Impact of a 25% rise in oil prices, (relative to the baseline scenario)			
	1st year (2004)	2nd year	3rd year
Scenario 1: A temporary rise in oil prices			
Oil prices (%)	25	0	0
GDP growth (percentage points)	-0.34	-0.15	-0.04
Inflation (percentage points)	0.19	0.09	0.02
Scenario 2: A permanent rise in oil prices			
Oil prices (%)	25	25	25
GDP growth (percentage points)	-0.29	-0.38	-0.41
Inflation (percentage points)	0.22	0.28	0.31
Source: European Commission (Quarterly Report on the Euro Area, July 2004)			

World oil prices have been rising since April last year, when the price was USD 23 per barrel, to total an average of about USD 33 in the first seven months of this year (the average price of a basket of seven most important types of oil produced by OPEC; the price was USD 35.94 per barrel in July, USD 36.27 in May, and USD 34.61 in June). Oil prices climbed by 44% from April last year to end-June this year, however, this rise was just 29% measured in euro terms. During the oil shocks of the 1970s or 1999-2000, the respective rises exceeded 300% and 100% while, in the meantime, the euro-area economy's dependence (measured by oil imports relative to GDP or oil consumption relative to GDP) fell by over 40% according to the European Commission's estimates (Quarterly Report on the Euro Area, July 2004). Another factor limiting the impact of oil prices on the economy is the fact that taxes levied on fuel products in the euro area are dominated by duties calculated per physical unit, as opposed to ad valorem taxes. As a result, percentage changes in after-tax prices tend to be much lower than corresponding percentage changes in oil prices. The impact of oil prices on the economy also depends on the wage system, which can offset the fall in the purchasing power of employees by allowing a wage increase. Further, this impact can be bigger if the economy is going through the phase of overheating, rising inflation or a positive output gap, while it also depends on the confidence of economic entities, their responses and expectations. During the oil shock of 1999-2000, wages did not rise in the euro area, however, the saving rate declined as a result of the lower purchasing power of income. Given that the labour market is currently looser than in 2000 with unemployment still increasing, wage indexation is less prevalent. Considering all these elements, the **European Commission estimates** that this year's rises in oil prices will not have a particularly big **negative impact on growth** of the euro-area economies: a 25% rise in oil prices could reduce GDP growth by 0.3 of a percentage point, however, if oil prices continue to rise in the following two years the negative impact could increase to 0.4 of a percentage point, according to Scenario 2 (see table). It should be noted that if the level of end-June prices is retained, oil prices would rise by 12% compared to the average of 2003 (11% more than assumed in the European Commission's spring forecasts). There are, however, other risks that might additionally reduce economic growth: a relatively weak economic cycle in the euro area and the continuing negative output gap of these economies, as well as indirect negative influences on the world economy, especially on oil-importing emerging economies which also record a high energy intensity (China). The European Commission estimates that a 25% rise in oil prices in 2004 over the year before could push inflation up by an average of 0.2 of a percentage point. If oil prices rose further, the impact on inflation would be about 0.3 of a percentage point in the third year (Scenario 2; see table). However, price rises vary significantly from country to country depending on their oil intensity, the weight of energy prices in the consumer price index, the extent to which petrol price increases are buffered by adjusting taxes, the size of the pass-through effect of oil prices, which depends on the country's market characteristics and, finally, on the labour market and wages policy, that is higher wage claims, which would trigger a rapid monetary policy response, especially if these claims emerge in large countries.

Graph: **Oil price movements (Brent crude, USD per barrel)**