

# The Econometrics of Oil Market VAR Models

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**Abstract:** Oil market VAR models have become the standard tool for understanding the evolution of the real price of oil and its impact on the macro economy. As this literature has expanded at a rapid pace, it has become increasingly difficult for mainstream economists to understand the differences between alternative oil market models, let alone the basis for the sometimes divergent conclusions reached in the literature. The purpose of this survey is to provide a guide to this literature. Our focus is on the econometric foundations of the analysis of oil market models with special attention to the identifying assumptions and methods of inference.

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## 1. Introduction

In the last decade, structural vector autoregressive (VAR) models of the global oil market have become the standard tool for understanding the evolution of the real price of oil and its effect on the macro economy. These models have helped create a consensus among researchers and policymakers that shifts in the global demand for oil are the primary determinant of the real price of oil. As the oil market literature has grown at a rapid pace, there has been a proliferation of alternative approaches to modeling the real price of oil, some refining existing models of the global oil market and others challenging this consensus. As a result, it has become increasingly difficult for mainstream economists to understand the differences between alternative oil market models, let alone the basis for the sometimes divergent conclusions reached in the literature. The purpose of this survey is to provide a guide to this literature.<sup>1</sup>

Our focus is on the econometric foundations of the analysis of oil market models with special attention to the identifying assumptions and methods of inference. We not only explain how the workhorse models in this literature have evolved, but also examine alternative oil market VAR models. Our review is intended to help the reader understand why the latter models sometimes have generated unconventional, puzzling or erroneous conclusions. Our analysis is of interest not only to applied researchers interested in modeling oil markets and their relationship with the domestic economy, but also to applied econometricians interested in structural VAR modeling more generally.

The remainder of the paper is organized as follows. In section 2, we trace the evolution of the oil market literature from its origins to the workhorse model of Kilian and Murphy (2014). We also discuss extensions to larger-dimensional models. Section 3 reviews some commonly

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<sup>1</sup> We do not address in this survey studies of the effects of global oil price shocks on the economy that do not differentiate between oil demand and oil supply shocks.

used methods of estimating oil market VAR models and the question of how to conduct inference about the structural impulse responses and similar statistics. It also discusses the arguments for and against time-varying coefficient models. Section 4 examines some recent controversies about the specification and estimation of oil market VAR models. Section 5 discusses extraneous measures of oil demand and supply shocks. The concluding remarks are in section 6.

## **2. Conventional Identification Strategies in Oil Market Models**

VAR models of the global oil market evolved in three main stages, starting with the work of Kilian (2006, 2008a, 2009) which exploited short-run exclusion restrictions. This approach was followed by the introduction of static and dynamic inequality restrictions as an alternative to short-run exclusion restrictions, as exemplified by Lippi and Nobili (2012), Kilian and Murphy (2012) and Inoue and Kilian (2013). Finally, Kilian and Murphy (2014) extended this framework to allow oil price expectations to have an effect on the real price of oil through shifts in storage demand. This last extension is crucial because it addresses concerns about previous oil market models being informationally deficient. It also provides a direct link to the literature on modeling oil futures markets (see Alquist and Kilian 2010, Knittel and Pindyck 2016).<sup>2</sup> In this section, we review these benchmark models and their extensions.

### **2.1. Short-Run Exclusion Restrictions**

The importance of disentangling demand and supply shocks in oil markets was first pointed out in Barsky and Kilian (2002). A quantitative framework for this task was provided in Kilian (2008a, 2009) who proposed a monthly structural VAR model of the global oil market since

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<sup>2</sup> Variations of the Kilian and Murphy (2014) framework have been used in a range of recent studies including Kilian and Lee (2014), Juvenal and Petrella (2015), Kilian (2017), Baumeister and Hamilton (2019), Herrera and Rangaraju (2020), Zhou (2020), Kilian and Zhou (2020a, 2022a), and Cross, Nguyen and Tran (2022).

1973 that includes the percent change in global oil production ( $\Delta prod$ ), an index of cyclical variation in global real economic activity derived from bulk dry cargo ocean freight rates ( $rea$ ), and the log of the real price of oil ( $rpoil$ ). Variation in these data is explained based on three shocks: (1) a shock to the amount of oil pumped out of the ground (“oil supply shock”), (2) a shock to the demand for all industrial commodities including crude oil (“aggregate demand shock”), and (3) a residual oil demand shock (“oil-market specific demand shock”) designed to capture precautionary oil demand shocks (see Alquist and Kilian 2010). The latter shock may also be interpreted as a preference shock. For example, an increased preference for smaller, more fuel-efficient automobiles would result in lower demand for oil, given the same level of global real activity. Thus, there are two oil demand shocks and one oil supply shock in this model.

