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Falling Oil Prices Provide a Mild Stimulus to U.S. Economic Activity

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World oil prices have dropped by more than $30 per barrel since June and the futures market shows the drop will be sustained (Figure 1). The drop in oil prices is the result of both weak demand and increased supply. World oil market participants have gradually realized that weak economic activity in China and Europe has weakened oil demand. At the same time, the world oil market has seen growing supply, particularly from U.S. shale oil production.

As a result of lower crude oil prices, U.S. gasoline prices are the lowest they have been in four years. The reduction in oil and gasoline prices are a mild stimulus to U.S. economic activity. The economic effects are likely to be uneven across the country.

Figure 1. Brent Crude Oil Prices

Sources: U.S. Energy Information Administration; CME Group

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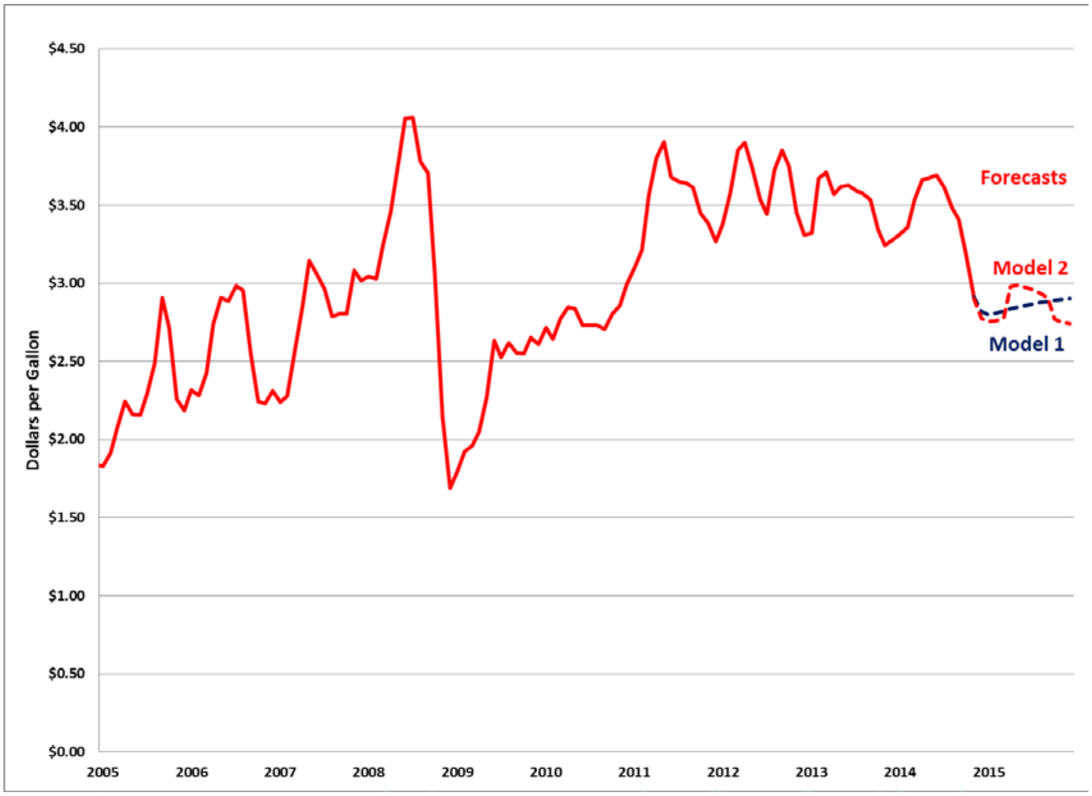
Effects on Gasoline Prices

The reduction in crude oil prices should translate to about an 80 cent per gallon reduction in U.S. pump prices for gasoline (Figure 2). Most of that reduction has already occurred. The result is gasoline prices that are the lowest they have been since November 2010.

Figure 2. U.S. Pump Prices for Regular Gasoline



Sources: U.S. Energy Information Administration; Center for Business and Economic Research, UNLV

The futures market for crude oil shows a slight upward trajectory. If that trajectory is sustained, a simple model based on the relationship between pump prices for gasoline and those for crude oil prices (Model 1) shows that U.S. pump prices for regular gasoline can be expected to range from $2.80 to $2.90 per gallon in 2015.

If we take into account the normal seasonal variation in gasoline prices, we see a slightly different picture (Model 2). Gasoline prices are higher in the summer months than the winter months. We should expect to see a seasonal high just under $3.00 per gallon in May 2015 and a low of $2.73 per gallon in December 2015.

