IFG Progress Digest

Historical Lessons on 1970s-1980s Oil Shocks As a Consequence of Middle East Conflicts

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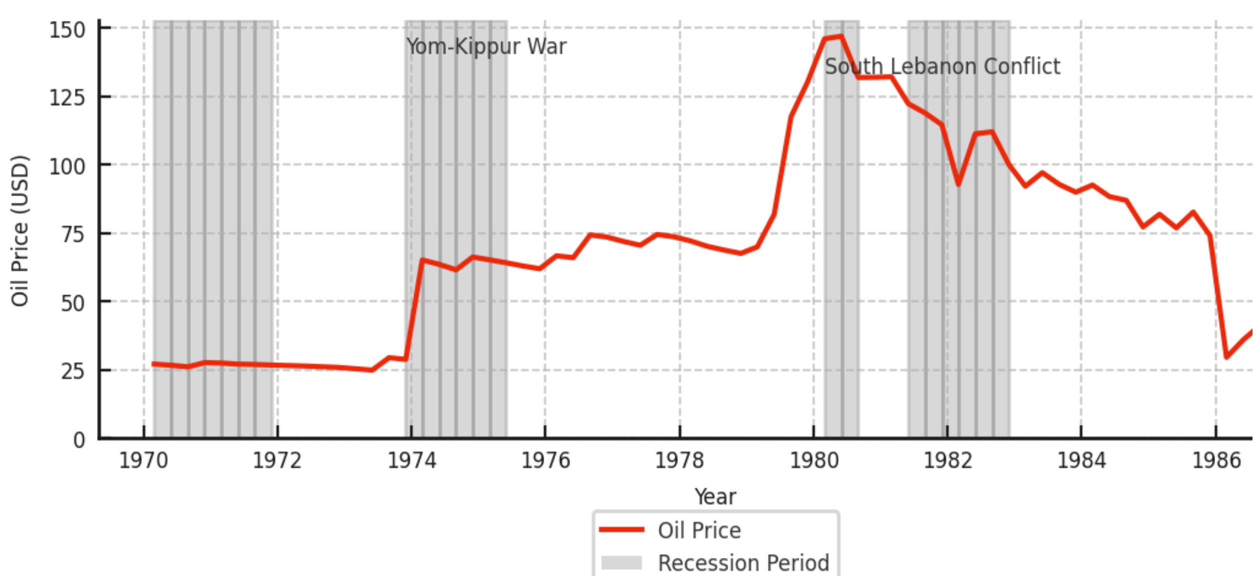
- *Historical oil shocks offer valuable insights for contemporary policymaking. The evolving nature of global energy markets and geopolitics necessitates adaptive strategies to navigate the complexities of resource-dependent economies and global market fluctuations.*
- *The 1970s-1980s oil shocks, caused by Middle East conflicts, challenged existing economic policies and led to strategic changes in energy dependence and geopolitical alignments. The oil price volatilities facilitated Indonesia's transition from an agrarian to a resource-rich economy, boosting its export performance through increased global demand for alternative energy sources like natural gas and coal.*
- *The oil shocks created a ripple effect in Indonesia's economy, increasing prices of export commodities like natural gas and coal, but did not necessarily translate to higher economic growth due to the increase of prices mainly driven by supply constraints. In contrast, the post-Covid period saw a synchronized recovery in these commodity prices, influenced by global demand resurgence and interconnected supply chains, differing from the supply-driven shocks of the earlier era.*

Exhibit 1. Crude Oil Price in 1970s-1980s Middle-East Conflicts



Sources: Macrotrends, IFGP Research

The Geopolitical Catalysts

The 1973 Arab-Israeli War, colloquially known as the Yom Kippur War, catalyzed one of the most significant disruptions in the global oil market in the 20th century. The conflict, deeply rooted in the geopolitical chessboard of the Middle East, was not merely a regional skirmish but a pivotal event with far-reaching global implications. The subsequent strategic decisions of the Organization of the Petroleum Exporting Countries (OPEC), predominantly led by the Arab oil-producing nations, were instrumental in shaping the economic landscape of that era.

The embargo imposed by these nations on the United States and other allies of Israel was not just a demonstration of oil as a potent geopolitical weapon but also a clear indication of the shifting dynamics of global economic power. The embargo resulted in an unprecedented quadrupling of oil prices, sending shockwaves through economies dependent on this crucial resource (Exhibit 1). The geopolitical conflict witnessed the West grappling with the reality of its vulnerability to oil supply disruptions, leading to a reevaluation of energy policies and a heightened sense of urgency in seeking energy independence.

