Economic SYNOPSES

short essays and reports on the economic issues of the day

2003 ■ Number 14

A Case for Oil?

Richard G. Anderson and Michelle T. Meisch

As economic growth slowed during the first half of 2003, many analysts again focused on increases in the price of oil. In the United States, increases in the price of oil generally have preceded business-cycle downturns since World War II.[1] In late February, oil prices were close to $40 as oil supplies were throttled in Venezuela and Nigeria and the world anticipated war in the Middle East. Some analysts feared prices could reach $50 if the war in Iraq bogged down into an urban guerilla conflict or spread to other nearby oil-producing nations. At the same time, nuclear power-supply troubles in Japan and unusually cold weather in the United States boosted demand. Fears of further sharp oil price increases seemed well-founded.

An extensive economics literature has explored the various mechanisms whereby higher oil prices affect economic activity.[2] One of the more plausible mechanisms operates by means of the postponement effect. In this scenario, increases in the current price of oil increase uncertainty about future oil prices which, in turn, causes households and businesses to postpone purchases of durable goods and equipment. Unraveling the economy's recent performance depends, at least in part, on understanding the extent to which businesses and consumers believed that this year's oil price increases would be reversed in the near future. If this belief was widely held, then oil prices might have affected business and consumer spending very little—and the economy's slow growth might have been signaling broader underlying weakness.

It seems plausible that many firms and households judged world events during 2002-03 by comparing them to those that surrounded the first Gulf War. Looking back, oil price movements during 2002-03 in fact were quite similar to those during the 1990-91 Iraqi invasion of Kuwait and subsequent Gulf War, albeit with somewhat different timing. The figure shows the spot price for benchmark Texas-type light, sweet crude oil before and after the peak price observed during each period. (We aligned the prices based on the peak price because of the differing timing of events.) In 1990, prices peaked after the Kuwait invasion but well before the beginning of the American liberation of Kuwait. In 2003, similarly, prices rose sharply during the military buildup, when uncertainty regarding war was high, and then decreased after the degree of uncertainty was reduced by the American entry into Iraq. During both episodes, oil futures prices (not shown) moved in similar patterns; indeed, even during 2003, futures prices generally remained below the spot price, suggesting that the price run-up would be short-lived.

The similarity of oil price movements during 1990-91 and 2002-03 suggests that the slow pace of economic activity during this year's first-half should not be attributed to higher oil prices. It also suggests that the recent retreat of oil prices to more normal levels may provide no more than a small boost to economic growth later this year. ■

[1] See Kevin L. Kliesen, "Rising Oil Prices and Economic Turmoil," Federal Reserve Bank of St. Louis *Regional Economist*, January 2001. www.stls.frb.org/publications/re/2001/a/pages/lead-article.html.

[2] Many of these mechanisms are discussed in James D. Hamilton, "What Is an Oil Shock?" *Journal of Econometrics*, April 2003, Vol. 113, pp. 363-98.