The Asymmetric Effects of Changes in Price and Income on Energy and Oil Demand

by Dermot Gately and Hillard G. Huntington

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Abstract

This paper estimates the effects on energy and oil demand of changes in income and oil prices, for 96 of the world's largest countries, in per-capita terms. We examine three important issues: the asymmetric effects on demand of increases and decreases in oil prices; the asymmetric effects on demand of increases and decreases in income; and the different speeds of demand adjustment to changes in price and in income. Its main conclusions are the following: (1) OECD demand responds much more to increases in oil prices than to decreases; ignoring this asymmetric price response will bias downward the estimated response to income changes; (2) demand's response to income decreases in many Non-OECD countries is not necessarily symmetric to its response to income increases; ignoring this asymmetric income response will bias the estimated response to income changes; (3) the speed of demand adjustment is faster to changes in income than to changes in price; ignoring this difference will bias upward the estimated response to income changes. Using correctly specified equations for energy and oil demand, the long-run response in demand for income growth is about 1.0 for Non-OECD Oil Exporters, Income Growers and perhaps all Non-OECD countries, and about 0.55 for OECD countries. These estimates for developing countries are significantly higher than current estimates used by the US Department of Energy. Our estimates for the OECD countries are also higher than those estimated recently by Schmalensee-Stoker-Judson (1998) and Holtz-Eakin and Selden (1995), who ignore the (asymmetric) effects of prices on demand. Higher responses to income changes, of course, will increase projections of energy and oil demand, and of carbon dioxide emissions.

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I Introduction

This paper analyses the determinants of commercial energy and oil demand, for 96 of the world's largest countries (listed in Appendix A), using 1971-97 data on a per-capita basis. Our primary interest is estimating the long-run response of demand to income changes. This parameter has important implications for future energy and oil demand, and for emissions levels for carbon dioxide and other pollutants – not to mention its effect on the future prices of oil and other forms of energy. However, estimation of this parameter is relatively sensitive to the assumed specification of demand as a function of income and price. We are especially interested in whether there are:

- asymmetric effects on demand between increases and decreases in price;
- asymmetric effects on demand between increases and decreases in income;
- differences in the speed of demand adjustment for changes in price and for changes in income;
- differences across countries and various groups of countries.

To address these issues, we examine various specifications of the demand equation for various groups of countries. Specifically, we test whether allowing for asymmetries in the demand response to price and income at the country level can improve our understanding of world energy consumption trends.

The paper was motivated by estimates of the income elasticity of energy and oil demand in the recent literature that seemed too low, both for developing countries and for high-income countries. For example, demand projections reported by the US Department of Energy's Energy Information Administration (EIA)[1], whose outlooks are used extensively by number of organizations, used an income elasticity of about 0.65 for energy and oil in Asian Developing Countries. In contrast, econometric estimates reported by Pesaran *et al*. (1998) are 1.0 or higher for those countries.

For higher-income countries, several recent articles in the literature on world energy and carbon dioxide emissions have reported income elasticities that are close to zero and sometimes negative – for examples, Schmalensee, Stoker, and Judson (SSJ, 1998), Judson, Schmalensee, and Stoker (JSS, 1999) and Holtz-Eakin and Selden (1995). For the highest-income OECD countries, SSJ (1998) estimated income elasticities that are quite low; in fact, their estimates were not even positive for the richest set of countries. The SSJ (1998) estimate of –0.30 for carbon emissions and –0.22 for energy implies that both per capita energy and carbon dioxide emissions will decrease with per capita income growth in the future. The HES (1995) analysis, although it does not report elasticities for different sets of countries, suggests an income elasticity of 0.36 for the highest-income countries considered by SSJ (1998).

The outline of the paper is as follows. In Section II we describe important features of the data, namely: the fundamental influence of income growth upon the demand for energy and oil; the asymmetric effects on demand of price increases and decreases; the asymmetric effects on demand of income growth and decline; and the substantial heterogeneity across countries, not only between the OECD and the Non-OECD countries but also among the Non-OECD countries themselves. In Section III we describe the various specifications of the demand equations that we shall examine. Section IV presents the econometric results for these alternative specifications of the demand for energy and for oil, for several groups of countries: for the OECD countries, for

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[1] See *International Energy Outlook 2001.*

the Non-OECD countries, and then for three sub-groups within the Non-OECD countries whose behavior differs substantially from each other: the Oil Exporters, the Income Growers (those developing countries with the fastest income growth), and the Other Countries. Section V summarizes our conclusions.

II. Background Issues

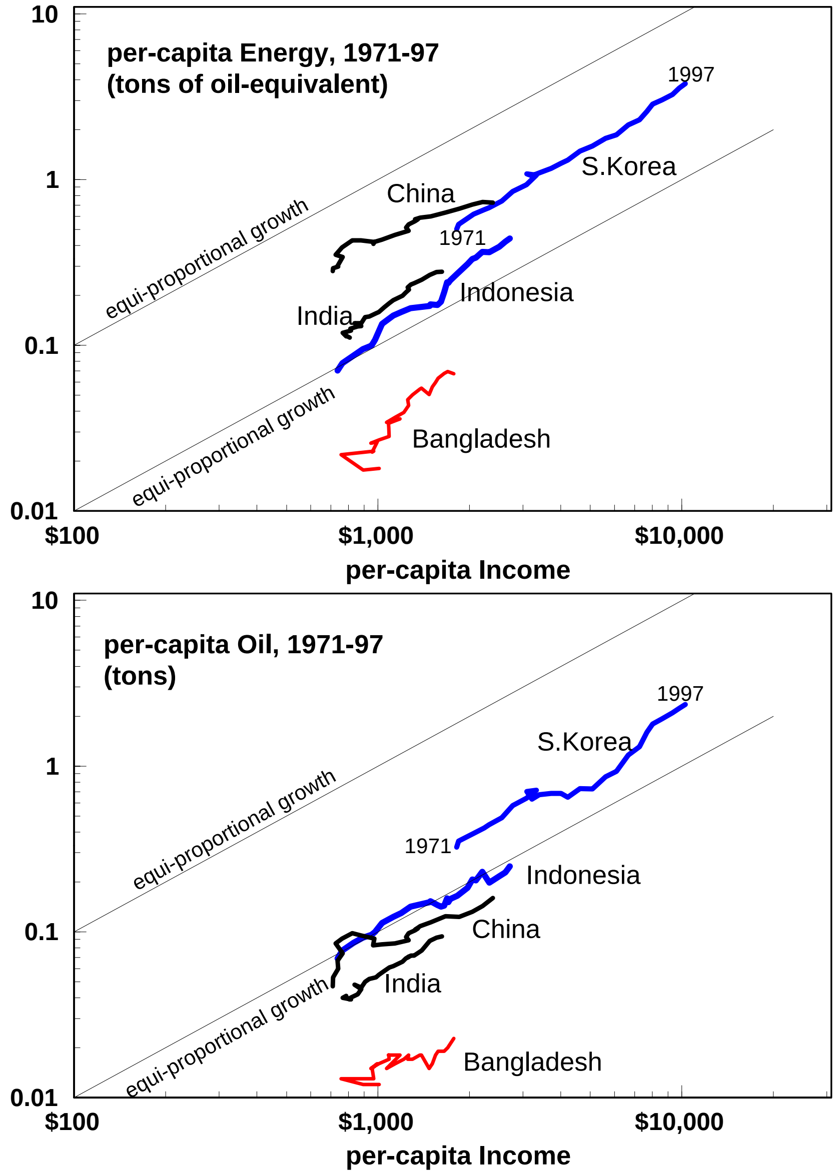
Important Determinants of the Growth of Energy and Oil Demand: Income and Price, and Heterogeneity across countries

We assume that a country's per-capita energy and oil demand are determined by changes in income and price. These effects on demand may be asymmetric. That is, the demand-reducing effect of price increases may not necessarily be completely reversed by a comparable reduction in price. Likewise, the demand-increasing effect of an increase in income may not necessarily be completely reversed by a comparable decrease in income.

In several graphs below, we illustrate important phenomena that we shall attempt to capture in our econometric modeling.

- Figure 1 shows fundamental role of income growth for developing countries' demand growth; it shows the 1971-97 time-paths of per-capita energy and oil demand vs. per-capita income, for five large Asian countries. We see that their energy and oil demand increased about as fast as income over this period.
- Figure 2 illustrates the difference between symmetric and asymmetric response of demand to changes in price.
- Figure 3 uses 1971-97 data for US oil demand and price to illustrate the phenomenon of asymmetric demand response to price changes: the demand reduction caused by price increases are not reversed when price falls.
- Figure 4 illustrates the difference between symmetric and asymmetric response of demand to changes in income.
- Figure 5 uses 1971-96 data for Saudi Arabia to illustrate the asymmetric effect on oil demand of changes in *income:* the demand-increasing effects of income increases are not reversed by income decreases.

Figure 1. Growth in Income and Demand, for 5 Asian Countries



The top graph of Figure 1 depicts the 1971-97 time-paths of per-capita energy demand against per-capita income (moving left to right, with increasing income), for five large Asian countries. The bottom graph shows the analogous time-paths for per-capita oil demand. In each graph, the scales are logarithmic -- which allows for order-of-magnitude differences among countries, and which facilitates growth-rate comparisons across countries and between energy [or oil] growth and income growth. Movement parallel to the diagonal lines indicates equi-proportional growth in energy and income; steeper [less steep] movement indicates that energy is growing faster [slower] than income. For example, in the top graph we see that South Korea's tenfold income growth was the fastest (greatest horizontal movement) and that its energy demand increased as fast as its income (movement parallel to the equi-proportional growth lines). China's energy demand grew more slowly than its income, while Bangladesh's energy demand grew faster than its income.

