BBVA Research

U.S.

Economic Watch

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Economic Analysis

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Will this oil shock kill the recovery?

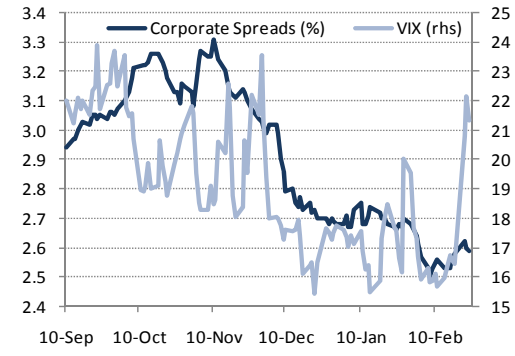
We foresee a temporary shock and limited effect on GDP

- **Oil will eat away at currently-high consumer savings, slowing deleveraging**
- **Oil price increases lower deflation risk, but increases business uncertainty**
- **Higher oil prices will therefore result in a more cautious Fed exit strategy**

Disruption to oil production and the US economy

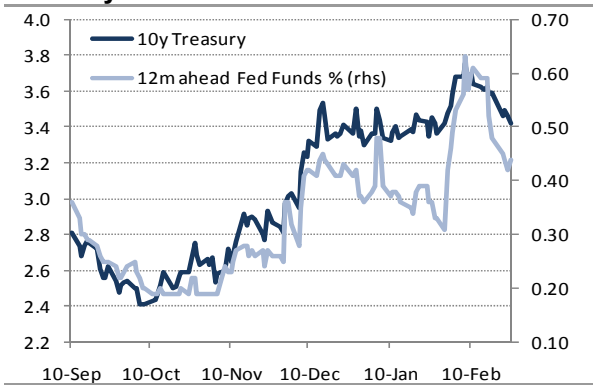
Recent political events in Middle East North Africa (MENA) are pushing oil prices above $100 per barrel. The market's reaction to this price rise is manifested in higher risk perception (VIX), 10-year Treasury bond prices, and Fed Funds futures contracts. This reaction suggests flight-to-quality and downward revisions to forecasted real GDP growth. Stepping back from the instantaneous reaction, understanding the longer-term implications of this shock will depend on two factors: first, the degree to which the shock is permanent or transitory, and second, the pass-through of the shock to core inflation. Naturally, it is difficult to judge if this is a permanent shock. The longer higher prices prevail, the larger the impact on GDP. Second, the shock arrives at an unusual time for the US economy, given extensive resource slack and high fiscal and monetary stimulus. These conditions may temper the pass-through to core inflation, which is one of the primary indicators for monetary policy action. Outside of these long-term issues, we expect oil to impact the economy in five ways: household consumption, business activity, substitution effects, net exports, and inflation. With regard to household consumption, consumers currently save more now than in the past decade. Oil price increases will therefore eat into these buffer savings. However, this also means less-rapid repayment of debt and therefore slower deleveraging. Higher crude prices will slow businesses' pace of investment and hiring, with a negative effect on labor market indicators and nonresidential investment. This also represents the third major uncertainty shock in a short span of time (Lehman, European sovereign debt crisis, and now oil). Firms will suffer from higher transportation costs and input prices. In the very long term, more expensive oil will help move the US towards alternative energy and investments in new oil-minimizing technologies. With regard to net exports, the increase in oil prices will negatively affect the trade balance, thereby reducing further the contribution of net exports to growth. This is detrimental given that the expectation is for a structural shift towards more exports in the US.

Graph 1
Implied Volatility and Corporate Spread



Source: Haver Analytics

Graph 2
Treasury Yields and Fed Funds Futures



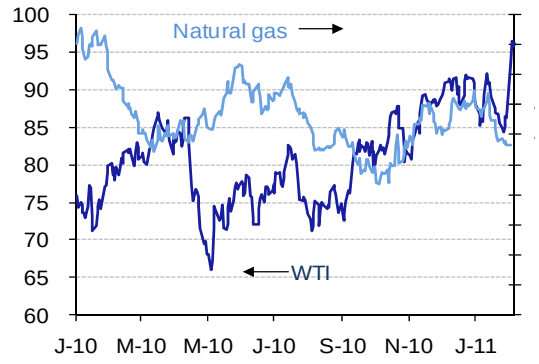
Source: Bloomberg

Bottom line: greater uncertainty, lower deflation risk, and a cautious Fed

Our estimation is that so far this oil episode seems transitory and the impact on GDP will be minimal. One significant change is that previously we viewed upside factors as risks to our forecast. This period of higher oil prices and uncertainty will counterbalance the upside risks for the time being; this also assumes political conditions return to normal within a few months. In retrospect, we have witnessed similar episodes in various oil-producing countries, such as Venezuela's strikes in 2002-03. For example, in 1990 during the Persian Gulf War, world oil production dropped by 8.8%, which reduced US real GDP by 0.1%, according to Hamilton (2003). Libya today represents less than 2% of world oil production. It is important to note that persistent unrest in other large oil-producing countries would more likely translate into a permanent and more destructive oil shock. Additionally, it is still possible for OPEC to increase production to compensate for lost Libyan production. Indeed, Saudi Arabia announced increased production to mitigate lost Libyan oil production. Another factor is increased energy efficiency over the past decade due to technological improvements and government incentives, which would minimize the negative effect of the oil shock on US real GDP.

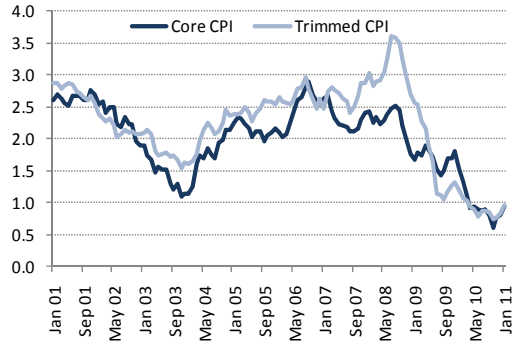
We believe that this oil episode reduces the probability of deflation and increases the vulnerability of the recovery. Higher oil prices, given limited pass-through to core inflation, will extract out the remaining deflation risk. Reduction in consumption and higher uncertainty will extend expectations of the labor market's sluggishness. Given all these circumstances, the Fed will be reluctant to execute early rate hikes. Moreover, certain studies indicate that Fed Funds rate increases to combat inflation from oil shocks may in fact be counterproductive (Bernanke et al 1997). The policy response to this current oil increase is therefore more likely to be dovish.

Graph 3
Energy Prices, Dpb & DpMMBtu



Source: Bloomberg

Graph 4
Core and Trimmed-Mean CPI, YoY%



Source: BBVA Research and Haver Analytics

Table 1
Estimates of Oil Shock Impacts on US Real GDP

Date	Event	Drop in World Production (%)	Drop in US Real GDP (%)
Nov-56	Suez Crisis	10.1	-2.5
Nov-73	Arab-Israel War	7.8	-3.2
Nov-78	Iranian Revolution	8.9	-0.6
Oct-80	Iran-Iraq War	7.2	-0.5
Aug-90	Persian Gulf War	8.8	-0.1

Source: Hamilton (2003)