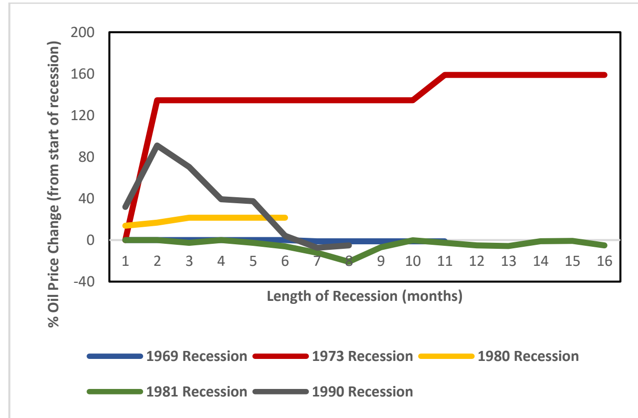
Economic Repercussions

The repercussions of the oil shocks were felt globally following the Middle East Conflicts of 1970s and 1980s, with varying degrees of severity across different economies. Western nations, heavily reliant on imported oil, faced the brunt of the crisis. The sudden spike in oil prices led to stagflation – a period characterized by stagnant economic growth and high inflation. This economic anomaly challenged the conventional Keynesian wisdom of the time, leading to a rethinking of economic policies and theories. The spike in oil price, driven mainly by supply constraints as a consequence of OPEC embargo, has proven to be sticky, and it took 6 months (in the 1980 South Lebanese Conflict) to 18 months (in the 1973 Yom Kippur War Period) before the oil price started to normalize (Exhibit 2).

Developing nations, particularly those non-oil exporting, were hit hard by the oil crisis. The increased cost of energy significantly affected their balance of payments, leading to increased borrowing and a subsequent debt crisis in many of these countries. The global economic landscape was reshaped, with a clear demarcation between the oil-rich and the oil-dependent nations. The surge in oil prices also led to a shift in consumer and industrial preferences, increasing the demand for alternative energy sources. This shift resulted in a significant increase in the prices of natural gas and coal, commodities that served as substitutes for oil in various sectors (Exhibit 3).

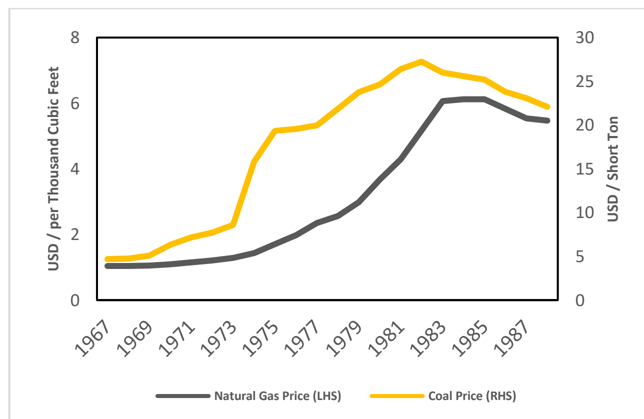
In Indonesia, a country with abundant natural resources, these global price dynamics had a notable impact. The initial phase of the crisis had a contractionary effect on the Indonesian economy, as the surge in oil prices led to increased costs of imported energy and inflationary pressures. However, as Indonesia ramped up its oil production and became a net exporter, the situation began to shift. Moreover, the increased global demand for alternative energy sources led to a rise in Indonesia's natural gas and coal exports, amplifying Indonesia's commodity export. (Exhibit 4).

