Summary of Chapter II: *Oil Prices and Global Imbalances*

World Economic Outlook, April 2006

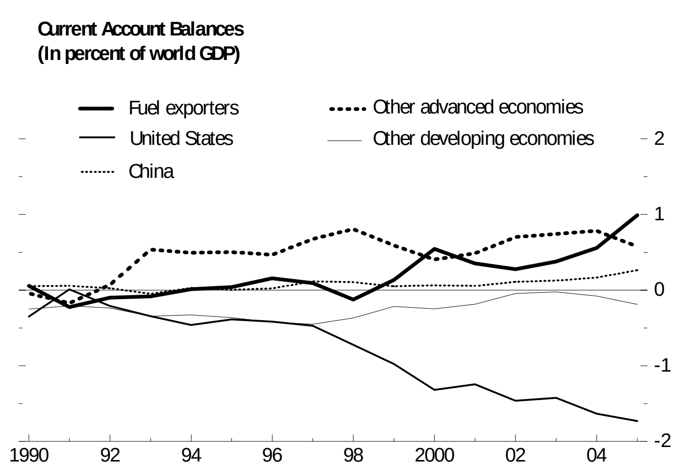
Prepared by Alessandro Rebucci and Nikola Spatafora
(Economists, Research Department)

Chapter II of this World Economic Outlook concludes that the contribution of higher oil prices to current account imbalances will persist longer than in the past, adding to the risks associated with these imbalances. Oil producers are being more circumspect about spending, mindful of past waste. Consequently, their current account surpluses, often exceeding 15 percent of GDP, will take time to revert to lower levels. And because the inflationary consequences of oil prices have been limited and external financing conditions have been benign—partly a result of globalization—oil consumers have not had to adjust as much as they did in the past.

The chapter also finds that the recycling of petrodollars through international capital markets is helping to keep interest rates low in the United States, thereby further fueling the current account deficit by supporting consumption. High international capital inflows have depressed yields on government bonds in the United States, by perhaps ¾ of a percentage point. Although the precise impact of petrodollars on financing conditions is difficult to isolate, the evidence suggests that some of these capital inflows are oil related.

Other key elements of the analysis in the chapter are:

- **High oil prices are widening the already large global external imbalances**. The higher oil price accounts directly for one-half (or about one percentage point of GDP) of the deterioration in the U.S. current account over the past two years.



- **The lack of adjustment in current account imbalances across the world is a concern**. As discussed extensively in recent issues of the *World Economic Outlook*, the large current account deficit in the United States increases the risks of a downward adjustment in the U.S. dollar, which would push U.S. interest rates up sharply and possibly lead to a recession.

- **The IMF analysis suggests that the adjustment of global current account imbalances would be aided by policy actions in both oil-consuming and oil-exporting countries**. For oil exporters, most of which are developing countries, measures to boost expenditures in areas that will have a permanent positive effect on growth and living standards (such as education and infrastructure) would be highly desirable both from a domestic perspective, and to help reduce global imbalances. Such spending would need to be supported by structural reforms to boost domestic supply, particularly of non-tradable goods and services. For oil consuming countries, the full pass-through of world oil prices into domestic energy prices to reduce oil consumption is needed.

- **Previously, current accounts in oil-importing countries have tended to adjust quickly to oil price increases**. Higher energy prices have led to a rise in interest rates, a slowdown in growth and domestic demand, and changes in exchange rates and asset prices. In past episodes of higher oil prices, for example, real GDP growth in the United States fell by up to ½ of a percentage point on average, while inflation increased by an annualized ¾ of a percentage point. The effects in other countries were somewhat smaller. This time, in part because of improved monetary frameworks and credibility, interest rates have not had to rise as much, and the impact of higher oil prices on the world economy has been smaller. Together with deeper global financial integration and the fact that spending in oil exporters has remained relatively subdued, current accounts are adjusting more slowly.