Still-fragile world economy braced for effects of yet another oil shock

Indebted households have already tightened belts. Higher petrol prices are likely to depress demand – just what the recovery doesn't need right now, writes Heather Stewart


Crude oil traders in New York last week as the clashes in Libya pushed the oil price to almost $120 a barrel. Photograph by Mary Altaffer/AP

The outbreak of revolutionary fervour on the streets of Cairo and Tripoli has made compelling viewing, but the latest jump in oil prices last week was a sharp reminder that the consequences of chaos in the Middle East will be felt across the world.

Brent crude had come down to $112 a barrel by Friday, after hovering close to $120 earlier in the week, but that's still an increase of more than 10% in seven days, an increase the global economy can ill afford as it struggles to find its feet two years after the wrenching crisis of the credit crunch.

The initial impact of a higher oil price is, not surprisingly, a rise in the headline rate of inflation, as costlier oil feeds through to petrol prices, and eventually the cost of all sorts of other goods that use oil, from plastics to fertiliser.

But how an economy copes in the longer term with such a one-off jump in energy prices depends on its underlying health. If demand is strong enough, workers can respond to the rising cost of living by bidding up their wages, and companies, in turn, can pass on their rising costs in higher prices, instead of taking a painful hit to their margins. This is the kind of toxic "wage-price spiral" Britain became locked into after the early 1970s oil shock.

For fast-growing emerging economies, many of which were already concerned about reining in inflation – Russia and China have both been raising interest rates, for example – the inflationary effect will be the biggest danger in the coming months, and central banks will want to take firm action.

Melissa Kidd, economist at Lombard Street Research, says the strong demand from China and other healthy economies will mean oil prices will not plummet back down to earth as they did two years ago, after hitting $145 a barrel. "Rather than a repeat of July 2008, where everything just collapsed, it will be this slow-burning monetary tightening," she says,

> **'Higher oil prices are a shock in themselves; if they lead to a loss of confidence and we raised interest rates, that will be a killer'**
>
> Gerard Lyons

predicting that it will be 2012 before these anti-inflation measures really start to bite, choking off demand in the emerging world and bringing the oil price back down to earth.

In the west, meanwhile, where consumers and governments are still working off the legacy of the noughties boom, the story is different. Where demand is already fragile, and workers are unable to push up their wages to compensate for the rise in energy prices, the oil shock could simply act like a tax – yet another rising cost that hard-pressed households have to bear. With a fixed budget, they are forced to respond by tightening their belts. So in the long term, the impact of rising oil prices is deflationary: it depresses demand.

Karen Ward, senior international economist at HSBC, puts it like this: "Without an increase in pay, using more of the monthly pay cheque to fill up the petrol tank will mean households have little choice but to cut back on other spending – eat out a little less, and buy fewer new clothes. In this scenario, a rise in oil prices simply serves to dampen spending on domestic goods and services, and depress their prices."

