Shock treatment

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Oil prices and recessions

- The two nastiest recessions of recent decades were preceded by huge and sudden rises in the price of oil
- First in 1973, then in 1979

Oil shock

- Economic “shock”: A sudden change in business conditions
- Higher oil prices hurt the economy because they act like a tax increase
- Oil-producing countries benefit from higher crude prices
- So the impact on global demand depends how their extra income is spent
- The abrupt shift in the distribution of global income will still be destabilizing, however

Today's higher oil prices

- Unthinkable until very recently
- Then why the economy is still doing relatively well?
  - Oil is used less intensively
  - Economy is more flexible
  - Central banks are better at controlling inflation
- Rich countries use less than half as much oil as they did in 1970s

Economy is more flexible

- In 1970s, union power and indexed contracts meant wages were unyielding
- This magnified the adverse effects of oil shocks
- Today, workers view higher oil prices as a temporary tax increases that lowers their real wage take-home pay, so the collateral damage will be smaller

Monetary policy

- Today's consumers have more trust in policymakers to keep inflation under control
- Expectations of future price increases have remained remarkable stable
- Employees are less pushy in seeking inflationary wage deals and firms think twice about raising their own prices
- Central banks are doing much better than before