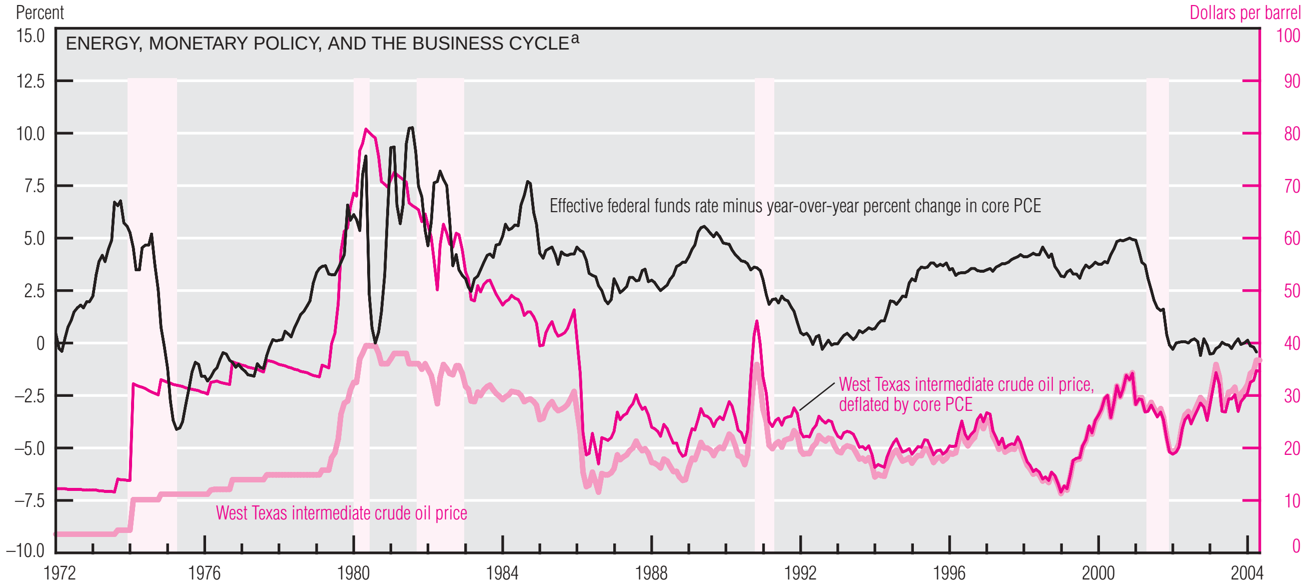
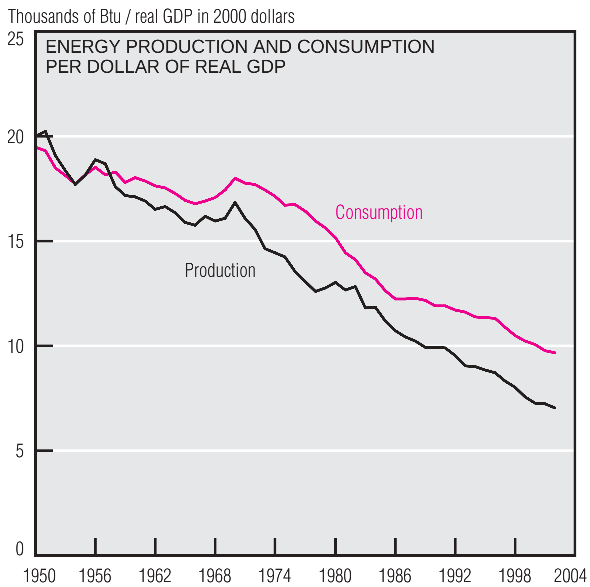
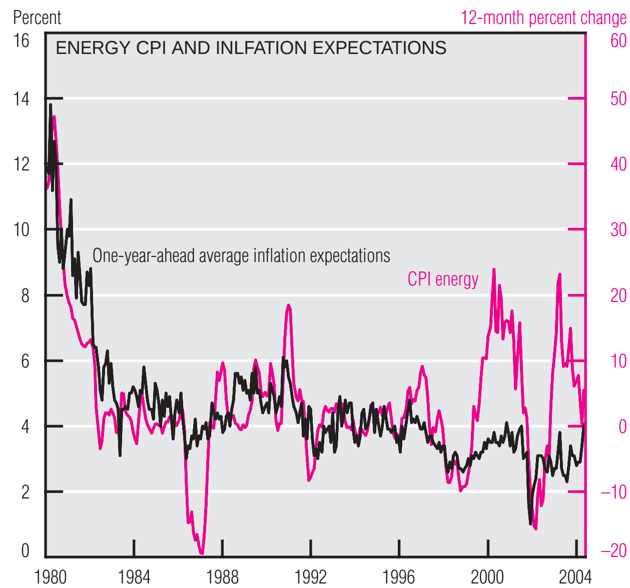
Oil Prices and the Business Cycle







a. Shaded areas indicate recessions as dated by the National Bureau of Economic Research.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Energy, *Annual Energy Review 2002;* Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; University of Michigan, *Survey of Consumers;* National Bureau of Economic Research; and *Wall Street Journal*.

With oil trading around a record high of $40 per barrel, is another recession far behind? Since World War II, oil prices have spiked before nearly every U.S. recession, including the most recent one.

Many economists suggest that oil costs alone are too small relative to output to explain such a severe business cycle response to energy price spikes. They contend that imperfections in the adjustment process or some other mechanism must interact with oil prices to leverage such shocks into full-blown economic downturns.

A prime suspect is monetary policy. Indeed, an increase in the real federal funds rate—the observed funds rate minus the inflation rate—also has preceded nearly every recession.

If the relationship between business activity and oil prices does, in fact, turn on the stance of monetary policy, more's the concern. Market observers expect the FOMC to raise the federal funds target rate before year's end.

Fortunately, some studies suggest that the economic impact of oil price shocks has waned since the early 1980s. The U.S. economy has become much less dependent on oil. We now use about half as much energy to produce a unit of GDP as we did in the 1970s. Other analysts, however, attribute the post-1980 break between oil prices and economic activity to monetary policy changes. Over the past two decades, the Federal Reserve has built a strong reputation for price stability, and inflation expectations no longer parallel energy price patterns closely. Calm inflation expectations provide the Fed with more policy leeway.