

WHY HAVEN'T HIGH OIL PRICES PRODUCED A RECESSION?

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The simple answer is that the gradual creep up in the price of oil has been negated by the strong ongoing productivity gain that has kept the economy from tipping into a recession. In this arena, we have also been lucky on two fronts. One is that politicians have kept their nose out of this problem. Yes, there have been some half-baked attempts to control prices, like in Hawaii, but by-and-large they have left the market alone to equilibrate itself. Some hot air does get expelled whenever gasoline prices spike up but that is a minor side-effect of free speech.

The second fortuitous factor is that oil prices have not shown up in core inflation, forcing the FED in the last two years to be deliberative and somewhat slow in hiking rates which in turn gives the economy ample cushion to adjust to high prices. Remember, the urge to conserve is always there but actual conservation and ability to make lifestyle adjustments takes time. In past recessions, which also coincided with oil price spikes, either due to wars or embargo, the FED was trying to curb inflation or inflationary expectations. Let's first take the example of the October 1973 recession that started shortly after the Arab oil embargo. Even before the embargo, President Nixon's wage and price controls were artificially keeping inflation under wraps and the global economy experienced a synchronized boom. Inflation was lurking just below the surface and the embargo finally unleashed this genie out of the bottle. To complicate matters,

misguided attempts to control gas consumption led to long gas lines, flared tempers, anxiety and work-place chaos. These conditions aren't ideal for good productivity growth and the slowdown that ensued turned into a full-blown recession only by late 1974, if one goes by the job loss metric, when the FED had to step in to counter inflation. The recession then deepened but was over very quickly by March 1975 when the FED eased off the brake pedal.

The cause of the 1980's double-dip recession was the fact that the stop-and-go monetary policy undertaken by the FED in the mid-70's led to a credibility problem, and a nasty buildup of inflationary expectations that had only one answer: step on the brakes so hard that the vehicle comes to an abrupt halt. This is what Paul Volcker did with the tacit blessing of the White House and as a result, we suffered the sharpest postwar recession. It's again a coincidence that the 1979 oil embargo happened just before this recession's start date. In fact, the first phase of the 80's recession was due to the Carter administration's credit controls that caused the first dip. The recession ended quickly (in a technical sense) once they were withdrawn. However, the inflation fire was still burning and the only cure was an unpleasant series of rate hikes which Volcker, to his credit, made us swallow.

Now, let's examine the 1990 recession which started right after Saddam invaded Kuwait.

Why Haven't High Oil Prices Produce a Recession?

This time the FED had been battling mildly rising inflation for almost two years, and rates were so high that any small shock would have tipped the economy into a “technical” recession. With the Kuwaiti invasion, this again happened to be oil.

This coincidence argument tells you that when one runs a regression of oil prices and real GDP growth, one will find negative effects of oil disruptions on growth (and the economic joke that eight of the last six recessions were preceded by oil shocks!). However, this time oil prices have been high for almost two years but the economy hasn't slowed much. I decided to investigate this issue with Karsten Jeske at the Federal Reserve Bank of Atlanta this winter and we have some interesting results to report (the full text can be downloaded at <http://www.robinson.gsu.edu/efc/director/research.html>). First, we found a portfolio rebalancing effect in the economy's expenditure pattern. What does this mean? In response to an oil price shock, the economy adjusts by reducing its investment in durable goods but increases its spending on building capital stock at least temporarily. In plain words: postpone your car purchase but increase your spending on machinery or capital goods. As these goods generate output or income tomorrow, and if you want to maintain your future consumption standards, then rational choice implies investing more in capital goods today and decreasing your consumption of durables to buy this insurance.

Now, have people cut back on consumption of durable goods? Yes, in the months the Big 3 don't offer car discounts! The moment they drop the price, a rational consumer enjoys making up for the hit on consumption from the previous period.

We were also looking for evidence that oil price volatility causes fluctuations in the economy, as regression equations typically predict. Building a general equilibrium model of the U.S. economy from the first principles we found that oil shocks, surprisingly, do not explain the majority of fluctuations in real GDP. One has to complement this disturbance with shocks to total factor productivity (i.e. technology) to explain the nature of observed fluctuations in the data. We found that even though the ongoing oil price shock is comparable to the one seen in the 70's, recent productivity

improvements have been significant enough to keep the negative effects of oil in check. Mind you, these productivity levels depend upon the political philosophy and social norms prevailing in the country at any given time. Any interference with the working of the free market is always deleterious to productivity growth, period.

This brings us to the luck part. The FED has been restrained as oil prices haven't fed into core inflation. What if it did? That is where the hedging in the recent FOMC statement of May 10th comes into play. The word “yet” means that they can pause and observe what this oil will do to inflation. If it does affect it more than their comfort level, then they will start the hikes again. That time of deliverance will arrive by the fall of this year. So, neither they nor, consequently, your humble forecaster can predict what they will do until they have seen the actual data. I hope this section helps you understand the plain-speak of this new chairman. Mercifully, the era of reading between the lines of Greenspeak is over, and it's time to get used to the new Sheriff in town.

But when FOMC sees oil trending into core inflation, how restrictive will it be? Our past experience suggests that the FED can be pretty mean in these situations. Don't forget Greenspan's 75-basis point hike just before Christmas of 1994. When I teach macroeconomics in my class I have struggled with this issue too. In the face of cost-push inflation resulting from oil, which can slow the economy on its own, raising rates can have even more of a dampening effect. So why do it? If they don't raise rates then the 70's experience comes to mind where ignoring inflation led to an erosion of credibility and ironically required the drastic Volcker remedy for the stubbornly high inflation expectations. Damned if they do and damned if they don't. I think Hamlet had an easier time figuring a way out of his dilemma.