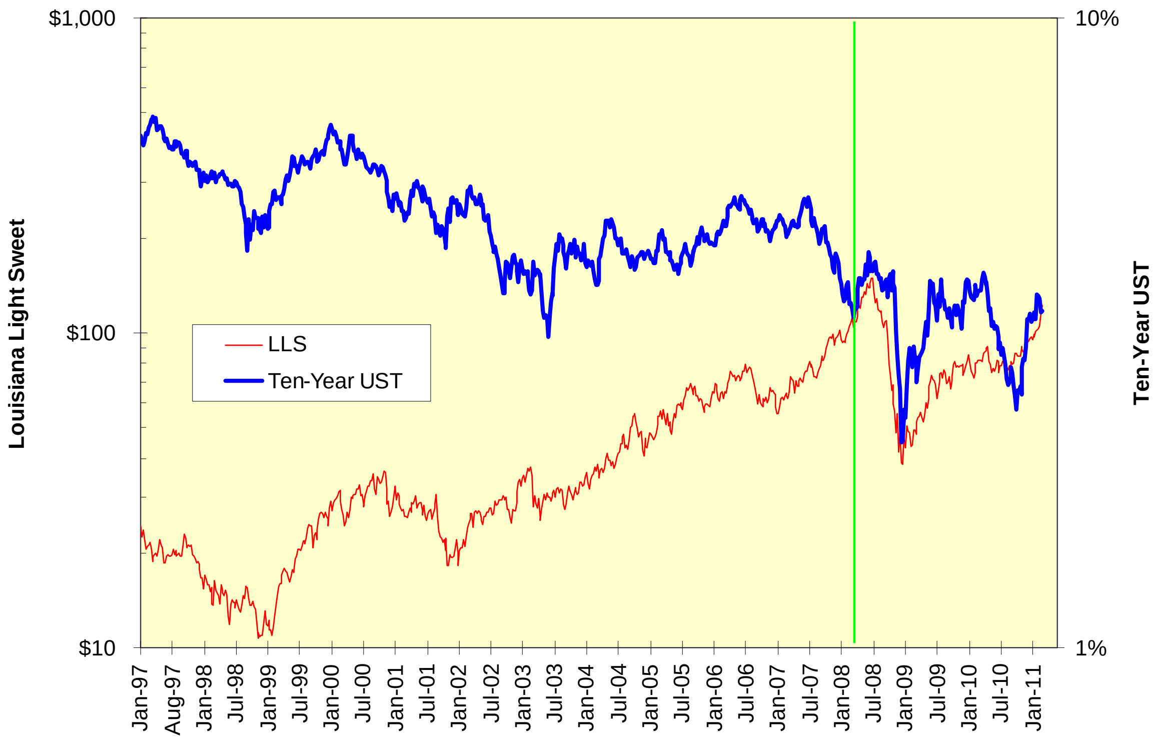
Crude Oil And Inflation. Different This Time?

Back in the wayward days of my youth – actually, as an oil industry economist in the late 1970s – when I still had a puckish sense of humor and enjoyed watching peoples' jaws drop, I used to hit them with the old one-two. First, rising crude oil prices were, if left un-monetized, disinflationary. Second, they were going to be better off in the long-term if they paid more for natural gas as it would encourage new supplies.

