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Hosna Jahan Shewly

GLOBAL OIL PRICE RISE AND ITS FALLOUT ON SOUTH ASIA

Abstract

Energy use has been central to the development of world economy over many centuries. Among the energy sources, oil has gained a global predominance due to its relative versatility, low cost and transportability. The price of fuel oil, on which most of the wheels of industrial civilization run, has been rising sharply for the last couple of years. High oil prices are fuelling one of the biggest transfers of wealth from oil importing countries to oil exporting countries. On the other hand, oil price hike creates bigger economic problems for the oil-importing developing countries. In this context, this paper tries to elucidate the underlying factors causing this unremitting oil price hike and its consequences on the South Asian economy. Although the paper aims to focus on the oil price rise and its fallout, the conclusion analyses the current rapid fall in price and recent global economic downturn, and how the unexpected rise and fall of price affects weaker economies.

1. Introduction

Energy use has been central to the development of the world economy over many centuries. As countries develop their industries, rapid urbanization and higher living standards drive up energy use. Oil has gained a global predominance among energy sources in industrialized economies due to its relative versatility, low cost and transportability. The price of fuel oil, on which most of the wheels of

Hosna Jahan Shewly is Research Officer at the Bangladesh Institute of International and Strategic Studies (BIISS), currently doing Ph.D. in University of Durham, UK. Her E-mail is: hjshewly@yahoo.com

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industrial civilization run, has been climbing sharply for the last couple of years. Hence, most of the oil importing countries are suffering because of this hike, resulting in a poor global economic outlook. Since the 1970s, there have been three oil crises taking place in 1973/74, 1979/80 and 1990/91 respectively. In the first case, oil prices surpassed $10 per barrel. In the latter two occasions, oil prices peaked around $40. In the year 2008, the surge of oil prices has caught global attention as it reached $147 per barrel. Relationships of mutual dependence along the oil commodity chain have been consolidated in recent years. Therefore, oil prices still matter to the health of the world economy.[1]

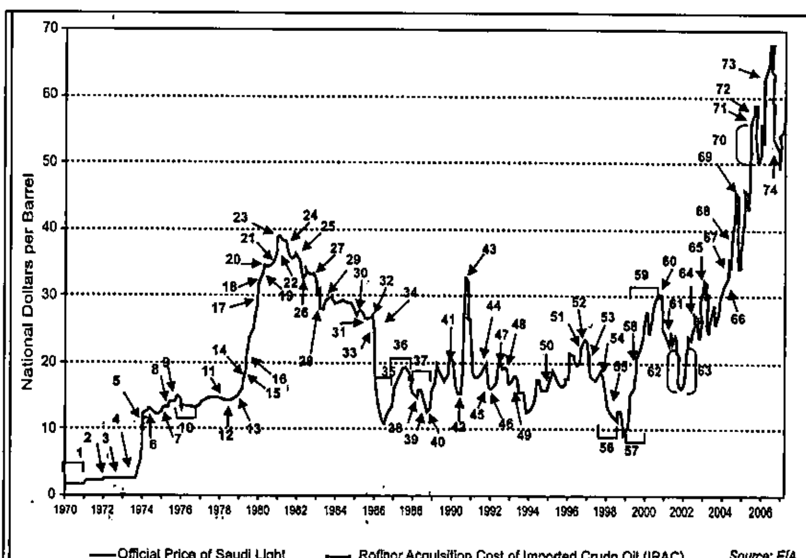
The vulnerability of the oil importing countries to higher oil prices varies markedly, depending on the degree to which they are net importers and the oil intensity of their economies. With oil hovering around $147 a barrel, South Asian countries with high import dependent energy markets are particularly vulnerable. The rapid surge in global oil prices has created political and economic stress all over South Asia with serious implications for India, Pakistan, Bangladesh and the region at large. In this context, this paper tries to elucidate the underlying factors causing this unremitting increase of oil price and its consequences for consumers and the South Asian economy. In the first section of the paper, a brief introduction is given. The second section discusses the oil price fluctuations since the first oil shock in 1970s until the present price surge .The third section of the paper focuses on the factors, which caused oil price rise in the past and present, in particular. Fourth section starts with a brief account of the impact of recent oil price hike on global economy. However, this section largely highlights the impact of oil price hike in South Asia with specific focus on India, Pakistan and Bangladesh. Although the paper aims to focus on the oil price rise and its fallout, the conclusion analyses the recent rapid fall in price and current global economic downturn, and how the unexpected rise and fall of oil price affects weaker economies.

