Special Bulletin

A Japanese Perspective on the International Energy Landscape (595) July 29, 2022

Global Economy and Developing Countries Plagued with Energy Price Spikes

Ken Koyama, PhD
Chief Economist, Managing Director
The Institute of Energy Economics, Japan

As the escalation of the Ukraine crisis has rapidly destabilized international energy markets, energy price spikes have been remarkable. The average Brent crude futures price to date this year stands at about $105 per barrel, up nearly $40/bbl or some 60% from about $66/bbl a year earlier. European gas price hikes have been even more rapid. The average Dutch Title Transfer Facility natural gas price to date this year comes to $34.5 per million British thermal units (some $200/bbl oil equivalent), more than quadrupling from $8.2/MMBtu (about $50/bbl oil equivalent) a year earlier. Price hikes are not limited to oil and gas. Coal and electricity prices have also increased substantially. We now see serious and simultaneous energy price spikes.

As prices of energy indispensable for civic life and economic activities rise substantially, national economies as well as the global economy are affected naturally to decelerate growth. Adding fuel to the economic deceleration is growing inflation. Energy price hikes have been coupled with food price spikes and cost increases caused by personnel cost hikes and supply chain bottlenecks and confusion to bring about global price hikes. The U.S. consumer price index in June scored a year-on-year increase of 9.1%, the highest in 40 years since November 1981, accelerating from an 8.6% rise in May. The inflation rate for the entire Organization for Economic Cooperation and Development reached 9.6% in May. Record inflation has prompted European and U.S. monetary authorities to raise interest rates. The U.S. Federal Reserve increased the federal funds rate by 0.75 percentage points for the second straight month, demonstrating an unusual response to inflation. The increase of 0.75 points is three times faster than usual. However, the International Monetary Fund's World Economic Outlook released in July forecast that inflation in 2022 will reach 6.6% in developed countries and 9.5% in developing and emerging countries, indicating that it would not be easy to reduce inflation.

As interest rate increases and monetary tightening have been enhanced amid growing inflation driven by energy price hikes, the global economy's deceleration has become clearer. U.S. gross domestic product in the second quarter of this year posted a real annualized contraction of 0.9%, following a 1.6% decline in the first quarter. The U.S. economy thus contracted for the second straight quarter, seemingly on the brink of plunging into a recession. In China as the world's second largest economy after the United States, real GDP growth in the second quarter this year declined to 0.4%, close to zero, decelerating rapidly from 4.8% in the first quarter. This represents a clear economic deceleration. It must be noted that the Chinese economic deceleration reflected great impacts of lockdowns implemented in response to a COVID-19 infection spread in addition to energy and resources price spikes. As economic management is extremely important for Chinese President Xi Jinping seeking to be elected as secretary general of the Chinese Communist Party for the third term at the party's Congress expected to take place in October or later, the Xi regime is expected to implement an economic stimulus package to secure an economic rebound while suppressing COVID-19. However, China is plagued with turbulent factors including the global economic deceleration and the COVID-19 infection expansion.

In the meantime, the above-cited IMF World Economic Outlook forecasts that global economic growth in 2022 will nearly halve from 6.1% in 2021 to 3.2%. The IMF thus revised the 2022 growth projection down by 0.4 points from 3.6% as predicted in April. Factors behind the downward revision include inflation driven by energy price spikes, relevant interest rate hikes, geopolitical risks behind energy price spikes and the COVID-19 infection expansion in China. The IMF outlook also predicts that global economic growth in 2023 will decelerate to 2.9%. The IMF is also considering a downside-risk scenario in which global economic growth will fall to 2.6% in 2022 and 2.0% in 2023 if the Ukraine crisis, inflation and the COVID-19 infection spread become even more serious. Red lights may be blinking for the future global economy.

Highlighted among various factors considered for the downside-risk scenario is the risk of energy market destabilization. The IMF outlook first takes up the recent Russian gas supply insecurity, noting that if Russian gas supply is completely halted, further energy price hikes will spill over throughout the world, exerting great negative impacts on the global economy. In Europe, particularly, the IMF points out that the economy will plunge sharply on the introduction of an energy rationing system and its impacts on major industries. Another IMF analysis indicates that if general price hikes driven by energy price spikes become even more serious under the potential deterioration of the Ukraine crisis, further interest rate hikes to counter inflation may lead to stagflation, or the combination of stagnation and inflation.

While economic deceleration in giant markets such as the United States and China and the huge impacts of gas supply chaos on the European economy attract attention, we must understand that developing countries are the most plagued with energy price spikes. Although developed countries implement measures to relieve low-income people from energy price spikes, such spikes' negative impacts are extremely serious in developing countries with lower average income levels than in developed countries. Such impacts may be even more serious in some developing countries that cannot implement subsidy and other relief measures to counter price hikes. Substantial price hikes in international energy markets may make it difficult for developing countries to stably procure energy sources or secure stable domestic energy supply. In developing countries vulnerable to the expansion or escalation of blackouts, grave constraints may arise not only on economic activities but also on civic life, sanitation and safety.

The abovementioned IMF downside risk analysis also points out that high interest rate policies implemented to fight against inflation may risk plunging economically vulnerable developing and emerging countries into a debt crisis. If high interest rate policies make progress in developed countries, debt risks will increase in developing countries due to borrowing cost hikes, relevant downward pressure on their currencies and rises in their dollar-denominated net debt. In the first half of the 1980s, developed countries' high interest rate policies led to defaults and accumulated debt crises mainly in Latin America, creating a grave issue for relevant developing countries and the global economy. As national situations have changed since then, external debt conditions may now differ among developing countries. However, debt-related economic risks are surely rising in economically vulnerable developing countries.

The impacts of energy price spikes are highly regressive, exerting more serious effects on lower-income people and countries. We must not overlook the fact that while energy price spikes have become a serious problem among developed countries, developing and emerging countries are the most plagued by the spikes. As a matter of course, energy destabilization under the Ukraine crisis is a big problem in Europe facing gas shortage concerns and in the United States where gasoline price hikes have become a serious political problem. However, Group of Seven and other developed countries must understand that energy price spikes have become a grave problem that could impede economic growth and shake social and political stability in developing and emerging countries that are expected to make important contributions to global economic growth. Based on this understanding, developed countries should enhance not only their respective energy security but also global initiatives to stabilize international energy markets.

Contact: report@tky.ieej.or.jp
The back issues are available at the following URL
http://eneken.ieej.or.jp/en/special_bulletin.html