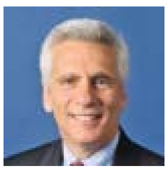
PostEverything

Why cheap oil is not an economic blessing



By Jared Bernstein January 19 Follow @econjared

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This August 21, 2013 file photo shows an oil well near Tioga, North Dakota. (Karen BLEIER/AFP/Getty Images)

There are two different flavors of "supply side" economics. One that dates to President Ronald Reagan argues that if you cut taxes on the wealthy, they'll work harder and invest more of their larger after-tax income. The benefits will "trickle down" to both the unwashed masses and to the Treasury.

This version is false.

The other version, a tenet of growth economics, is that while adequate demand is essential to tapping the economy's full capacity, it is through the expansion of supply-side variables — inputs in the growth process — that we boost that capacity. These include labor supply, technological and productivity gains, capital inputs, and the commodities on which economies run, one of which — an important one — is oil. The theory suggests that cheaper oil should boost growth and not just cyclically (near-term) but structurally (long-term), and vice versa: Big jumps in the price of oil should be and have been recessionary.

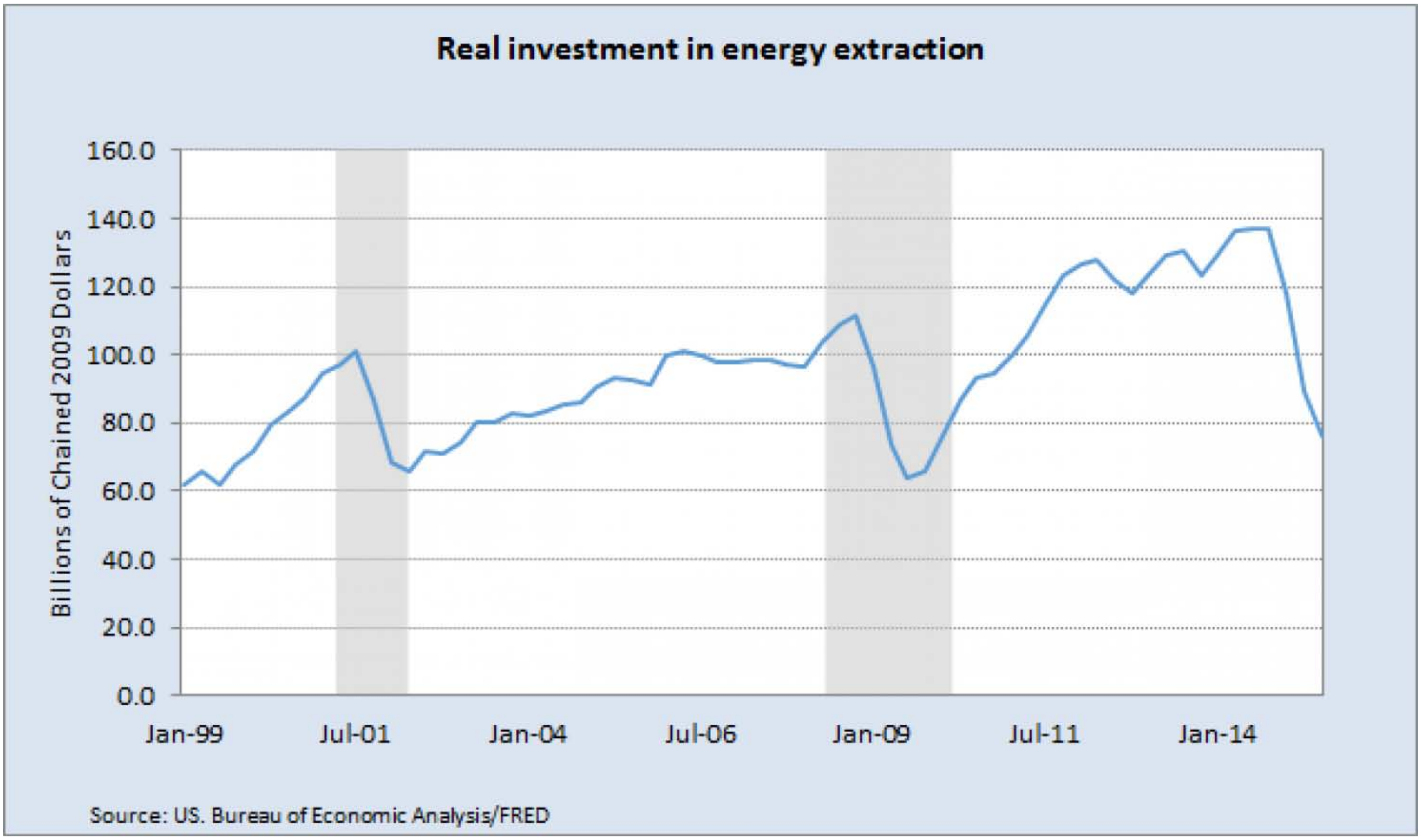
This version is true.