The identifying restrictions are imposed on the structural impact multiplier matrix,  $B_0^{-1}$  with  $ij$ th element  $b_{ij}^0$ , that links the vector of reduced-form errors,  $u_t$ , to the vector of structural shocks,  $w_t$ :

$$\begin{pmatrix} u_t^{\Delta prod} \\ u_t^{rea} \\ u_t^{rpoil} \end{pmatrix} = \begin{bmatrix} b_{11}^0 & 0 & 0 \\ b_{21}^0 & b_{22}^0 & 0 \\ b_{31}^0 & b_{32}^0 & b_{33}^0 \end{bmatrix} \begin{pmatrix} w_t^{\text{oil supply}} \\ w_t^{\text{aggregate demand}} \\ w_t^{\text{oil-specific demand}} \end{pmatrix} \quad (1)$$

The real price of oil is allowed to respond instantaneously to all three structural shocks. The impact price elasticity of oil supply is assumed to be zero, which means that global oil production does not respond to either demand shock on impact ( $b_{12}^0 = b_{13}^0 = 0$ ). The model also postulates that an oil-specific demand shock that raises the real price of oil does not lower global real activity within the same month ( $b_{23}^0 = 0$ ).<sup>3</sup> There are no restrictions on the responses at

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<sup>3</sup> Kilian and Zhou (2018) establish the validity of this assumption for the measure of global real activity utilized by Kilian (2009). Whether this assumption holds for alternative measures of global real activity is less clear.

longer horizons.<sup>4</sup>

Although Kilian (2009) imposes a recursive structure on the structural impact multiplier matrix, this structure is not atheoretical. Every exclusion restriction can be motivated on economic grounds. Notably, the assumption of a zero impact price elasticity of oil supply is consistent with evidence about how OPEC oil producers historically have set production levels (see Kilian 2009). It is also consistent with the theoretical result that oil producers in response to higher prices adjust their production levels only with a delay, because adjusting the level of oil production is costly (see Anderson, Kellogg and Salant 2018). Likewise, the restrictions on the response of global real economic activity can be rigorously defended (see Kilian and Zhou 2018).<sup>5</sup>

## 2.2. Long-Run Exclusion Restrictions

Long-run identifying restrictions are rarely used in oil market models. Stürmer's (2018) analysis of the oil market between 1840 and 2014 is an exception. His model relies on the same three variables as in Kilian (2009), except that all variables are annual and global real GDP growth takes the place of the global real activity index. Since the data are annual, the short-run identifying restrictions employed by Kilian (2009) are not economically plausible. Stürmer therefore develops a different approach to identification.

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<sup>4</sup> There is a strong case to be made for imposing the additional restriction  $b_{21}^0 = 0$ , because, based on the same reasoning that suggests that  $b_{23}^0 = 0$ , oil supply shocks should not affect global real activity on impact. Kilian and Lütkepohl (2017) show that this overidentifying restriction cannot be rejected at conventional significance levels. When the Kilian (2009) model is estimated by GMM subject to the overidentifying restriction, the impulse response estimates are indistinguishable from the original estimates in Kilian (2009). The reason is that even without the overidentifying restriction, the estimate of  $b_{21}^0$  is close to zero.

<sup>5</sup> While the identifying restrictions in the recursive Kilian (2009) model are not testable, they may be treated as overidentifying restrictions within an oil market VAR model identified by heteroskedasticity. Lütkepohl and Netšunajev (2014) report not being able to reject these overidentifying restrictions. Similarly, Herwartz and Plödt (2016) establish that the impulse response estimates obtained from a non-Gaussian oil market VAR model under the stronger assumption of independent (rather than mutually uncorrelated) structural shocks are similar to those reported in Kilian (2009). In addition, Angelini, Cavaliere and Fanelli (2021) provide support for the structure of the Kilian (2009) model based on a proxy VAR model.

There are no restrictions on the short-run effects of the structural shocks on the model variables. Instead, it is assumed that persistent global economic expansions are associated with gains in total factor productivity and hence permanently raise the level of global real output. These expansions are also associated with sustained increases in the real price of oil because they raise the aggregate demand for all industrial commodities. Persistently high real oil prices in turn stimulate technological innovation in oil extraction and discoveries of new oil deposits. Thus, these oil demand shocks also tend to have a permanent effect on the level of oil production. In contrast, oil supply shocks are associated with strikes, industrial accidents, natural disasters, and political unrest or wars. Such shocks typically have only short-lived effects on global real output. Hence, it makes sense to model their effect on real output as transitory, while allowing oil supply shocks to have permanent effects on the production of oil.<sup>6</sup> Finally, oil-market specific demand shocks such as oil inventory demand shocks do not affect either global real output or oil production in the long run. These assumptions yield three exclusion restrictions on the long run level response of global real activity and oil production that suffice to identify all three shocks.