[1] "Analysis of the Impact of High Oil Prices on the Global Economy", *International Energy Agency*, May 2004.

2. Oil Price Surge since 1970s

Since the 1970s, the Organisation of Petroleum Exporting Countries (OPEC) began to assert power by raising tax rate and posting prices. In 1972, it began its nationalisation process and raised prices in response to falling US dollar. However, the 1973 Arab-Israel war and subsequent Arab oil embargo increased oil prices. Since then, oil prices increased sharply and reached more than \$10 per barrel until the oil embargo ended in March 1974. Since 1974, oil prices increased slightly but a very sharp rise of prices occurred following Iranian revolution in 1979 and Iraq-Iran war in 1980. The OPEC raised oil prices by 14.5 percent on 01 April 1979.[2] According to the chart, oil prices increased very sharply till 1982 and reached almost \$40 per barrel during the Iran-Iraq war.

Figure 1: World Nominal Oil Price Chronology: 1970-2006



Different events such as US boycott of Libyan crude oil, cut off of Iraqi pipeline by Syria, Norway, UK and Nigeria's cut of prices

[2] Annual Oil Market Chronology, Energy Information Administration (EIA), available at: *http://www.eia.doe.gov/cabs/AOMC?Overview.html*, accessed on 10 September 2008.

created a steady oil price plunge till 1984. In addition, higher oil prices led to a reduction in demand as consumers and industry looked at ways of becoming more energy-efficient. The price rise also led to increased exploration for new sources of oil outside the traditional oil producing regions. Therefore, an oil price crash occurred during 1986 when crude prices fell to $11 per barrel. Since the oil price crash in 1986 till 2000, oil price fluctuated following different events but price did not sustain for too long. For example, there were temporarily high prices due to the Gulf crisis, but until 1995 oil prices remained stably in the range of $14 to $20 (Fig- 1). Before 2003, oil price was around $25 per barrel, which rose to $40 in 2004.

By the third quarter of 2005, it was $60 per barrel and reached $75 in mid 2006. After Israel launched attacks on Lebanon, oil prices reached a new high of $78 per barrel. Although, neither Israel nor Lebanon is an oil producing country, the conflict increased tension in the Middle East with prices soaring. Interestingly, oil price rise did not obstruct the world demand for oil. World crude oil demand grew an average of 1.78 percent per year from 1994 to 2006, with a rise of 3.4 percent in 2003-04. In terms of oil use, transportation is the largest sector and the one that has seen the largest growth in demand in recent decades. There was however a fall in early 2007. Nevertheless, the oil consumers are paying $4 billion to $5 billion more for crude oil every day than they did just five years ago, pumping more than $2 trillion into the coffers of oil companies and oil producing nations in 2007 alone.[3] Therefore, high oil prices are fuelling one of the biggest transfers of money from oil importing countries to oil exporting countries.

Conversely, throughout the first half of 2008, oil regularly reached record high prices, such as $90 per barrel in February and $119 in April 2008. Thus, prices have doubled from the rates seen in January 2007. The price of oil peaked on July 11, 2008 at $148 a barrel. Therefore, the current year can be considered as a year of the continuous breaking of records in oil price. However, this new high point in petroleum prices has arrived over five years, and many

[3] "Oil Price Rise Causes Global Shift in Wealth", *Washington Post*, 10 November 2007.

believe it will represent a new plateau even if prices drop back. Crude oil prices in the last several years have steadily risen from about \$25 bbl in August 2003 to over \$130 bbl in May of 2008, with the most significant increases happening within the last year. The present oil-pricing trend indicates that the current market conditions are unstable than ever. Kenneth Rogoff, a Harvard University economics professor and former chief economist at IMF, said, "There's never been anything like this on a sustained basis the way we've seen the last couple of years." The spectacular rise in the oil prices since 2004 has flummoxed the world. In effect, no concrete reason explains the phenomenal rise in crude oil prices from a mere \$30 per barrel in few years back to well above \$148 per barrel in 11 July 2008 – a rise in excess of 350 percent.

