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Will Oil Prices Choke Growth?

Oil price hikes have often preceded global recessions in the modern era. Recently, oil prices have been rising again. The price of a barrel of Brent crude bottomed out at \$16.57 on November 15, 2001—as disruptions from the September 11, 2001, attacks reduced demand from air traffic and related economic activity—before rising to \$39.07 on May 17, 2004. Will recent oil price increases bring the current growth to a premature end?

James Hamilton, a noted researcher on the macroeconomics of oil shocks, argues that several factors differentiate the current situation from those of past recessions.¹ He points out that the source and size of the recent oil price surge might mean there is less risk for the economy than one might think.

One difference is that past oil shocks—like those of the 1970s—resulted from restrictions of supply that raised the price of oil. In the present situation, rapidly growing demand from the world economy has bid up the price of oil. The top figure shows the oil consumption of four of the five largest oil-consuming nations (excluding Germany). U.S. and Chinese consumption has been expanding rapidly, as these two nations have enjoyed vigorous growth recently.

A second difference is that part of the recent uptick in oil prices merely retraces earlier price declines. Comparing current prices to the lows of the fall and winter of 2001 is misleading; prices of Brent crude were above \$30 in 2000 and in January 2003. An increase from \$30 to \$36 is very modest compared with the doubling or tripling of prices seen in 1974 and 1979. Further, real oil prices were much higher in 1979 than they are today, about \$80 a barrel in 2004 dollars.

Oil is also relatively less important to the U.S. economy than it was in the past. The lower figure illustrates that oil consumption per unit of real GDP has fallen about 50 percent in the United States and Japan since 1970. A shift of U.S. and Japanese output to high-tech manufacturing, as well as vehicles and machinery that are more fuel-efficient probably contributed to this drop. Chinese output data are probably less reliable over long periods but there appears to have been a large drop in oil consumption per unit of

output since the 1970s. In contrast, oil has become more important to Indian output as its formerly agrarian economy has industrialized.

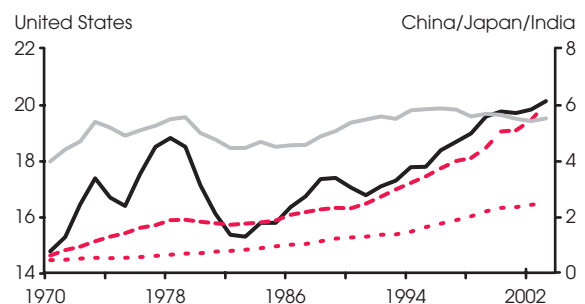
One also would hope that regulatory and monetary policy responses to oil price changes have improved since the 1970s. To the extent that this is true, it provides another reason to be sanguine about the economic effect of the latest oil price rises.

On the other hand, concerns about Middle Eastern political tensions could be generating speculative accumulation of inventories, driving some of the recent increase in oil prices. If such fears were realized—if supplies from the Persian Gulf region were significantly disrupted—the world price of oil could quickly soar, with serious consequences for the global economy.

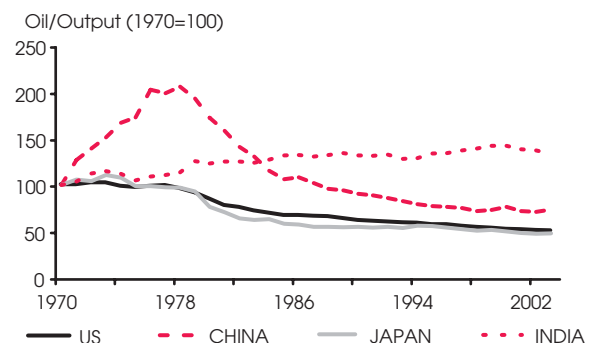
—Christopher J. Neely

¹ See Hamilton's "Causes and Consequences of the Oil Shock of 2004" and "Historical Effects of Oil Shocks," available at <http://weber.ucsd.edu/~jhamilto/>.

Oil Consumption in Mills of Barrels per Day



Oil Consumption per unit of Output



SOURCE: British Petroleum, International Financial Statistics, and the author's calculations.