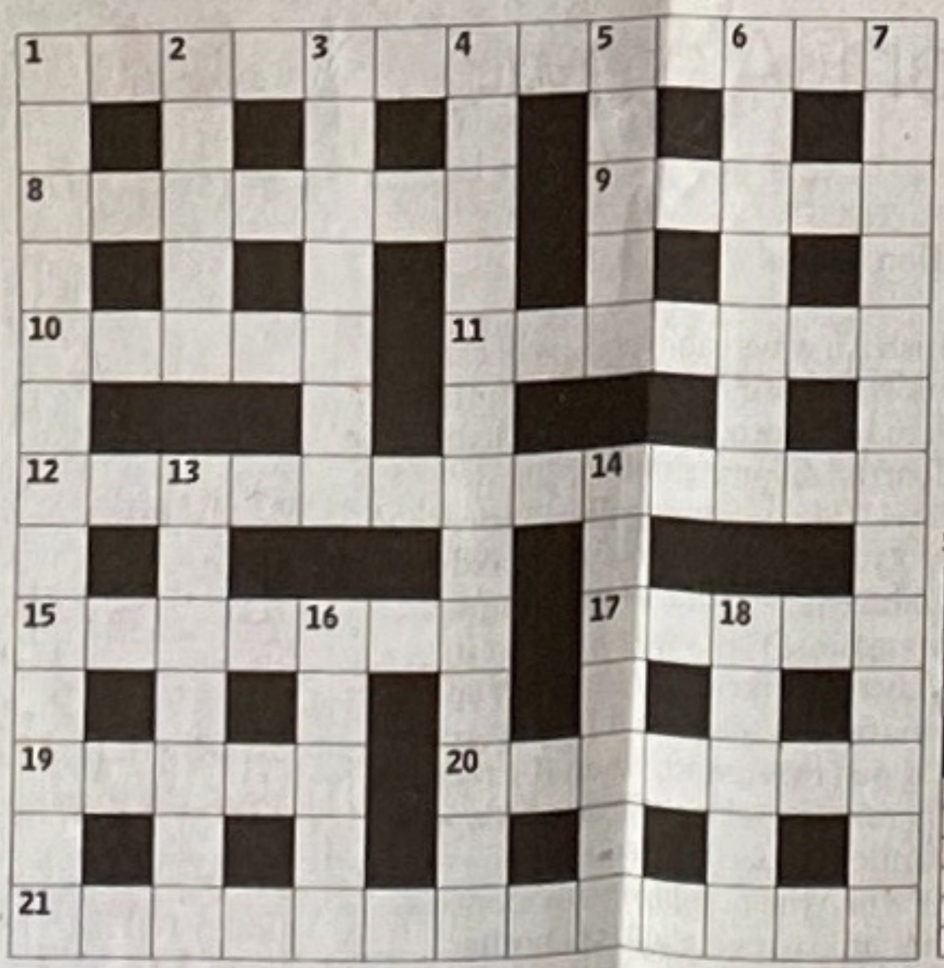
Governments can help to offset this effect temporarily, using subsidies or tax cuts, but that looks impossible given the dire state of public finances in most developed countries. (Chancellor George Osborne may, however, attempt to dull the pain of recent petrol tax rises in next month's budget with a so-called "fuel price stabiliser".)

Consumers could borrow to tide themselves over the short-term squeeze, but again, that doesn't look very plausible for the heavily indebted households of the US and much of Europe. Higher oil prices have occurred "at the worst possible time", according to Ward, with central banks already concerned about their inflation-fighting credibility in the face of rising global commodity prices.

In the UK, the latest rise comes as Bank of England policymakers were already juggling the conflicting influences of strong international commodity prices and sickly demand at home. News on Friday that GDP had contracted by an even larger than expected 0.6% at the end of 2010 will only sharpen their dilemma. Kidd at Lombard Street says they should grit their teeth and keep rates on hold, though she admits this will take "nerves of steel" in the face of the clamour for higher rates in some corners of the City – and among members of the monetary policy committee, including the hawkish Andrew Sentance.

Gerard Lyons, chief economist at Standard Chartered, warns that if the Bank makes the wrong decision, the UK could be at real risk of relapsing into recession. "A double dip could be caused by one of three things – a policy mistake, an external shock, or a loss of

SPEEDY CROSSWORD NO 806



SOLUTION NO. 805

ACROSS
1 Paid what's due (6,3,4)
8 Site of numerous battles or campaigns (7)
9 Dog-like carrion-feeding mammal (5)
10 Deep vascular inner layer of the skin (5)
11 Legendary siren and rock in the R Rhine (7)
12 Left home (6,3,4)
15 UK, smart? (anag) (7)
17 Body's circumference around the middle (5)
19 Warhorse (5)
20 Put out of action by illness (4,3)
21 Is victorious or successful (7,3,3)

DOWN
1 Carried the can (5,3,5)
2 Take place (5)
3 Atone (7)
4 Gossips, talks about nothing important (6-7)
5 Colourless volatile highly inflammable liquid (5)
6 Movement of glaciers (7)
7 In the van (7,3,3)
13 French chemist and biologist (1822–1895) (7)
14 International language, by assumption (7)
16 Straight lines from the centre of a circle (5)
18 Made angry (5)

confidence," he says. "With rising oil prices, it's possible that here in the UK we could get all three. Higher oil prices are a shock in themselves; if they then led to a loss of confidence, and we foolishly raised interest rates, that would be a killer."

