Is Korea Ready for the “Third Oil Shock?”

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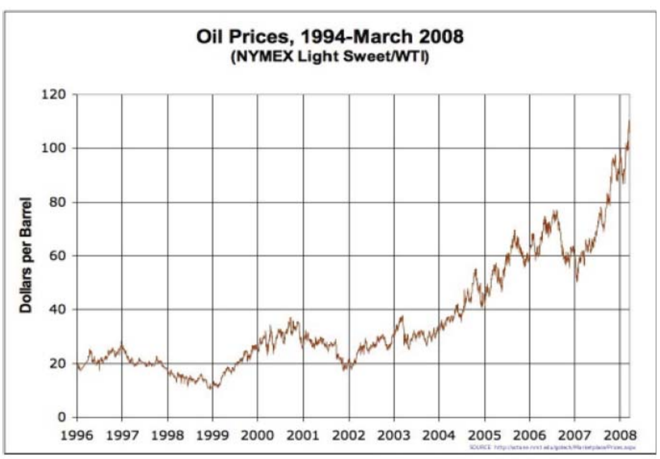
International oil prices have risen dramatically, raising the possibility of a “third oil shock.” During the first oil crisis in 1973, the annual average price soared to $85/barrel (bbl) in today’s equivalent value. Just six years later, the second oil shock arrived, as crude averaged $152/bbl. As of May this year, the average price stood around $99/bbl, already surpassing the price of the first oil shock. The average monthly price of Dubai crude oil, which accounts for 82% of Korea’s oil imports, increased from $60/bbl in January 2007 to an all time high of $140 recently. Oil prices thus increased by nearly 150% in the past 17 months. The Korea Energy Economic Institute predicted that the price could rise to an average $140/bbl in the second half of the year, or to an average $121/bbl for the full year. Officials of the Organization of Petroleum Exporting Countries (OPEC) as well as other global investment firms have a prevailing negative view that the price could surge to $200/bbl by 2010. What if oil hits $200? Is Korea ready for such an oil shock?

History of Oil Price Trends

From the mid-1980s to September 2003, the price of crude oil averaged under $25/bbl. Following the 2003 invasion of Iraq, the oil price rose to $40, then $50/bbl during 2004. During that period, oil production in Iraq declined from 3 million to 2 million bbl per day. After retreating for several months in late 2004 and early 2005, the price broke the psychological barrier of $60/bbl in August 2005. Analysts believed that a series of events, including the continued tension between Iran and the United States and the violence in Nigeria, prompted the price rise. The crude oil price continued to soar and reached $79/ bbl in July 2006, an all-time record. This increase was attributed to geopolitical tensions as North Korea launched missiles, and Israel and Lebanon went to war. In addition, hostilities in Nigeria caused a supply disruption of 675,000 bbl per day. Oil prices began decreasing in the fall of 2006, reaching $56/bbl in October, the first drop since December 2004. At the same time, OPEC members declared that they would cut production by 1.2 million bbl per day in order to stop the price slide. In mid-2007, oil prices began moving up rapidly, reaching $80/bbl by September, $92/bbl in October, and $99/bbl by December. Analysts said that a combination of ongoing tensions in eastern Turkey and the weakening of the U.S. dollar were the main contributors to this rise. By January 2008, oil prices had surpassed $100 and continued to rise as it became evident that the supply of oil was outpaced by demand. The price hit a record $147 on July 11, the highest since 1983 when it rose to $144/bbl in today’s dollars. Basically, crude prices increased 400% during 2003–2008.



Source: hhp://octane.nmt.edu/gotech/Marketplace/Prices.aspx

What Caused the Price Hike?

The oil shocks in 1973 and 1979 stemmed from sudden interruptions of oil supplies from the Middle East due to the Arab-Israeli war and the Iranian revolution, respectively. Once peace was restored and order established, Middle East oil supplies returned to normal. But the “third oil shock” is different. The recent price rise has largely reflected in global demand for energy having outpaced the available supply. Some OPEC members have refused to produce more oil, and some oil producing countries are suffering from political insecurity. At the same time, thriving economies such as China and India are quickly becoming large oil consumers. In the first half of 2008, 85 million bbl of oil were available every day, while demand was 87 million bbl. A weak dollar is also blamed for moving up prices in many countries as are speculative investors.

