Higher Prices Paradoxically Could Be Deflationary

Earlier this week the Energy Information Administration reported demand for finished motor gasoline fell nearly 700,000 barrels per day to around 7.8 million for the latest week. As illustrated in the chart below, this is a relatively low reading, generally last seen during the early stages of the pandemic.

In response, oil prices fell sharply, down five dollars. They are now down over $11 in just the last week to around $82 per barrel. For now, fear of $100-plus oil prices has been cast aside. But the latest data are important in two regards.

One, **weaker gasoline demand could reflect a softening economy.** Since gasoline is a central input into the economy’s daily functioning, falling demand could signal a pullback in business production and spending. It is noteworthy that the factory sector which in general is an outsized user of energy has been in recession for the last 11 months according to the Institute for Supply Management.

Two, **consumers may be balking at paying such high prices at the pump, causing them to drive less.** This has critical implications for the inflation outlook because higher prices may not be inflationary as many investors think. Rather, it may be the exact opposite. **High oil prices could ultimately be deflationary.**

When oil prices soared to about $125 per barrel in March 2022, the economy had been booming and interest rates were still zero. Headline inflation went up, and higher petroleum prices were passed through into the core. But today, year-over-year GDP growth has slowed markedly, and interest rates are up considerably. Overall headline and core consumer prices have been trending noticeably downward.

**In the short-term a surge in oil prices would boost inflation, but against the backdrop of weaker growth and “tight money”, higher gasoline prices would also effectively act as huge tax on businesses and consumers.**

The ensuing collapse in aggregate demand could cause a recession that would ultimately lead to much lower inflation. If so, market participants could eventually start fretting the possibility of deflation rather than inflation.

It is interesting to note that the recent increase in oil prices did not coincide with a similar increase in 10-year breakeven inflation or survey-based measures of inflation expectations. Today’s environment is much different than 18 months ago. Consequently, if there is a renewed surge in oil prices, the outcome for the economy and the financial markets may be very different.
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