Figure 2. Demand Response to Oil Price Changes: Asymmetric and Symmetric

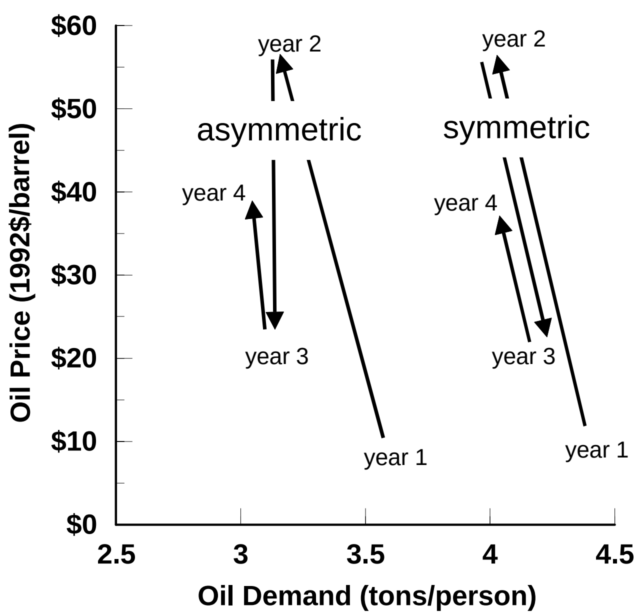


Figure 2 illustrates the difference between asymmetric and symmetric demand response to changes in price. If demand responds symmetrically, the demand-reducing response to a price increase (year 2) will be reversed by the demand-increasing response to a price cut (year 3). That is, the slopes will be the same. In addition, the response to any price increase will be the same, whether it is an increase in the maximum historical price (year 2) or only a price recovery (year 4).

In contrast, if demand responds asymmetrically, the demand-increasing effect of a price cut (year 3) will not simply reverse the demand-reducing effect of a price increase (year 2). Nor will a price recovery (year 4) necessarily reduce demand at the same rate as occurred with the first, larger price increase (year 2); the slopes need not be the same for the price increases in year 2 and year 4.

Figure 3. US Oil Demand Response to Changes in Oil Price: Asymmetric

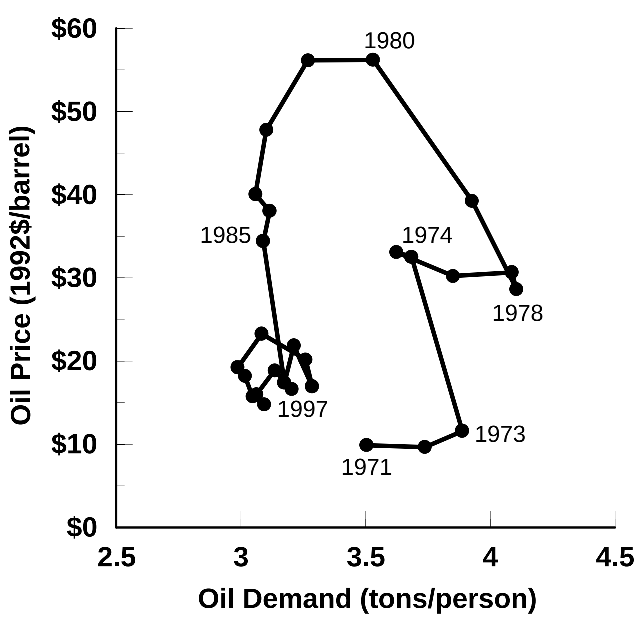


Figure 3 plots the 1971-97 path of US oil demand and oil price, which illustrates asymmetric demand response to price changes. The demand reductions caused by the oil price increases of 1973-74 and 1978-80 were not reversed by the oil price decreases of 1981-86. Even the demand-increasing effect of income growth (most obvious in 1971-73 and 1975-78) cannot obscure the asymmetric effect of the price changes.

Figure 4. Demand Response to Income Growth and Decline: Asymmetric and Symmetric

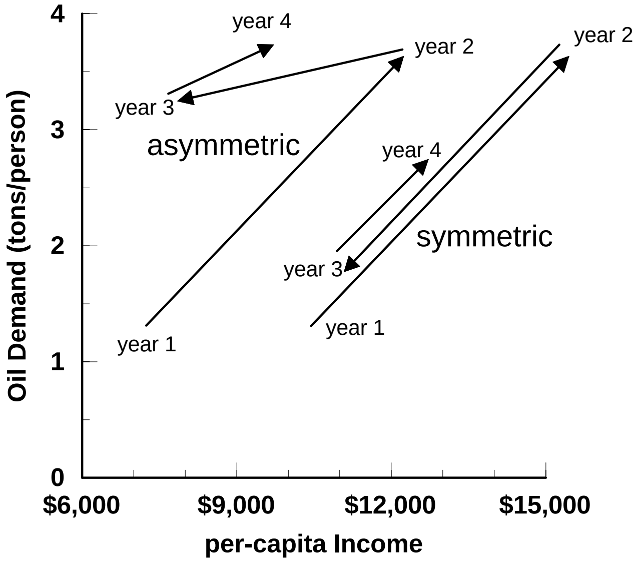


Figure 4 illustrates the difference between asymmetric and symmetric demand response to changes in *income*, analogously to Figure 2 -- except that the dependent variable, demand, is now on the vertical axis rather than on the horizontal.

If demand responds symmetrically, then the demand-increasing response to an income increase (year 2) will be reversed by the demand-reducing effect of an income decrease (year 3). Moreover, the demand response to an income recovery (year 4) will be that same as that to an increase in maximum historical income (year 2). All the slopes will be the same.

In contrast, if demand responds asymmetrically, the demand-reducing effect of an income reduction (year 3) will not simply reverse the demand-increasing effect of an income increase (year 2). Nor will an income recovery (in year 4) necessarily increase demand at the same rate as occurred with the first, larger income increase; the slopes need not be the same for the income increases in year 2 and year 4.

Figure 5. Saudi Arabia: Oil Demand Response to Income Changes – Asymmetric

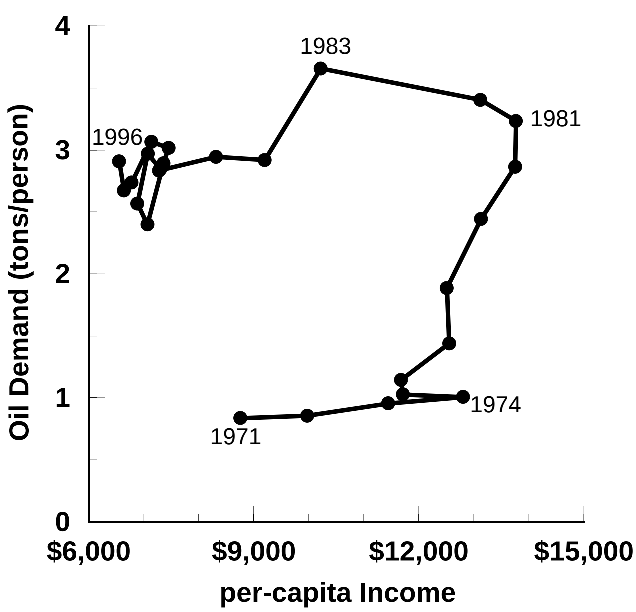


Figure 5 plots the 1971-96 path of oil consumption and income in Saudi Arabia, which illustrates an *asymmetric* demand response to income changes. The demand increases resulting from the income increases of 1971-81 were only slightly reversed by the income decreases of 1981-96.

The above graphs have illustrated the heterogeneity of experience for a few countries in a variety of dimensions: in their income growth (or decline), and in the response of demand to changes in income and to changes in price. To summarize the relationship between the growth of income and the growth of energy and oil demand for *all* countries, we plot in Figure 6 each country's energy and oil demand growth rates versus their income growth rates. The names and 3-letter abbreviations of the 96 countries appear in Appendix A. The OECD countries are plotted in the two graphs on the left, and the Non-OECD countries in the two graphs on the right. The top graphs plot countries' energy growth rate on the vertical scale and their income growth rate on the horizontal. Similarly for the two bottom graphs: oil growth rate on the vertical, and income growth rate on the horizontal. The scales on all four graphs are the same: ranging from –5% to +10% annual growth.