7-Jun	66.89
7-Jul	71.89
7-Aug	68.71
7-Sep	74.18
7-Oct	79.32
7-Nov	88.84
7-Dec	87.05
8-Jan	88.35
8-Feb	90.64
8-Mar	99.03
8-Apr	105.16
8-May	119.39
8-Jun	128.33
8-Jul	135.06

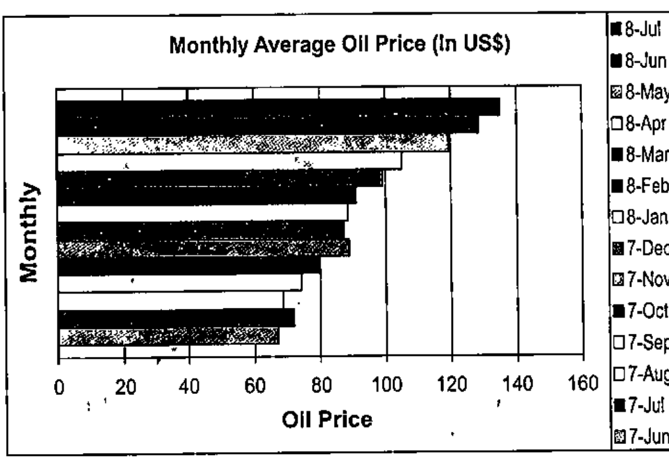


Figure 2: Monthly Average Oil Price: June 2007-July 2008

3. Factors behind Oil Price Hike: Past and Present

"The history of oil has, to a large extent, been a history of violent conflict, repression and interventionism."[4] Beginning in the late 1960s, the Persian Gulf acquired increasing significance for the US as a consequence of the British withdrawal from East of Suez,

[4] Michael Renner, "The New Geopolitics of Oil", *Development*, Vol. 49, No. 3, 2006, p. 56.

announced in 1968 and completed in 1971.[5] On the other hand, growing dependence of the US on Gulf oil and the gradually increasing Soviet involvement in the Persian Gulf increased super powers intervention in the region's key issues. Previously, oil price increased or dropped following different key world events, most of which are related to the conflict in the Middle East. For example, during the time of 1973 Arab-Israel War, the OPEC orchestrated the Arab oil embargo sending prices soaring by 400 percent in six months.[6] It was the first time when oil had been used as a political weapon putting pressure on the US, which in turn persuaded Israel to accept the UN mediation on the crisis. Subsequently, 1979 Iranian Revolution, 1980 Iran-Iraq War and 1990 Gulf War significantly affected the oil price. The Middle East oil is a strategic commodity not only because it is fuel for the most dramatic economic growth in the world but also because its access and use are becoming intimately intertwined with national security and power.[7] Similarly, oil plays an important, even central, role in the US foreign policy. Oil has also played an important role in a range of armed conflicts active during the 1990s and the current decade with a horrendous human, economic and environmental toll.[8]

The US is the biggest consumer of oil in the world and its continued dependence on the Middle East oil are two major factors for its interest in all the Middle East issues. Thus, the US is trying to secure stable oil supplies by attempting to dominate the Middle East. Perhaps, the most forceful exponent of this argument is Michael Klare who has argued, "the US has a two-pronged strategy that effectively governs the US policy toward much of the world. Although arising from different sets of concerns-one energy - driven, the other security driven - these two strategic principles have merged into a single, integrated design for American world dominance in the

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[5] Gary Sick, "The Evolution of US Strategy toward the Indian Ocean and Persian Gulf Regions" in Alvin Z. Rubinstein (eds.) *The Great Game: Rivalry in the Persian Gulf and South Asia*, New York, Praeger, 1983.

[6] "Why Oil Price keeps Rising", *BBC NEWS*, 09 June 2008, available at: http://news.bbc.co.uk/go/pr/fr/-/2/hi/business/7501939.stm, accessed on 14 July 2008.

[7] Mamdouh G. Salameh, "Quest for Middle East Oil: The US versus the Asia-Pacific Region, *Energy Policy*, Vol. 31, 2003; pp. 1085-1091.

[8] Michael Renner, *op. cit.*

21st Century."[9] Similarly, the neoconservative approach resembles the US oil strategy during the Cold War when, during Reagan Administration, Washington encouraged Saudi Arabia to suppress prices in order to cause economic damage to the Soviet Union.[10] In this context, control of oil may be seen as the centre of gravity of the US economic hegemony and, thus, the logical complement of its declared strategy of permanent, unilateral military supremacy. The US may be said to have a comparative advantage, relative to both its allies in Europe and Japan and its potential rivals, Russia and China, in the military and diplomatic exercise of geopolitical leverage *vis-à-vis* other states. Indeed, this may be an important channel of the US influence in the international oil industry.