Or is it? When the price of a key input such as oil comes down as much as it has in recent months, supply-side theory would tell you this is pro-growth, especially in a country like ours that is still a net importer of energy. And yet … let us count the ways this simple insight — cheaper inputs lead to more output — requires a much more nuanced understanding.

— ***Global financial markets***: The larger-than-expected decline in the price of oil — it was more than $90 a barrel before it started falling and was last seen breaking $30 a barrel — has rippled through financial markets, generating losses in share prices and higher volatility both here and abroad. The finance channel is another supply-side channel, and the negative impact of oil's sharp falloff has the potential to hurt growth through negative wealth effects (declining asset values, even just on paper, make people feel poorer, so they spend less).

— *"Sheiks and shale:"* Why has the price of oil fallen so much? Scott Tinker of the University of Texas at Austin compactly summarized it as "sheiks and shale." The latter refers, of course, to our own shale boom, a clear contributor to the glut. "Sheiks" refers to the impactful decision of the large Middle Eastern producers not to cut back production in reaction to the glut but to try to use their cartel-driven clout to force out weaker producers in the interest of market share. A market response to the sharply negative price signal would have been to reduce production, but the Saudis et al. have not done so. That has led to a much larger drop in price than expected and generated some of the destabilizing outcomes that we don't typically associate with cheaper inputs on the supply side. It's a good example of how "non-market forces" (cartels) mess up the simple, classical model.

— ***Industry mix:*** The simplest story about cheap oil is that how it affects your macroeconomy depends on whether you're a net importer (helps you) or exporter (hurts you). "True dat," but here again, nuance is required. That shale boom noted above has made us more of a global player, as the United States has doubled its domestic oil production since 2008, with the boom adding 3 million barrels per day to a global market that consumes 94 million per day. So although we're still a net importer, a lot more jobs, families and towns are now engaged in energy extraction.



The figure above shows the sharp tanking of investment in the industry. Before getting too freaked out — the recent decline is sharper than previous recessionary drops — keep in mind that this sector was 6.5 percent of business investment before the price crash, and is now about 3 percent. That's a huge drop over a short period, but still a small share. Still, economist Andy Levin raises legitimate concerns as to whether industrial production indicators writ large are flashing red.

— ***Deflation:*** If inflation were running high and cheaper oil took it down a notch, the Federal Reserve would breathe a sigh of relief. But both inflation and interest rates have been around zero, a symptom of long-term weak demand (which I'll get to next). Yes, the Fed's main inflation gauge excludes the price of energy; it's volatile and set in global markets, so the central bank's actions don't broadly affect it. But cheap oil prices are also part of a broader price decline in other commodities as well, another signal of weak demand.

Amid all this, the Fed recently set out on a rate-hike campaign *against* the threat of inflation.

That's in part because of a stated belief that the oil glut is temporary. That assumption, however, looks questionable. If they're wrong, and especially if markets remain so edgy, it's unlikely that the central bank will continue their plan to raise rates throughout the year.

That doesn't help its credibility, but deflation — the term really means a falling general price level but it's used here to mean (much) weaker-than-usual price growth — creates its own set of problems for the economy and the Fed. Very low inflation further constrains demand through preventing the real interest rate from falling; it also makes it tougher to pay back debts (as nominal debts are eroded by inflation). Eventually, people build low inflation into their expectations and that makes it a lot harder for the Fed to hit its inflation target of 2 percent.

— ***Weak demand:*** If demand were stronger, the job market were at full employment, wages were rising at a decent clip, and not just here but in both emerging economies (China) and advanced ones (Europe), a positive supply shock would be more of an unequivocal blessing, further boosting real activity instead of threatening deeper deflation. But what we have instead is strong supply met by weak demand, and that's putting further downward pressure on prices and initiating a reinforcing, negative cycle.

— ***Environmental costs:*** Fossil fuels were already underpriced from the perspective of carbon emissions. The fact that gas prices are heading back to numbers I remember as a kid driving around with my mother many decades ago exacerbates this problem, with long-term consequences that go far beyond the economic cycle.

Those are downsides, and there are, of course, upsides. You've filled your gas tank recently, right? I'm saving about $15 per fill-up. There's a debate as to whether households are spending their cheap-gas dividend, but it looks as though many are, and in a 70 percent consumption economy, that's seriously pro-growth. As I've often stressed, when inflation is running about zero, nominal wage gains don't have to rise for them to become real wage gains: Increased buying power is driven by slower inflation, not faster wage growth.

But my broader point is that there are virtually no assumptions in economics you should take as given. Question them all! Even the good supply-side doctrine is not always true. There's always nuance. That may make economics less of a science, where variables perform in expected ways, but it also makes it more interesting.

Note: an earlier version of this piece mistakenly included the phrase "we're not yet a net importer" of oil. This version correctly says "we're still a net importer..."

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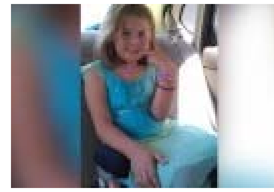

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