# VAKIFBANK GLOBAL ECONOMY WEEKLY

## The Impacts of Oil Price Changes on The Economy and The Markets

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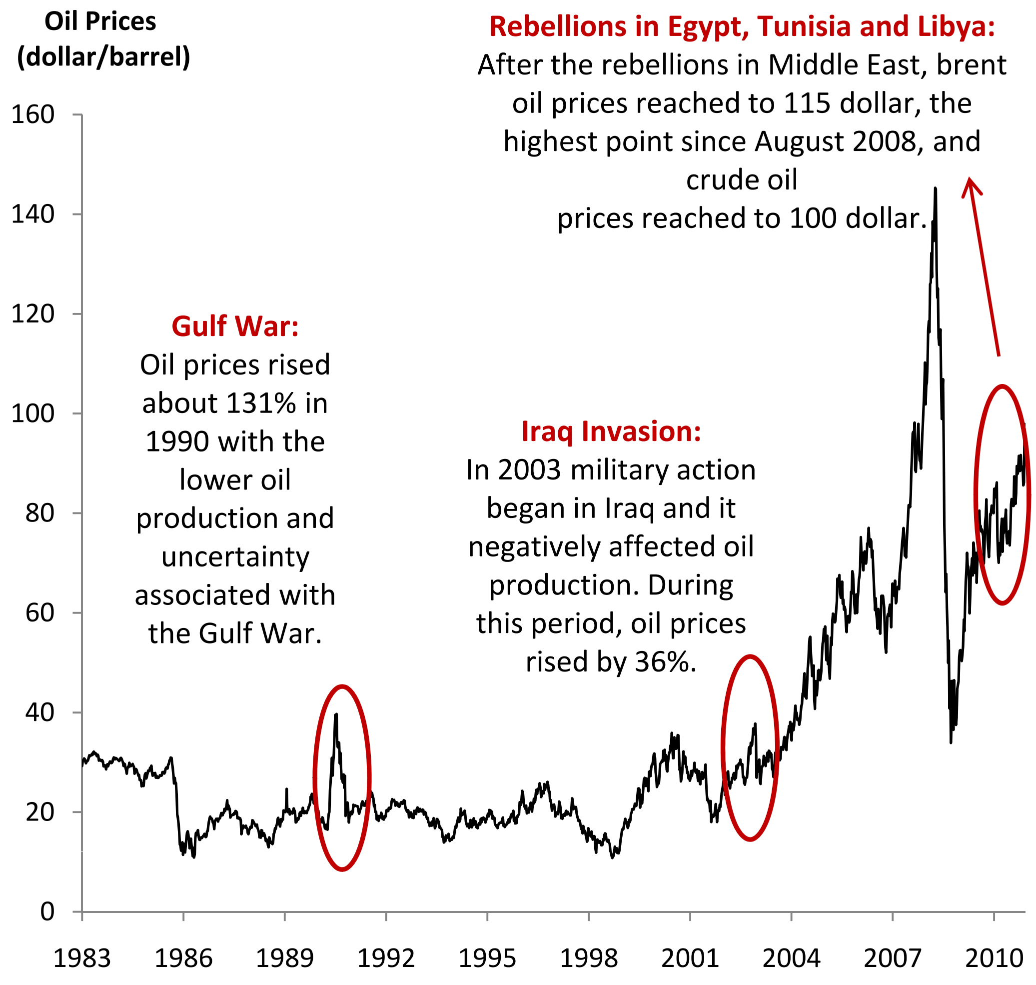
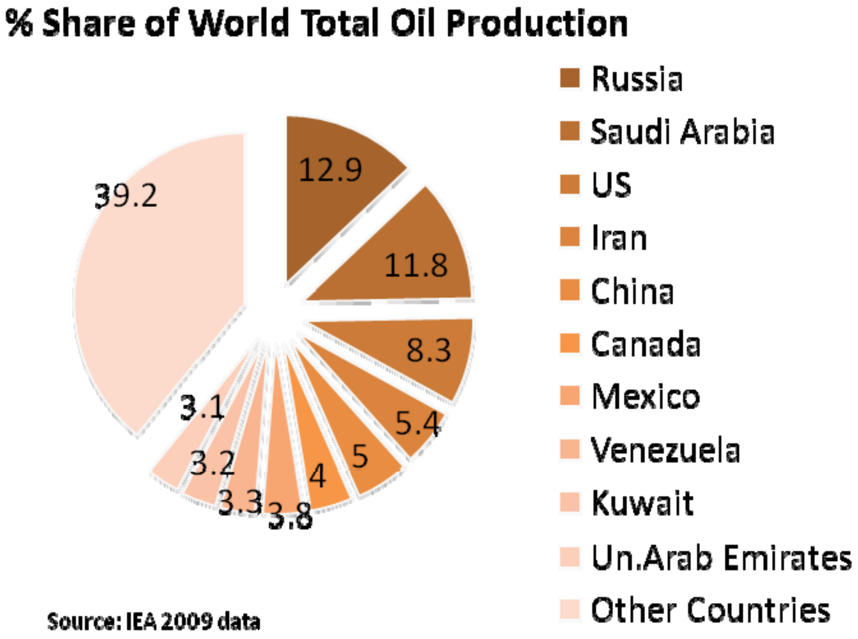
## *In the past, oil supply shocks increased the oil prices sharply...*

