

Impact of energy cost



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Impact of Energy Cost An article in BusinessWeek Online Energy Costs are Draining Asia," 19 Sept 2005), discusses how the reduction or eventual elimination of subsidies in the midst of high crude price level has substantially impacted aggregate supply and aggregate demand. The article elaborates on how firms' bottomline and countries' economic growth are being affected by subsidy removal which in turn puts upward pressure on energy costs. This gives way to rising inflation as illustrated in the graph below.

As in the case of Asian nations Indonesia and Thailand, removal of government subsidies on the retail price of oil would necessarily entail an increase in the cost of production (Mishkin, 1997). Note that various industries such as manufacturing, transportation, and fishery among others are oil-intensive. In this regard, an increase in the pump price of petroleum products would push up their production cost. This translates to an upward shift in the aggregate supply curve from AS1 to AS2, wherein higher price is seen.

This condition proves that in the event of energy cost uptrend, increase in inflation is highly likely. Such is especially applicable to oil dependent nations which are extra sensitive to the volatility in energy cost. When energy costs increase, the prices of final output rise to recoup higher production cost incurred. With this, rising inflation occurs.

Aside from affecting inflation, the removal of oil subsidies, a form of fiscal policy, also affects real gross domestic product (GDP) equilibrium. This can be illustrated in the graphs below.

As mentioned in the article, subsidy on high crude prices is unsustainable as

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it weighs down government budget. As such, Indonesian and Thai governments lifted such subsidies and allowed firms and consumers to fully absorb price increases instead.

The elimination of subsidies is comparable to increasing net taxes because essentially it decreases deductions in taxes. This results in the downward shift in the income function as rising energy cost reduces consumption given a particular marginal propensity to consume (MPC), from AE1 to AE2.

Relative to this, AD curve shifts downward from AD1 to AD2. Thus, at the same price level a lower GDP results, i. e. from \$15 trillion down to \$10 trillion. (McDowell, Thom, Frank & Bernanke, 2006)

The lower GDP resulting from oil subsidy removal and subsequent increase in energy cost is evidenced by the fact that the economic growth of Thailand was projected to fall from 6.1% in 2004 to only 3.5% in 2005 as elaborated in the article.

References

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