

Low Real Oil Prices not a New Paradigm

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by

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Unemployment in a number of western countries is now lower than it has been for twenty years. In consequence, there is talk of a new paradigm. A new epoch has begun: technology and other things have changed our lives and lowered forever the natural rate of unemployment.

This view is mistaken. If it is the job of a central banker to take away the punchbowl before the party gets too rowdy, it is the job of the professor to have got to the mail room in time to steam the stamps from the party invitations. They are best saved for other occasions.

Despite common perceptions, nothing surprising is happening in the world economy or in the UK. What we have been seeing is the result of extraordinarily cheap oil – and thus extraordinarily cheap energy. The current boom was predictable and is likely to continue for a little longer. The strong rise in oil prices over the last few months, however, will eventually slow the economies of the western democracies. Like other forces, the price of energy takes time to have its effect. These lags are actually an enormous help to, and can be exploited by, central bankers.

The most cursory look at plots of the last few decades shows that movements in the price of energy are the main trigger for later movements in unemployment and output. The price of oil – not Mr William Gates's inventiveness or globalization or something else with the transient flavour of the 1990s – should therefore be the key variable on our computer screens in planning economic policy.

Here are the facts. In 1998, the real price of crude oil reached its lowest level in post-war history. For a short time last year it was actually one half of the real price of oil in the 1950s, and one fifth of the real oil price that prevailed at the start of the 1980s. The 1998 figure followed a secular decline in energy prices through the decade of the 90s.

The logic of the ensuing boom is not complicated. Everything in the world can be thought of as having been constructed from two things. One is labour. The other is energy. There are, of course, raw materials like iron ore and intermediate inputs like steel bars, but these in turn are obtained by using labour and energy. For the moment they can be left to one side in our mental picture.

The price of labour and the price of energy are, therefore, particularly important prices. As usual in economics, it is best to focus on the concept of real prices not nominal ones.

Fuelled by the decline in energy costs, firms' total costs fell through the decade of the 1990s. Profits, it is known, shot up. This was a good time, therefore, to hire workers or to be a new entrant if you were an entrepreneur. Employment rose and unemployment fell.

One reason why it is surprising to hear ready talk of new paradigms and global transformations (whatever the latter might mean) is that we have been here before. The world has seen this oil-price mechanism at work many times – working the other way around.

There have been two famous upward oil shocks in the post-war period. These were in 1973/4 and at the end of the 70s. Each move up in energy prices was followed by a slump -- and a sharp and then sustained rise in global unemployment. There is one less famous oil shock (it is unclear why this has not entered commentators' consciousness as sharply), namely, the doubling of oil prices around the time of the invasion of Kuwait on August 2, 1990. This too was followed by a recession and a spike in unemployment. Some macroeconomists have described this as the mystery recession of the 90/91. Yet it conforms exactly to type.

The boom has touched every country recently, but many start from a different unemployment level and can only dream of the 4-5% unemployment rate of the United States.

There will continue to be large amounts of structural joblessness in many countries. Its cause is different – and still debated. The conventional view is that the unshakeable unemployment levels of countries like Spain and Italy are due to labour market inflexibilities. Benefits are too high; unions are too strong; taxes and hiring and firing costs distort firms' decisions. Although there may be something to all this, the cool-headed evidence is not great. These beliefs about unemployment's cause are mainly the result of theoretical preconceptions. For example, until recently Italy had almost no unemployment benefits, and Spain even now has one of the lowest union density levels in the world. Moreover, there is no correlation, if you look across nations, between high labour tax rates and high unemployment.

A more plausible explanation is that the housing market has gone wrong in most European nations. Young people and low-skill workers are too often stuck in the wrong place, because the private rental housing market has been largely extinguished in most of Europe. The nations that have the largest private rental housing markets, like Switzerland and the Netherlands, have the least joblessness.

These facts continue to go largely un-remarked by macroeconomists and pundits. Yet they are the main reason for the patterns we see in the world.

Over the last year, politicians in many nations have begun to take credit for a continuing decline in joblessness. That is likely to intensify this autumn. Their particular country's policies, we will come to hear, have created a more vibrant and efficient labour market. The reason to doubt this is that nearly all nations now have declining joblessness. It is black gold, not a golden age, that is the main thing to be kept in mind.

Where next? Autumn crude oil prices at the time of writing have hit \$22 a barrel, from around \$11 earlier in the decade. This is a large oil shock and is already showing up in firms' costs. It is already being passed on through the web of costs across the economy -- as it feed into prices of intermediate inputs and eventually to firms' selling prices. Prices change first. Output and employment changes come a little behind.

But by next year, normal mechanisms will have begun to reduce output and employment. The fourth oil shock will have started to take effect.