- After the 2nd World War, oil prices increased by 4 times because of supply shocks.
  - 1973-74: Yom Kippur War
  - 1979-81: Iran Revolution and Iran-Iraq War
  - 1990: Gulf War
  - 2003: Iraq Invasion
- **Yom Kippur War:** In 1973, the Yom Kippur War between Syria, Egypt and Israel broke out and oil prices increased by 367% as several Arab exporting countries together with Iran imposed an embargo aganist the Western countries supporting Israel. Arab countries also declined oil production to increase the prices.
- **Iran Revolution and Iran-Iraq War:** In 1979 Iranian Revolution led to a sharp reduction in oil production. After Iran-Iraq war broke out, oil prices increased by 156%.




Source: Bloomberg

## ➢*The impacts of the oil price rises on the economy...*

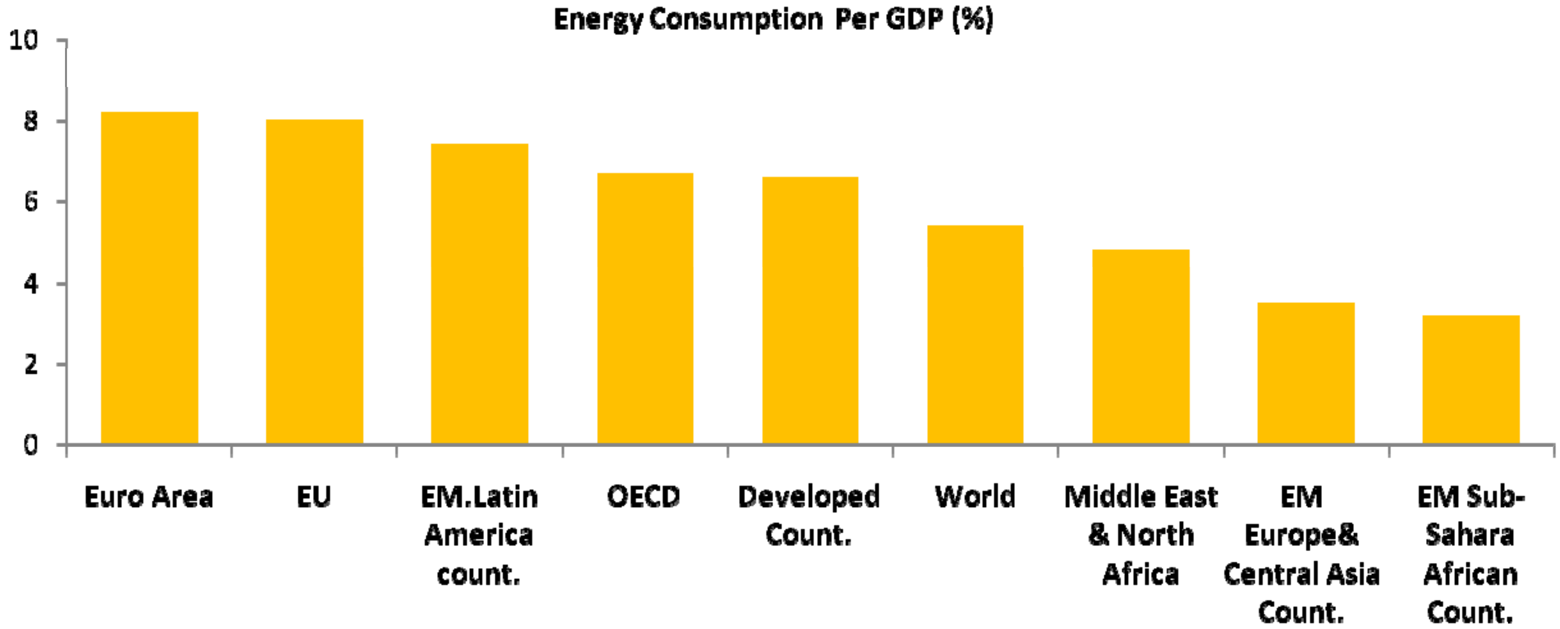



