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News release

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Has Oil Lost the Capacity To Shock? - Speech by David Walton

Speaking at the University of Warwick Graduates' Association Senior Directors' Forum, David Walton, member of the Monetary Policy Committee, said that the UK economy appears to have emerged relatively unscathed from a doubling in oil prices since the end of 2003.

For Mr Walton, in explaining this fairly benign outcome relative to previous episodes of rising oil prices, "the size and nature of the oil price shock are important. But so too are the mechanisms by which the shock gets propagated through the economy. Among other things, this depends on the state of the economy at the time the shock hits, the extent of rigidities in the economy, the monetary policy framework and the monetary policy response."

After considering each of these in turn, Mr Walton reaches several conclusions.

"The size and nature of the shock have been different. Relative to previous episodes, the shock has taken longer to unfold. The economy is also less dependent on oil than during the 1970s. And oil prices have risen as a consequence of strong global demand rather than as a result of supply disruptions associated with wars."

"The UK economy has been better placed to absorb the current oil price shock. There were few inflationary pressures in the economy when oil prices first began to rise sharply and there has been little sign subsequently of higher wage demands."

"The monetary policy framework has played an important role. Inflation targeting has helped to anchor inflation expectations, yet it has allowed the MPC to respond flexibly to the oil shock."

Mr Walton also argues that this episode has provided important lessons for the conduct of monetary policy. "An oil shock can have effects on supply and demand in the economy, both in the short run and the long run. It is the balance between supply and demand that matters most for inflation and, hence, interest rates. But the magnitude and timing of these demand and supply effects are very hard to determine. There is no mechanical formula that can be applied to tell the MPC how to adjust interest rates to deal with higher oil prices."

Reflecting on recent interest rate considerations, Mr Walton said: "With inflation expectations remaining stable, the MPC did not have to respond directly to the first round effects of higher oil prices on consumer price inflation. The MPC was able instead to pay more attention initially to the negative consequences for demand. But the Committee also needs to watch carefully for any signs of an adverse impact on supply, particularly now that GDP growth appears to have returned to around its long-run average rate. And we do not yet know how large the shock will be ultimately. After dipping during the final months of last year, oil prices have been rising again in recent weeks; wholesale gas prices have also risen sharply. At all times, the Committee's focus will be on achieving the appropriate balance between demand and supply to keep consumer price inflation on track to hit the government's target of 2 per cent."

Key Resources

"Has Oil Lost the Capacity to Shock?"
Speech by David Walton to the University of Warwick Graduates' Association Senior Directors' Forum in London on 23 February 2006
http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2006/speech268.pdf