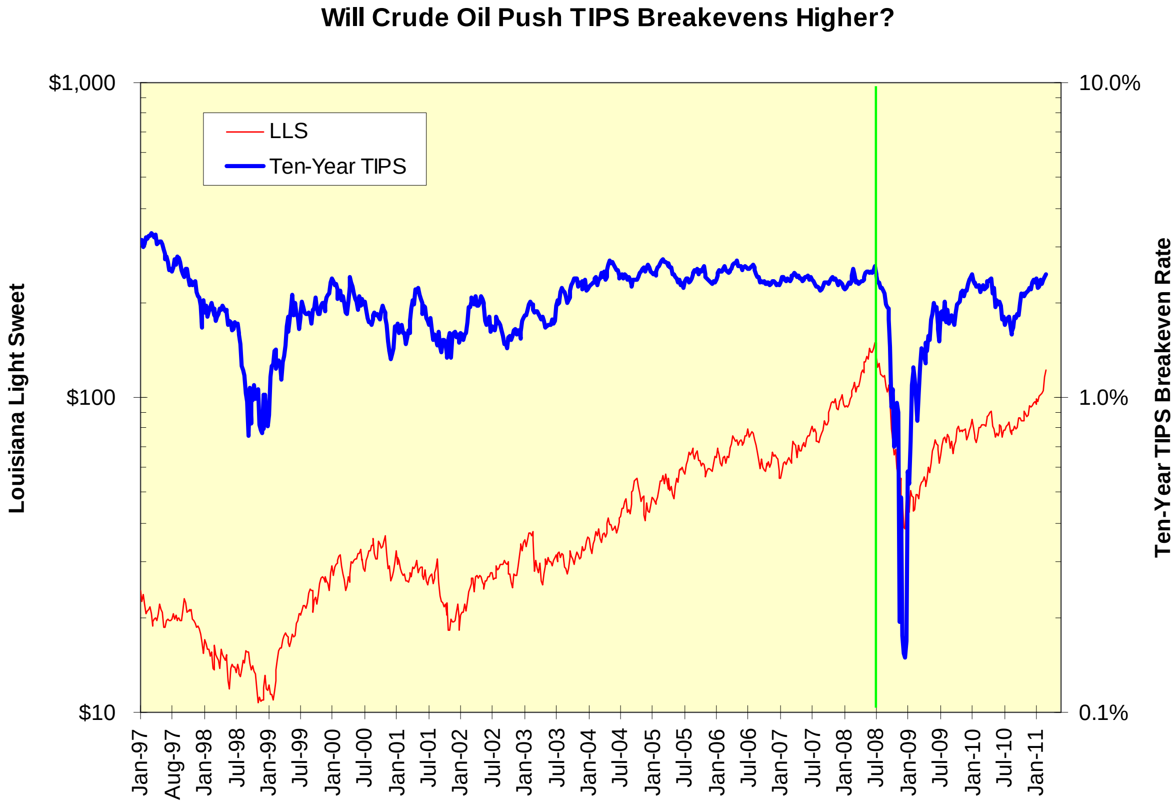
Let's focus on the crude oil one. Higher crude oil prices act as a tax and as they are a major component of our current account deficit, they depress GDP growth, all else held equal. They also induce a frictional drag on the economy as higher energy prices lead to a reallocation of resources in accommodation. Finally, the monetization part is key: The money spent on petroleum products is money not being spent elsewhere. If velocity stays constant, and the overall transaction level faces downward pressure from the implicit energy tax, then the overall price level can increase only if the money supply increases more rapidly.

Of course, we live in a world of rampant monetization, and this leads us to a clear and present danger of inflation arising as energy and other factor prices move higher. Let's take a comparison of Louisiana Light Sweet (LLS) crude oil, chosen to sidestep the [mid-continent discount] and U.S. ten-year Treasury rates since the January 1997 inception of TIPS. Both are plotted on a logarithmic scale. From January 1997 through the March 2008 bailout of Bear Stearns, marked here with a green vertical line, long-term interest rates fell while crude oil prices surged. After March 2008, the relationship switched from a negative one to a positive one.

Will Crude Oil Push Long-Term Treasury Yields Higher?



Now let's repeat the exercise with ten-year TIPS breakevens. Rising crude oil prices did nothing to push TIPS breakevens higher until the July 2008 backstopping of Fannie Mae and Freddie Mac, also marked with a green vertical line. Then a non-relationship became highly pro-cyclical.



What changed on these two dates in 2008? While the Federal Reserve had been in "risk management" mode since the mid-1990s as Alan Greenspan refused to allow either a recession or a financial market hiccup on his watch when a bubble could be blown instead, the financial crisis really kicked the Federal Reserve's money-mania into high gear. Not only was a non-member financial institution rescued in March, but the Treasury put the government's full faith and credit behind the mortgage giants in July.

The net result is we are in a monetization mode, and higher energy prices will not produce the scrimping on other expenditures they should. This will preserve the transaction level and raise the price level. The result will not be a stagflation but rather inflation. Should commercial lending pick up and the monetary base convert into credit at a greater velocity that we have seen in recent years, we will be off to the races with this inflation. This is why the Federal Reserve should begin contracting its balance sheet as soon as possible.