Exhibit 2. % Change in Oil Price during Recession Episodes



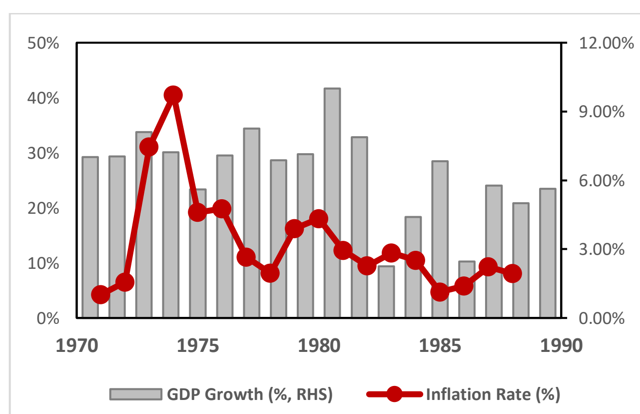
Sources: Macrotrends, IFGP Research

Exhibit 3. Co-Movements of Natural Gas and Coal Prices, 1970s – 1980s



Sources: Macrotrends, IFGP Research

Exhibit 4. Indonesia's GDP Growth and Inflation Rates, 1970s – 1980s



Sources: BPS, IFGP Research

The subsequent increase in oil revenues coupled with natural gas and coal export revenues provided a significant boost to Indonesia's economy. It enabled the government to invest in infrastructure, diversify its economy, and reduce its reliance on foreign aid. However, this windfall also brought challenges, such as the Dutch disease – a phenomenon where a boom in natural resources leads to a decline in other sectors of the economy. Indonesia's experience during this period offers valuable insights into the complexities of managing resource-rich economies and the importance of economic diversification.

Drawing Parallels with Modern Oil Markets

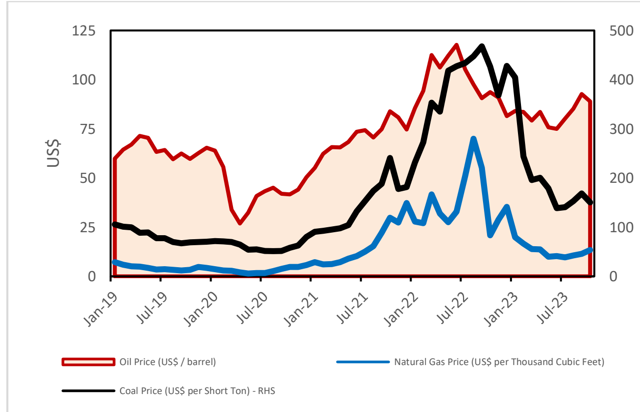
The oil shocks of the 1970s-1980s and recent events such as the post-Covid-19 economic recovery provide a fascinating comparative study. The evolution of the global oil market, now more interconnected and influenced by a broader array of factors, has led to new dynamics. Modern geopolitical events, while still impactful, do not necessarily mirror the direct influence seen in the past due to diversification in energy sources and advancements in renewable energy.

The Covid-19 pandemic, for instance, caused a significant but short-lived disruption in oil markets, showcasing the resilience and adaptability of modern economies. This contrast underscores the importance of understanding historical oil shocks in the context of an evolving global energy landscape. Indonesia's GDP growth that came after the commodity export boom reached an average of ~7.5% in 1970s. As opposed to the 1970s era, the significantly higher oil price post Covid-19 pandemic era was driven mainly by economic activity reopening, hence sudden surge in demand caused a demand-pull inflation in energies instead of supply shocks. Thus, demand-driven higher oil price tends to drive other commodity prices simultaneously, as can be seen in natural gas, coffee, and coal prices, which are among Indonesia's top 5 exports (Exhibit 5).

On the other hand, the rising tension in the Middle East starting at October 2023 might pose a strikingly similar commodity prices landscape to that in the 1970s-1980s period. Research produced by Bloomberg commodity team predicted that oil price could exceed US$100/barrel (up to US$150) in higher-geopolitical-risk scenario, where the conflict expands into a regional crisis (where Iran and several other OPEC members participate in the conflict), vs. near US$90 with relatively subdued geopolitical risk. Price volatility may remain elevated as long as the Middle East conflict is still not subdued. Another research from Barclays showed that higher oil price may negatively impact Indonesia's Current Account Balance.

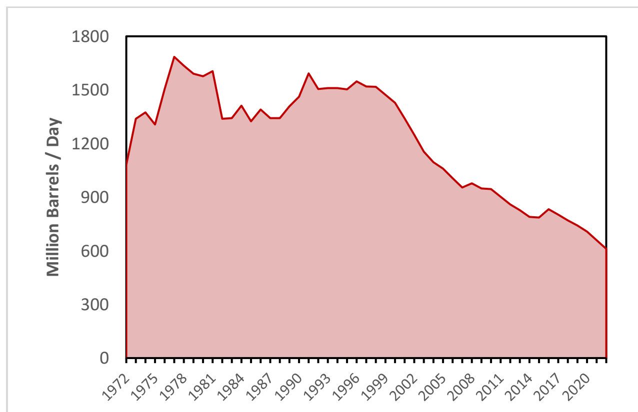
As can be learned in the 1970s era, higher oil price would not necessarily translate to economic growth boom if the price increase were induced by supply shocks. The main difference between the 1970s-1980s period and the current period is that Indonesia has now become the net importer of oil, due to low oil reserve in the country (Exhibit 6). Even though Indonesia might get some export boost due to increased natural gas and coal exports, those boosts will be offset by the higher imported oil price.

