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Signals on the Fritz

Energy Price Volatility Impedes Investment by Creating Uncertainty

Amanda Logan and Christian E. Weller June 2009

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Introduction and summary

Surprises can be fun for birthdays, wedding proposals, and the birth of a child, among other things. But they are less welcome in the economy, where predictability is generally more desirable. A more certain future means business and individuals can plan better and be more confident that they will recoup their initial investments.

It would then be reasonable to assume that brisk and unexpected changes in something as far reaching as the price of energy would have a large effect on consumers and businesses since they wreak havoc on even the best-laid investment plans. The purchase of an energy-efficient vehicle makes sense when gasoline prices are at record highs, but not as much sense when they near lows not seen in years. Energy prices in general and gasoline prices in particular have gone from red hot to stone cold to red hot again in the span of a few months in recent years.[1] From January 2008 to July 2008, for instance, the average monthly national gasoline prices rose by 33.5 percent, before dropping by 58.5 percent in December 2008 and then rising again by 34.3 percent to $2.266 in May 2009.[2]

Businesses and consumers will likely delay economic decisions and economic growth slows as these groups scratch their heads trying to figure out which price will ultimately turn out to be the right one that forms the basis for economic decisions.

In fact, the data shows that energy price volatility does hurt investment by families and businesses while bringing profits to oil companies:

- **Consumers will delay buying a car after extraordinarily high energy price volatility.** There is an 83.3 percent chance that consumers will spend a smaller share of their disposable income on vehicles after they have just gone through a period of high price volatility. In fact, consumers buy about 1.6 percent fewer cars one year after experiencing a year-long episode of large energy price swings.

- **Families also spend less money on buying or upgrading their homes when they just lived through the roller coaster ride of large energy price swings.** Investment in residential structures—new home purchases and upgrades—dropped by 0.5 percentage points relative to gross domestic product on average after energy prices swung wildly for 12 months.

- **Businesses cut their investment spending following large price swings, too.** There is a 91.7 percent chance that business investment in transportation equipment—such as trucks—and tractors—as a share of gross domestic product will decline after extraordinary energy price volatility, largely because businesses will buy 11.0 percent fewer vehicles, delaying purchases of new ones.

- **Not everything declines after high energy price volatility.** The profit rate—profits to assets—of the oil and gas industry tends to surge during periods of high energy price volatility.

This report details the extent to which several categories of consumer and business spending change following periods of high energy price volatility. We also briefly examine whether policymakers can step in, for instance by promoting the use of and investment in renewable energy sources and reducing our dependence on imported oil—or if we are doomed to stay on this energy price roller coaster forever.

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