



Unique survey of 600 business leaders  
across Europe reveals attitudes  
on investment in people

Click here to try **our new website** — you can come back at any time

July 14, 2016 10:22 am

# Is cheap oil really good for the global economy?

Kamiar Mohaddes and M Hashem Pesaran

[Share](#) [Author alerts](#) [Print](#) [Clip](#) [Gift Article](#)

[Comments](#)

## The old view is largely correct, say two experts



**A**re low oil prices good for the world economy?

A decade ago that question would have been met with an unbridled “yes” from most investors, who were used to seeing stock markets rise when energy prices fell, or struggle when oil got too hot.

But in recent years oil prices and equity markets have started to move in tandem, leading prominent economists, including former Federal Reserve chairman Ben Bernanke, to question this long-held view. Oil’s crash to below \$30 a barrel in early 2016 triggered a stock market sell-off as investors worried it signalled a sharp slowdown in the world economy.

So did we economists have it wrong all along? Are higher oil prices actually better for global growth and investor returns? We were keen to find out.

In a recent study we found that the old view was largely, on balance, correct.

Taking a relatively long historical perspective (1946-2016), we compared real oil prices (adjusted for inflation) with US equity prices, as measured by the S&P 500 index.

Over the 71 years, we found that lower oil prices do, overall, improve profit opportunities and dividends in oil importing economies, which is good for the world economy.

But our other main finding was that the relationship is far from stable. Over the seven decades we found sub-periods where changes in real oil prices and real equity prices were unrelated, as well as sub-periods over which they are negatively and positively correlated.

That suggests that the recent response of equity markets to oil price changes should not be taken as evidence that lower oil prices are no longer beneficial for the US and the world economy.

There could be a number of reasons for the recent relationship.

First, while markets are generally efficient and move to reflect the fundamentals affecting a company's strength, there are also episodes when prices do not reflect the state of the economy. In such periods any evidence of a perverse relationship between real equity and oil prices could be due to the disconnect between equity markets and economic fundamentals and not necessarily any breaks in the relationship between oil prices and the real economy.

Second, sovereign wealth funds accumulated large assets during the most recent oil boom (2002-08) and they have come to play a major role in managing oil revenues for producer countries.

On average 65 per cent of SWF assets are held in public and private equities. During periods of rising oil prices, these funds are topped up with equity purchases. However, when oil prices fall, most major oil exporters withdraw money from the funds in order to maintain other expenditure, such as on welfare.

Given their size, SWFs can induce an unintended positive correlation between oil and equity prices. While it is true that such effects may, on their own, not be that large, they can trigger overreactions due to the presence of a large seller or buyer in the market.

To back up our findings we conducted further statistical analysis including US industrial and manufacturing activity, as well as equities and dividends compared to inflation-adjusted oil prices. While this confirmed the positive relationship between oil and equities since the financial crisis, it also confirmed the much longer-term trend. Since 1946, all signals of economic strength have been stronger when oil prices were weak.

To take into account the feedback effects of oil price changes on global energy demand, interest rates, financial markets and world trade, we also used a quarterly multi-country model (known as the GVAR-Oil model), and showed that a fall in oil prices tends relatively quickly to lower interest rates and inflation in most countries, and increase global real equity prices. The effects on world real output are positive, although they take longer to materialise, which supports the results based on monthly data.

While commodity-dependent economies may suffer from lower prices — and they make up a larger share of the world economy than they once did — it is still not enough to offset the benefits felt in the much larger importing countries. Alone, the four largest net oil importers — China, US, Japan and India — make up more than 50 per cent of the world's gross domestic product.

If weak oil prices are good for the world economy, why has it not appeared stronger since oil prices started falling in mid-2014?

Political and financial uncertainty — from a slowdown in China and the threat of terrorism, to Brexit and the US election — have all dragged on the world economy. Indeed, they may well continue to do so. But without the lower oil price, it could have been worse.

*The Commodities Note is an online commentary on the industry from the Financial Times*

*Kamiar Mohaddes is a senior lecturer and fellow in economics at Girton College, University of Cambridge*

*M Hashem Pesaran is the John Elliot distinguished chair and professor of economics at University of Southern California and the director of the USC Dornsife Institute for New Economic Thinking. He is also an emeritus professor of economics at the University of Cambridge and a fellow of Trinity College, Cambridge*

## RELATED TOPICS Oil, Global Economy

 Share  Author alerts  Print  Clip  Gift Article

 Comments

---

### PROMOTED CONTENT

Promoted By **Zurich Insurance Group**

## How employers can help bridge the Income Protection Gap

The good news is that people are living longer. The problem is that no one seems to know what to do about it. How do we fund these longer lives, particularly as we're likely to encounter more illness and disability as we grow older and state coffers are running out of money? See more...

---

### VIDEOS