MarketNews international | DEUTSCHE BÖRSE GROUP

By Brai Odion-Esene

March 4, 2011

WASHINGTON (MNI) – If the oil prices remain above $100 a barrel — and the peak levels of 2008 are no longer out of reach — then there will be significant consequences for the global economy, analysts and bank economists warned Friday.

Friday, West Texas Intermediate hit $104.20 per barrel, while that other key benchmark Brent remained above the $100 level at $116.05.

Economists at Barclays Capital Friday cautioned that if large oil exporters are seriously affected by the unrest sweeping the Middle East and North Africa, there is the potential for further large rises in oil prices, and the peak levels seen in 2008 are not unthinkable.

The Middle East political turmoil has also added to the uncertainty about the future path of monetary policy, they said, increasing not just the uncertainty about the timing of policies, but also their direction.

They predicted that an oil price shock could further divide the European Central Bank and the Federal Reserve by making the Fed focus more on the unemployment consequences and the ECB more on the inflationary fallout. "As a typical supply shock, the increase in energy prices would indeed raise inflation, and decrease employment and growth, creating a policy dilemma," they said.

"Oil prices are rising rapidly – up 15% in just the past three weeks – and this follows a period of sustained energy and food price increases," they wrote in a research note. "The global economic consequences in terms of growth and inflation could be significant."

Bernard Baumohl, chief global economist for The Economic Outlook Group agreed, issuing his own warning that "if the oil remains above $100 a barrel and gasoline stays in excess of $3.50 a gallon for

the rest of the year, it will have a detrimental impact on the economy."

While it will not extinguish the economic recovery, **Baumohl** said, "it will significantly squeeze household finances and erode corporate profit margins."

And in keeping with the theme of large spikes in oil price hurting economic growth, economists at Wells Fargo said that they continue to believe that "a sustained increase to $115 a barrel or more would have a meaningful negative impact."

"Higher energy prices of this magnitude will reduce incomes through higher gasoline prices and rising transportation costs, which will impact food prices both directly and indirectly," they said in a research note examining the impact of higher oil prices.

The Barclays Capital economists agreed that the main effect on economic growth from high oil will be on consumption via gasoline and energy prices. As consumption generally accounts for 60% of GDP, the effect is large, they noted.

"In our view, the oil price increase in 2008 significantly contributed to the recession and the financial crisis in the U.S., which then spread globally," they wrote. "By raising CPI inflation, it reduced real disposable incomes and, hence, the purchasing power of the average households, leading to a contraction in real consumer spending and lowering the ability to repay mortgages."

According to Wells Fargo, U.S. real after-tax income would be about 0.6% lower for 2011 if prices were to remain above $115 per barrel through the end of the year. Reduced after-tax income would restrain the rebound in consumer spending, shaving at least 0.3 percentage points off 2011 growth.

"The largest impact on consumer spending from a sustained increase in oil prices would be in the second quarter, when driving increases," Wells said, and with oil at $115 a barrel, second quarter real GDP growth could be a full percentage point lower than the bank currently projects, putting growth at around 2%.

For the year, Wells Fargo said $115 per barrel oil would cut real U.S. GDP by about half a percentage point from the 3.0% growth it is currently forecasting.

Employment will also be impacted, with **Baumohl** arguing that despite the "reasonable increase" in hiring reported Friday, in light of the sustained rise

in operating costs and the uncertainty over how the turmoil in the Middle East will affect future revenues and profits, “we would not be surprised if private employers remain cautious about hiring the next several months.”

The effect of oil prices on growth is quite sizable, Barclays’ economists said, especially with the lag of a quarter. They said this suggests that if WTI oil prices stay at about $100 per barrel, the effect on global growth of the price increase from Q4′10 is likely be about 0.2% by the end of 2011.

If oil prices reach $125 per barrel — or $150 — by Q2 2011 and stay there, “the effect would be double (or triple).” The inflationary consequences under the same scenarios would range from 1% to over 3%, the Barclays economists said.

They noted that the effect may be higher, as the calculations do not factor in the effect on consumption and investment from heightened uncertainty, as well as possible repercussions in the mortgage and housing markets.

However, the Wells Fargo economists noted that although higher energy prices will modestly reduce business fixed investment — as corporate profits and cash flow are reduced — “investment outlays are being helped by accelerated depreciation, however, and so far this is more than offsetting the initial drag from higher oil prices.”

As for how monetary policymakers in different nations would respond, Barclays noted that most advanced economies may lack the policy space to support employment and growth in the face of a sizable oil shock.

“One of the consequences of excessively loose fiscal and monetary policies is the limited room to expand in the face of new shocks,” the research note said. “Therefore, it will be imperative for policymakers to retain their credibility.”

Using the experience of the 1970s as an example, the Barclays Capital economists said warned that if policymakers lose credibility, the consequences of a supply shock can become “disastrous” by entrenching inflationary expectations.