As we have entered the new millennium, two very powerful geopolitical factors decisively determine oil prices. These two factors are the growing dependence of the US on imported oil, particularly from the Middle East and the Asia Pacific region's thrust for oil and the increasingly Chinese dependence on oil from the region. China's spectacular economic growth has led to a growing dependence on oil imports and China imported 31 percent of its total imports from the Middle East in 2000. Therefore, the dominant trend in the Asia-Pacific region is one of the growing oil dependence on the Middle East. As, Mamdouh G. Salameh argues, a new US-versus-Asia-Pacific scenario begins to emerge, which links global oil security to oil geopolitics in the Middle East and the Asia Pacific region.[11] Such dependence on Middle East oil exerted an upward pressure on the price of oil and will likely impact global oil supplies as the bulk of global oil supplies come from the Middle East. On the other hand, there is also a trend of diversification of oil import sources, which aims at securing stable oil supply reducing dependence on Middle East oil. For example, West Africa has emerged as a major diversification source for Asia Pacific countries since the 1990s because most of the West African crude oil contains low sulphur and

[9] Michael Klare, "Blood for Oil: The Bush-Cheny Energy Strategy", in *Socialist Register*, 2004, London, Merlin Press, 2003, p.180.
[10] Michael Renner, *op. cit.*
[11] Mamdouh G. Salameh, *op. cit.*

also because many refineries in the Asia Pacific region are designed to process locally produced low sulphur crude.[12]

The invasion of Iraq in 2003 may be seen as an expansion of US dominance over the Middle East and another attempt to control the global oil spigot. Iraq contains the second largest proven oil reserves (11 percent) in the world after Saudi Arabia. Iraq also potentially contains the world's second or third largest gas reserves.[13] The economic status is thus undoubtedly high. Following the Iraq war, the past several years have been quite tumultuous in the oil market. There has been considerable uncertainty-much of which caused by geopolitical factors affecting the oil exporters, such as general strike by opponents of the Chavez government in Venezuela, civil unrest in Nigeria, civil unrest in Iraq and US-Iran tensions. In 2002, Iraqi production averaged 2.1 million barrels per day under the UN Oil-For-Food programme.[14] Therefore, turbulence in the Middle East, the world's largest oil-producing region, has led to decreased exports, especially civil unrest in Iraq after the US invasion. Similarly, growing instability in West Africa contributes to supply decline.

A confluence of factors contributes for the present price increase. However, huge increase of demand and conflict/violence in oil exporting countries are two major factors causing the present unremitting increase of oil price. In this tight market even a rumour of supply disruption can send prices soaring, yielding huge profits for traders. World oil consumption continues to grow despite seven consecutive years of rising prices. In this regard, transportation sector is a major driver of oil consumption. There are now more than 603 million passenger cars on roads worldwide, plus another 234 million commercial vehicles-double the fleet of 1980.[15]

Demand has risen by about 3 million barrels a day since 2005 and is expected to rise by 32 million barrels a day in the next two

[12] *Ibid.*
[13] Philippe Le Billon and Fouad El Khatib, "From Free Oil to Freedom Oil: Terrorism, War and US Geopolitics in the Persian Gulf", *Geopolitics*, Vol. 9, No. 1, 2004, pp. 109-137.
[14] *Ibid.*
[15] Michael Renner, *op. cit.*

decades.[16] It is argued that the demand is at an all-time high fuelled by the continued breakneck economic expansion of the Indian and Chinese economies. China overtook Japan as the world's second-largest consumer of oil in 2003 and its demand for oil is growing at about 15 percent a year.[17] Besides, the US remains the world's largest oil consumer and high individual fuel usage continues to put pressure on crude stockpiles. Although the US is the world's largest consumer of petroleum, the demand growth is highest in the developing world. For instance, US consumption of oil increased 3 million bbl a day between 1995-05 while Chinese consumption of oil increased 3.6 million bbl a day in the same time frame. International Energy Agency (IEA) says that annual demand will rise by 2 percent up to 2012. On the other hand, some analysts argue that the global demand for oil is so intense that supplies may not keep pace because the supply/demand balance remains very tight at present. Therefore, any speculations over disruption of supply create oil price fluctuations. In addition, some of the major oil exporting countries is rapidly developing and they are using more oil drastically. In addition, world population grew faster than oil production, which is another large factor on petroleum demand. While the demand for oil is at an all time high, the slow down in oil supply growth contributed to price increase.

