of 1973, the Iranian revolution in 1978-79 and Saddam Hussein's invasion of Kuwait in 1990 are all painful reminders of how the region's combustible mix of geopolitics and geology can wreak havoc. With protests cascading across Arabia, is the world in for another oil shock?

There are good reasons to worry. The Middle East and north Africa produce more than one-third of the world's oil. Libya's turmoil shows that a revolution can quickly disrupt oil supply. Even while Muammar Qaddafi hangs on with delusional determination and Western countries debate whether to enforce a no-fly zone, as foreign workers flee and the country fragments. The spread of unrest across the region threatens wider disruption.

The markets' reaction has been surprisingly modest. The price of Brent crude jumped 15 percent as Libya's violence flared up, reaching $120 a barrel on February 24th. But the promise of more production from Saudi Arabia pushed the price down again. It was $116 on March 2nd -- 20 percent higher than the beginning of the year, but well below the peaks of 2008. Most economists are sanguine: global growth might slow by a few tenths of a percentage point, they reckon, but not enough to jeopardise the rich world's recovery.

That glosses over two big risks. First, a serious supply disruption, or even the fear of it, could send the oil price soaring. Second, dearer oil could fuel inflation -- and that might prompt a monetary clampdown that throttles the recovery. A lot will depend on the skill of central bankers.

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Of stocks, Saudis and stability

So far, the shocks to supply have been tiny. Libya's turmoil has reduced global oil output by a mere 1 percent. In 1973 the figure was around 7.5 percent. Today's oil market also has plenty of buffers. Governments have stockpiles, which they didn't in 1973. Commercial oil stocks are more ample than they were when prices peaked in 2008. Saudi Arabia, the central bank of the oil market, technically has enough spare capacity to replace Libya, Algeria and a clutch of other small producers. And the Saudis have made clear that they are willing to pump.

Yet more disruption cannot be ruled out. The oil industry is extremely complex: getting the right sort of oil to the right place at the right time is crucial. And then there is Saudi Arabia itself. The kingdom has many of the characteristics that have fuelled unrest elsewhere, including an army of disillusioned youths. Despite spending $36 billion so far buying off dissent, a repressive regime faces demands for reform. A whiff of instability would spread panic in the oil market.

Even without a disruption to supply, prices are under pressure from a second source: the gradual dwindling of spare capacity. With the world economy growing strongly, oil demand is far outpacing increases in readily available supply. So any jitters from the Middle East will accelerate and exaggerate a price rise that was already on the way.

What effect would that have? It is some comfort that the world economy is less vulnerable to damage from higher oil prices than it was in the 1970s. Global output is less oil-intensive. Inflation is lower and wages are much less likely to follow energy-induced price rises, so central banks need not respond as forcefully. But less vulnerable does not mean immune.

Dearer oil still implies a transfer from oil consumers to oil producers, and since the latter tend to save more it spells a drop in global demand. A rule of thumb is that a 10 percent increase in the price of oil will cut a quarter of a percentage point off global growth. With the world economy currently growing at 4.5 percent, that suggests the oil price would need to leap, probably above its 2008 peak of almost $150 a barrel, to fell the recovery. But even a smaller increase would sap growth and raise inflation.

Shocked into action

In the United States the Federal Reserve will face a relatively easy choice. America's economy is needlessly vulnerable, thanks to its addiction to oil (and light taxation of it). Yet inflation is extremely low and the economy has plenty of slack. This gives its central bank the latitude to ignore a sudden jump in the oil price. In Europe, where fuel is taxed more heavily, the immediate effect of dearer oil is smaller. But Europe's central bankers are already more worried about rising prices: hence the fear that they could take pre-emptive action too far, and push Europe's still-fragile economies back into recession.

By contrast, the biggest risk in the emerging world is inaction. Dearer oil will stoke inflation, especially through higher food prices -- and food still accounts for a large part of people's spending in countries like China, Brazil and India. True, central banks have been raising interest rates, but they have tended to be tardy. Monetary conditions are still too loose, and inflation expectations have risen.

Unfortunately, too many governments in emerging markets have tried to quell inflation and reduce popular anger by subsidising the prices of both food and fuel. Not only does this dull consumers' sensitivity to rising prices, it could be expensive for the governments concerned. It will stretch India's optimistic new budget. But the biggest danger lies in the Middle East itself, where subsidies of food and fuel are omnipresent and where politicians are increasing them to quell unrest. Fuel importers, such as Egypt, face a vicious, bankrupting, spiral of higher oil prices and ever bigger subsidies. The answer is to ditch such subsidies and aim help at the poorest, but no Arab ruler is likely to propose such reforms right now.