### 2.3. Sign Restrictions

One limitation of the Kilian (2009) model is that it suggests that the spike in the price of oil following the invasion of Kuwait in 1990 was entirely caused by the oil-specific demand shock, which does not seem credible, given the large oil supply disruption that took place in 1990. This prompted Kilian and Murphy (2012, 2014) to explore alternative identification schemes that restrict the sign of selected impulse responses rather than imposing zero restrictions on  $B_0^{-1}$ . One advantage of sign-identified structural VAR models is that they allow the impact price elasticity

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<sup>6</sup> This contrasts with the traditional approach in macroeconomics of viewing domestic demand shocks as having no long-run effect on real output and identifying any domestic shock that affects real output in the long as a supply or productivity shock (see Blanchard and Quah 1989).

of oil supply to be close to zero without requiring it to be literally zero (see Kilian and Murphy 2012).<sup>7</sup>

### 2.3.1. The Kilian and Murphy (2012) Model

Kilian and Murphy (2012) proposed a model that is analogous to Kilian (2009) except that the identification is based on sign restrictions rather than exclusion restrictions.

$$\begin{pmatrix} u_t^{\Delta prod} \\ u_t^{rea} \\ u_t^{rpoil} \end{pmatrix} = \begin{bmatrix} - & + & + \\ - & + & - \\ + & + & + \end{bmatrix} \begin{pmatrix} w_t^{\text{oil supply}} \\ w_t^{\text{aggregate demand}} \\ w_t^{\text{oil-specific demand}} \end{pmatrix} \quad (2)$$

The rationale of these sign restrictions is that an unexpected decline in the supply of oil shifts the oil supply curve to the left along the oil demand curve, causing global oil production to fall, the real price to increase, and global real activity to fall. In contrast, a positive aggregate demand shock raises global real activity and the real price of oil and stimulates global oil production. Finally, an increase in oil-specific demand (such as an increase in oil inventory demand) causes the real price of oil to increase, while stimulating global oil production and causing a decline in global real activity.

One key difference from other early examples of sign-identified oil market models such as Peersman and van Robays (2009) and Lippi and Nobili (2012) is that Kilian and Murphy (2012) emphasized the importance of bounding the impact price elasticity of oil supply, which they defined as the ratio of the impact responses of global oil production and of the real price of oil to an oil demand shock.<sup>8</sup> They observed that there is a consensus in the literature that the one-month price elasticity of oil supply is near zero. Not imposing a bound on this elasticity means

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<sup>7</sup> It should be noted that sign-identified oil market models cannot be used to validate the exclusion restrictions in oil market models, because the latter models are not nested by sign-identified models (see Kilian and Lütkepohl 2017).

<sup>8</sup> There are different elasticity concepts in use in the oil market literature. For a review of what the appropriate use of each concept is see Kilian (2022a).

that we consider models with impact price elasticities of oil supply as high as 2 as plausible as models that imply elasticities close to 0. That approach is clearly unreasonable. Kilian and Murphy (2012) proposed an upper bound of 0.0258 on the one-month price elasticity of oil supply based on historical evidence. A detailed discussion of the derivation of this bound can be found in Kilian (2022a). Kilian and Murphy concluded that it is not possible to generate large responses of the real price of oil to oil supply shocks, once the oil supply elasticity is restricted in this manner.<sup>9</sup> Once a reasonable supply elasticity bound is imposed, the responses to oil supply shocks in the Kilian and Murphy (2012) model are broadly similar to those reported in Kilian (2009). As Kilian and Murphy showed, even with a supply elasticity as high as 0.08, oil supply shocks would explain only 10% of the variation in the real price of oil.

Inoue and Kilian (2013) extend the Kilian and Murphy (2012) model to include additional dynamic sign restrictions. They restrict the real price of oil to be positive for the first year in response to unanticipated oil supply disruptions and in response to positive oil demand shocks. The validity of the identifying assumptions in the models of Kilian and Murphy (2012) and Inoue and Kilian (2013) has been empirically assessed and confirmed in a number of studies including Lütkepohl and Netšunajev (2014) and Herwartz and Plödt (2016).

Antolin-Diaz and Rubio-Ramirez (2018) show how more precise estimates of the Kilian and Murphy (2012) model may be obtained by imposing additional narrative restrictions in Bayesian estimation. Narrative restrictions refer to restrictions on the signs or relative magnitudes of structural shocks or of historical decompositions during selected periods, for which extraneous evidence exists. For example, we know from oil industry sources that there was a surge in storage demand for oil between May and December 1979. Thus, it makes sense to

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<sup>9</sup> This conclusion has recently been confirmed for other oil market models (see Herrera and Rangaraju 2020).

impose the restriction that this feature also holds in the estimated oil market model. Similarly, we know that in August 1990 a negative oil supply shock took place when Iraq invaded Kuwait. Oil production in both countries ceased and the real price of oil rose. Any model that does not reproduce this feature clearly would not be credible. We also know that the sharp increase in the real price of oil in mid-1990 was not caused by increased flow demand, and we know that there must have been a simultaneous increase in storage demand, raising the real price of oil further, because otherwise oil inventories would have fallen sharply in response to the oil supply disruption. These considerations provide further restrictions on the historical decomposition of the real price of oil.

