

Evaluating price hikes: Research shows that recent oil shocks are not causing inflation

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While the price of oil has risen in recent years, it has not affected the price of goods as much as in the past, according to research by two Kansas State University economists.

More than that, the prices of many goods -- such as clothing or vacations -- are actually deflating instead of inflating because of improved technology and reduced [energy costs](#).

Lance Bachmeier, associate professor of economics, and Inkyung Cha, adjunct professor of economics, discuss oil shocks and [inflation](#) in an article titled "Why Don't Oil Shocks Cause Inflation? Evidence From Disaggregate Inflation Data." The article appeared in a recent issue of the *Journal of Money, Credit and Banking*, a leading journal in economic research.

Bachmeier and Cha used inflation data from the [Bureau of Labor Statistics](#) to look at more than 100 core goods. Core goods do not include groceries, but rather include goods such as cars, [household appliances](#), clothing, cosmetics, toys and vacations. Such goods are not affected as much by oil shocks, Bachmeier said, but have actually experienced some minor deflation from rising oil prices.

"If you used to spend \$10 to fill your tank, and now you are spending \$20, that gives you \$10 less to spend on cosmetics or clothing," Bachmeier said. "So that causes the demand of those goods to fall, and then the price falls."

Bachmeier and Cha focused their efforts on data from 1973 to 2006. They began with the 1970s because of two large oil price increases that occurred in 1973 and 1979 and caused inflation in the prices of core goods. The 1990s brought even larger oil shocks, yet the prices of core goods didn't go up. The researchers wanted to understand the two decades and how they related to inflation and the current [oil industry](#).

"Many [economists](#) would say that the difference in inflation for these two decades was caused solely by [monetary policy](#)," Bachmeier said. "But when we looked at the data for core goods, we found that is not the case."

Instead, the researchers found another factor that influenced inflation: As time progressed, manufacturers began to use less energy. When production costs are lower, prices often lower, too.

The biggest cost for some manufacturers is energy, so even small advances in technology have helped reduce production costs. For instance, newer technology has helped diesel trucks get 7 miles per gallon, when they used to get 4.8 miles per gallon in 1977. Other technologies have created more energy-efficient methods of producing paper and steel, among other developments.

The researchers attribute reduced energy usage for two-thirds of the change in inflation response to oil shocks and they attribute monetary policy for the remaining one-third.

"There is always a demand for energy-efficient technology," Bachmeier said. "But now, manufacturing plants are adopting new technologies faster, saving more money and lowering prices."

Gas prices and the oil industry

Consumers have noticed it at the pump: [Gas prices](#) are temporarily lowering.

Bachmeier attributes the lower prices to uncertainty about the global economy. Without this uncertainty, gas prices might reach \$5 a gallon, he said.

Even more, it is hard to predict the direction of gas prices right now because of market uncertainty in Iran and other Middle Eastern countries, the weak United States and European economies, and the fact that consumers might change their behavior now that they realize gas prices are not likely to return to \$1.50 per gallon.

"United States consumers will realize that gas prices are not likely to go much below where they are right now," Bachmeier said. "Some college students and others with low incomes will walk or ride bicycles when possible. Consumers will put more emphasis on gas mileage when they buy a new vehicle. Even at \$3 per gallon, an average middle-age male driver will save about \$200 per month on gas by driving a Hyundai Elantra rather than an SUV."

Provided by Kansas State University

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