

MASARYK UNIVERSITY, BRNO

Faculty of Economics and Administration



Essay:

Implications of the oil price drop for inflation and investments

Essay for the course Finance (Basics) (MPF AFIN)

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Autumn 2015

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Implications of the oil price drop for inflation and investments at the example of Germany

In this essay I will give an overview over the oil price drop that occurred from mid-2014 onwards. I will explain the linkage between oil price and inflation rate and what effect fluctuations in those have on investments in a national economy.

Brief history of the oil price drop

For most of the last decade oil prices used to be high, in the past five years mostly above 100\$ per barrel¹. The main drivers were high demand, especially from developing and emerging countries and conflicts in key oil regions like Iraq and Libya that lead to delays on the supply side. For years, global oil demand was higher than oil supply and so the prices spiked. But some of these dynamics started shifting.

First, the prices were high enough to make the hydraulic fracturing (“fracking”) method economically viable. The fracking boom in the United States lead to declining oil imports from one of the biggest oil consuming countries. On top of that, weak economic activity in industrial nations, increased energy efficiency and the focus on other fuels than oil in Western Europe, China and the US supported the development of decelerating global oil demand².

When Saudi Arabia in its role as swing producer of the OPEC refused to cut down its production the oil prices plummeted, from 115\$/barrel in June 2014 to below 50\$/barrel in January 2015.³ Right now prices are slightly above 40\$/barrel⁴.

Effects on inflation

The oil price and inflation rate are in a so-called ‘cause and effect relationship’. As oil prices move up or down inflation generally follows in the same direction⁵. Why is that?

¹ <http://oil-price.net/> (As of 14th November 2015)

² Plumer, Brad: Why oil prices keep falling – and throwing the world into turmoil (23rd January 2015), URL: <http://www.vox.com/2014/12/16/7401705/oil-prices-falling> (As of 14th November 2015)

³ <http://oil-price.net/>

⁴ Ibid.

⁵ Langager, Chad: What is the relationship between oil prices and inflation? (no date), URL: <http://www.investopedia.com/ask/answers/06/oilpricesinflation.asp> (As of 14th November 2015)

It is because oil is pervasive as a commodity. It is everywhere and a major input in the economy. It is used in critical activities such as transportation and heating and if input costs rise so should the cost of end products. So in Germany, simultaneously to the oil price drop, the inflation rate went down from 1,1 percent in June 2014 to -0,4 percent in January 2015⁶.

Effects on investments

Generally speaking a low oil price benefits most companies (if they did not rely on high oil prices) as lower transportation costs save them money. As long as they did not have to pass on their savings entirely to the end consumer they will have more money to invest than they did before the oil price drop.

However, it has shown that a condition for ongoing investments is price stability. As the German Bundesbank stated in its report from June 2012: *“Increased insecurity that can lead to postponements of investments is generally related to price fluctuations on the oil market, not to price changes in one particular direction”*⁷. Several experts agree that oil price volatility is a bigger impediment for investments than continuously high prices. This is because in times of sinking oil prices investors tend to wait in the hope of further decreasing prices.

The same applies to a low inflation rate. In case of stagnation or even deflation, investors tend to postpone their purchases. Why spend your money now if you can make an investment for the same amount of money (or even less) later?

This is why the European Central Bank set the key interest rate on a record low of 0,05 percent in September 2014 and left it at that rate ever since⁸. By pumping new money into the circulation the ECB tries to tackle the low inflation rate, thereby incentivize investments and boost economic activity in the Eurozone.

⁶ <http://www.tradingeconomics.com/germany/inflation-cpi> (As of 14th November 2015)

⁷ Deutsche Bundesbank: Der Rohölpreis und seine Bedeutung für die Konjunktur in den Industrieländern (June 2012), in: Deutsche Bundesbank Monatsbericht Juni 2012

⁸ Dpa: Rekordtief: EZB hält an niedrigem Leitzins fest (15th April 2015), URL: <http://www.spiegel.de/wirtschaft/unternehmen/europaeische-zentralbank-ezb-belaesst-leitzins-auf-rekordtief-a-1028736.html> (in German) (As of 15th November 2015)