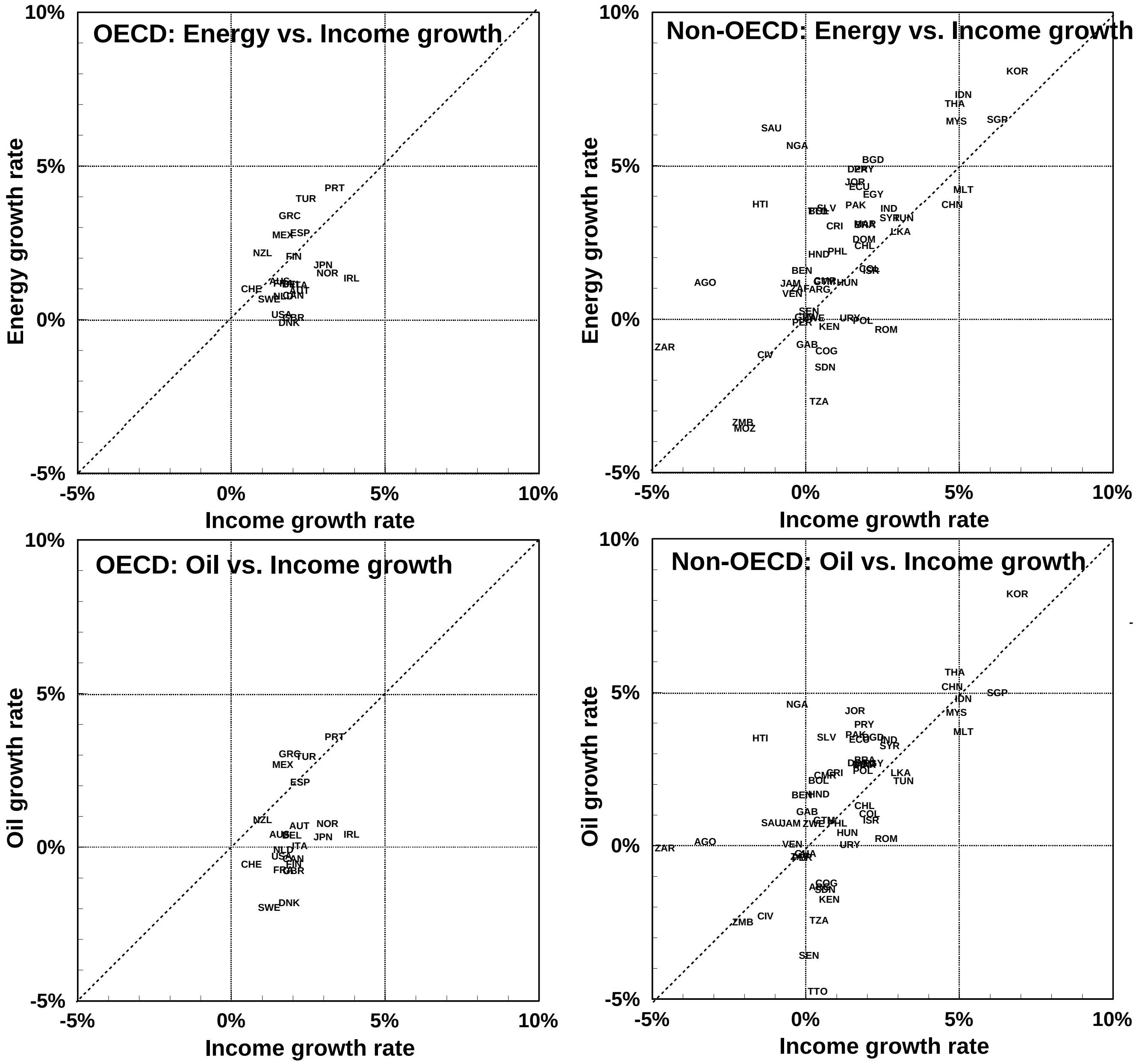
The OECD countries all had relatively similar rates of income growth of about 2% annually, with the rates ranging between 1% and 4%. But the Non-OECD countries had widely different rates of income growth. Several Asian countries had income growth of 5% or greater: South Korea, Singapore, Malaysia, Indonesia, Thailand, and China. In contrast, several other countries experienced negative growth: Zaire, Angola, Zimbabwe, Cote d'Ivoire, Haiti, Saudi Arabia, Nigeria, Jamaica, and Venezuela.

There were also important differences across countries in the relationship between energy growth and income growth, and between oil growth and income growth. In the simplest case, if energy (or oil) demand were growing at the same rate as income, a country's point would be plotted on the dashed diagonal line: the energy (oil) growth rate would be the same as the income growth rate. The closest to that case would be the upper left graph, OECD energy vs. income growth, where many of the points are close to the dashed diagonal line; only a few are far removed, with energy growth much lower than income growth: Ireland, Norway, Japan, Great Britain, Denmark, and the USA. In the lower left graph, OECD oil vs. income growth, most of the countries had oil demand growth rates considerably lower than their income growth rates, and many had negative growth rates for oil demand, reflecting the demand reductions in response to the two price shocks of the 1970s. Those countries whose oil demand grew as rapidly as their income were those that started at the lowest income levels in the OECD: Portugal, Greece, Mexico, Turkey, and Spain.

The Non-OECD countries exhibited much greater heterogeneity, not only in their rates of income growth but also in the relationship between their energy (or oil) growth rates and their income growth rates. Although some countries' energy and income growth rates were similar (e.g., Singapore at 7%, Tunisia at 3%, Chile at 2%, Cote d'Ivoire at –1.5%), there were many more countries whose energy growth rates were much greater than their income growth rates. Some had negative income growth but positive growth in energy demand, such as Saudi Arabia, Nigeria, Haiti, and Angola. Others had positive rates of income growth but negative growth in energy demand: Romania, Kenya, Congo, Sudan, and Tanzania. Similarly heterogeneous were the Non-OECD countries' relationships between oil demand growth and income growth: countries with virtually no income growth had oil demand growth that ranged from about +5% (Nigeria) to -5% (Trinidad & Tobago).

This heterogeneity, within the Non-OECD especially, will frustrate our efforts to use a standard econometric specification. We address this difficulty below, by clustering the Non-OECD countries into three groups that are somewhat more homogeneous: the Oil Exporters, the Income Growers, and Other Countries.

Figure 6. Energy and Oil Demand Growth vs. Income Growth: average annual % growth rates 1971-97



III. Demand Model

Data: Sources and Units

- Income, 1971-97: Real GDP per capita in constant dollars (Chain Index), expressed in international prices, base 1985. Sources: Data for 1971-92 from Penn World Tables 5.6. Data for 1993-97 calculated from growth rates of deflated PPP per-capita income data from World Bank, 1999 World Development Indicators.
- Energy Consumption, 1971-97: Total Final Consumption of "modern", commercial energy only (excluding "Combustible Renewables and Waste": traditional biomass fuels such as wood) in tons of oil-equivalent per person; Source: International Energy Agency.
- Oil Consumption, 1971-97: Total Final Consumption of oil products plus Oil used in Transformation (e.g. for electricity generation) in tons per person; Source: International Energy Agency.
- Population 1971-97, US Census Bureau, International Data Base, Table 1 www.census.gov/ipc/www/idbnew.html.
- Price of international crude oil[2], 1971-97: US Dept. of Energy, Energy Information Administration, Refiner Acquisition Real Cost of Imported Crude Oil, 1992$/barrel.

Definitions

D_{ct} log of per-capita demand, either energy or oil, in country c in year t.

Y_{ct} log of real per-capita GDP, in country c in year t

P_t log of real price of oil

Model Specification

Various specifications shall be examined for the demand for energy (or oil) and the results presented and compared. This approach addresses the heterogeneity across countries and the likelihood that some specifications will be more appropriate for some groups of countries than for others. It also takes account of an important conclusion from the surveys by Dahl (1991, 1993, 1994), that the estimated income and price elasticities are dependent upon the specification chosen. We estimate reduced-form price and income responses in a single pooled equation of demand for major groups of countries. We will refer to these "reduced-form" responses as elasticities, even though they have not been estimated from a structural model specifying both supply and demand conditions. A structural model that included energy supply conditions would be a useful extension, but this approach appears to go beyond current understanding of world supply behavior and available data. Moreover, our interest in forecasting and understanding future oil and energy consumption does not require structural parameters.

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[2] It would be preferable to have refined petroleum prices for the oil equations and delivered energy prices for the energy equations for each country. However, this data is unavailable for most countries, especially in the developing world. Analysts frequently ignore all prices when pooling data from many countries; instead they employ year-dummy variables that could incorporate energy prices, but could also represent technology and other time-dependent events. Rather than ignore prices altogether, we will include the world price of oil as an important independent variable in estimating energy and oil demands. Since delivered oil and energy prices are unavailable for most countries, we apply the consistent treatment that the world crude oil price is the primary price variable of interest in our specifications.

The simplest specification makes current demand a log-linear function only of current income:

(1) $D_t = k + \gamma Y_t$

A second specification would allow demand to be determined by current and past values of income, in which the weights for past values of income decline geometrically.

(2) $D_t = k + \gamma Y_t + \gamma\, \theta\, Y_{t-1} + \gamma\, \theta^2\, Y_{t-2} + \ldots$

Such a specification, commonly called a Koyck-lag equation, is equivalent to the following function of current income and lagged demand:

(2′) $D_t = k_0 + \gamma Y_t + \theta\, D_{t-1}$

We expect that the lagged-demand coefficient θ would have a value between 0 and 1. The implied speed of adjustment to changes in income, measured by 1- θ, could range from instantaneous (when θ = 0) to very slow (when θ approaches 1).

A similar Koyck-lag model could also assume that demand is determined by both income and price together with lagged demand[3]:

(3) $D_t = k + \beta P_t + \gamma Y_t + \theta\, D_{t-1}$

This specification assumes that the effects of past price levels decline geometrically, and at the same rate as the effects of past income levels. That is, the speed of demand adjustment (1-θ) is the same for changes in price and for changes in income.

