



By Robert N. Stavins

## Is Cheap Oil Good News or Bad?

Is the dramatic decline in oil prices since last summer a gift because of the enormous funds being saved? Or is it a curse impeding the development of renewable energy as well as new fossil-fuel sources, posing longer-term challenges?

First, why did prices fall? The dramatic price decline from August 2014 (\$96 a barrel) to March 2015 (\$44) was due, in part, to decreased demand, a function of slow economic growth in Asia, Europe, and elsewhere; endogenous, price-driven technological change leading to greater fuel efficiency; and policy-driven technological change, such as more stringent Corporate Average Fuel Economy standards in the United States. It was also due to increased supply, partly a function of the growth of unconventional U.S. oil production, a product of horizontal drilling and hydraulic fracturing. And, in the presence of all of this, Saudi Arabia decided not to restrict its output to prop up crude oil prices.

The fall in prices brings both good news and bad news. I begin with the latter. First, low crude oil prices are bad for the economic and political stability of some of the oil-producing/exporting countries, including Saudi Arabia, Russia, Venezuela, and Nigeria.

Second, it's frequently asserted

that low oil prices are bad news for the development of alternative forms of energy, including renewable sources. But in the United States, there isn't much effect on electricity generation from renewables (wind and solar), because renewable supplies compete with coal and natural gas, not with fuel oil.

Third, there can be — indeed, has been — a major impact in the U.S. motor fuels sector, where the market for biofuels (mainly ethanol) is negatively affected by low conventional gasoline prices. However, these impacts are somewhat muted by public policies, which directly or indirectly subsidize (or, in fact, require) the use of biofuels.

Fourth, low gasoline prices have resulted in decreased demand by consumers for motor vehicles with high fuel efficiency, and SUV and pickup truck sales have rebounded from previous lows. But these effects are also muted, to some degree, by public policies, including CAFE standards in the United States. Finally, low gasoline prices also have short-term effects in the form of more driving and fuel use by the existing fleet of motor vehicles, which is bad news in terms of emissions (and congestion).

Before turning to the “good news” about low crude oil prices, it's worthwhile noting that whether individual businesses find these low prices to be good or bad depends largely upon the economic sector in which they operate. For example, whereas commercial airlines are finally making profits, due to the low price of jet fuel, manufacturers of commercial aircraft will see lower demand for new planes if low jet fuel prices are sustained. The primary factor driving the major airlines to replace aircraft in their fleets is the lower operating costs due to greater fuel efficiency of new models. And, of course, low oil prices are systematically bad news for

oil producers, including the major U.S. companies.

Now for the good news — the upside of these significant changes in crude oil markets.

Low oil prices are unambiguously good for aggregate global welfare. This includes consumers in the United States, Europe, Japan, and South Korea. And, at least temporarily, OPEC seems to have lost its ability to set a price floor.

Low oil prices mean an increase in consumers' disposable income, amounting to nearly \$2,500 per U.S. household annually. If we subtract the income losses to U.S. oil producers, the net gain per U.S. household amounts to a bit more than \$800 per year, with gains accruing disproportionately to low-income households.

Turning to the environmental realm, there is also good news, or at least the possibility of good news. An opportunity for new, sensible energy and climate change policies has

emerged with these low oil prices.

First, now is the time to reduce — or better yet, phase out — costly and inefficient fuel subsidies, which exist in many

parts of the world, particularly in developing countries.

Second, with gasoline prices relatively low — and natural gas supplies holding down electricity prices, at least in the United States — there has never been a better time to introduce progressive climate policies in the form of carbon-pricing, whether via carbon taxes or through carbon cap-and-trade. Unfortunately, none of us should hold our breath waiting for that to happen.

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*Low oil prices mean new, sensible energy and climate change policies could emerge*