A closely related frequentist approach to imposing narrative restrictions on structural shocks has been proposed by Ludvigson, Ma, and Ng (2020). Both Antolin-Diaz and Rubio-Ramirez (2018) and Ludvigson, Ma, and Ng (2020) apply their approach to model (2) and confirm the substantive conclusions of Kilian and Murphy (2012).

### **2.3.2. The Kilian and Murphy (2014) Model**

The Kilian and Murphy (2014) model generalizes the Kilian and Murphy (2012) model by explicitly identifying shocks to storage demand (also referred to as speculative demand or inventory demand shocks). This extension is made possible by the inclusion of a proxy for global crude oil inventories, constructed by scaling U.S. crude oil inventories, as reported by the EIA, by the ratio of OECD petroleum inventories over U.S. petroleum inventories.<sup>10</sup> Global oil

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<sup>10</sup> This proxy excludes Chinese crude oil inventories, which became important sometime after 2006, when China started building its strategic oil reserve. The Kilian and Murphy proxy also excludes crude oil stored on oil tankers at sea. A simple way of addressing this problem of measurement is to combine this proxy with the proprietary global crude oil inventory series compiled by the Energy Intelligence Group (EIG), which includes these and other missing components of global crude oil inventories starting in the 2000s. Sensitivity analysis in Kilian and Lee (2014) and Kilian (2022b) using this EIG inventory series confirms the substantive conclusions in Kilian and Murphy (2014).

inventories are best expressed in changes ( $\Delta inv$ ) rather than growth rates.<sup>11</sup>

The importance of modeling storage demand is that it allows oil price expectations to affect the real price of oil, even when oil price expectations cannot be directly observed. This fact allows the structural VAR model to capture shifts in oil price expectations not captured by the information set of the VAR model.<sup>12</sup> For added clarity, the oil supply and aggregate demand shocks in this model are relabeled as flow supply shocks and flow demand shocks, respectively.

$$\begin{pmatrix} u_t^{\Delta prod} \\ u_t^{rea} \\ u_t^{rpoil} \\ u_t^{\Delta inv} \end{pmatrix} = \begin{bmatrix} - & + & + & b_{14}^0 \\ - & + & - & b_{24}^0 \\ + & + & + & b_{34}^0 \\ - & - & + & b_{44}^0 \end{bmatrix} \begin{pmatrix} w_t^{\text{flow supply}} \\ w_t^{\text{flow demand}} \\ w_t^{\text{storage demand}} \\ w_t^{\text{other oil demand}} \end{pmatrix} \quad (3)$$

Effectively, this model decomposes the residual oil demand shock in Kilian and Murphy (2012) into a storage demand shock and another oil demand shock that represents, for example, shocks to inventory technology and preferences as well as idiosyncratic shocks to the U.S. Strategic Petroleum Reserve that are not otherwise accounted for. This other oil demand shock is implicitly defined as the complement to the first three structural shocks and has no explicit structural interpretation. Negative flow supply and positive flow demand shocks are associated with declines in oil inventories, as refiners smooth the production of refined products. A positive storage demand shock, in contrast, increases oil inventories, the real price of oil and global oil production on impact, while lowering global real activity.<sup>13</sup>

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<sup>11</sup> This stabilizes the variance of the oil inventory series. It also facilitates the computation of the price elasticity of oil demand and the imposition of identifying restrictions based on economic theory.

<sup>12</sup> Abstracting from changes in the risk premium, expectations shifts would also be captured by oil futures prices, but for much of the estimation period in Kilian and Murphy (2014), the oil futures market did not exist. Kilian and Murphy (2014) show that the oil futures spread, when it does exist, does not contain more information than already captured by the information set of the Kilian and Murphy (2014) model. This amounts to testing whether the VAR model is fundamental in the sense described in Kilian and Lütkepohl (2017).

<sup>13</sup> Kilian and Murphy (2014) originally did not impose the restrictions  $b_{41}^0 < 0$  and  $b_{42}^0 < 0$ , but adding these restrictions tends to sharpen the results when conducting inference.

As in Kilian and Murphy (2012), the one-month price elasticity of oil supply is bounded by 0.0258. The estimates are robust to relaxing this bound to 0.04 (see, e.g., Zhou 2020; Herrera and Rangaraju 2020, Inoue and Kilian 2022b). In addition, the one-month price elasticity of oil demand is bounded by the fact that this elasticity cannot exceed the corresponding long-run oil demand elasticity. The latter elasticity is bounded by 0.8 based on extraneous microeconomic estimates (see Hausman and Newey 1995, Kilian and Zhou 2022b). One legacy of the analysis in Kilian and Murphy (2012, 2014) is that it drew attention to the importance of oil supply and oil demand elasticities for interpreting the relationship between prices and quantities in the global oil market. Indeed, much of the recent controversy about how to model oil markets evolves around this question (see, e.g., Baumeister and Hamilton 2019; Caldara, Cavallo and Iacoviello 2019, Kilian 2022a).<sup>14</sup>

In addition, Kilian and Murphy (2014) restricted the dynamic responses of global oil production and global real activity to a negative flow supply shock to be negative, and the response of the real price of oil to be positive for the first 12 months. This joint dynamic restriction can be motivated on economic grounds. Finally, Kilian and Murphy (2014) impose what nowadays would be referred to as narrative restrictions on the historical decomposition of the real price of oil (see Antolin-Diaz and Rubio-Ramirez 2018). Such restrictions are especially important when conducting inference in this class of models (see, e.g., Kilian and Zhou (2020a, 2022a); Zhou (2020); Inoue and Kilian (2022b)).