Since it not necessarily true that the speed of demand adjustment to changes in price would be the same as the speed of demand adjustment to changes in income, we also consider a specification in which lagged-adjustment coefficients for price θ_p and income θ_y are estimated separately:

(4) $D_t = k + \beta\, P_t + \beta\, \theta_p\, P_{t-1} + \beta\, \theta_p^2\, P_{t-2} + \ldots + \gamma\, Y_t + \gamma\, \theta_y Y_{t-1} + \gamma\, \theta_y^2\, Y_{t-2} + \ldots$

Equivalently, we have[4]:

(4′) $D_t = k_0 * (1- \theta_p) * (1- \theta_y) + (\theta_p + \theta_y) * D_{t-1} - (\theta_p * \theta_y) * D_{t-2} + \beta\, P_t - \theta_y\, \beta\, P_{t-1} + \gamma\, Y_t - \theta_p\, \gamma\, Y_{t-1}$

More complicated specifications of the demand equation take account of two important asymmetry phenomena:

- imperfect price-reversibility: the demand response to a price increase is not necessarily reversed completely by an equivalent price decrease, nor is the demand response to an increase in the maximum historical price necessarily the same as the response to a price recovery (sub-maximum increase);
- imperfect income-reversibility: analogously, the demand response to an income increase is not necessarily reversed by an equivalent income decrease, nor are the effects of all income increases necessarily the same.

The phenomenon of imperfect price-reversibility has been analyzed extensively, initially by Dargay and Gately; see Dargay (1992), Gately (1992, 1993), Dargay and Gately (1994 , 1995a, 1995b), Gately and Streifel (1997), Walker and Wirl (1993), and Haas and Schipper (1998). Energy consumption decisions differ from many others in the economy in that they are tied closely to the capital stock for energy-using equipment. The basic idea is that higher energy prices induced investment in more energy-efficient equipment and retrofitting of existing capital,

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3 This specification is closest to the one whose results are most commonly reported in Pesaran *et al.* (1998).

4 Such a specification is derived in Johnston (1984), equation 9-14, page 347.

such as greater insulation. But when prices fell, these responses were not reversed symmetrically. Certain retrofitting such as building insulation requires large sunk costs; when energy prices fall, such retrofitting is not reversed. In addition, technological change induced by past energy price increases have dramatically altered the attributes of the energy-using capital stock such that today's consumers do not go back to earlier vintages when the price falls. For example, automobile technology has advanced considerably in a number of dimensions, including fleet efficiency. When fuel price increases were reversed, there may well have been more intensive usage, such as driving more miles or adjusting thermostats to more comfortable levels, but the improved fuel-efficiency was not abandoned. Thus, the responses to price increases and decreases could potentially be quite different.[5]

In this approach, we use the following three-way decomposition of (the logarithm of) price: the cumulating series of increases in the maximum historical price, the cumulating series of price cuts, and the cumulating series of price recoveries (sub-maximum increases in price).

(i) $P_t = P_1 + P_{max,t} + P_{cut,t} + P_{rec,t}$;

where P_1 = log of price in starting year t=1, which is 1971

$P_{max,t}$ = cumulative increases in log of maximum historical price; monotonically non-decreasing: $P_{max,t} \geq 0$

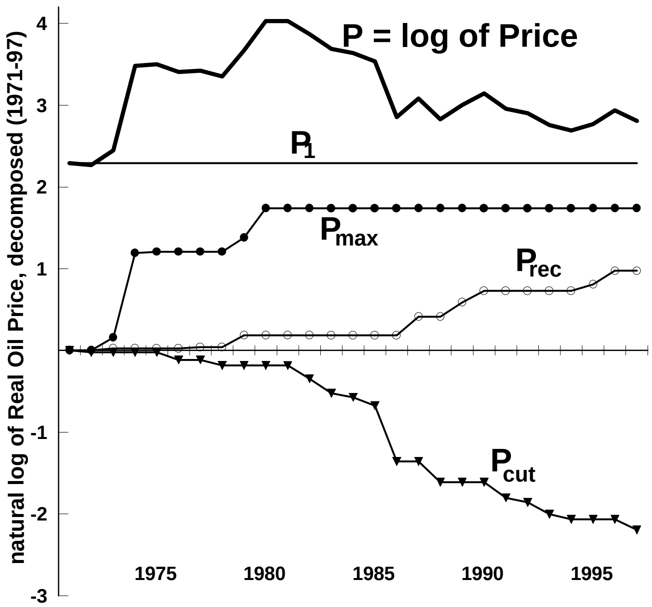
$P_{cut,t}$ = cumulative decreases in log of price; monotonically non-increasing: $P_{cut,t} \leq 0$

$P_{rec,t}$ = cumulative sub-maximum increases in log of price; monotonically non-decreasing: $P_{rec,t} \geq 0$

These three types of price changes correspond to the three price changes that are shown in Figure 2, in years 2, 3, and 4 respectively. Figure 7 depicts the (log) price of oil and its decomposition into three price series.

[5] Observed asymmetries in the oil demand response to the world crude oil price could be due to various reasons: (1) there is asymmetry between demand and delivered product prices, and/or (2) there is asymmetry between a country's delivered product prices and the world crude price (for example, if delivered prices rose when crude price rose but did not fall when crude price fell). Similarly, asymmetry in energy demand could be in its response to price or in the response of delivered fuel prices to the world crude oil price. Although price controls, taxes, and alternative fuel mixes could all complicate this story, we believe that it is essential to include a price variable, no matter how imperfect, to adequately test the hypotheses of interest.

Figure 7. Decomposition of the Logarithm of Price



We also argue in this paper that the demand effects of changes in *income* (as well as price) are not necessarily perfectly reversible, which most demand equations assume implicitly. The hypothesis of imperfectly income-reversible demand is suggested in Dargay-Gately (1995, Fig. 19, p. 132), in which the effects on demand of income increases are not symmetric to the effects of income decreases. Possible explanations for such asymmetry include the following. Some sectors may expand more strongly than others when the economy grows, while other sectors may decline more strongly than others when the economy contracts; these sectors may have different energy intensities. In addition, even when incomes decline in many developing countries, the process of urbanization may continue, requiring a continuing shift from traditional biomass fuels toward modern, commercial fuels

To examine this possibility we use an approach analogous to our price decomposition. We decompose the logarithm of per-capita income into three component series: the cumulating series of increases in maximum income, the cumulating series of income declines, and the cumulating series of income recoveries (sub-maximum increases in income).

(ii) $Y_t = Y_1 + Y_{max,\,t} + Y_{cut,\,t} + Y_{rec,\,t}$;

where Y_1 = log of GDP in year t=1, which is 1971;

$Y_{max,\,t}$ = cumulative increases in log of maximum historical per-capita GDP;

monotonically non-decreasing: $Y_{max,\,t} \geq 0$

$Y_{cut,\,t}$ = cumulative decreases in log of per-capita GDP;

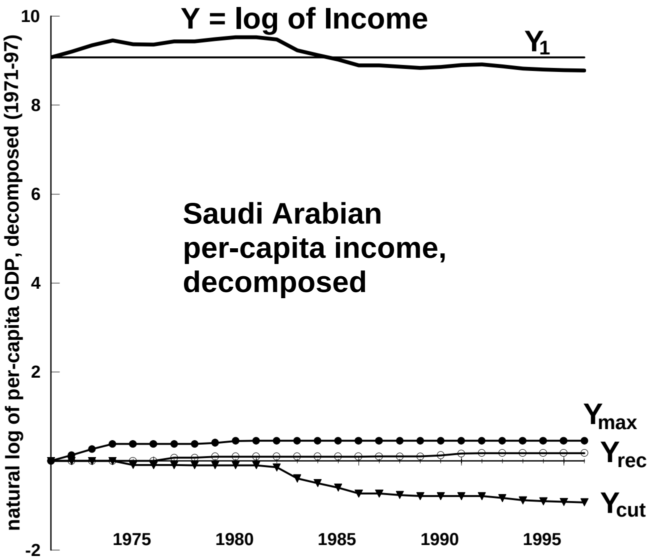
monotonically non-increasing: $Y_{cut,\,t} \leq 0$

$Y_{rec,\,t}$ = cumulative sub-maximum increases in log of per-capita GDP;

Monotonically non-decreasing: $Y_{rec,\,t} \geq 0$

These three types of income changes correspond to the three income changes that are shown in Figure 4, in years 2, 3, and 4 respectively. Figure 8 depicts the log of per-capita income for Saudi Arabia and its three-way decomposition.

Figure 8. Decomposition of the Logarithm of Per-capita Income



Combining the decomposition of price (i) and the decomposition of income (ii) into equation (4′), and combining the constants into a single constant k_1 gives us the following:

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\begin{aligned}
(5)\quad D_t = k_1 &+ (\theta_p + \theta_y) * D_{t-1} - (\theta_p * \theta_y) * D_{t-2} \\
&+ \beta_m P_{max,\, t} + \beta_c P_{cut,\, t} + \beta_r P_{rec,\, t} \\
&- \theta_y * (\beta_m P_{max,\, t-1} + \beta_c P_{cut,\, t-1} + \beta_r P_{rec,\, t-1}) \\
&+ \gamma_m Y_{max,\, t} + \gamma_c Y_{cut,\, t} + \gamma_r Y_{rec,\, t} \\
&- \theta_p * (\gamma_m Y_{max,\, t-1} + \gamma_c Y_{cut,\, t-1} + \gamma_r Y_{rec,\, t-1})
\end{aligned}
$$

In the econometric results below, we use pooled cross-section/time-series data for various groups of countries, using energy (or oil) demand for each country, income for each country, and the price of oil, with a separate constant estimated for each country – what is called a "fixed effects" model.[6] In the most general specification, in which both income and price are decomposed and the lagged-adjustment coefficients for income and price are estimated separately, we estimate the following regression:

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\begin{aligned}
(6)\quad D_{c,t} = k_{1c} &+ (\theta_p + \theta_y) * D_{c,t-1} - (\theta_p * \theta_y) * D_{c,t-2} \\
&+ \beta_m P_{max,\, t} + \beta_c P_{cut,\, t} + \beta_r P_{rec,\, t} \\
&- \theta_y * (\beta_m P_{max,\, t-1} + \beta_c P_{cut,\, t-1} + \beta_r P_{rec,\, t-1}) \\
&+ \gamma_m Y_{max,\, t} + \gamma_c Y_{cut,\, t} + \gamma_r Y_{rec,\, t} \\
&- \theta_p * (\gamma_m Y_{max,\, t-1} + \gamma_c Y_{cut,\, t-1} + \gamma_r Y_{rec,\, t-1})
\end{aligned}
$$

where k_{1c} are the constants for the individual countries and the other parameters are the same across countries.