| Top 10 Net Oil Exporters | Top 10 Net Oil Importers |
|---|---|
| Saudi Arabia | US |
| Russia | Japan |
| Iran | China |
| Un. Arab Emirates | India |
| Nigeria | Korea |
| Angola | Germany |
| Norway | Italy |
| Kuwait | France |
| Iraq | Spain |
| Venezuela | Netherlands |

Source: IEA 2008 data

- Net oil importer countries like US, Japan and China are negatively affected by the rise in oil prices, as increased oil prices would drive up the rate of inflation and slow down economic growth.
- The net oil exporter countries like Saudi Arabia and Russia are positively affected as they would benefit from the increase in energy prices.

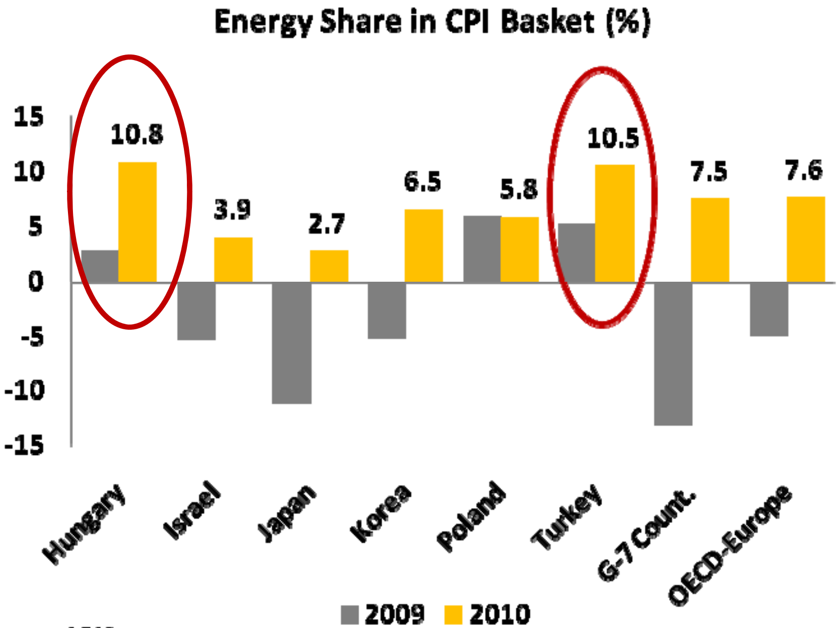
## With global economic recovery, energy consumption is again becoming a very large share of global GDP ....



