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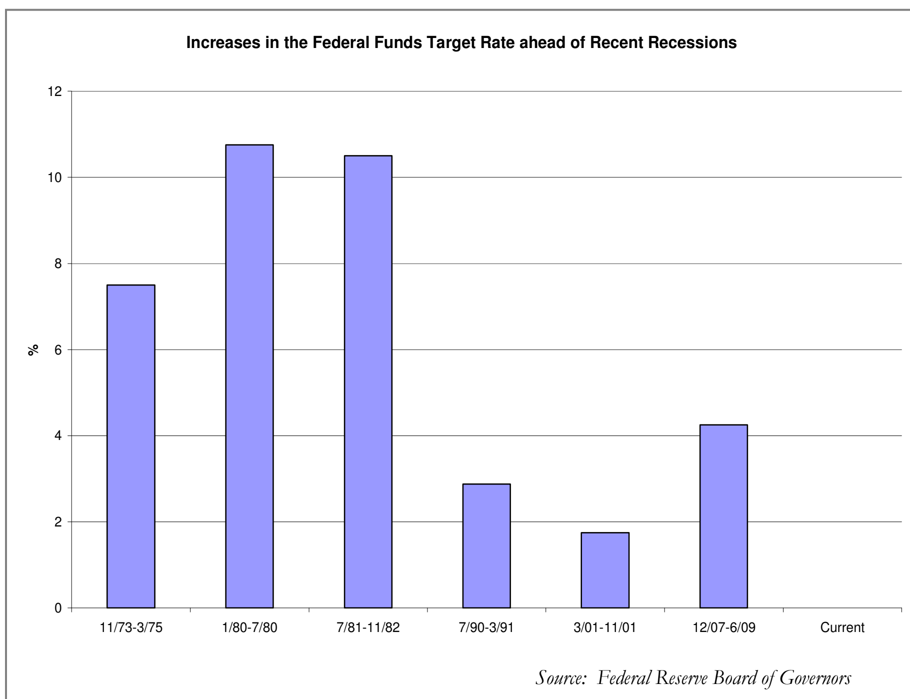
Oil Prices: Myth & Reality

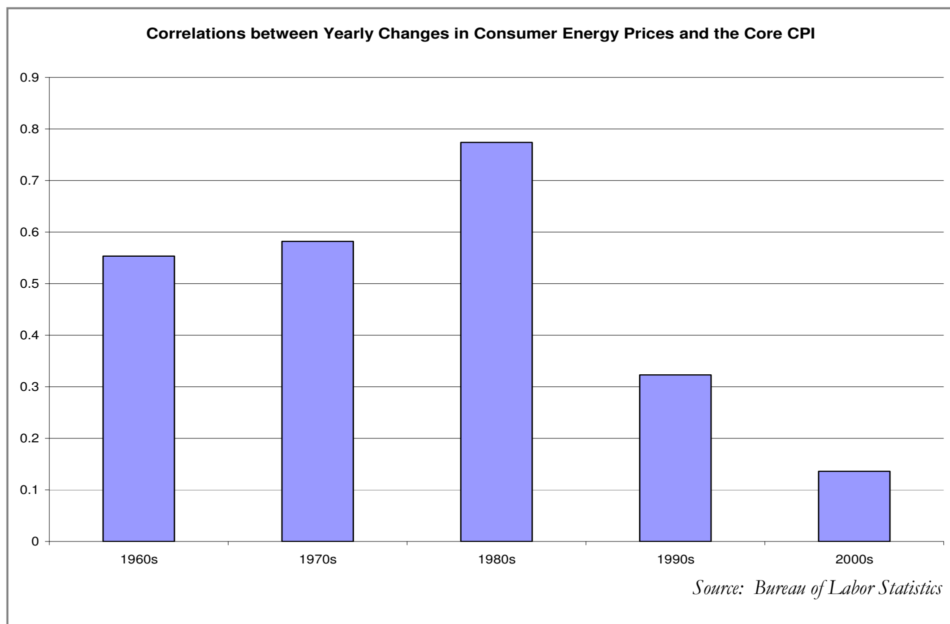
Just three years after an oil price spike helped to cement the last recession, the unrest in the Middle East has led to another surge that has in turn raised fears about the viability of the still-budding recovery. Benchmark futures prices crossed over $100 per barrel in early March, and by the end of the first quarter had tacked on nearly $40 from their low point in 2010.

