Oil prices and global consequences

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Oil prices have risen dramatically over the last year but are unlikely to herald inflation in the way they did in the 1970s, according to Vanguard chief economist Joseph H. Davis, Ph.D., and senior economist Roger Aliaga-Díaz, Ph.D. Nonetheless they could have wide-ranging effects on global economies.

A threat to the economy

Rebecca Katz: Hello. I'm Rebecca Katz and today I'm joined by Joe Davis, Vanguard's chief economist, and senior economist Roger Aliaga-Díaz. They're here today to talk about the possible impacts of higher oil prices on global economies. Thanks for being here.

Joe Davis: Thank you, Rebecca.

Roger Aliaga-Díaz: Thank you.

Rebecca Katz: So, Joe, it seems to me that rising oil prices may be one of the greatest threats to the global economy. At what price does oil threaten to push the United States back into recession?

Joe Davis: For the United States, the threshold for another recession as we would estimate is around $150 a barrel for oil. That's effectively $5 a gallon of gasoline nationally.

That's not to say that prices below $150 wouldn't have material impact. In fact, I think we've recently seen that in the United States. And in our estimation, oil even at $120 a barrel, by domestic standards, would start to impact growth, economic growth, employment growth and so forth. And that would certainly introduce financial market volatility. So we're not there yet, but we're uncomfortably close.

Rebecca Katz: How does this apply, Roger, to Europe and other developed markets?

Roger Aliaga-Díaz: Well, it applies to many other developed markets and even to some emerging countries that, like the U.S., depend on foreign-produced oil for energy needs. Directionally, we would say that the impact of higher oil prices on inflation, unemployment, economic growth would be similar as long as countries are exposed to world oil prices.

Japan, Italy, France, Germany all have similar exposure, similar volume, net import of oil as the U.S.

Also some emerging economies, some key emerging countries such as China and India have certain exposure also in terms of net import of oil.

1970s redux?

Rebecca Katz: So, Joe, do we need to fear an oil shock like we saw in the 1970s and 1980s where oil prices rose and inflation also rose?

Joe Davis: And certainly not just rose, but rose materially over a number of years. And in the United States and other developed markets, the U.K., Europe, rose at double-digit levels. And we all can imagine, recall the very pronounced market volatility we saw in equities and fixed income as well.

By our estimations, given current conditions, although anything is possible, it is very unlikely that we would see a repeat of the '70s and '80s in terms of the very high persistent levels of inflation, even if, Rebecca, oil gets to $150 or perhaps even higher.

Why that is, is that although even if oil prices go that high, and that certainly will drive up, at least on a temporary basis, broad consumer price index measures, where you would typically get a dynamic of much higher trend inflation for all goods that we purchase, not just food and energy, so furniture, housing, cars, you name it. That largely depends upon other conditions that facilitate the pass-through of higher energy prices into higher products for things that have nothing to do with energy.

In the 70s and 80s, those conditions included wage growth that was going at almost double-digit pace and money growth so that not only were central banks too easy, which, you could argue today they're very accommodative. However, consumers and businesses had the ability to take those energy prices and to pay them or to pass them on. And that's the dynamic that today by and large in most developed markets we certainly do not see at the present time.

Central banks' response

Rebecca Katz: How do central banks around the world need to respond? Roger?

Roger Aliaga-Díaz: When we look at central banks like the European Central Bank or Bank of England, clearly they are following the trends pretty closely.

One key difference between those two central banks and the Fed is that they have a single mandate, which is price stability, compared to the Fed that has a dual mandate of price and employment stability.

Now, in our view, having the single mandate of price stability doesn't necessarily mean that the central bank is more hawkish against inflation than the bank that has a dual mandate. In fact, much more important for inflation fighting is the reputation, the historical ability to contain inflation shocks from passing through the rest of the economy.

And in that sense, the ECB, because it has a much shorter existence, needs to continue building the reputation, and in that sense, we probably hear more strong language when facing the same inflation shock and even see some preemptive early action.

In the U.K., the situation's a little bit different because inflation expectations in Britain are increasing faster than in the U.S. and in Europe, so as that trend continues, probably the central bank will have to respond, although fiscal consolidation and weak economic growth are maintaining prices in check probably in the near term.

Rebecca Katz: What about the Fed?

Joe Davis: I think for global investors, it's one of these great debates, what the Fed will do or may do if we face oil under any sort of scenarios, if it's lower, higher or somewhere in between.

That under most scenarios, regardless of where oil is, that it's optimal to have an interest rate that's a little bit higher than where it is today, which is effectively at zero. Why that would be, if more likely than not, if oil prices are lower, then with less pressure on economic growth, some stronger recovery and so you would consider a rising rate environment.

If, however, unfortunately, oil would be higher, growth would certainly be lower, but there would be some pass-through to non energy-related prices, which would also suggest more likely than not a slight bias toward rising rates.

So in our judgment, that seems to be the bias. It's not a dramatically rising rate environment, but it's something that if you use the Federal Reserve's own rules, it would be consistent with that sort of response. But I think, that said, the oil price shock is one of the trickiest phenomena that central banks have to handle, because it does compete, puts into competition lower growth with higher inflation, and they want neither of those events.

Considerations for investors

Rebecca Katz: Sounds like they have some tough choices to consider. What do investors need to

consider in light of higher oil prices?

Roger Aliaga-Díaz: Well, as we survey countries across the world and see how they respond to higher oil prices, we see countries that are net importers of oil, as we were mentioning before, and other countries that are net exporters, that are energy-independent and they export oil. I'm talking about non-OPEC countries such as Canada, Mexico, even Brazil that clearly could even benefit from higher oil prices, at least temporarily.

So when investors see these various responses, clearly one would have to think in global diversification as the key approach to investing globally simply because oil would have differential effects in different markets.

Joe Davis: I think the other thing to keep in mind is that oil prices are very important, or commodity prices in general, very important in terms of volatility, can drive volatility in financial markets, that they still will explain a very low percentage of overall returns that we see over time from an investor's portfolio.

So for example, if you look over the past 30, 40 years, the United States, the U.K., Europe, Australia, Canada, various developed markets around the world, the correlation, so to speak, between changes in, say, oil prices and stock returns month to month or quarter to quarter is on average around 5 percent, that we've found.

That means 95 percent of the returns that we see over time, the volatility, has nothing to do with energy prices.

And so I think it's important to keep in mind that there are various other factors that can impact the returns in one's portfolios and it's something that we have seen in the past year and I think we will continue to see going forward, which is just another reason why you have broad diversification and focus on the strategic asset allocation in one's portfolio.

Rebecca Katz: I think that's great advice. Thanks so much for being with us today.

Roger Aliaga-Díaz: Thank you, Rebecca.

Joe Davis: Thank you.

Rebecca Katz: And thanks to all of you for watching. We hope that you'll join us in the future for further Vanguard insights on economic trends.

Note:

Diversification does not ensure a profit or protect against a loss in a declining market.