At the same time, some analysts are pointing out that it is important not to rule out more extreme scenarios in the Middle East in the months ahead. Saudi Arabia's King Abdullah announced a $35bn package of handouts to calm his restive nation last week, including the introduction of unemployment benefit for the first time.

Most experts believe Saudi Arabia is stable, but many would have said that about Egypt, Tunisia and Libya even a few months ago. Saudi supplies can easily offset the shortage of oil production from Libya; but if the chaos spreads to Riyadh, all bets are off.

Kidd adds that even without a revolution on the streets of Saudi Arabia, some other scenario could hit the world economy by shattering confidence: the oil shock could be compounded by another, unexpected and unrelated, event bursting into the markets' consciousness – a renewed fiscal crisis in Spain, for example. That could send markets spiralling downwards, by shattering the sanguine world-view of many investors and causing confidence to collapse.

For now, she says, the most probably impact of the oil shock is that it will act as a "slow puncture", gradually letting the air out of the world economy over the next two years or so – but it wouldn't take too much more bad news to turn it into a blowout.

FIRMS BATTERED

From airlines and distributors, through to farmers and manufacturers, almost every company in Britain will take a hit from the surge in oil prices.

Although nobody knows quite what will happen to oil prices and when, £10bn could be wiped off Britain's total output this year if the price of oil stays at its current level of $110 (£68.50) a barrel.

John Cridland, director general of the Confederation of British Industry, says: 'If this situation continues, many companies' input costs will increase more sharply and we will see added inflationary pressure being passed on to retail prices.'

Clearly any company using a lot of petrol – or other forms of oil-derived energy – will suffer badly. But that is only part of the burden UK Plc and its hard-pressed customers – must bear. For typically they share the cost of rising oil prices between them.

Oil is used in plastic, meaning that many manufactured products – and the packaging they come in – will be hit, as will tractor-driving, pesticide-spraying farmers, putting further pressure on food prices.

Every $10 increase in the price of oil knocks 0.5 percentage points off gross domestic product, according to the International Monetary Fund. Since the Egypt uprising began towards the end of last month, the commodity has jumped by $15. If the resulting price of $110 persists, it would knock £10bn off GDP.

Tom Bawden

OIL SECTOR PROFITS

It's no surprise that high oil prices are good news for oil companies, directly boosting their profits. In the past fortnight the FTSE 100 index of shares has fallen by 1%, but the likes of BP and Shell have increased their price by 2.5% and 4% respectively.

High prices also make more expensive ways of producing oil economic. Oil giants such as Shell typically judge the viability of long-term projects assuming an oil price of $50–$90 a barrel. Clearly prices are well above this level, but based on the industry's past record, it will take at least a year of much higher oil prices before companies ratchet up their assumptions.

When oil prices slumped to below $50 a barrel following the financial crisis in 2008, oil sands projects – the more expensive of which are only economic at $60 a barrel – were the first to be scaled down. Oil prices are so much higher today that almost any form of oil and gas production looks attractive. But first the reserves have to be found, frequently in inaccessible regions such as the Arctic, and the higher prices – and the gusher of profits that results – will encourage companies to look harder.

Andrew Horstead, risk analyst at consultancy Utilyx, points out that an extreme increase would be bad for the industry in the long term, as consumption would drop and consumers might permanently switch to alternative sources of energy. 'But no one knows what level that tipping point is,' he says.

Tim Webb

HTC closes in on Apple with launch of new smartphone conjured up by 'magic lab'

by Dominic Rushe

According to his business card, John Wang is a wizard. Chief innovation wizard to be precise. He certainly seems to be working his magic at HTC, the Taiwanese firm where he oversees new products at a company that is rapidly becoming one of the hottest brands in tech.