Unfortunately, much of the world's oil is concentrated in volatile regions, leading to fears of frequent and unpredictable disruptions to supplies. In addition to civil unrest in Iraq, violence in Nigeria and Algeria triggered oil price rise in early 2008. Militant groups in Nigeria's main oil-producing region have recently impeded about a quarter of its output. In view of the tighter supplies worldwide, terrorist and insurgent groups have increasingly targeted oil and gas installations to maximise both chaos and political gains. The assassination of the former Pakistani Prime Minister Benazir Bhutto increased oil prices because stability in Pakistan is important to US

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16 "What is Keeping Oil Prices so High?", *BBC NEWS*, 23 June 2008; available at: *http://news.bbc.co.uk/2/hi/business/7469124.stm*, accessed on 15 July 2008.

17 "What is Driving Oil Prices so High?", *BBC NEWS*, 02 January 2008, available at: *http://news.bbc.co.uk/go/pr/fr/-/2/hi/business/7048600.stm*, accessed on 15 July 2008.

policy in the Middle East. Tensions between the US and Iran have affected oil price since January 2008. As Jeremy Stretch remarks, "The broader geopolitical risk - with the uncertainties revolving around the news flow from Iran...is playing into market sentiment."[18] Recently, oil price has gone up to $147 per barrel after Iran's successful missile test. Iran has a tenth of world oil reserves. However, this event did not create any supply disruption but oil price increased. There were fears that an Israeli attack on Iran's nuclear installations could trigger a wider conflict and threaten traffic through the strategically vital Strait of Hormuz, used to ship 40 percent of the world's oil. Therefore, the speculative forces determine the latest price rise. Oil exporters say that the price surge cannot be explained by the fundamental ratio of supply to demand and point their fingers at market speculators. It is claimed that some traders are making huge amounts of money betting on the direction of prices, in turn forcing prices higher. Others maintain that traders are simply hedging their investments against future market developments to reduce risk. The US regulators are looking for evidence of market manipulation while the IMF is examining the role of traders in the price spike.

Geo-economics is another factor for the recent oil price rise. The falling dollar means oil prices are not rising in euros and pounds as fast as the dollar price suggests. The weak dollar makes oil cheaper for importers to buy dollar-denominated oil supplies. In recent years, the world is also suffering from different catastrophic events like cyclones, which contribute to recent oil price rise.

4. Impact of High Oil Price on South Asia

High oil prices are fuelling one of the biggest transfers of wealth from oil importing countries to oil exporting countries. Oil consumers are paying $4 billion to $5 billion more for crude oil everyday than they did just five years ago, pumping more than $2 trillion into the coffers of oil companies and oil pumping nations in 2007 alone.[19] Thus, oil price hike creates bigger economic problems

[18] "Crude Rises on Iran Missile Tests", *BBC NEWS*, 09 July 2008, available at: *http://news.bbc.co.uk/1/hi/business/7496823.stm*, accessed on 25 August 2008.

[19] Washington Post, *op. cit.*

for the oil-importing countries. On the other hand, the oil-exporting countries are sitting on their huge profit. Again, impact on the oil-importing countries also varies from developed to developing countries. For example, price rise slowed the US economic growth; however, it did not affect adversely the EU countries because of strong euros and pounds against dollar. On the other hand, as Britain produces almost all the oil it consumes, its economy has been cushioned against increasing oil prices.[20] Even though, consumption is also defying high prices. For example, new-vehicle sales in 2006 rose to 15.7 percent over 2005 in South Asia. Highly developed consumer nations have been better able to adapt. In Japan, which relies on imports for nearly 100 percent of its fuel, nearly every business enterprise is losing with the exception of Toyota.

The adverse economic impact of higher oil prices on oil-importing developing countries is generally even more severe than for OECD countries. This is because their economies are more dependent on imported oil and more energy-intensive, and in such countries energy is used less efficiently. The vulnerability of oil-importing countries to higher oil-prices varies markedly depending on the degree to which they are net importers and the oil intensity of their economies.[21] Hence, oil-importing developing countries face their own challenges and high oil prices are likely to first affect less affluent countries, particularly, the developing world with less discretionary income. In this regard, recent oil price hike adversely affected South Asian countries since they are heavily dependent on imported oil. Previously, state fuel subsidies shielded consumers in many nations from the price rise, but now most of them failed to do so. India, Bangladesh, Pakistan and Sri Lanka raised their regulated oil price. Therefore, the surge of oil price has triggered fears of over-inflation and slower economic growth.