Looming Oil Shock and Korea’s Economy

If oil prices remain above $100/bbl for more than six months, there is a great possibility that Korea’s economy would slow significantly. Oil prices have been hovering around $100/bbl since early this year.

Growth Prospects: According to the Hyundai Research Institute, if oil prices rise to an average of $150/bbl in the second half of this year, Korea's growth rate will fall to 2% and inflation will rise above 9%. Samsung Economic Research Institute (SERI) reported that, if the annual average price of oil rises 10% year-on-year, growth will be 0.35 percentage points lower. Considering that the average oil price was $60 in January 2007, this year's growth could decline by more than one percentage point if the average price remains in the $90–$100 range.

Consumer Prices: Consumer prices climbed 5.5% in June from a year earlier, the fastest pace since the rise of 6.8% in November 1998, in the wake of the financial crisis. It is well above the Bank of Korea's target range of 2.5% to 3.5% and the government's projected 3.3% rise. Economists are concerned that such data may hurt consumer sentiment and decrease spending, which is the engine of the growth. Additionally, consumer prices will grow more rapidly in the second half since international oil prices are reflected in consumer prices with a time lag of one or two months.

Commodity Prices: The price of raw materials, including crude oil and grain, jumped 92% in June year-on-year. The recent rise has been taking place over a period of 10 months starting in September 2007. Officials said that soaring commodity prices are an important factor in the nation's foreign exchange policy, as they impact on ordinary people's livelihoods, especially low-income families. The government maintained a weak *won* policy until recently, to help boost exports and improve the current account balance. But that policy was blamed for further increasing the already high prices of imported goods, forcing businesses and households to pay more.

Policy Direction and Implication

Rising prices are making it difficult for the Bank of Korea to cut the key interest rate. At its recent meeting, the Monetary Policy Committee decided to maintain the rate at 5% for the 11th consecutive month, choosing to prevent a recession rather than aggressively combatting inflationary pressure. Some analysts argue that keeping inflation under control should be the higher priority, but, without a rate cut, the economy may continue to slow.

Korea is not the only country suffering from high oil prices. But surging oil prices have put additional pressure on the Korean economy, which imports all of its energy needs from overseas, at a time when the county is struggling from weak domestic consumption and slowing exports. President Lee Myung-bak said that the government will take all possible measures to curb rising consumer prices and help stabilize the livelihoods of citizens, especially lower-income households. He also announced that the nation would go into crisis mode if crude prices surpass $170/bbl and that his administration will place top priority on controlling inflation.

In June, the government announced a $10.3 billion spending package to help ease the burden of high oil prices on low-income families and self-owned businesses. Under this plan, individuals earning less than $35,000 annually will receive tax rebates, while bus drivers, truckers, farmers, and fishermen will be compensated for half of the rise in diesel prices and will receive a rebate of the tax on fuel for one year, beginning July 1. Approximately 9.8 million workers and 4 million self-employed individuals will benefit from the aid package. The government said that $6.1 billion out of the total spending package will be disbursed in the second half of 2008.

Korea sustained solid economic growth until last year despite high oil prices and a strong currency. But oil prices have escalated much faster than expected, and a "third oil shock" might become reality in the latter part of the year. Global experts agree that the days of cheap oil are gone and that the world has to embrace living with high oil costs. Supply is essentially fixed in the short term because it takes years to find a new field and commence production. Demand, meanwhile, is also largely fixed because there is no ready substitute for expensive oil. A price at $60/bbl was a psychological red-line, $100/bbl was a surprise, but now $150/bbl is inevitable. Oil may hit $200/bbl sooner rather than later. Is Korea ready for an era of expensive oil?