[6] See Hsaio (1986).

The following can be said about the lagged-adjustment coefficients:

θ_p lagged price coefficient; $0 \le \theta_p \le 1$

$1-\theta_p$ is the speed of adjustment to changes in P;

if $\theta_p = 0$: adjustment to price change is instantaneous; no lag

θ_y lagged income coefficient; $0 \le \theta_y \le 1$

$1-\theta_y$ is the speed of adjustment to changes in Y;

if $\theta_y = 0$: adjustment to income change is instantaneous; no lag

Normally we would expect the price-lag coefficient to be larger than the income-lag coefficient; that is, we expect that demand adjusts more slowly to price changes than to income changes:

$0 \le \theta_y \le \theta_p \le 1$

With regard to the price coefficients, we expect that:

$\beta_m < 0$ demand response to change in P_{max}

$\beta_c < 0$ demand response to change in P_{cut} ; note that $P_{cut} < 0$

$\beta_r < 0$ demand response to change in P_{rec}

Normally we would expect that, in absolute values, $\beta_c < \beta_r < \beta_m$

With regard to the income coefficients, we expect that:

$\gamma_m > 0$ demand response to change in Y_{max}

$\gamma_c > 0$ demand response to change in Y_{cut}; note that $Y_{cut} < 0$

$\gamma_r > 0$ demand response to change in Y_{rec}

Normally we would expect the relative values to be $\gamma_c < \gamma_r < \gamma_m$

That is, we expect demand to rise more rapidly when income rises than it would decrease when income falls, and rise most rapidly when a new maximum income is reached.

IV. Econometric Results

Next we summarize the econometric results for the various specifications of the demand equations for energy and oil, for several regions. First we present results for the OECD countries, and then for the Non-OECD countries. Given substantial heterogeneity within the Non-OECD countries, as suggested by Figure 6 above, we then present results for more homogenous clusters of countries: the Oil Exporters, the Income Growers (developing countries with income growth exceeding 2% per annum), and then for the Other Countries.

As noted above, we emphasize the effects of alternative specifications upon the income and price elasticities; this is an important result from the surveys by Dahl (1991, 1993, 1994). We shall illustrate this for each of the regions, describing in detail the estimated elasticities that result from alternative functional specifications.[7]

IV.1 OECD Countries

Table 1. OECD Countries' Results

		Income coefficients				Oil Price coefficients				Lagged adj.coef.		Long-run Income Elasticity	Long-run Price Elasticity
fuel	eq.#	Y	Ymax	Ycut	Yrec	P	Pmax	Pcut	Prec	Income	Price		
energy	2	0.08								0.86		0.57	
energy	3	0.05				-0.03				0.87		0.39	-0.20
energy	3a	0.15					-0.04	-0.01	-0.04	0.88		1.28	-0.35
								reject equality					
energy	6	0.59					-0.03	-0.01	***-0.02***	0.00	0.90	0.59	-0.24
								reject equality					
oil	2	0.03								0.90		0.31	
oil	3	***-0.02***				-0.05				0.91		-0.18	-0.59
oil	3a	0.16					-0.08	-0.04	-0.08	0.89		1.48	-0.71
								reject equality					
oil	6	0.53					-0.08	-0.04	-0.05	0.06	0.88	0.56	-0.64
								reject equality					

Notes: i) A coefficient that was not statistically significant is boldfaced, italicized and underlined.

(ii) The equation # listed above correspond to the equation # described in Section III above. The letter "a" following an equation number (e.g. 3a) indicates an asymmetric response was allowed, via decomposition of price and/or income.

(iii) When price or income is decomposed, we performed a Wald test of the null hypothesis that the three coefficients are equal. Below those coefficients we indicate whether the equality hypothesis was rejected or not rejected, using a 5% cutoff for the F-statistic probability.

(iv) Long-run income elasticity was calculated as $\gamma / (1- \theta_y)$; similarly for price. When income [price] is decomposed, the long-run elasticity for income [price] refers to changes in Y_{max} [P_{max}].

(v) The Adjusted R^2 for almost all specifications were very high, usually above 0.99.

OECD: Energy Demand

Using a Koyck-lag equation with only income and lagged demand (equation 2), the income elasticity is 0.57. Also including price, a standard Koyck-lag equation (3), with price, income, and lagged demand, the income elasticity falls to 0.39.

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[7] As noted by Pesaran (1998, p.66), there appears little point in applying unit root and cointegration tests on annual time series that span such a short period. The literature establishes the low power of these tests in small samples.

If we allow demand to be imperfectly price-reversible (equation 3a), not only do we see the coefficients for price increases to be much larger than for price decreases, but also we see that the income elasticity is increased significantly, to 1.28. However, this estimate seems implausibly large.

When adjustment coefficients for both price and income are estimated separately as in equation (6) (results not shown in Table 1), the income adjustment coefficient is estimated to be negative but not significantly different from zero. With a modified version of equation (6) that estimates an adjustment coefficient only for price (with a zero coefficient for adjustment to income changes, i.e. instantaneous adjustment), the resulting income elasticity is 0.59, with a price elasticity of –0.24. This is the preferred specification[8], equation (6).

Thus, if the economy grows by 3% per annum, energy demand will grow by 1.8% per annum, and energy intensity will decline by 1.2% per annum if energy prices do not change. This long-term trend toward decreasing energy intensity is sometimes called by energy modelers the economy's "autonomous energy efficiency improvement, AEEI". It is autonomous in their models because it is unrelated to energy price movements. In fact, it could be due to trends in technology or in the structural mix of the economy, or other factors that have not been included.

These OECD energy results can be contrasted with results of others such as the energy and climate change estimates of SSJ (1998), JSS (1999), and HS (1995). Those studies performed a valuable contribution by emphasizing that the response of energy demand and carbon emissions to income changes may be nonlinear. SSJ (1998) and JSS (1999) estimated the response for 10 different country income groups using a spline technique, while HS (1995) estimated a polynomial function that shows the response to lessen for higher-income countries. For the highest-income OECD countries, their estimated income elasticities are substantially below the 0.55 level that we estimate for the OECD in this paper. In fact, their estimates are not even positive: SSJ (1998) estimate an income elasticity of –0.30 for carbon emissions and –0.22 for energy. Although HS (1995) did not report elasticities, their estimated coefficients for carbon emissions imply an income elasticity of 0.36 for the highest-income countries considered by SSJ (1998).[9] Demand projections using income responses below zero would allow for unwarranted optimism that per-capita demand would decrease with per-capita income growth.

Due to the unavailability of a full set of international energy prices, those authors ignored price entirely and used yearly time variables to capture the complex asymmetric effects of prices and other factors. Moreover, they assumed that these time-related variables have the same effect on all countries because they pooled all countries in one large equation. However, our results below show that the price response in OECD countries is dramatically different from its effect in the developing countries. In other words, much important information is lost by ignoring both the heterogeneity of different countries and the effects of price on demand, especially its asymmetric effects.

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[8] Decomposing income as well as price is not warranted. When such an equation was estimated, a Wald test could not reject the hypothesis that the income coefficients are equal.

[9] Since these studies ignore price, they do not incorporate any lagged adjustment terms. Energy demand and carbon emissions are functions of country intercept terms, time intercepts, and income which enters the equation nonlinearly. SSJ (1998) estimates a 10-knot piece-wise-linear spline function; HS (1995) use a polynomial function with income and income squared terms. HS (1995) adjusts for autocorrelation, but SSJ (1998) does not .

OECD: Oil Demand

With a simple specification with income and lagged price, the income elasticity is 0.31. However, when price is also included, equation (3), the income elasticity becomes negative, although not statistically significant. This would indeed be a puzzling result, that OECD oil demand would decrease when OECD income increased.

To resolve this puzzle, we allow demand to be imperfectly price-reversible (equation 3a). The resulting decomposed price coefficients indicate that price increases have a much greater impact on demand than do price decreases; a Wald test of the hypothesis that these three coefficients were equal allowed us to reject the hypothesis. Moreover, the income coefficient is positive and statistically significant – although the income elasticity of 1.48 is implausibly large.

When adjustment coefficients for both price and income are estimated, in equation (6), the income adjustment coefficient was estimated to be positive, although not significantly different from zero. The resulting income elasticity is 0.56. Again there was clear evidence of imperfect price-reversibility: a Wald test allowed us to reject the hypothesis that the price coefficients were equal. Decomposing income as well as price was not warranted: a Wald test could not reject the hypothesis that the income coefficients are equal (results not shown).

The preferred specification is equation (6). The long-run price elasticity is –0.64, which is substantially above energy's response to price. Its long-run income elasticity is 0.56. Thus, if the economy grows by 3% per annum, oil demand will grow by 1.65% per annum, and oil intensity will decline by 1.35% per annum if price does not change.

