GLOBAL ECONOMICS UPDATE

23rd Feb. 2016

CAPITAL ECONOMICS

Will lower oil prices finally boost global growth?

- **Last year, the slump in oil prices turned out to be less of a bonanza for the world economy than most had anticipated. This year we expect oil prices to be more stable, but still relatively low. In these circumstances, the positives should finally outweigh the negatives**.
- Like most analysts, we originally thought the slump in oil prices was likely to be *positive* for the world economy – although we did at least warn that "the losers from low oil prices may be hit so hard that the fallout from their problems offsets the more diffuse benefits to the winners". (See our *Global Economics Update*, "Winners and (even bigger) losers from lower oil prices", 17th December 2014.)
- In the event, **lower oil prices turned out to be bad news last year not only for "oil economies", such as Saudi Arabia and Russia, but also for some net oil *importers***. Most strikingly, mining investment in the US halved from 0.8% of GDP in 2014 to around 0.4% in 2015. (See Chart 1.) This decline probably outweighed the boost to consumption: the windfall for US households from cheaper fuel was around 0.5% of GDP but only a fraction if this seems to have been spent. Admittedly, lower oil prices were positive for countries which produce little or no oil, including the euro-zone and Japan. But the overall boost for the world economy seems to have been minimal at best.
- **This year, the positives from lower oil prices should exceed the negatives for several reasons**. So far, households have seemed reluctant to step up their spending on other goods and services in response to the fall in energy prices. Instead, households in the US and (to a lesser extent) the euro-zone increased their savings last year, although those in the UK reduced theirs. (See Chart 2.) Household spending is, of course, affected by numerous factors, but there is at least plenty of scope for an increase.
- **Second, energy sector investment is unlikely to fall as sharply this year as in 2015**. The International Energy Agency estimates that global oil and gas investment fell by 24% last year and will fall by around 17% this year. In the US, having been cut by 50% in 2015, investment in mining structures would need to drop to zero this year to be as big a drag on GDP growth. That seems highly unlikely.
- **And third, the speed of the slide in oil prices has greatly added to uncertainty about the world economy in recent months. This uncertainty is likely to fade as oil prices stabilise or even recover**. Brent crude has held up above $30pb for most of the past four weeks, suggesting that it may already have found a floor. We expect demand to hold up better than many anticipate this year, partly because fears of a further sharp downturn in China look misplaced, while non-OPEC production, particularly in the US, is likely to fall. With this in mind, we expect the price of Brent crude (and WTI) to rise to around $45pb by year-end. (See our Energy service for more.)
- **In sum, the hit to investment should be lower this year than last, there is scope for a further rise in consumption, and more stable oil prices should ease the anxiety about the health of the global economy and financial system. As a result, the world should finally begin to benefit from cheaper oil**.

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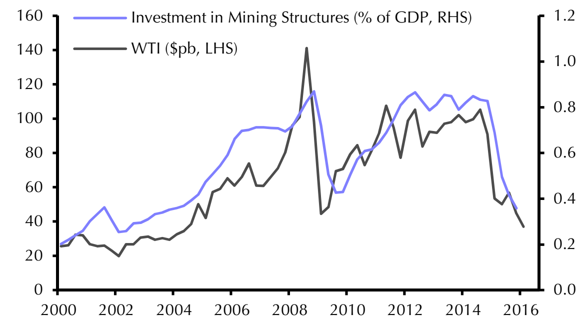
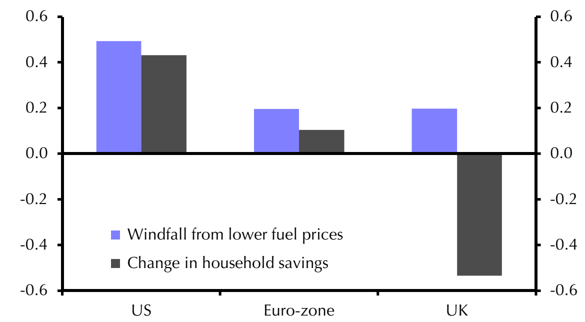
Chart 1: US Fixed Investment in Mining Structures & Oil Price



Source – Thomson Datastream

Chart 2: Windfall from Lower Fuel Prices & Change in Household Savings (2014 to 2015, % of GDP)



Sources – Thomson Datastream, Capital Economics