A cursory review of recent history would suggest that the concerns are well-founded. Oil price shocks have either preceded or coincided with each of the last six recessions and have been widely credited as the driving force behind at least four of those episodes. The 1973-75 recession, for example, began just one month after the Arab oil embargo while the double-dip contraction in the early 1980s came on the heels of the 1979 energy crisis that developed in the aftermath of the Iranian Revolution. Similarly, the recession in the early 1990s coincided with the Iraqi invasion of Kuwait that caused oil prices to double in just over two months. The geopolitical drivers weren't quite the same through the two cycles in the 2000s, but both contractions followed oil shocks that were similar to those over the prior three decades. In fact, crude oil prices have at least doubled either before or during every economic downturn in the last 40 years.

It is ominous to note, then, that oil prices have more than tripled since the depths of the last recession. But to this point, the similarities between the current environment and those prior periods largely end there. In each of the cases cited above, oil price shocks were accompanied by broader inflation and monetary tightening, two trends that, while drawing closer, are still not part of the prevailing backdrop. The core inflation rate, which excludes both food and energy costs, rose to at least 2.5% during each of the oil shocks listed above, but is currently just barely above 1.0%. In fact, none of the major sub-components in the Consumer Price Index outside of transportation (which includes gasoline) is rising by as much as 3.0% on a year-over-year basis. As a result, the Federal Reserve has yet to begin removing policy accommodation. The Fed has tightened in front of every downturn in recent history and, not coincidentally, the yield curve has inverted in advance of each of these periods. In contrast, the gap between short and long-term interest rates is now among the widest in recent history.



Source: Federal Reserve Board of Governors



Source: Bureau of Labor Statistics

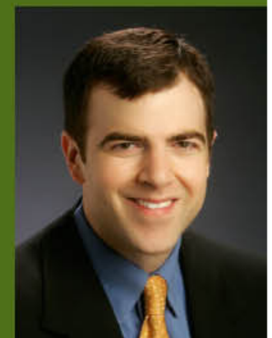
In other words, rising oil prices in isolation are not recessionary (technically, they are not even inflationary, but rather represent a relative price increase). Because energy prices are so volatile – the standard deviation of yearly changes in the CPI's energy component has been 11.0% vs. 3.0% for the overall index – what they can do is have a disproportionate impact on the inflation rate. Still, energy accounts for just 9.1% of the index and doesn't have nearly the same pull on the other 90.9% that it used to. The correlation between annual changes in energy prices and the core CPI was over 50% in both the 1960s and 1970s and hit nearly 80% in the 1980s. In the two full decades since, however, this relationship has weakened dramatically; the correlation coefficient fell to 32.3% in the 1990s and just 13.6% in the 2000s. As the economy has become more efficient and the Fed has gained credibility as an inflation fighter, the influence of energy costs on other goods and services has waned.

Because of this, the bar is set higher now for oil price shocks to impact the economy in the same way they did in the past. And here it should be stressed that it is the change in oil prices that matters, not the dollar level. Just over a decade ago, it was widely thought that crude at $40 per barrel or gasoline at $2 per gallon would be the death knell for the economy. As it turned out, a recession did take hold in 2001 with oil prices below $30, but oil then rose to nearly $100 (with gas prices well above $3) in the recovery that followed before the next turn in the cycle. The point is that there is nothing mystical about any particular oil price point. The inflation rate has been positive over time (the CPI has averaged an annual increase of 3% over the last three decades), so it shouldn't be expected that the price of any good or service, especially one so cyclically sensitive, will be stationary. Nor is it useful to think of higher oil prices as a tax. Taxes cause costs to exceed revenues, reducing incentives to both consume and produce. A relative price increase such as an oil price shock, in contrast, involves a transfer of wealth from consumers to producers that is at least partially funnelled back into the economy in the form of investment and jobs. Quantity demanded may be lower at higher prices (the demand curve slopes downward), but the same trend should also bolster quantity supplied.

It is entirely conceivable that oil prices will continue to climb and will contribute to the next downturn in the economy and markets, as inflation moves broadly higher and the Fed tightens policy. However, economic theory, history, and the empirical relationships between these variables all suggest that prices will have to rise substantially higher than they already have in order to trigger such a turnaround on their own.

About the Author

BRYAN JORDAN, CFA is the Chief Economist and Director of Financial Markets Analysis at Nationwide Investments, the entity that manages the invested assets for Nationwide's Life and Mutual companies, Nationwide's Pension, as well as some subadvised fixed income mutual funds for Nationwide Financial.



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