At its worst, the danger is circular, with dearer oil and political uncertainty feeding each other. Even if that is avoided, the short-term prospects for the world economy are shakier than many realise. But there could be a silver lining: the rest of the world could at long last deal with its vulnerability to oil and the Middle East. The to-do list is well-known, from investing in the infrastructure for electric vehicles to pricing carbon. The 1970s oil shocks transformed the world economy. Perhaps a 2011 oil shock will do the same -- at less cost.

China's huge labour pool shows signs of drying up

AFP, *Shanghai*

As one of the more than 200 million people in China's huge migrant workforce, Lu Jun has had to hustle for jobs his entire life, but suddenly he finds he has more choices and bargaining power than ever.

Lu, whose skin is tanned and his navy suit jacket faded from the sun, says he is standing taller these days as he surveys his many options at a state-funded job fair in Shanghai following the annual Lunar New Year holiday.

"Nowadays it's not easy to find an experienced worker like me," the 25-year-old Lu, who worked at a package printing factory in the eastern province of Anhui for five years, said proudly.

China's vast worker pool, which has powered the explosive growth of its labour-intensive exports over the past decade, is tightening up, analysts say. That means that, while dissatisfied migrant workers are still seen as a source of potential unrest, power is tilting from employers to employees like Lu.

"The firm where I used to work has called me several times to ask me back. But their salary raise is not satisfying and I want a job in Shanghai just like my wife," Lu said, after casually asking a recruiter about wages.

Lu's former employer offered him 3,800 yuan ($578) a month, a 27 percent raise, but he aims to earn 4,000 yuan and says he will "keep looking around until I find an ideal job".

Chinese manufacturers and local governments are vying for the services of people like Lu as the labour crunch -- the first signs of which surfaced in 2007 -- has spread from coastal export powerhouse zones to the rural heartland.

The shortage is the result of three decades of rapid economic expansion colliding with demographic changes due to China's one-child policy, economists say.

"The overall story is clear -- thanks to the decline in births 20 years ago, China's labour pool will likely stop expanding in size very soon," Stephen Green, an economist with Standard Chartered Bank, said in a research note.

The impact is especially felt after the Chinese New Year holiday when many workers leave their jobs and do not come back. Outside Shanghai's main train station, a giant electronic billboard welcomed migrant workers to the city after the holiday.

AFP

A migrant worker is seen outside the central railway station as he proceeds to the entrance.

Labour woes in the world's second-largest economy made waves last year after Toyota, Honda and other foreign manufacturers were hit by a rare spate of strikes as workers demanded higher wages. Many ended up offering salary hikes.

Once the disputes tapered off, a growing number of companies started looking at moving factories inland and offering migrant workers jobs nearer to their hometowns in the countryside, so as to improve employee morale.

"I am returning home and won't come back," 21-year-old Jiang Buyi, who just quit his job at an electronics factory in Shanghai, told AFP as he waited outside a bus station, taking a bite from a McDonald's hamburger.

"I am young and have a long way to go. So I need to pick up some skills. I'm going to learn how to do car repairs at a relative's shop," said Jiang, who is from Sichuan province in the southwest, a traditional source of migrant labour.

"Most of my co-workers are returning home to look for jobs too. A minimal salary increase here is nothing. Prices are rising faster than my wages," he said.

Employers are feeling the effects of such sentiments. At the Shanghai job fair, Teng Kewu, an office director for machinery maker Shanghai Shenlong Enterprise, said: "I am under much bigger pressure this year as many southern companies are investing inland and attracting locals."

In his own home town in Anhui, he said, authorities were helping local firms recruit by sending buses into the streets to bring people to job fairs.

"Hundreds of job seekers came around and the pay level has improved a lot compared with last year," the veteran recruiter said, but added that after three days, he had yet to meet his target of signing up 80 people.

In addition to salary hikes, his company is spending money on setting up matchmaking events with nearby clothing factories, where workers are mostly female, in an effort to retain its young male staff.

Mo Rong, a senior researcher with the Ministry of Human Resources and Social Security, played down concerns about a labour crunch, saying plenty of workers were willing to work for firms that offer higher pay.

Shen Jianguang, a Hong Kong-based economist with Mizuho Securities, argued the labour shortage, expected to plague China in coming years, provides opportunities as well as challenges for the country's economy.

"It is an illustration that it is increasingly pressing for China to shift its growth pattern... Only when the low-scale, labour-intensive sectors are scaled back will the problem ease, which has yet to come," Shen said.

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