Exhibit 5. Co-Movements of Oil, Coal, and Natural Gas Prices, 2019 - 2023



Sources: Bloomberg, IFGP Research

Exhibit 6. Indonesia Oil Production, 1970s – 2020s



Sources: Kementerian ESDM, US EIA, IFGP Research Analysis

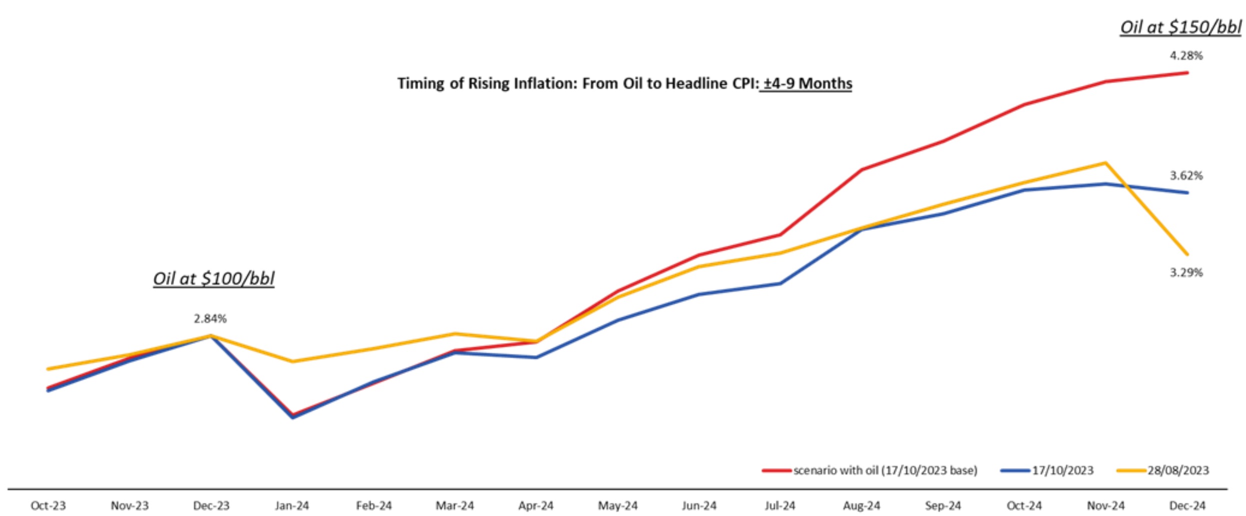
Hence, Indonesia's export value would not change much while its import value will tend to increase, leading to current account deficit in the short run. In addition, according to the predictive model derived from IFG Progress Economic Bulletin #10: Oil Price and Shipping Cost – Tailwind for Inflation, Indonesia's CPI Inflation for 2024 can rise to as high as 4.28% from the baseline inflation rate of 3.29% if oil price reaches US$150/barrel, adding more stress to the economy due to cost-push inflation that would dampen growth further, and making less room for the central bank (Bank Indonesia / BI) to cut its rate to support growth (Exhibit 7).

In summary, the oil shocks of the 1970s-1980s, triggered by Middle East conflicts, had profound and lasting impacts on the global economy, with diverse effects on different nations. The period was marked by a significant power shift in the oil market, from consumer-dominated to producer-dominated dynamics. For Indonesia, these events presented a complex mix of challenges and opportunities, influencing its economic trajectory and policy formulation.

Contemporary economic models and historical comparisons provide valuable insights into managing the complexities of a resource-rich economy and the importance of diversification and strategic planning, as well as early warning signal for the headwind risks ahead. The lessons learned from this period remain relevant, offering guidance for current economic policies and future outlooks in an ever-evolving global energy and geopolitical landscape.

Moreover, recent developments in the global energy sector offer additional perspectives. The transition towards renewable energy sources, driven by environmental concerns and technological advancements, is reshaping the global energy landscape. Countries are increasingly investing in solar, wind, and other renewable energy projects, aiming to reduce their dependence on oil and mitigate the impacts of future price shocks. Thus, in order to reduce fossil fuel energy dependency in the long-run, investing in renewable energy is becoming a very reasonable strategy to implement in Indonesia.

Exhibit 7. Inflation Scenario Under Oil Turbulence (Full Pass-Through Assumption)



Sources: IFGP Research (IFG Progress Economic Bulletin 10: Oil Price and Shipping Cost - Tailwind for Inflation

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