In model (3), storage takes place above the ground and is driven by the demand side of the oil market. Most storage is held by refineries in oil importing countries. Although it is

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<sup>14</sup> It should be noted that the rationale for adding elasticity bounds is not to make the impulse response error bands narrower, although this may be a side-effect, but to eliminate as inadmissible models that are economically implausible. Including these models in the admissible set would bias the estimates of the oil market model (see Kilian and Murphy 2012).

possible to view the stock of oil left below the ground as another form of oil inventories, the latter type of inventories is economically distinct because it cannot be used by refineries to smooth the production of refined products in the event of an unexpected shortfall of domestic oil production or oil imports. Below-ground inventories are important in their own right because oil producers expecting a higher price for future deliveries may withhold oil from the market and accumulate inventories below the ground, resulting in a reduction in flow supplies, a higher spot price, lower oil consumption and hence lower global real activity. Such a speculative supply shock, however, is observationally equivalent to any other disruption of flow supplies, say due to civil strife or a strike in the oil industry. Thus, Kilian and Murphy stress that, for all practical purposes, speculative supply shocks and flow supply shocks cannot be separately identified within existing global oil market models.<sup>15</sup>

### **2.3.3. Larger-Dimensional Extensions of the Kilian-Murphy Framework**

As with any structural model, the validity of structural oil market VAR models hinges on the premise that the model does not omit any important determinants of the real price of oil. An obvious concern is that decomposing the structural shocks further within an extended VAR model may change the substantive conclusions obtained in the baseline model. In general, it is difficult to assess the importance of omitted structural shocks, short of extending the model to include additional variables and imposing the restrictions required to identify the additional structural shocks.

A case in point is the analysis in Kilian and Murphy (2014) who showed that the substantive conclusions Inoue and Kilian (2013) are largely robust to including the change in global oil inventories and explicitly modeling storage demand. They also found, however, that

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<sup>15</sup> An empirical test of the proposition that storage below the ground responds to price signals is discussed in Kilian (2022a).

for specific episodes such as the 1990 oil price spike there are noticeable differences in the interpretation of the data.

By the same token, we need to ask how robust the conclusions in Kilian and Murphy (2014) are to further extensions of their model. This question could not be addressed at the time that paper was written, because the estimation period was too short to consider models with more than four variables. There are several more recent studies, however, that suggest that the substantive conclusions of Kilian and Murphy (2014) are robust to extending their model further. For example, Kilian and Zhou (2020a) confirm these findings based on a model that explicitly allows for shocks to the U.S. Strategic Petroleum Reserve. Cross, Nguyen and Tran (2022) reach the same conclusion when differentiating between storage demand shocks driven by changes in the expected price of oil and changes in oil price uncertainty. Finally, Kilian and Zhou (2022a) confirm the robustness of the conclusions of Kilian and Murphy (2014) to modeling exogenous variation in the U.S. real market rate of interest and in the trade-weighted U.S. real exchange rate.

### **2.3.4. Incomplete Oil Market Models**

There are also examples of studies that seek to simplify the benchmark models (1), (2) and (3) in the interest of greater parsimony. Just as we compared the Kilian-Murphy framework to larger-dimensional extensions of that framework in section 2.3.3, we need to ask whether such lower-dimensional models are capable of recovering at least approximately the estimates from the benchmark models (1), (2), and (3). If they do not, these lower-dimensional models must be considered incomplete and misleading. A case in point is the study of Bjørnland and Zhulanova (2019) who rely on a global oil market model of the form

$$\begin{pmatrix} u_t^{rea} \\ u_t^{rpoil} \end{pmatrix} = \begin{bmatrix} b_{11}^0 & 0 \\ b_{21}^0 & b_{22}^0 \end{bmatrix} \begin{pmatrix} w_t^{\text{flow demand}} \\ w_t^{\text{oil-specific demand}} \end{pmatrix}. \quad (4)$$

Bjørnland and Zhulanova's discussion makes it clear that they have in mind a simplified version of model (1) in which there are only two shocks, namely a flow demand shock and an oil-specific demand shock, which is identified by a delay restriction.<sup>16</sup> They argue that the oil supply shock in model (1) may be dropped, given that Kilian (2009) showed that this shock plays only a modest role. This argument is problematic. Although oil supply shocks play only a modest role on average, for specific episodes such as the shale oil boom after 2010 their effect may be quantitatively important. Moreover, there is strong evidence for the importance of including oil inventories in oil market models and of modeling storage demand explicitly (see Kilian and Murphy 2014; Kilian and Lee 2014; Kilian 2017; Herrera and Rangaraju 2020). Thus, model (4) is misspecified in that it conflates the structural shocks in the data generating process.