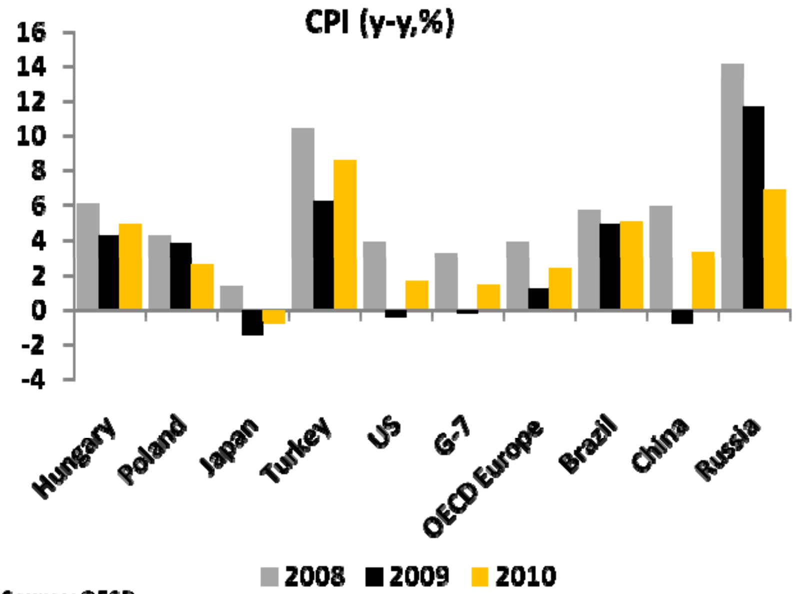

Source: World Bank 2007 data

- In developing countries the size of energy consumption as a share of GDP is at 7%-8% levels which is more than that of the OECD. In developed economies which still continue loosing monetary policies, energy consumption as a share of GDP stands at high levels. Thus high oil prices would negatively affect both country groups through cost rises. If oil prices continue rising, the output decrease together with economic slow down would be inevitable for most of the countries in the medium term.

# Higher energy prices are putting upward pressure on the inflation of emerging economies...




Source: OECD




Source: OECD

After global crisis the increasing input prices in emerging market countries lead to inflationary pressures. Today higher energy prices are putting upward pressure on the inflation of emerging economies which have already stood at high levels. The most risky countries in terms of inflation are Hungary and Turkey with their high energy share in CPI baskets.