Effects on Overall Economic Activity

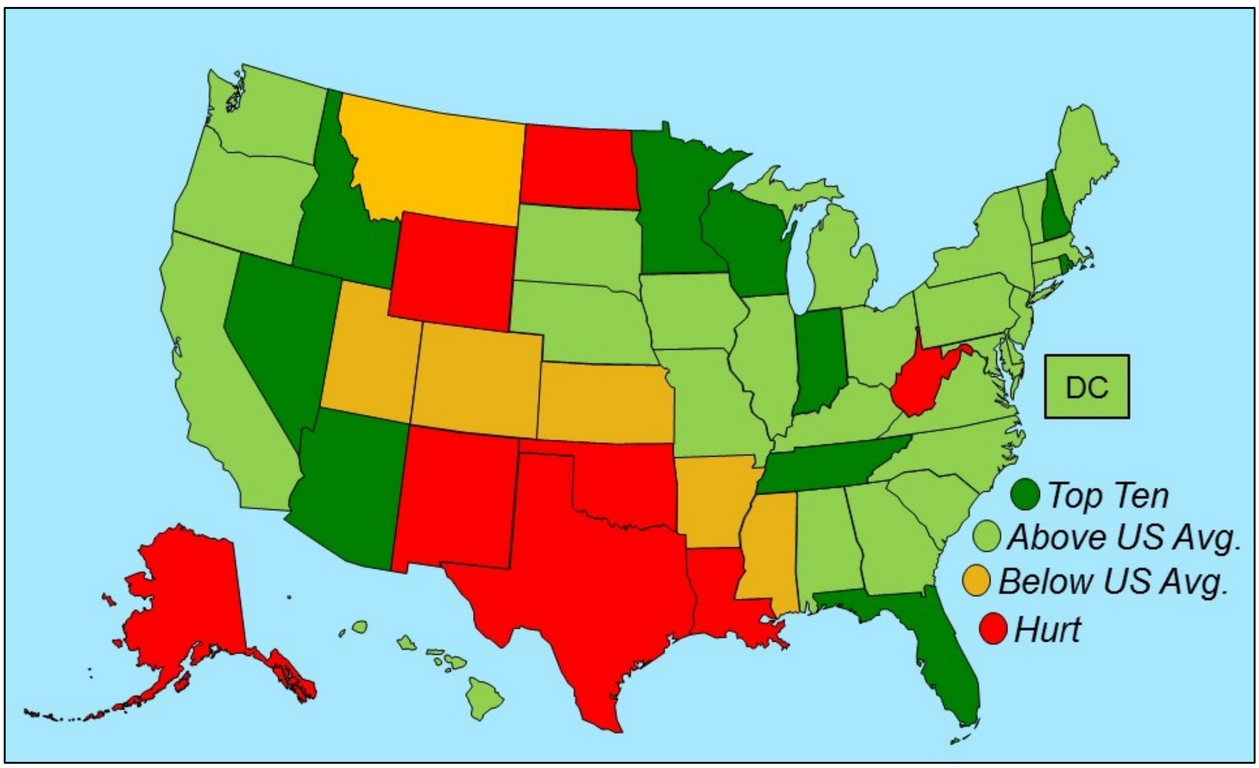
The reduction in oil prices provides U.S. consumers with what amounts to an annual increase in disposable income of $219 billion (about $1,800 for the average U.S. household) through reduced prices for gasoline, other petroleum products, and goods and services whose production uses petroleum products. The small increase in consumer spending will boost overall U.S. economic activity.

Some of the increase will be offset by reduced corporate income. Because the United States now produces about two-thirds of its oil consumption, only $73 billion of that increased spending power comes from foreign oil producers. The rest comes from domestic oil producers.

Economic Effects Uneven Across the United States

The economic effects of lower oil prices will be uneven across the United States (Figure 3). The economies of 42 states and the District of Columbia will be helped by lower oil prices. The extent of the help in each state owes to its energy dependence of its economy and the lack of oil and natural gas resources. The economies of eight states—Alaska, Louisiana, New Mexico, North Dakota, Oklahoma Texas, Wyoming and West Virginia—will be hurt by lower oil prices. These eight states have economies that rely on producing energy for export to other states.

Figure 3. Lower Oil Prices Will Boost Economic Activity in 42 States



Source: Adapted from Brown, Stephen P. A. and Mine K. Yücel (2013), "The Shale Gas and Tight Oil Boom: U.S. States' Economic Gains and Vulnerabilities," Council on Foreign Relations (October).

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