

President's Message



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Latest Oil "Shock" Differs Significantly from Those of the '70s

Oil prices began rising in late 2003 and now stand at record levels in current dollars. Past sharp increases in oil prices, or "oil shocks," often preceded economic downturns. Indeed, nine of the 10 economic recessions in the United States since the end of World War II were preceded by a dramatic increase in the price of oil.

Many economists, most notably James Hamilton of the University of California at San Diego, argue that high oil prices were a key factor in causing past recessions. However, rising oil prices are not derailing the current economic recovery, nor do experts predict that the economy will fall into a recession soon. Why are things different this time?

To determine the impact of high oil prices on economic activity, we should understand the forces that drive prices upward. Many past oil shocks were driven by supply disruptions, such as the OPEC oil embargo in 1973 and the Iranian revolution in 1979. Such events reduce the amount of oil available, which increases prices. Supply shocks raise the production cost for businesses that use oil and cause them to curtail their output, perhaps enough to cause a recession.

By contrast, experts say that high demand for oil, not supply disruptions, is driving the current price surge. For instance, global oil consumption in 2004 grew at a faster rate than it had in 25 years, led by rapid increases in China, India and the United States. Thus, past high oil prices were a driver of economic weakness, while the recent surge in oil prices is being driven by the world economy's strength.

Also, while the *nominal* price of oil is at record levels, the *real* price of oil (the price adjusted for inflation) is nowhere near a record. For example, when measured using today's dollars, the price of a barrel of West Texas Intermediate, a common grade of crude oil, was roughly \$80 in the late 1970s. Compare that to the \$50 a barrel prices of today. Thus, the current oil shock has been less of a shock than previous ones.

The U.S. economy is less dependent on oil since the shocks of the 1970s. Reduced dependence helps insulate us somewhat from sharp price increases. The spike of the 1970s gave U.S. businesses the incentive to find substitutes for petroleum as an input in a broad range of production. Motor vehicles still depend on petroleum,

of course, but they are more fuel-efficient, thanks in part to government policies such as the Corporate Average Fuel Economy (CAFE) standards. Overall, the amount of oil the United States uses, if figured as a percentage of our total output, has fallen by half in the past 30 years.

High oil prices certainly burden U.S. businesses and consumers, as anyone who fills up at the gasoline pump can attest. However, at current levels, oil prices probably will not derail the economic recovery.