# ➢ *The impact of high oil prices on the markets...*

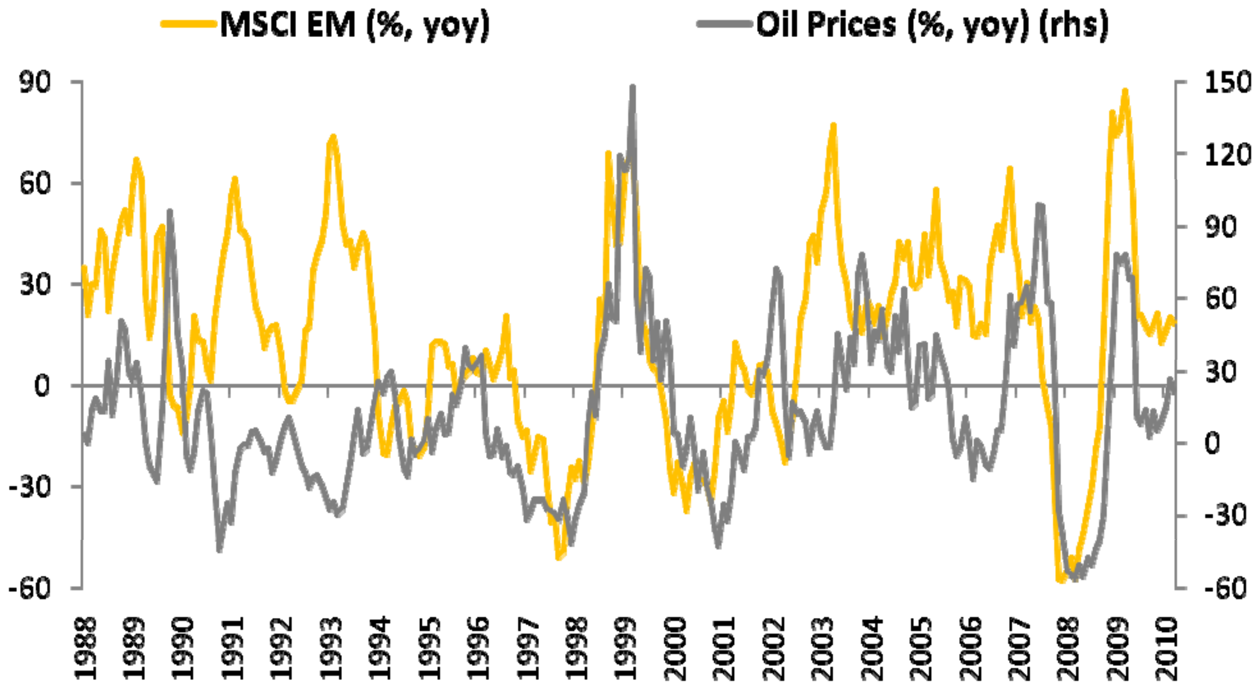
| Movements in S&P 500 and in US 10 Year Treasury Yields During The Major Oil Supply Shocks | | | |
|---|---|---|---|
| | **Oil Price** | **S&P 500** | **US 10Y Bond Yields** |
| Jan 73 | 2.48 | 116 | %6.5 |
| Jan 74 | 11.58 | 96 | %7 |
| **Change %** | **+%367** | **-%17** | **+50 bp** |
| Jan 79 | 12.91 | 100 | %9.1 |
| Mar 80 | 30.10 | 102 | %12.8 |
| **Change %** | **+%133** | **+%2** | **+370 bp** |
| Jul 90 | 17.07 | 358 | %8.4 |
| Oct 90 | 39.51 | 306 | %8.8 |
| **Change %** | **+%131** | **-%15** | **+40 bp** |
| Dec 02 | 26.89 | 936 | %4.2 |
| Mar 03 | 36.60 | 841 | %3.7 |
| **Change %** | **+%36** | **-%10** | **-50 bp** |

Source: Reuters, Bloomberg, BP

- Equity and bond markets were weak throughout the four oil supply shocks periods.
- Equity markets gave the strongest reaction in the first oil shock. Hence, S&P 500 and Dow Jones decreased respectively by 17% and 14% in that period.
- In 1979 Iran Revolution while oil prices increased by 133%, bond yields rised 370 basis point. This was the highest increase among four oil supply shocks .
- In 2003 with the invasion of Iraq, oil prices increased less than the previous oil supply shocks. However equity markets contiuned to decrease by 10%.
- Hence, the magnitude of oil prices on those four occasions was dramatically higher than what we have seen so far.

- Due to recent political unrest in Libya, oil prices increased by 5% since the beginning of 2011.
- However in this period the decrease in equity markets is limited as emerging countries continued to rate hikes.

# High oil prices affect equity markets in emerging countries...




Source: Bloomberg, Reuters

- MSCI emerging markets index decreased during major oil supply shocks periods. MSCI EM index decreased by 17% in 1990 and by 7% in 2003. After the rebellions in Middle East, the index decreased by 3.5% since the beginning of 2011.

- Emerging countries are negatively affected by increasing oil prices. If the rise in oil prices and politic instability continue, equity markets will face additional sales in the medium term.