These results confirm our assertion that wrongly assuming demand to be perfectly price-reversible will bias downward the income elasticity; similar results were presented in Gately (1993). They also help to explain other estimates of income elasticities of demand for energy and oil in the literature that are much smaller, and sometimes even negative, when the price effect is ignored for the richest countries.

IV.2 Non-OECD Countries

Table 2. Non-OECD Countries' Results

		Income coefficients				Oil Price coefficients				Lagged adj.coef.		Long-run Income Elasticity	Long-run Price Elasticity
fuel	eq.#	Y	Ymax	Ycut	Yrec	P	Pmax	Pcut	Prec	Income	Price		
energy	1	0.86										0.86	
energy	2	0.16								0.84		0.86	
energy	3	0.17				-0.03				0.84		1.02	-0.16
energy	3a		0.19	0.16	0.31		-0.03	***-0.01***	***0.002***	0.83		1.11	-0.17
			reject equality				cannot reject equality						
energy	4	0.44				-0.02				0.00	0.88	0.44	-0.16
energy	6		0.52	0.48	0.31		***-0.01***	***-0.01***	***0.03***	0.00	0.86	0.52	-0.01
			cannot reject equality				reject equality						
oil	1	0.72										0.72	
oil	2	0.15								0.82		0.72	
oil	3	0.15				-0.03				0.82		0.84	-0.16
oil	3a		0.18	0.15	0.22		-0.05	***-0.001***	***0.02***	0.82		1.01	-0.27
			reject equality				cannot reject equality						
oil	6		0.53	0.46	0.07		-0.03	***-0.01***	***0.04***	0.00	0.84	0.53	-0.18
			reject equality				reject equality						

Notes: see Table 1.

Non-OECD: Energy Demand

With the simpler specifications (equations 1, 2, or 3) the estimated income elasticity is between 0.86 and 1.02. When income and price are decomposed in a specification with lagged demand, equation (3a), there is partial evidence for asymmetric response to changes in income changes and in price, and the income elasticity (1.11) is slightly higher than in the previous specifications.

Notice that the income elasticity for either equations (3) or (3a) appears relatively high and slightly higher than unity. In fact, the estimated response of 1.02 in equation (3) appears comparable to what we will estimate for the same equation in the following sections for the oil exporters (1.11 in Table 3), for fast growers (1.17 in Table 4), and for all others (0.93 in Table 5). Thus, one might be tempted to conclude that disaggregation of the Non-OECD countries would not change the estimates of the income elasticities. However, this conclusion would hold only if equation (3), which imposes the same adjustment process on price and income, is properly specified.

When the lagged-adjustment coefficients are estimated separately for income and price, that coefficient for income is negative (results not shown) – implying faster-than-instantaneous adjustment to income changes. Hence we examined a modified version of equation (4) in which income's lagged-adjustment coefficient was assumed to be zero and the lagged-adjustment coefficient was estimated only for price. A similar variant of equation (6) allowed for asymmetric response to changes in both income and price. In both specifications, (4) and (6), the estimated income-elasticity was relatively low: either 0.44 or 0.52.

The preferred specification would be equation (4), rather than equation (6). For the latter equation, a Wald test did not allow us to reject the hypothesis that the decomposed-income coefficients were equal. Moreover, in equation (6) none of the decomposed-price coefficients were statistically significant, although a Wald test did allow us to reject the hypothesis that the coefficients were equal.

Non-OECD: Oil Demand

The econometric results for oil were generally similar to those for energy. For the simpler specifications, the estimated income elasticity ranged from 0.72 to 0.84. When income and price were decomposed, in equation (3a), there was evidence of asymmetric response for income and perhaps for price. The relative magnitudes of the decomposed-income coefficients were somewhat unexpected: the largest coefficient was for income recoveries Y_{rec}.

Separate estimation of the lagged-adjustment coefficients resulted in the lagged-income coefficient being negative (results not shown). In a modified version of equation (6), income's lagged-adjustment coefficient was assumed to be zero and the lagged-adjustment coefficient was estimated only for price. There was evidence for asymmetric response to changes in both income and price: a Wald test allowed us to reject the hypotheses that the decomposed-income coefficients were equal; similarly for the decomposed-price coefficients. Of the three decomposed-price coefficients, only that for P_{max} was statistically significant. The estimated income-elasticity was 0.53. This equation (6) would be the preferred specification.

Note that for both energy and oil demand, the apparent income-elasticity for all Non-OECD countries grouped together is relatively small: only slightly greater than 0.5. This is no greater than that for the OECD countries. Such an estimated income elasticity is surprisingly small, especially with reference to Figure 1, where the time-paths for the 5 Asian countries move parallel to the equi-proportional growth lines, suggesting an income elasticity that is approximately 1.0.

However, these Non-OECD countries are extremely heterogeneous, as suggested in the scatterplots of Figure 6 above. Thus we shall cluster these countries into more homogeneous sub-groups, so that their differing behavior may be characterized more accurately. One natural group of Non-OECD countries is the Oil Exporters, who have abundant domestic resources of oil and gas, and whose prices for domestic consumption are often significantly below export prices. A second cluster of countries that we shall examine separately is what we call the Income Growers: those developing countries that have had average growth in per-capita income exceeding 2% annually. The third cluster consists of the Other Countries. These clusters of countries are identified in Appendix A.

IV.3 Non-OECD Oil Exporters

Table 3. Non-OECD Oil Exporters' Results:

		Income coefficients				Oil Price coefficients				Lagged adj.coef.		Long-run Income Elasticity	Long-run Price Elasticity
fuel	eq.#	Y	Ymax	Ycut	Yrec	P	Pmax	Pcut	Prec	Income	Price		
energy	1	0.42										0.42	
energy	2	0.11								0.89		0.97	
energy	3	0.12				***-0.02***				0.89		1.11	-0.18
energy	1a		1.67	***0.11***	0.74							1.67	
				reject equality									
energy	2a		***0.10***	0.14	0.36					0.87		0.82	
				reject equality									
oil	1	0.30										0.30	
oil	2	0.11								0.73		0.41	
oil	3	0.11				***0.002***				0.70		0.37	0.01
oil	1a		0.97	0.09	0.14							0.97	
				reject equality									
oil	2a		0.31	0.08	***0.11***					0.66		0.91	
				reject equality									

Notes: See Table 1.

Oil Exporters: Energy Demand

In the simplest specification, equation (1), with just income but not lagged demand, the income elasticity is 0.42. When lagged demand is also included, equation (2), the income elasticity increases to 0.97. However, the lagged adjustment coefficient for income (0.89) seems implausibly high, implying that only 11% of the adjustment to changes in income would be accomplished in the first year.

With the standard Koyck-lag specification – equation (3) with both income and price -- the coefficients have the expected signs, although price is not significant. In fact, for all the equations examined, price is never statistically significant, whether standard price or decomposed price is used, or whether the income lag adjustment is estimated separately from the price lag coefficient. This should not be surprising for these countries, whose prices for domestic consumption are often significantly below export prices and little correlated with export prices.

If only decomposed income is used in the specification, equation (1a), then we see evidence of asymmetric response: the coefficient for increases in Y_{max} is much larger than for the other two coefficients; the coefficient for Y_{cut} is small and not statistically significant.

When lagged demand is also included with decomposed income, equation (2a), the income asymmetry result is blurred. The lagged coefficient is statistically significant, but the implied speed-of-adjustment for income changes is implausibly slow, at.13 (= 1-.87): that is, in the first year after the change in income, only 13% of the ultimate demand adjustment is accomplished. Moreover, the income coefficients have unexpected relative magnitudes: those for Y_{max} & Y_{cut} are similar in size but that for Y_{rec} is by far the largest.

Which would be the best specification for energy demand? In terms of Adjusted R^2 and Sum of Squared Residuals (not shown), the preferred specification would seem to be (2a), with decomposed income and lagged demand. However, two aspects of this specification are troubling: the high value for the lagged adjustment coefficient -- implying an implausibly slow speed of adjustment to changes in income -- and the surprising relative magnitudes of the coefficients for decomposed income. Hence none of the specifications yield results that are especially good.

Oil Exporters: Oil Demand

In the simplest specification with income only, equation (1), the income elasticity is surprisingly small, at 0.30. With income and lagged demand, equation (2), the long-run income elasticity is not much larger, at 0.41. If we also include price, equation (3), the results are no better. The price coefficient has the wrong sign, although it is not statistically significant. As with energy demand, the price coefficient is never statistically significant with the correct sign – whether standard price or decomposed price is used, or whether the lagged adjustment coefficient for price is estimated separately from that for income.

In a specification with only decomposed current income, equation (1a), the results are asymmetric; the coefficient for increases in Y_{max} is much larger (0.97) than the coefficients for Y_{cut} and Y_{rec}. A Wald test allows us to reject the hypothesis that the coefficients are equal.

If we decompose income and also include lagged demand in the equation, equation (2a) the results show asymmetric coefficients for income changes. A Wald test allows us to reject the hypothesis that the three income coefficients are equal. The long-run elasticity for increases in Y_{max} is 0.91.

Which is the best specification for oil demand? The preferred specification (as it was for energy demand) would be (2a), with decomposed income and lagged demand. However, the two problematic aspects of the *energy* equation (2a) are not relevant for the *oil* equation (2a): the value for the lagged adjustment coefficient is smaller and thus more plausible, and the relative magnitudes of the coefficients for decomposed income are closer to what might be expected.