4.1 India

Today, China and India, the world's second and sixth leading oil consuming countries respectively, are in worrisome situations because of their mounting dependence on imported oil. In 2006-07,

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[20] Chris Skrebowski, *Petroleum Review*, Energy Institute, London, 2008.
[21] IAEA, 2004, *op. cit.*

India's consumption of crude oil was around 147 million tons, of which only 34 million tons was produced domestically.[22] High oil prices in recent time severely affected India's industrial growth and airlines business. Industry registered a growth of 7 percent in the month of April 2008 as compared to 11 percent growth registered in the same month of the previous year.[23] The reason ascribed for the slump in industrial growth is surge in the oil prices globally that doubled in less than two years time. The impact of high fuel prices will be felt across the board by industry, leading to increased production costs and higher retail prices. Such higher retail prices may cause a fall in demand affecting the overall growth rate of the manufacturing sector, which has been a major contributor so far to the high GDP growth in India.

However, the run-up in oil prices after 2003 began eroding airline profits, and the future doubling of oil prices from May 2007 to May 2008 began to have a substantial impact on airline operations, forcing airlines to reduce flight schedules, and pushing weaker carriers into merger or bankruptcy. During the first half of 2008, at least twenty-five airlines worldwide entered bankruptcy or were forced to cease operations.[24] Domestic Indian air carriers have announced a hike in fares to cope with the increased prices of aviation turbine fuel. This in turn will affect the booming travel and tourism industry. Fuel accounts for 50 percent to 60 percent of airlines' total operating costs. Air India has withdrawn at least 20 services from different routes from 01 July while Jet Airways, the country's largest private airline, has withdrawn its low-cost subsidiary JetLite from 25 routes.[25] The losses confronting India's two of the biggest carriers - Air India and Jet Airways, each reporting losses of US $2 million a day - reflect the woes in the

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[22] "Oil Shocks", *Frontline*, Vol. 25, No. 13, 21 June - 04 July 2008.

[23] "Current State of Indian Economy", *Federation of Indian Chambers of Commerce and Industry*, New Delhi, June, 2008.

[24] For detail see *http://news.asiaone.com/news/Latest+News/Business/Story/A1Story20080708-75407.html*, accessed on 20 September 2008.

[25] "Indian Airlines Flush out Costs", *Asia Times* Online, 24 July 2008, available at: *http://www.atimes.com/atimes/South_Asia/JG24Df02.html*, accessed on 05 September 2008.

wider global industry.[26] The International Air Transport Association estimates that the global airline industry will record a loss of $6.1 billion this year as opposed to a net profit of $5.6 billion last year. Accumulated losses at India's airlines could reach $2 billion in 2008-09, according to the Center for Asia Pacific Aviation (CAPA).

In addition, the Planning Commission in its approach to the Eleventh Five Year Plan has estimated that high oil prices could affect the growth rate by up to 0.5 percent. The oil sector in India is dominated by the public sector, and consumer prices of sensitive energy products are subsidized.[27] At present, India spends billions of dollars subsidizing fuel for its citizens every year. By some accounts, state-run Indian oil firms are losing $100m a day.[28] Therefore, it is considered that the soaring cost of oil is having a significant impact on the country's economy. And if oil prices continue to rise, the problem will get much worse. In such a scenario, emerging economies like India which is among the largest oil consumers are going to be hard hit.

4.2 Pakistan

Pakistan has sharply raised fuel prices as the cost of crude oil continues to soar. For Pakistanis, the rise in the price of petrol was the fifth in four months. Natural gas prices in Pakistan rose by 46 percent between May 2007 and May 2008, which has been further increased by upto 31 percent in July 2008. Similarly, Pakistan increased petrol and diesel prices by 10 percent. Soaring oil and food prices have pushed inflation in Pakistan to its highest level in more than thirty years. Thus, high energy prices make Pakistan vulnerable because of its steady increase of energy consumption and high import dependence. Pakistan imports 80 percent of its crude oil from the Persian Gulf. For Pakistan, oil represented 28 percent of its imports in 2006-07 and the value of import is likely to increase by 50

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[26] *Ibid.*

[27] Krishna Sutaria and Jonathan Robins, "Running on Empty: South Asia's Food and Fuel Crisis", *South Asia Monitor*, No. 121, 01 August 2008.