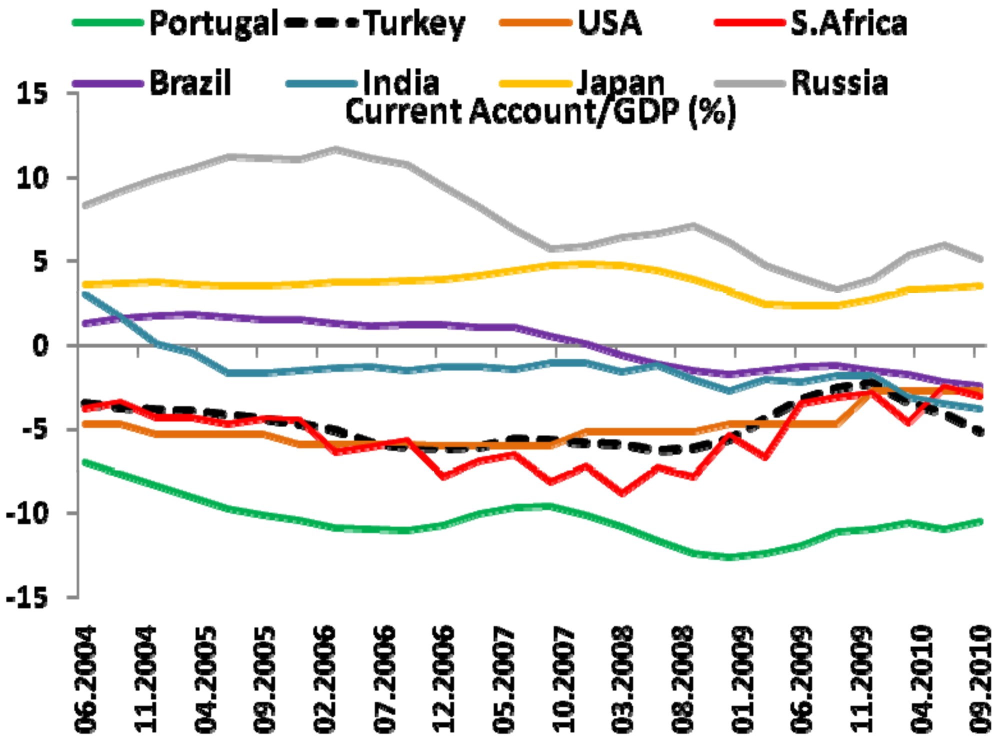
# How will the rising oil prices affect the economy?

- The recent rise in oil prices has supressed the western countries' consumption and the corporation's income via the cost channel, as real incomes in these countries are growing much more slowly or even contracting in some advanced economies.
- Net oil importer economies have negatively affected by the rise in oil prices, whereas net oil exporter countries have positively affected:

  -If the country is a net energy importer like China, Japan, Germany, India, Korea, Indonesia, Brazil and Turkey, these countries will be negatively affected by the rise in oil prices.

  -If the country is a net energy exporter like GCC region (Gulf Cooperation Council of the Persian Gulf) and Russia, these countries will benefit from high energy prices.
- The OECD and the periphery Europe, including Ireland, Portugal and Spain, are also exposed to rising energy costs. Rising oil prices which are triggered large current account deficit, government deficit and high levels of sovereign debt, could damage these country's economic outlook for 2011.
- The higher oil prices would lead to a wealth transfer from oil-consuming countries to oil-producing countries. Hence when the oil prices are higher, oil producers will earn and spend more, and then net exports from Eurozone countries to oil producer countries will increase. Thus it can be said that Eurozone countries won't be the ones of the biggest loosers.
- The US seems less vulnerable to high oil prices, due to low energy sector share of GDP. Energy sector share of GDP which was 11% in 1980's has decreased to 5.4% in 2010.

# Each country could tolerate the rise of oil prices at different levels, depending on the countries' own internal dynamics and the energy sector share of GDP...




Source: Bloomberg

- In this circumstances,
  - The US economy could tolerate the oil price rises up to $140-150,
  - This toleration level declines to $120-130 in Euro Area, Japan, Brazil, India, South Korea and China.
  - In Turkey, this level decreases to $100. With the large current account deficit and rising inflation fears, Turkey is one of the countries whose limit is the lowest.

**To sum up**,
Oil prices that are over $100 per barrel may even increase up to $120 in the coming days. This situation increases 'stagflation' concerns which is a situation in which the inflation rate is high and the economic growth rate is low at the same time. Rising oil prices, in addition to the inflation worries in EM, triggers the growth concerns.

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