This week is set to be another Apple week – the second generation of the iPad is expected to be unveiled on Wednesday. But in the UK the biggest-selling launch is likely to be HTC's. The hyperbolically named HTC Incredible S is Wang's latest smartphone and has received glowing reviews so far in the tech press.

Later this year HTC will launch its iPad rival, the Flyer. With tech firms churning out more tablets than ancient Mesopotamia, Wang says the Flyer will not be another "me-too" device. "Whatever we do has to be quietly brilliant," he says.

He says the Flyer was designed to weigh the same as the average paperback book (420 grammes), about half the weight of an iPad, and will be far smaller. And while it will be a touch-screen device, Wang says it won't be defined by touch – users will be able to draw and write notes on any part of the device. The aim, he says, is to produce something different, something that produces "moments of delight".

In order to get to these moments HTC has a "magic lab" where ideas are worked through. One idea from the lab is a technology that makes its smartphones ring loudly in a bag or pocket, but softly when picked up.

Wang started the lab five years ago and its engineers work through ideas to make their devices as simple and user-friendly as possible. The Incredible S, for example, has buttons that change their orientation depending on which way the phone is held. "When people use the word innovation they are often referring to the 1.5ghz, the 4.4in display, megapixels," he says. "But it's often the details, not the specifications that make customers think 'that is so right'."

The strategy seems to be paying off. According to technology analysts Gartner, HTC sold 3m smartphones in the UK last year, compared with Apple's 5m. In the last quarter of the year HTC sold 1.1m, close to Apple's 1.4m. Overall, the company made a net profit of $500m (£310m) for the last quarter of 2010, a leap of 160% from 2009's final quarter. Sales surged 153% from a year ago.

The firm, formerly known as High Tech Corporation, started life in 1997 making notebook computers. It has been building a position in smartphones for years, but Gartner analyst Carolina Milanesi says the turning point for HTC was the launch of Google's Android mobile operating system in 2007. The success of Android and HTC's close co-operation with Google gave the firm a new lease of life in mobile.


The Flyer will be launched later this year.

Google and HTC are close partners: the search giant's team used HTC phones when they were developing Android. Initially Android looked like a dud, but it now outsells all its competitors combined in the US. Next up is the tablet, where Google is also keen to make its mark. "I think we are just at the beginning for innovation in the tablet market," says Wang.

> **'HTC has targeted people who want the latest technology. They've done an incredible job'**
> Graham Stapleton

Graham Stapleton, chief commercial officer for Carphone Warehouse and Best Buy, said the retailer had seen enormous growth in HTC sales in recent months. "Their customer traditionally has been more of a business/professional user. In the last 12-18 months they've targeted more of the pioneering customers, people who want the latest technology."

He said HTC was becoming a brand people asked for unprompted. "That's a huge change. They've done an incredible job over the last 18 months."

It hasn't gone unnoticed. HTC and Apple are now locked in a patent spat, with each side accusing the other of ripping it off. Milanesi says that's the price of success. "Can Apple go after Google? No, they don't make phones. They will go after who they can go after," she says.

It's probably the biggest compliment Apple is ever likely to pay them.

MOTORISTS SQUEEZED

Every $2 rise in the oil price equates to an extra 1p on pump prices, according to the AA, with the recent rise threatening to add £2.50 to the cost of filling up a tank.

A recent survey shows that three-quarters of the motoring organisation's least well-off members are cutting back on household spending in order to fund their car costs, or reducing four-wheeled trips to the shops, work and school.

An AA spokesman said: 'The freedom of the road is being steadily denied to members of society who are on lower incomes. They need that access for equality in society, to get to their jobs and take their children to school.'

Stephen Glaister, director of the RAC Foundation, warned that the average household already spends more on transport than on heating, mortgage costs or food.

According to the Office for National Statistics, transport accounts for more than £1 out of every £10 spent by a UK household. On top of that, it is the poorest households that own the least fuel-efficient cars.

Glaister says: 'At least half of those living in the poorest 10% of households now have access to a car. It means they can live normal daily lives. But for how much longer? While the relentless rise in fuel prices is punishing us all, the poor are being particularly hard hit.'

Dan Milmo