It should be noted that the income elasticities in equations (2a) for energy and oil demand respectively are considerably higher than for the simpler specifications (1) or (2). This illustrates the importance of a specification that allows for asymmetric response to income increases and decreases. It provides support for our conjecture that ignoring the possibility of imperfectly income-reversible demand can cause an underestimate of the income elasticity.

IV.4 Non-OECD Income-Growers

Another group of Non-OECD countries whose experience has been fairly homogeneous is the group of countries that experienced steady growth in per-capita income over this period. In contrast to the many "developing" countries whose income growth was at best sporadic and often negative, there were 14 developing countries whose average annual growth in per-capita income has exceeded 2% (listed in order of their per-capita-income-growth rates) -- South Korea, Thailand, Malaysia, Tunisia, Syria, India, Sri Lanka, Egypt, Colombia, Israel, Singapore, Malta, Morocco, and Bangladesh. Two other developing countries, China and Indonesia, have also experienced this rate of income growth; China was excluded from this sub-group given its size and unique characteristics, and Indonesia was excluded because it is an Oil Exporting country.

Table 4. Non-OECD Income-Growers' Results:

		Income coefficients				Oil Price coefficients				Lagged adj.coef.		Long-run Income Elasticity	Long-run Price Elasticity
fuel	eq.#	Y	Ymax	Ycut	Yrec	P	Pmax	Pcut	Prec	Income	Price		
energy	1	1.18										1.18	
energy	2	0.23								0.82		1.23	
energy	3	0.24				-0.03				0.80		1.17	-0.14
energy	3a		0.28	***-0.05***	0.24		-0.04	-0.02	***-0.05***	0.74		1.09	-0.17
			reject equality				cannot reject equality						
energy	6		1.08	***-0.50***	0.47	-0.02				0.00	0.72	1.08	-0.08
			reject equality										
oil	2	0.24								0.76		0.98	
oil	3	0.23				-0.02				0.76		0.94	-0.10
oil	3a		0.34	***0.14***	0.29		-0.05	***-0.01***	***-0.01***	0.73		1.26	-0.20
			cannot reject equality				reject equality						
oil	6		0.95	***0.04***	0.29		-0.03	***-0.003***	***0.02***	0.00	0.75	0.95	-0.12
			reject equality				reject equality						

Notes: see Table 1.

Non-OECD Income-Growers: Energy Demand

In the specification with only income, equation (1), the income elasticity is 1.18. When lagged demand is also included, equation (2) the income elasticity is slightly higher, at 1.23. If the standard Koyck-lag specification that also includes price, equation (3), then price has the expected negative sign and the coefficient is statistically significant; the income elasticity is almost unchanged, at 1.17.

If the above specification is modified by using decomposed price and income, equation (3a), then we see evidence of asymmetric response for changes in income and, perhaps, for price. This equation's income elasticity, for increases in Y_{max}, is 1.09.

Separate estimation of the lagged income and price coefficients yielded a negative coefficient for lagged income adjustment, implying a speed of adjustment that is even faster than instantaneous (results not shown). Modifying that specification by assuming instantaneous income adjustment (that is, a zero lagged-adjustment coefficient for income) yields the most satisfactory results, in equation (6). There is asymmetric response to income changes; the income elasticity, for increases in Y_{max}, is 1.08. Thus income growth in the absence of energy price changes does not reduce energy intensity (energy/GDP ratio), and will increase it slightly.

Non-OECD Income-Growers: Oil Demand

For oil demand, almost regardless of the equation specification, the long-run income elasticity is about 1.0 – whether income is decomposed or not, whether price is included or not, whether price is decomposed or not, or whether the income lag coefficient is estimated separately or not. This result should not be surprising in view of Figure 1, which plots the 1971-97 time-paths of oil against income for several of these countries.

There is evidence of asymmetric price responsiveness – not previously found for this group of countries, indeed for any group of developing countries. There is also evidence of asymmetric income responsiveness.

Separate estimation of the lagged income and price coefficients yielded a negative coefficient for lagged income adjustment, implying a speed of adjustment that is even faster than instantaneous (results not shown). Modifying that specification by assuming instantaneous income adjustment (that is, a zero lagged-adjustment coefficient for income) yields the most satisfactory results, in equation (6).

Note the similarity to results for the OECD countries. Price is significant, although the price elasticities are lower than for the OECD; moreover, there is evidence of asymmetric response to price changes. Income elasticities are higher for these countries than for the OECD, which is not surprising given the relatively low levels of energy and oil demand from which these developing countries started in 1971. Finally, the speed of adjustment for income changes is considerably faster than the adjustment for price changes.

These estimates of the income elasticity are consistent with the estimates made for Asian countries by Pesaran *et al*. (1998), by Galli (1998), and by the International Energy Agency's *World Energy Outlook 2000*; those Asian countries considerably overlap the above group of Income Grower countries. They are considerably higher than the income elasticities used by EIA in their *International Energy Outlook 2001* – about 0.65 for energy and oil demand in Developing Asia.

IV. 5 Non-OECD: Other Countries

The remaining Non-OECD countries – excluding the Oil Exporters and the Income Growers – were grouped together as the Other Countries. Within this remaining group there is, of course, substantial heterogeneity. But we did not attempt to identify any homogeneous clusters within this group.

Table 5. Non-OECD Other Countries' Results:

fuel	eq.#	Income coefficients				Oil Price coefficients				Lagged adj.coef.		Long-run Income Elasticity	Long-run Price Elasticity
		Y	Ymax	Ycut	Yrec	P	Pmax	Pcut	Prec	Income	Price		
energy	2	0.20								0.77		0.87	
energy	3	0.21				-0.03				0.77		0.93	-0.11
energy	4	0.50				-0.02				0.00	0.81	0.50	-0.09
energy	6		0.71	0.46	0.44	-0.02				0.00	0.80	0.71	-0.09
			cannot reject equality										
oil	2	0.14								0.84		0.90	
oil	3	0.15				-0.04				0.85		1.02	-0.23
oil	4	0.49				-0.03				0.00	0.87	0.49	-0.22
oil	6		***0.24***	0.70	0.16		-0.04	***-0.01***	***0.04***	0.00	0.86	0.24	-0.25
			reject equality				reject equality						

Notes: see Table 1.

Other Countries: Energy Demand

In the simplest specification, with income and lagged demand (equation 2), the income elasticity is 0.87. If price is also included, equation (3), the price coefficient has the expected sign and is statistically significant; the income elasticity is increased somewhat, to 0.93.

If separate lagged-adjustment coefficients are estimated for price and income, that for income is negative (results are not shown). With an alternative specification in which income's lagged-adjustment coefficient is assumed to be zero, equation (4), we get good results. All coefficients have the expected signs and are statistically significant. The income elasticity is relatively low, at 0.5.

If instead we use decomposed income, equation (6), the results are similar and there is evidence of asymmetric response to income changes. However, a Wald test does not allow us to reject the hypothesis that the decomposed-income coefficients are equal. Hence our preferred specification would be equation (4).

Other Countries: Oil Demand

For these countries' oil demand the results are generally similar to those for energy demand. The resulting income elasticities are similarly low – especially in comparison with those for the Income-Growers group of countries.

With income and lagged demand, equation (2), the income elasticity is 0.9. If we also include price, as in equation (3), all the coefficients have the expected signs and are statistically significant; income elasticity is about 1.

When the lagged-adjustment coefficients are estimated separately for income and price, the former is negative (results are not shown). If instead that lagged-adjustment coefficient for income is assumed to be zero, the resulting specification (4) provides useful results: all coefficients have the expected signs and are statistically significant.

Using a similar specification but using decomposed income and price, equation (6), yields the most interesting results, with evidence of asymmetric response for both income and price. The income asymmetry is unusual, although consistent with other evidence for these countries: the greatest demand response is to income declines.[10] The price asymmetry is more conventional: the greatest demand response is to increases in P_{max}, with the coefficients for P_{cut} and P_{rec} not being statistically significant.

For both energy and oil, these Other Countries' income elasticity – 0.5 or less – is much lower than those for the two other sub-groups of the Non-OECD. For most of these countries, modern commercial fuels – especially oil – must be imported. Due to economic difficulties within these countries (as evident in their slow and uneven growth in income) and their common practice of extensive import controls and restrictions on foreign exchange use, the very slow growth of energy and oil demand may not truly measure *consumers*' income elasticity, but rather reflect the *governments'* behavior in limiting imports of oil and energy. The price-elasticity of oil demand – higher than for other Non-OECD groups – might be explained similarly, as reflecting the behavior not of consumers but of government allocation of scarce foreign exchange in response to changes in world crude oil prices. Such a conjecture might also explain these countries' unusual income-asymmetry for oil demand: oil demand falls much more when income declines than it increases when income rises. Such income decreases were common in these countries, and were often caused by decreases in export earnings, which prompted tighter import controls by the government that could have reduced oil consumption disproportionately.

IV. 6 Summary of Results for Long-run Income Elasticity of Energy & Oil Demand

Having described the details of the econometric results for a large number of alternative functional specifications of demand equations for energy and oil for several different groups of countries, let us now focus on the preferred specification for each. These are listed in Table 6. The elasticities for income and price, as well as other important aspects of these preferred equations are presented in Table 7.

[10] This possibility is suggested in Gately (1995, Fig. 19, p. 132) in which declining-income Non-OECD countries, cut back on oil consumption most dramatically for non-transportation uses, which constitute about two-thirds of total oil demand.

