Shock treatment

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Why the economy has absorbed high oil prices fairly easily, and why it may no longer

OIL prices have a special place in economic folklore. The two nastiest global recessions of recent decades were preceded by huge and sudden rises in the price of oil, first in 1973 and then in 1979. These twin spikes, both engineered by the Organisation of the Petroleum Exporting Countries limiting its oil shipments, are still the textbook example of an economic "shock"—a sudden change in business conditions. Abrupt increases in the oil price have prompted anxiety about stunted growth ever since.

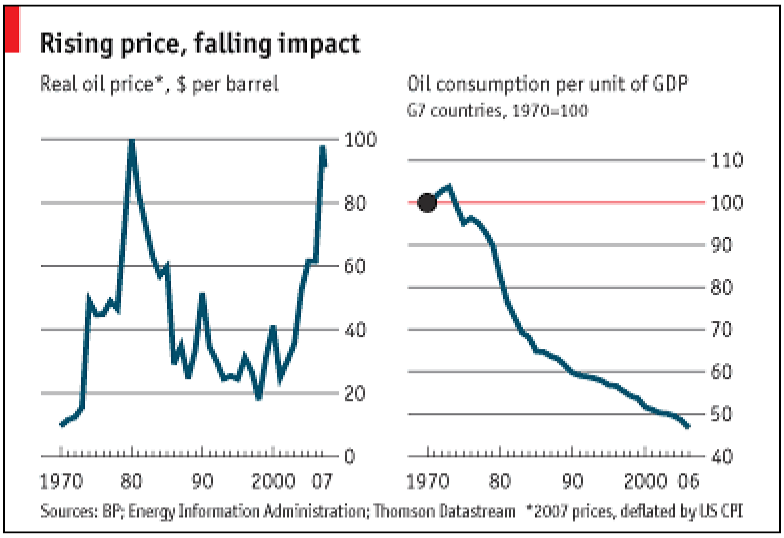
Higher oil prices hurt the economy because they act like a tax increase. Firms that use oil face higher costs which, if they cannot be passed on in higher prices, might mean that some production becomes unprofitable. Consumers paying more for their petrol and heating oil have less to spend on other things. If they look for higher wages to compensate for a drop in purchasing power, that will only lead to job losses.

Oil-producing countries benefit from higher crude prices so the impact on global demand depends how their extra income is spent. But even if oil windfalls are spent largely on goods produced by oil importers, the abrupt shift in the distribution of global income will still be destabilising.

Given the gloomy history, the lingering unease about higher oil prices is understandable. A demonstration of this came on November 13th when, after a rough few days, stockmarkets rose on news that the oil price had fallen below $93. After all the talk of breaking the three-figure barrier, a drop towards a mere $90 spurred a relief rally.

Yet for all that, something has changed. Today's oil prices would have been unthinkable until very recently. Six years ago, when a barrel of crude could be bought for as little as $20, oil prices at today's levels would have raised fears of deep recession. Notwithstanding the spectre of past oil shocks, crude prices have risen to ever-dizzier heights without derailing a five-year period of strong global growth. But why has the oil bogeyman become less scary? Two new papers* by three well-known economists set out to explain. They come to similar conclusions: oil shocks do not hurt as much because oil is used less intensively than before, because the economy is more flexible and because central banks are better at controlling inflation.

What makes oil special is that it is a uniquely dense and portable form of energy. It is not easy to switch to alternatives very quickly, so disruptions to supply are damaging. Yet improvements in energy efficiency mean dependence on oil is not what it once was. Rich countries use less than half as much oil as they did in 1970 for each inflation-adjusted dollar of GDP. So although prices in real terms have returned to levels last seen in the 1970s, their impact is not as powerful when set against the diminished economic importance of oil (see charts).



The blow from dearer oil is less powerful than it was and compared with their rigid state in the 1970s, today's more flexible economies are better able to take a punch. Higher oil prices have some unavoidable direct consequences on companies' production costs and on prices paid by consumers for oil-derived products. Wider damage to jobs and output depends on how well these increased costs are absorbed. If workers insist on higher cash wages to maintain their spending power, firms' costs will take an additional hit, resulting in lay-offs, higher unemployment and depressed demand. To the extent that workers take it on the chin, accepting higher oil prices as a temporary tax increase that lowers their real take-home pay, the collateral damage will be smaller. The rigidity of the 1970s economies, where union power and indexed contracts meant wages were unyielding, only magnified the adverse effects of oil shocks. Today's flexible jobs markets allow oil shocks to be absorbed less harmfully.

If consumers are more forgiving of oil shocks, it is partly because they have become more accustomed to volatile prices and partly because they have greater trust in policymakers to keep inflation under control. Dearer oil has pushed up consumer prices, but expectations of future price increases have remained remarkably stable. That in turn reflects a belief that central banks will act where necessary to keep a lid on inflation. There is a self-fulfilling aspect to that faith. Employees are less pushy in seeking inflationary wage deals and firms think twice about raising their own prices. As a result, central banks do not need to respond as aggressively as in the past to the inflation caused by higher oil prices. A less jerky monetary policy makes for greater stability.

Pump-action problems

Both papers help tell us why oil shocks hurt much less than they used to. But that is not to say that oil prices no longer matter at all. Neither analysis takes the run-up in oil prices over the last year into account. The rise in crude prices since the summer has been rapid even by the standards of the 1970s shocks and comes at a particularly bad time for America, the world's largest oil user. Consumers are now having to absorb a flurry of punches. Falling house prices, tighter credit conditions, rising unemployment, as well as higher prices at the petrol pump, all cloud the outlook for consumer spending.

Moreover, part of the cost of absorbing past oil-price hikes has been higher consumer debt and a huge trade deficit, both of which make America's economy more vulnerable. And though the Federal Reserve's credibility has allowed it to cut interest rates in anticipation of a downturn, the persistence of oil-led inflation may yet shift expectations of future price pressures, forcing the central bank to keep monetary policy on a tighter chain. America's economy no longer has the glass chin that it had in the 1970s. But a combination of powerful blows could still have a shattering impact.