[28] "High Oil Prices Hit Global Economy", *BBC NEWS*, 28 May 2008, available at: *http://news.bbc.co.uk/2/hi/business/7421778.stm#india*, accessed on 20 July 2008.

percent in 2007-08.[29] Therefore, it will affect Pakistan's foreign reserve, which is not very strong. Similarly, Pakistan is facing budget deficit because of the recent price hike. In addition, Pakistan is facing inflation rate of 9-10 percent currently while food inflation is 12-14 percent. Power and water crisis are also acute in recent time. Finally, oil price rise in conjunction with food price hike, droughts and terrorism severely affects its economy and also the life of the poor people.

4.3 Bangladesh

As the entire world is suffering because of the extraordinary rise in oil price, the condition of weaker economies like Bangladesh is still more precarious. Natural gas constitutes 68 percent of Bangladesh's energy basket, followed by oil (30 percent) and hydro (two percent).[30] The country produces 10 percent of its oil requirement and the rest is procured from international markets. The steep rise in oil prices over the past few years has increased the misery of people in Bangladesh who have already been suffering the effects of near double-digit inflation. In the budget for current fiscal year (2008-09), the government has withdrawn a large chunk of the oil subsidy, causing an increase of prices between 33 to 50 percent. This is so far the first time in the history of Bangladesh that oil prices jumped so high. Such price hike has affected the poor. A report on the impact of oil price hike by *Shamunnay*, a local think tank, said that the increased price of diesel and Kerosene would lead to inflation and create 400,000 new poor in Bangladesh. Significantly, low-income people are the principal consumers of these two oil products. Even with the latest price hike, the government will still have to spend Tk.100 billion (about $1.47 billion) in oil subsidies annually.[31] Certainly, it will affect the poor foreign reserves of Bangladesh. On the other hand, high increase of oil price will increase inflation. According to Atiur Rahman, a well-known

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[29] Krishna Sutaria and Jonathan Robins, *op. cit.*

[30] M. Shahidul Islam, "The Third Oil Shock: The Path Forward for Bangladesh", *ISAS Brief*, No. 71, 10 June 2008.

[31] Anand Kumar, "Surging Energy and Food Prices will Accelerate Economic Downturn in Bangladesh", *IDSA STRATEGIC COMMENT*, 30 July 2008.

economist, the rise of diesel price by 40 percent will increase inflation by 1.8 percent. Therefore, the latest price rises are a further blow to the poor people, 40 percent of whom live on less than $1 a day.

Despite large subsidies in Asian countries, domestic energy prices have increased 20-50 percent while fertilizer, irrigation and transport costs have increased 30-50 percent.[32] Similar scenario is evident in Bangladesh. Oil price hike has a chain effect in different sectors of the economy. For example, the price hike of diesel will mostly affect the agriculture sector of the country. Both irrigation and fertilizers are critical inputs to the production of high-yielding varieties of food grains but these are energy incentive. Hence, the present hike increases 23 percent production cost for the farmers. In addition, fuel price also increased transportation cost of food commodities. Therefore, among all the users of this essential commodity, the farmers are the worst hit. Accidentally, the latest oil price hike occurred in a very crucial moment of the country's economy as Bangladesh experienced an incredible natural hazard Sidr just six months before the price rise. Thus, Bangladesh has seen its rice imports swell by 300 percent in the last year, as a result of the damage caused by Cyclone Sidr.[33] Besides, international prices of basic food commodities have increased rapidly over the last three years. Bangladesh imports many food commodities and local market prices of all commodities were soaring since last year. However, new pricing of domestic fuel further increased cost of all essential commodities. Thus, Bangladeshi consumers are increasingly under pressure to meet their consumption needs. Sirajul Haq, a day labourer in Bangladesh who faces financial agony as the price goes up, says, "All the essential products prices are rising day by day, but my income is not rising accordingly."

Oil price rise also affects the garment sector of Bangladesh. According to the Bangladesh Garments Manufacturers and Exporters Association (BGMEA), the production cost of exportable apparel will go up by at least 15 percent due to fuel price rise. They will also have to pay more for transporting their consignments. This would

[32] Claude Mandil, "The Geopolitics of Oil after the Iraq War", *Speech*, IAEA, July 2003.
[33] Krishna Sutaria and Jonathan Robins, *op. cit.*

reduce the competitive edge of Bangladeshi export products and harm the country's overall industrial growth. Hence, oil price hike poses risks to Bangladesh's macroeconomic stability.

