Oil $150 a barrel!

At a recent OPEC conference it was acknowledged that oil could hit $150 a barrel. There is a strong view that current prices of $100 a barrel are sustainable, with demand likely to increase over the next year or two.

In the past, political uncertainties were expected to add $20 to a barrel. Now it is thought that figure could be nearer $30 a barrel. If conflict and tensions continue to increase in the Middle East £130 a barrel is possible. But equally if President Bush says oil consuming and oil producing countries need to work together, then prices could come down to $70.

Advisers to OPEC are suggesting that a new pricing structure for oil is required. This is because high oil prices are not the issue. Rather, volatility is the problem because it opens the possibilities for speculators to make a profit. Also, wide price swings make it difficult for oil companies to plan capacity expansion. Short term shareholders would rather see dividends flow from high oil prices, than bet on a high price, high demand in the future.

Of course, with each oil price spike there is the increasing incentive to ditch fossil fuels and find alternative means of producing energy. After the 1970s' oil price rise, cars became more efficient. In the new millennium, cars are increasingly running on ethanol and electricity. In addition, governments seeking to cut greenhouse gas emissions are taxing motorists and subsidizing public transport.

But it is equally possible that oil could be heading for a fall. With the US economy faltering, demand will drop not only from the US, but also the Asian economies which are dependent on the US for export led growth. If a global recession ensues, then a 30% reduction in oil prices is equally likely.

The International Energy Agency, watchdog for 26 industrialized consumer nations, sharply reduced its forecast for world oil demand growth through the rest of 2007 and into 2008 this week.

The gloomier outlook for world energy consumption comes amid growing evidence that high prices and economic strain are already grinding to a halt fuel demand growth in the United States, the world's top consumer.

Questions

1. How might higher fuel prices generate an output gap in oil consuming economies like the US?

2. How might higher fuel prices lead to a change in potential GDP?