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Oil Prices: Fueling Inflation?

OPEC's curtailment will not help the fight against inflation.

Editor's note: we are publishing a little early this week, recognizing that a number of you will be celebrating or observing spring holidays. We hope that those occasions are relaxing and restorative for you and your families.

This week began with an announcement that the Organization of Petroleum Exporting Countries (OPEC) will be decreasing output. The cut of over one million barrels per day follows a prior drop of two million barrels in October 2022, reducing the global flow of crude by about 3% in total.

OPEC's rationale was straightforward: a desire to support prices in anticipation of lower oil demand. Recent readings of factory activity suggest a slower year ahead; our forecast is for sluggish growth across major markets. Some observers were quick to spin a geopolitical story out of the news. Was this a sign of a further estrangement between the U.S. and Middle Eastern states? Is this indirect support of Russia, as a higher oil price helps Russia's challenged oil exports? We will leave that to the pundits and focus instead on the more tangible effects of this decision.

Not long ago, we questioned drawing down the U.S. Strategic Petroleum Reserve (SPR) as an inflation hedge; it stretched the chartered purpose of the reserve, and it didn't prevent inflation from surging. We took consolation that the federal government could benefit from a spread trade, selling reserves at last year's high prices with prospects of restocking at a lower future price. But that opportunity was squandered. U.S. Secretary of Energy Jennifer Granholm testified to Congress that "This year, it will be difficult for us to take advantage of this low price," as two of the SPR's four storage facilities are now offline for maintenance.

The SPR stock stands around 375 million barrels, 40% below its 2019 level. Private reserves of crude oil remain ample. If oil prices stay elevated, we will look back on this as a missed opportunity. If a disruption strikes the oil supply chain, we may feel much deeper regret.

Our more imminent concern is the effect of energy prices on inflation, both directly and in its perception. Improvement in inflation has slowed, and recent gains were led by falling energy prices. The price index on motor fuels is down by over 21% from its June 2022 peak, while fuel oil for home heating has trended lower throughout the winter.

A lower supply of oil could add to inflation at an inopportune time.

A reacceleration of energy prices would complicate the battle against inflation, as central banks can exert little influence over global energy markets. Higher gasoline prices keep inflation top-of-mind; they are closely and negatively correlated with other measures of sentiment. Another bout of high fuel prices can lead to higher inflation expectations, which can become a self-fulfilling prophecy.

Fortunately, markets have taken the news in stride. The cut pushed the price of Brent crude up 8.4% to $85.81. Though that was the largest one-day jump seen since the Ukraine invasion, oil prices have since leveled off. The price per barrel is now back to where it stood before banking stress added to growth fears, and we have not returned near the painful prices that were inescapable last summer. Higher prices do not always guarantee a recession; four months of oil over $100 last year did not halt the recovery. The resilience of the economy has been potent over the past three years. We do not expect that OPEC alone can stop the momentum.

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