This type of problem may also arise in sign-identified models. For example, the identification of the oil market block in Baumeister and Peersman (2013b) boils down to the sign-identified model.

$$\begin{pmatrix} u_t^{\Delta prod} \\ u_t^{rpoil} \end{pmatrix} = \begin{bmatrix} - & + \\ + & + \end{bmatrix} \begin{pmatrix} w_t^{\text{flow supply}} \\ w_t^{\text{flow demand}} \end{pmatrix}, \quad (5)$$

which is easily recognized as a restricted version of the model in Kilian and Murphy (2014) with two of the four structural shocks suppressed. It is immediately clear that such a model conflates the distinct shocks contained in the fully specified model. More importantly, even if we restrict attention to the flow supply shock and treat this model as partially identified, there is no reason for the underspecified model (5) to be able to recover the flow supply shock in the data generating process because the information set is different.

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<sup>16</sup> In discussing their model, we deliberately abstract from the possible inclusion of a second block of domestic variables and the additional identifying assumptions required to separately identify domestic and global shocks. We also abstract from the fact that the global real activity measure may be any of the indicators discussed in Kilian and Zhou (2018) or the leading principal component of a panel of real activity indicators.

### 2.3.5. Understanding the Impact of Oil Demand and Oil Supply Shocks on Domestic Macroeconomic Aggregates

Oil market VAR models are typically estimated on monthly data, because the exclusion restrictions and elasticity bounds used for identification tend to be more credible at monthly frequency than at quarterly or annual frequency. If we are interested in the effect of global oil demand and oil supply shocks on a monthly U.S. macroeconomic aggregate such as U.S. industrial production, a natural approach is to specify a block recursive VAR model with the domestic variable ordered last. A good example is the model of Kilian and Park (2009), who extended model (1) to include monthly U.S. real stock returns under the maintained assumption that global oil market variables are predetermined with respect to the U.S. stock market, which implies that  $b_{14}^0 = b_{24}^0 = b_{34}^0 = 0$ . The latter assumption is supported by evidence in Kilian and Vega (2011).

$$\begin{pmatrix} u_t^{\Delta prod} \\ u_t^{rea} \\ u_t^{rpoil} \\ u_t^{ret} \end{pmatrix} = \begin{bmatrix} b_{11}^0 & 0 & 0 & 0 \\ b_{21}^0 & b_{22}^0 & 0 & 0 \\ b_{31}^0 & b_{32}^0 & b_{33}^0 & 0 \\ b_{41}^0 & b_{42}^0 & b_{43}^0 & b_{44}^0 \end{bmatrix} \begin{pmatrix} w_t^{\text{oil supply}} \\ w_t^{\text{aggregate demand}} \\ w_t^{\text{oil-specific demand}} \\ w_t^{\text{other shocks to stock returns}} \end{pmatrix} \quad (6)$$

Here the upper left  $3 \times 3$  matrix contained in  $B_0^{-1}$  represents the oil market block and the lower right  $1 \times 1$  matrix is the domestic block. Obviously, the same approach would work, if the oil market block were identified based on sign restrictions, except that the conventional approach to Bayesian inference would have to be modified, as described in Arias, Rubio-Ramirez and Waggoner (2018).<sup>17</sup> One can include without loss of generality additional variables in the lower right block as long as one restricts attention to the responses of these variables to oil demand and

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<sup>17</sup> Further examples of Bayesian estimation and inference in block recursive oil market model can be found in Kilian and Zhou (2020a, 2022a).

oil supply shocks.<sup>18</sup>

Sometimes this block-recursive VAR approach is not feasible. One common situation is that we are interested in the effect of global oil demand and oil supply shocks recovered from monthly VAR models on quarterly or annual U.S. macroeconomic aggregates. One approach to this problem could be to estimate a mixed-frequency VAR model (see Ghysels 2016; Chudik and Giorgiadis 2022). A simpler approach proposed by Kilian (2009) is to sum (or, equivalently, average) the monthly structural shocks obtained from model (1) by quarter and to run a quarterly distributed-lag model second-stage regression. For example, consider the second-stage model

$$\Delta gdp_t = \alpha_i + \beta_{0,i} w_t^i + \beta_{1,i} w_{t-1}^i + \dots + \beta_{h,i} w_{t-h}^i + v_{t,i}, \quad i = 1, 2, 3,$$