4.4 Other Countries in the Region

Almost all of Nepal's imports come in through India, including energy. When the state-owned Indian Oil Corporation (IOC), which supplies all of Nepal's oil, cut supplies to its neighbours by almost half in response to unpaid debts, the Nepal government raised domestic fuel prices by almost 25 percent.[34] It formed massive strikes around the country, shutting down the capital city of Kathmandu, and shaking up the new Maoist government. Similarly, Sri Lanka also increased domestic oil price. On the contrary, recent price hike did not make much difference in the Maldives, as its economy is predominantly dependent on tourism.

5. Conclusion

Oil prices remain an important macroeconomic variable. Higher prices can certainly inflict substantial damage on the economies of oil-importing countries and on the global economy as a whole. One of its best evidence is the rapid fall down of oil price since the middle of July. On 20 November 2008, oil was trading at $49 per barrel, which was a third of the pick price reached four months earlier. Until three months ago, there were speculations that oil price is heading for $200 per barrel in the upcoming days because of its high demand. During the first half of this year, there was a speculation that prices could rise and people would buy just as much oil. However, the reverse happened. As prices rose to unexpected high amount, it led to a global economic down turn. Hence, shrinking global economic growth has caused oil demand growth to slow down dramatically. The US is the biggest energy consumer of the world and its consumption of oil has fallen by about 1 million barrels per day (bbl/d) in 2008 compared to 2007. It is also expected to fall again by a smaller amount in 2009. According to the US Commerce Department, the gross domestic product, the broadest barometer of a nation's economic health, shrank at a 0.3 percent

[34] *Ibid.*

annual rate in the July-September quarter, 2008. This scenario is also similar in many other wealthy nations. British Prime Minister, Gordon Brown, recently states that the global economy is recently facing the 'third great oil shock' of recent decades. On the other hand, the Economist has dubbed the phenomenon as a 'slow motion oil-shock'.[35] A convergence of events has actually worked in this occasion. Incredible oil price, credit crunch, financial crisis since 2007 and collapse of the US housing market are the factors behind recent global economic recession and oil price fall.

Crude price now costs 60 percent less per barrel than its price four months before. However, such fall did not increase the demand, rather OPEC reduced oil output by 1.5 million barrels a day in an attempt to prevent further decline in oil prices. Previously, China and India's fast economic growth were considered as a factor for steady oil price rise. In contrast, China's growth, which soared by more than 11 percent last year, slowed to 9.0 percent in the third quarter of 2008, dragged down by economic slowdowns in key export markets such as the United States, Europe and Japan. Similarly, India's growth also down turned in recent months as discussed in the previous section. On the other hand, the fall of oil price is a relief for many developing countries who are struggling with economic down turn. For example, Bangladesh government reduced its domestic fuel price by 12 percent following the fall of oil price in the international market. Therefore, it will positively affect the commodity prices as well as production costs in the industrial sector.

However, all the South Asian countries especially India, Bangladesh and Pakistan are involved in manpower export to Middle East which might face a set back in near future. Recruiters fear a cut in demand for cheap labour due to the sharp fall in oil prices and the looming threat of a prolonged global recession. In such an eventuality, Bangladesh will suffer largely because foreign remittance is one of the major drivers of its national economy. More than five million Bangladeshis are now working abroad. With oil prices still going strong, almost half million Bangladeshi found jobs mainly in the Gulf countries and South East Asia in the first half of 2008. Huge fall of oil price will certainly affect the oil-dependent

[35] Surging Energy and Food Prices, *op. cit.*

economies of the Middle-eastern countries. In other words, if the US economy sneezes, the rest of the world will get cold. Therefore, present depression is likely to affect new investments in South Asia.

The year 2008 can be seen as an extraordinary year for oil market. In this year, oil prices fluctuated from a very high rate to a very low price. During the 1970s oil price rise, there was a response from both the supply and demand i.e., demand decreased because of high oil prices. The oil shock of 1970s resulted in long-term fall in crude oil prices and drop in the Saudi Arabia's market share. This time sharp rise of oil price followed by economic down turn and fall in price contributed to fears of an economic recession similar to that of the early 1980s. On the other hand, oil importing countries especially the developed countries are looking for alternatives sources of energy such as bio fuels or solar energy. Following the two oil shocks in 1970s, people have changed their oil consumption pattern and industries were forced to enhance fuel efficiency. South Asia is basically dependent on imported oil for its industrial and agricultural sectors. Therefore, they can also consider alternative sources of energy as well as enhancement of fuel efficiency. Though oil price at the moment is very low, it will not stay such for long. With the increase of economic growth, oil price will also go up. Therefore, it needs long-term strategy that will maximise the risks of severe supply disruptions and sky rocketing prices.