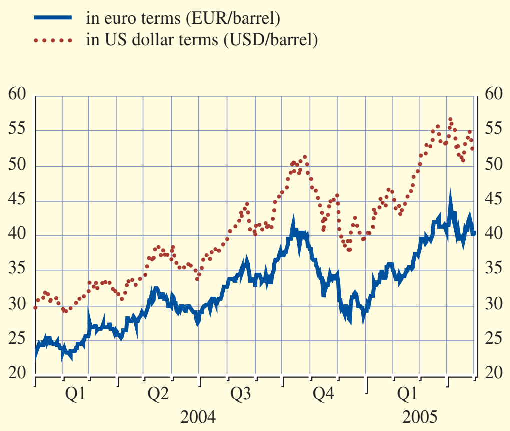
Box 1

RECENT DEVELOPMENTS IN OIL PRICES

Oil prices rose strongly in 2004 and the current year has thus far been marked by a further rise, with oil prices reaching historic highs in early April 2005 (e.g. USD 57 in the case of Brent crude oil). These developments highlight the continued risk to the outlook for global growth emanating from oil markets. Against this background, this box takes a closer look at recent oil price developments and the factors underlying them.

The surge in oil prices during the course of 2004 was dampened by the strengthening of the euro, with oil prices increasing by 34.0% throughout 2004 in US dollar terms and by 24.2% in euro terms. Since the start of 2005, however, the weakening of the euro vis-à-vis the US dollar has added to the price increase – 38.2% in euro terms, compared with 30.5% in US dollar terms (see Chart A).

Chart A Brent crude oil prices



Source: Bloomberg.

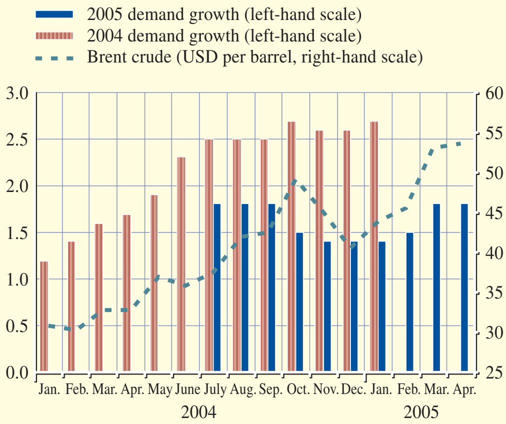
The main factors underlying the increase in oil prices in 2004 and 2005 were buoyant demand, supply bottlenecks and concerns with regard to the security of oil supplies, in part related to geopolitical uncertainties. According to the International Energy Agency (IEA), demand for oil grew at its strongest pace in almost three decades in 2004, mainly driven by strong growth in Asia and North America. Throughout 2004 demand forecasts had to be revised upwards continuously as demand exceeded expectations (see Chart B). Demand forecasts for 2005 were revised downwards towards the end of 2004. This was accompanied by a general easing of prices. The subsequent upward revisions in the first few months of 2005 coincided with the renewed rise in prices.

Looking ahead, the IEA expects oil demand growth to decline somewhat as compared with last year's levels on account of some deceleration in global growth. In particular, oil demand growth in China is expected to decline from the extraordinarily high rates observed in 2004. The IEA now expects global demand for oil to increase by 2.1% in 2005 as a whole, compared with a 3.4% increase in 2004.

Rising production aimed at matching soaring demand for oil has eroded spare capacity throughout the oil supply chain. According to IEA estimates, OPEC's spare production capacity excluding Iraq has shrunk to between 1.2 and 1.7 million barrels per day, constituting less than 2% of global oil supplies. Very high demand for finished oil products such as petrol, diesel and heating oil as well as environmental regulations have put great strain on the existing capacity for processing heavy and sulphur-rich grades of oil. This factor appears to have been

Chart B Oil demand forecasts

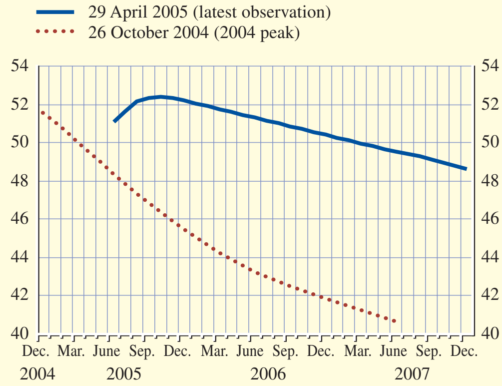
(annual percentage change; USD)



Sources: International Energy Agency and Bloomberg.

Chart C Brent crude oil futures prices

(USD/barrel)



Source: Bloomberg.
Note: The curves show the prices of Brent crude oil futures contracts traded on the International Petroleum Exchange for different maturities (horizontal axis). 26 October 2004 corresponds to the peak in oil prices in 2004.

particularly important in 2004, when the quality-related premiums that had to be paid for light and sweet grades of oil, such as the European benchmark Brent, over heavy and sour grades of crude oil, such as Dubai Fateh, rose temporarily to USD 14 per barrel. Although the spreads have since narrowed, they remain around three times as high as their historical average, indicating continued tightness in the processing industry. Looking ahead, capacity to produce and process oil is expected to increase, but spare capacity is likely to be rebuilt only very gradually.

Uncertainties about the security of oil supplies were a further important factor contributing to the price increase in 2004. Numerous acts of sabotage in Iraq, threats to the oil infrastructure of other Middle Eastern producers and civil unrest in Nigeria caused concerns among market participants with regard to the possibility of supply disruptions. Despite having moderated somewhat, such concerns remain, thereby continuing to put upward pressure on prices. In particular, non-OPEC production growth in 2005 is not expected to meet the rising demand, implying another year of an increasing call on OPEC oil.

A key difference between the recent oil price increase and last year's increase is that markets appear to expect the current high level of prices to last longer. While current spot oil prices, in euro terms, are close to the levels experienced during the previous peak witnessed at the end of October 2004, the prices of oil futures are considerably higher (see Chart C). The futures price for delivery in mid-2007, for example, is now almost USD 9 higher than it was last October. In addition, at shorter horizons, oil futures prices are increasing with the maturity of the contract (so-called "contango"), a situation not usually associated with high spot prices, while the opposite was true last October (so-called "backwardation"). This market structure may be a reflection of concerns as to whether oil supplies will be adequate to meet the expected peak in demand during the summer, and thus indicates market participants' desire to build inventories ahead of peak demand.

Oil prices continue to pose a significant risk to the global economic outlook. However, the negative effects on growth and inflation thus far appear to have been relatively contained. This may indicate a greater resilience on the part of the global economy to oil price shocks as compared with earlier episodes of oil price increases, possibly related to a generally lower level of oil dependency. However, the possibility cannot be ruled out that a further increase in prices, or a longer than expected continuation of current price levels, could trigger significantly more pronounced negative effects in the future. Against this background, continued heightened vigilance with regard to oil market developments is warranted.