where  $v_{t,i}$  denotes the possibly serially correlated and heteroskedastic regression innovation in equation  $i$ ,  $w_t^i$  denotes the sum of the three realizations of the structural VAR shock  $i$  in quarter  $t$ , and  $\partial gdp_{t+j} / \partial w_t^i = \partial gdp_t / \partial w_{t-j}^i = \beta_{j,i}$ . Inference on the impulse responses may be conducted using HAC standard errors or the block bootstrap. This approach works because the structural shocks are mutually uncorrelated at monthly frequency and approximately mutually uncorrelated at lower frequency. Similar temporal aggregation schemes are commonly used in the literature on aggregating high-frequency monetary policy shocks. Efficiency may be gained by including current and lagged values of all shocks:

$$\begin{aligned} \Delta gdp_t = & \alpha + \beta_{0,1} w_t^1 + \beta_{1,1} w_{t-1}^1 + \dots + \beta_{h,1} w_{t-h}^1 + \\ & \beta_{0,2} w_t^2 + \beta_{1,2} w_{t-1}^2 + \dots + \beta_{h,2} w_{t-h}^2 + \\ & \beta_{0,3} w_t^3 + \beta_{1,3} w_{t-1}^3 + \dots + \beta_{h,3} w_{t-h}^3 + v_t, \end{aligned}$$

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<sup>18</sup> This does not mean that the shocks in the lower-right block cannot be identified. One example is Kilian (2010) who jointly modeled the global oil market block and a U.S. gasoline market block. Another example is Kilian and Zhou's (2022a) model of oil prices, exchange rates and interest rates.

and imposing a common intercept.<sup>19</sup>

This two-stage approach has been widely employed in the literature (e.g., Kilian, Rebucci and Spatafora 2009; Kilian and Hicks 2013; Bützer, Habib and Stracca 2016). The same two-stage approach could be applied to sign-identified models, except that in this case inference is complicated by the fact that we need to evaluate the second-stage regression for each admissible draw from the posterior of the oil market model (see Herrera and Rangaraju 2020).

Another common situation in which block-recursive VAR models cannot be applied occurs when the U.S. macroeconomic aggregate of interest is not available for the full estimation period, but only for a comparatively short time span. In that case, it makes sense to recover the oil demand and oil supply shocks from a structural VAR model estimated on the full sample, but to fit the second-stage distributed lag model on the shorter subsample, even when the U.S. variable of interest is available at monthly frequency.

Because crude oil is traded in U.S. dollars, modeling the propagation of global oil demand and oil supply shocks to the U.S. economy is comparatively straightforward. The impact of oil demand and oil supply shocks on other net oil-importing economies, in contrast, will in addition depend on the value of the real exchange rate. The fact that the real price of oil in domestic consumption units depends on the value of the real exchange rate, however, makes it essential to include the bilateral U.S. dollar real exchange rate in the block recursive VAR model. It is not clear how to employ second-stage distributed lag models in that case.

### 3. Estimation and Inference

Oil market models identified by short-run or long-run exclusion restrictions are typically

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<sup>19</sup> Alternatively, one could also estimate these responses based on linear local projections, but that approach would be less parsimonious. It should be noted that, as in the local projection literature, using residuals from first-stage regressions creates a generated regressor problem, which is typically ignored in practice.

estimated by the least-squares method or by GMM with inference based on bootstrap methods, possibly making allowance for conditional heteroskedasticity in the error term (see Kilian and Lütkepohl 2017). In contrast, sign-identified oil market VAR models in the literature have typically been estimated by Bayesian methods. Because these models are identified by inequality restrictions, they do not generate unique point estimates of the impulse responses, but a potentially large set of admissible models that are consistent with the data and satisfy the identifying restrictions.

### **3.1. Standard Bayesian Inference in Sign-Identified Models**

The conventional approach to estimating sign-identified oil market models is based on Rubio-Ramirez, Waggoner and Zha (2010), Arias, Rubio-Ramirez and Waggoner (2018) and Antolin-Diaz and Rubio-Ramirez (2018). Consider a set of reduced-form VAR parameters consisting of the slope parameters,  $A$ , and of the reduced-form error covariance matrix,  $\Sigma$ , from which we can compute the lower triangular Cholesky decomposition,  $P$ , with positive elements on the diagonal. Candidate solutions for sign-identified models are created by generating at random draws for the orthogonal matrix  $Q$  such that  $PQ$  represents a candidate solution for the structural impact multiplier matrix  $B_0^{-1}$ . Algorithms for generating random draws for  $Q$  are discussed in Kilian and Lütkepohl (2017). This procedure is repeated for each of many random draws from the posterior distribution of  $(A, \Sigma)$ . Any combination of  $A$  and  $PQ$  is a model solution and is associated with a set of structural impulse responses. Model solutions that generate structural impulse response functions that satisfy all identifying restrictions on the

impulse responses are considered admissible and are retained. All other solutions are discarded.<sup>20</sup>

The traditional approach to summarizing this set of admissible models has been to report so-called posterior median response functions. This response function is constructed by connecting the posterior medians obtained from the marginal posterior distribution of each impulse response to form a line across the horizons of a given response function. As noted by Fry and Pagan (2011), Kilian and Murphy (2012), Inoue and Kilian (2013), Kilian and Lütkepohl (2017) and Kilian (2022b), among others, this approach is questionable because the shape of median response function may look substantially different from that of any of the impulse response function that could conceivably be produced by the underlying structural VAR model. Inoue and Kilian (2022a) prove that the posterior median response function is not in general the Bayes estimator.<sup>21</sup> An alternative approach is to derive the Bayes estimator of the impulse response vector under quadratic and under absolute loss, for example, as in Inoue and Kilian (2022a).

