Crude oil prices and the economy economics essay

According to FAUCON (2012), the turmoil in the Middle East, which began about year agao, and is continuing because if the civil War in Syria, the Israeli-palestinian War and the civil strife in Egypt, should have an upward effect on the pricing of crude oil futures, which will in turn have an upward effect on the pump prices (FAUCON, 2012). The Middle Eastern political difficulties have been the main reason behind the cost-push inflation in the world, since the 1973 oil prices spike. However, this article expects that the prices of oil may still reduce in the coming months, not least because the countries facing conflict are not major oil producers, and also because the prices of oil futures have beem falling since January of this year. Despite the ongoing difficulties in the country, the prices did not rise, ending up at more than 1. 8% lower than the prices a mong before, and a last most, Brent crude saw its prices increase by $3. 32%.

The OPEC member nations have shown little appetite towards cutting production to meet the political needs of its member countries, despite calls from Iraq to do so. By the close of october 2012, its production reached 30. 9 million barrels, much higher than the forecast production. In addition, OPEC reduced its forecast of the demand for oil, which effectively puts oil supply in a surplus in the short term. The factors influencing demand are however still driven by fears of increasing fuel prices as against the increased supply of oil. The movement towards holding higher fuel researves, and seeking aleternative oil supplies other than the Middle East have been key (FAUCON, 2012). In adiditon, the Eurozone crisis, which has seen the credit rating of countries sich as France and Greece reduced, will ensure that the overal demand by their respective economies will remain considerably lower. The lower demand also implies that there is increased sensitivity to the possible changes in the prices of oil.

Application of Economic Principles

Oil is a critical resource, and the changes in its prices causes cost push inflation across the entire economy. When crude oil prices increase, they force consumers within an economy to employ more of their incomes on transportation, heating and other consumption since the pricing will also be a factor in the increased transportation prices. The additional expenditures also reduce the overall consumption on all products, because of the reduce value of money (cost-push inflation) and the reduced income (because of the higher proportion spent on fuel). These have a two-fold effect on the economy (Krugman, 2009). The inflation, triggers more inflation, by increasing the prices of labor and inputs, which increases the costs across the economy. This is why the economy is extremely sensitive to actual or expected changes in the prices of crude oil.

Given the fact that many countries are actually net importers of oil, and the vast sources of oil do actually come from the Middle East (OPEC nations), any changes in the production of these countries implies a reduction in the global crude oil supplies. This should in turn create a surplus on the market, coupled by an increase in the prices of the commodity and the associated inflation. The inflationary pressures associated with crude price increases, coupled by the reduction in spending have negative effects on the economic growth, not least because it reduces the consumption or demand for other products in the economy (Eicher, Mutti, & Turnovsky, 2009). The reduction in the demand within the economy in turn discourages firms/producers from producing more products, hence reducing investment expenditure. Investments and consumptions form an important part of the GDP, which is given by the equation Y= C+I+G+ (X-M). The reduction, in the GDP growth and reduction in production have the effect of increasing unemployment and wages, which further contracts the household incomes, which further reduces the ability of the population to consume.

The effect of the crude oil prices on the economy are dependent on the ability of the economy to substitute the product with other products, including alternative fuel prices. However, the substitution for oil remains considerably poor, and hence, the suppliers of oil hold a near absolute monopoly of the fuel resources. They can freely alter the prices of their commodities by reducing supply and vice versa. There prices of brent crude are low, and such low prices mean that the pump prices in the next prices are expected to fall, which should reduce inflation and encourage growth. There forecase falls in the fuel prices are based on the fact that while there is excess supply by OPEC, the demand will remain low, because of the economic problems facing Europe, which should in turn reduce the demand.

Graphical Analysis

Figure 1: Cost Push Inflation

In figure 1 above, the initial equilibrium in an economy is given by the intersection of AD and AS curves, which are the demand and supply curves for oil in an economy. This equilibrium yield an equilibrium price of oil as well as the quantity demanded. When the supply of oil is reduced due to political problems in the Middle East, this will be reflected as a contraction in the supply, which causes the supply curve to shift leftwards, resulting in the new equilibrium price and quantity to be determined by the intersection of the demand curve AD and AS2. This equilibrium results in higher pump prices (European Wind Energy Association, 2009). Given the universal role of oil in economic production, this situation will be replicated across the economy, hence resulting in a persistent increase in the prices (or inflation).

Figure 2: Effect on the economy

Figure 2 depicts the effects of increased prices on the growth of the economy i. e. by affecting consumption (C) and investment spending (I). The GDP growth is inverse to the growth in fuel prices.

Conclusion

Oil represents an important resource for ay country7, not least because it is used for in nearly all forms of transportation, which makes it necessary that an increase in the prices of crude oil to lead to economy-wide inflation. While the supplies should be jeopardized by the unrest in the Middle East, the forecast in FAUCON (2012) that the prices of oil are unlikely to increase in the near future are based on the multiple factors. To begin, with the OPEC nations have indicated they are are unwilling to reduce their production and crucially, the production over the month of october and novemeber actually surpassed the projected levels. In addition, the crucial role played by the futures markets in the determination of the spot oil prices is evident here (European Wind Energy Association, 2009).