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America will fall harder if oil prices rise again

The price of imported oil in the US doubled between summer 2003 and summer 2005, reducing consumers' purchasing power by more than 1 per cent of gross domestic product. Nevertheless, the economic slowdown that was widely expected never occurred. Consumers kept spending and businesses kept investing. The growth rate of GDP rose and unemployment fell to 4.9 per cent.

The continued strong growth contrasts sharply with the economic weakness that occurred after almost every previous significant rise in the oil price. How do we explain this remarkable difference? And what are the implications for the likely response to a future rise in oil prices?

The key to the economy's strength in 2004 and 2005 was that household saving declined dramatically while the price of oil rose. Household saving fell from 2.5 per cent of after-tax income in the third quarter of 2003 to a remarkable minus 1.8 per cent two years later. This 4.3 per cent shift of after-tax income was equal to a rise in consumer spending equal to 3 per cent of GDP.

In dollar terms, saving fell from a $205bn (£115bn) annual rate in the third quarter of 2003 to dissaving at a rate of $159bn two years later. This shift of $364bn in the annual rate of saving far outstripped the fall in income caused by the higher cost of oil. This fall in saving allowed households to raise consumption spending on non-oil goods and services while paying for the higher cost of imported oil.

The primary cause of this dramatic shift was the fall in interest rates and the resulting rise in mortgage refinancing. Homeowners who refinanced their mortgages took out cash and reduced their monthly payments at the same time. Much of the cash obtained by refinancing was spent on consumer durables, home improvements and the like. The lower monthly payments permitted a higher level of sustained spending on all non-durable categories.

Mortgage debt grew nearly $3,000bn from the end of 2000 to the end of 2004, an amount equal to nearly 7 per cent of GDP. More than half of this mortgage borrowing was the result of refinancing existing mortgages. Although some of the refinance funds were used to pay down other debt or to finance portfolio investments, a Federal Reserve study found that about half of the mortgage refinance funds were used to pay for new consumer spending, an amount consistent with the swing in aggregate saving and consumer spending.

The faster increase in consumer spending caused businesses to invest more and raised the rate of growth of GDP. Faster GDP growth caused an accelerated rise in employment and a fall in the rate of unemployment.

Mortgage interest rates were falling because the Federal Reserve's fear of deflation had caused it to lower the short-term federal funds rate at which banks lend to each other to the extremely low level of 1.0 per cent in 2003 and to leave it there in the first half of 2004 before beginning a very gradual process of rate increases. As a result of the low short rate, mortgage interest rates fell in 2003, declining from 6.1 per cent at the start of 2003 (and more than 7 per cent two years earlier) to 5.5 per cent in early 2004. The lower mortgage rates induced refinancing and the subsequent gradual rise in rates induced additional refinancing by homeowners who wanted to borrow before rates rose further.

The powerful effect of mortgage refinancing on consumer spending was a very happy coincidence for the American economy at a time when oil prices were depressing consumers' real incomes. If oil prices were to rise again in 2006 or 2007, the adverse effect on consumers' real incomes would not be offset by increased mortgage refinancing. Mortgage refinancing has now peaked and is declining. The Federal Reserve is raising interest rates again to counter the inflationary pressures that remain from the rise in energy costs. And individuals no longer have the large amounts of household equity against which to borrow.

A rise in the oil price could happen again at any time. There is little spare capacity in global oil production and oil demand is rising rapidly in China and other Asian countries. A shock that reduced the production or shipping of oil could drive its price sharply higher. Speculative forces could compound this problem. The US was lucky after 2003 to escape the contractionary effect of an oil price rise even without an explicit change in monetary or fiscal policy. It would not be so lucky if a big oil price increase happened again now.

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