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Table 6. Preferred Demand Specifications for Each Region

region	fuel	eq.#	Income coefficients				Oil Price coefficients				Lagged adj.coef.		Long-run Income Elasticity	Long-run Price Elasticity
			Y	Ymax	Ycut	Yrec	P	Pmax	Pcut	Prec	Income	Price		
OECD	energy	6	0.59					-0.03	-0.01	***-0.02***	0.00	0.90	0.59	-0.24
									reject equality					
OECD	oil	6	0.53					-0.08	-0.04	-0.05	0.06	0.88	0.56	-0.64
									reject equality					
Non-OECD	energy	4	0.44				-0.02				0.00	0.88	0.44	-0.16
Non-OECD	oil	6		0.53	0.46	0.07		-0.03	***-0.01***	***0.04***	0.00	0.84	0.53	-0.18
					reject equality				reject equality					
Oil	energy	1a		1.67	***0.11***	0.74							1.67	
Exporters					reject equality									
Oil	oil	2a		0.31	0.08	***0.11***					0.66		0.91	
Exporters					reject equality									
Income	energy	6		1.08	***-0.50***	0.47	-0.02				0.00	0.72	1.08	-0.08
Growers					reject equality									
Income	oil	6		0.95	***0.04***	0.29		-0.03	***-0.003***	***0.02***	0.00	0.75	0.95	-0.12
Growers					reject equality				reject equality					
Others	energy	4	0.50				-0.02				0.00	0.81	0.50	-0.09
Others	oil	6		***0.24***	0.70	0.16		-0.04	***-0.01***	***0.04***	0.00	0.86	0.24	-0.25
					reject equality				reject equality					

Notes: see Table 1.

Table 7. Estimated Long-Run Elasticities for Energy and Oil Demand

Country Groups	Fuel	Elasticities:		Important Phenomena
		Income	Price	
OECD	Energy	0.59	-0.24	asymmetric response for price
OECD	Oil	0.55	-0.60	asymmetric response for price
All Non-OECD	Energy	0.44	-.01 to -0.16	asymmetric response for price, perhaps
All Non-OECD	Oil	0.53	-0.18	asymmetric response for both price & income
Non-OECD Oil Exporters	Energy	.82 to 1.0	-	oil price not significant; asymmetric response for income
Non-OECD Oil Exporters	Oil	0.91	-	oil price not significant; asymmetric response for income
Non-OECD Income-Growers	Energy	1.08	-0.08	asymmetric response for income & perhaps price
Non-OECD Income-Growers	Oil	0.95	-0.12	asymmetric response for both price & income
Non-OECD: Other Countries	Energy	.5 to .7	-0.09	apparently symmetric response for price & income
Non-OECD: Other Countries	Oil	0.24	-0.25	asymmetric response for both price & income; largest response to income declines

For all regional groupings, for both energy and oil (except for Other Countries' energy), the preferred specification involves asymmetric demand response to changes in price and/or income. This is an important result, insofar as few articles in the literature – other than those cited above – allow for this possibility that the demand response to price (or income) increases and decreases might be asymmetric. Yet we have shown that such asymmetry exists in the historical data: Wald tests on the decomposed price (or income) coefficients have allowed us to reject the null hypothesis that the coefficients are equal. Moreover, not only does such asymmetry exist, but ignoring it will bias the estimated elasticities not only for that variable but also for other variables. For example, wrongly specifying the demand equation as perfectly price-reversible will bias downward the estimated income elasticity; this result for the OECD countries has appeared previously (Gately, 1993) but it is worth repeating.

It is also important to model correctly the different speeds of demand adjustment to changes in price and changes in income: demand adjusts faster to income changes than to price changes.

For the OECD, income elasticity is 0.59 for energy and 0.56 for oil – when demand is properly specified as imperfectly price-reversible, and the lagged demand adjustment coefficients are estimated separately for price and income. Failure to allow for imperfect price-reversibility will bias downward the estimated income-elasticity.

For the Non-OECD Oil Exporters, asymmetric income responsiveness is an important phenomenon: income declines have not reversed the demand growth that resulted from income increases. When taken into account, the long-run elasticity with respect to increases in Y_{max} is about 0.9 for oil and 1.67 for energy. Oil price, however, is never a statistically significant variable in their demand equations.

For the Non-OECD Income Growers, the econometric results provide evidence of asymmetric response to price increases and decreases, and also to income increases and decreases. With correctly specified equations, the income elasticity is 0.95 for oil demand and 1.08 for energy demand.

For Other Non-OECD Countries – oil importers with slow and uneven income growth – the preferred specifications suggest that the income elasticities of demand for energy and oil are quite low: 0.5 or smaller. However, such estimates could reflect government behavior rather than consumer behavior: the import controls imposed by these governments restrict imports of oil and other modern fuels when the growth of income is slow and uneven.

V. Conclusions

Our econometric conclusions are the following.

- The long-run income elasticity of energy and oil demand is:
  - about 0.5 or 0.6 for the OECD countries;
  - about 1.0 for Non-OECD countries whose income is growing steadily;
  - about 0.5 for Non-OECD oil importers with slow and uneven income growth.
- Demand has responded more to increases than to decreases in price, not only in the developed OECD countries but also in many developing countries' oil demand. Wrongly assuming that demand in the richer OECD countries is perfectly price-reversible (i.e. symmetry between the effects of increases and decreases in price), or omitting price entirely, will bias downward the estimated income elasticity.
- Demand has responded more to increases in income than to decreases in income, for some groups of countries such as the Non-OECD Oil Exporters. Wrongly assuming that demand is perfectly income-reversible (i.e. symmetry between the effects of increases and decreases in income) can bias downward the estimated income elasticity.
- The speed of adjustment to changes in price is slower than to changes in income in virtually all countries. Wrongly assuming that demand responds to income changes at the same rate as it does to price changes will tend to understate the long-run income elasticity *ceteris paribus*.
- There are important differences across countries, not only between the developed OECD countries and the Non-OECD countries, but also among several Non-OECD sub-groups: the Oil Exporting countries, the Growing Income countries, and the Other Countries. This heterogeneity characterizes countries' experience with regard to the rate of income

growth and its variability over time, as well as the relationship between income growth and the demand for energy and oil.

The implications of these results for understanding future oil and energy markets are important, both for the OECD and for the developing countries.

For the OECD countries, both oil and energy consumption per capita will continue to increase, about half as fast as income per capita – unless energy prices increase substantially. As a result, these countries will find it impossible to meet the Kyoto targets or other similar constraints on energy use without raising energy prices or introducing major new technological developments.

Among the developing countries, those with faster income growth have increased their energy and oil demand about as fast as income. Those with slow and uneven income growth have limited their energy demand to grow only half as fast as income, and oil demand to grow even more slowly. This is a discouraging message for those who hope for income growth but wish to restrain the growth of energy and oil demand – unless there exist significant changes from historical experience, or much higher prices.

Of course, it is possible to experience steady income growth without using much more energy. Many OECD countries did that, especially in the decade after the 1973-74 oil price shock; but they started that period with high energy use, with much room for improved efficiency. The developing countries, in contrast, consume very low levels of energy and oil. It will be difficult to restrain their demand growth when their incomes grow.

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Appendix A: List of Countries and Abbreviations

OECD

AUS	Australia
AUT	Austria
BEL	Belgium
CAN	Canada
CHE	Switzerland
DNK	Denmark
ESP	Spain
FIN	Finland
FRA	France
GBR	United Kingdom
GRC	Greece
IRL	Ireland
ISL	Iceland
ITA	Italy
JPN	Japan
LUX	Luxembourg
MEX	Mexico
NLD	Netherlands
NOR	Norway
NZL	New Zealand
PRT	Portugal
SWE	Sweden
TUR	Turkey
USA	United States

Oil Exporters

ARE	United Arab Emirates
BHR	Bahrain
DZA	Algeria
ECU	Ecuador
GAB	Gabon
IDN	Indonesia
IRN	Iran, Islamic Rep.
IRQ	Iraq
KWT	Kuwait
NGA	Nigeria
OMN	Oman
QAT	Qatar
SAU	Saudi Arabia
VEN	Venezuela

Income Growers

BGD	Bangladesh
COL	Colombia
EGY	Egypt, Arab Rep.
IND	India
ISR	Israel
KOR	Korea, Rep.
LKA	Sri Lanka
MAR	Morocco
MLT	Malta
MYS	Malaysia
SGP	Singapore
SYR	Syrian Arab Republic
THA	Thailand
TUN	Tunisia

Other Countries

AGO	Angola
ARG	Argentina
BEN	Benin
BGR	Bulgaria
BOL	Bolivia
BRA	Brazil
CHL	Chile
CIV	Cote d'Ivoire
CMR	Cameroon
COG	Congo, Rep.
CRI	Costa Rica
CYP	Cyprus
DOM	Dominican Republic
ECU	Ecuador
ETH	Ethiopia
GHA	Ghana
GTM	Guatemala
HND	Honduras
HTI	Haiti
HUN	Hungary
JAM	Jamaica
JOR	Jordan
KEN	Kenya
MMR	Myanmar
MOZ	Mozambique
NIC	Nicaragua
PAK	Pakistan
PAN	Panama
PER	Peru
PHL	Philippines
POL	Poland
PRY	Paraguay
ROM	Romania
SDN	Sudan
SEN	Senegal
SLV	El Salvador
TTO	Trinidad and Tobago
TZA	Tanzania
URY	Uruguay
YEM	Yemen, Rep.
ZAF	South Africa
ZAR	Congo, Dem. Rep.
ZMB	Zambia
ZWE	Zimbabwe