Likewise, pointwise error bands constructed from the quantiles of the marginal distribution of each impulse response are invalid for quantifying the estimation uncertainty about impulse response vectors (e.g., Sims and Zha 1999; Inoue and Kilian 2013, 2022a; Montiel Olea and Plagborg-Møller 2019). One alternative is to construct approximations to the lowest posterior risk joint credible regions under the relevant loss function that capture the uncertainty about the vector of impulse responses, that provide information about likely departures from the

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<sup>20</sup> When sign restrictions are augmented by zero restrictions on elements of  $B_0^{-1}$  or by narrative restrictions, these posterior draws typically are reweighted based on the importance samplers proposed by Arias et al. (2018) and Antolin-Diaz and Rubio-Ramirez (2018).

<sup>21</sup> The same problem applies to the vector of pointwise medians of the oil supply shock series obtained from the Baumeister and Hamilton (2019) model. Likewise, vectors of pointwise quantiles of forecast error variance decompositions, of linear combinations of impulse responses, and of historical decompositions are subject to this problem.

path of the estimated impulse response function, and that are guaranteed to be contained in the set of feasible impulse responses functions (see Inoue and Kilian 2022a). Another option is to construct Bayesian joint error bands, as discussed in Montiel Olea and Plagborg-Møller (2019). The key difference between these methods and the traditional approach of reporting posterior median or mean response functions is the focus on joint rather than marginal Bayesian inference.<sup>22</sup>

### **3.2. The Role of the Prior in the Conventional Approach**

The conventional approach to Bayesian inference described in section 3.1 involves postulating a Gaussian-inverse Wishart prior for the reduced form parameters and a uniform (or Haar) prior for the orthogonal matrix  $Q$ . Identifying restrictions are imposed directly on the structural impulse responses or on transformations of these responses. Baumeister and Hamilton (2015) recently reiterated the well-known point that this two-step approach may be unintentionally informative about the prior for the structural impulse response functions.

Baumeister and Hamilton (2015) argue that a Haar prior on  $Q$  is virtually always unintentionally informative for the marginal prior distribution of the impact responses. However, they never formally derive the prior for the vector of impulse responses implied by the conventional uniform-Gaussian-inverse Wishart prior specification for the VAR model parameters. They only discuss the impulse response distribution conditional on the maximum likelihood estimate of  $A$  and  $\Sigma$ , ignoring the prior uncertainty about the latter parameters in the conventional approach. Inoue and Kilian (2022b) show that the impulse response prior implied

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<sup>22</sup> Another approach sometimes used in the literature is to report the admissible model that comes closest to an extraneous demand elasticity estimate and to construct credible sets based on the admissible models that come closest to this estimate (see, e.g., Kilian and Lee 2014, Kilian 2017). The drawback of this penalty function approach is that we must be confident in the extraneous demand elasticity estimate.

by the conventional approach differs substantially from the results reported in Baumeister and Hamilton's work.

Nor do Baumeister and Hamilton establish that the impulse response posterior is driven by the Haar prior in general. While there are examples in which the Haar prior dominates the impulse response posterior, Inoue and Kilian examine several sign-identified structural VAR models including the oil market model of Kilian and Murphy (2014) and find no evidence that the impulse response priors implied by the use of conventional priors on  $A$ ,  $\Sigma$  and  $Q$  are necessarily unintentionally informative or economically implausible. Moreover, they find that the impulse response posterior in many typical applications is dominated by the data rather than the Haar prior. This evidence suggests that recent concerns about the prior for  $Q$  have been overstated and that the credibility of these models must be assessed on a case-by-case basis.

### **3.3. An Alternative Bayesian Approach to Estimating Sign-Identified Oil Market Models**

Baumeister and Hamilton (2015) also propose an alternative approach to estimating sign-identified oil market VAR models that dispenses with the Haar prior for  $Q$ . In short, their proposal is to specify priors on the parameters of the structural VAR process

$$B_0 y_t = B_1 y_{t-1} + \dots + B_p y_{t-p} + w_t,$$

where  $w_t$  is zero mean Gaussian white noise. Abstracting from the lagged coefficients, this involves specifying priors directly on the elements of the matrix  $B_0$ . It is also possible to impose priors on selected elements of  $B_0^{-1}$ .<sup>23</sup>

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<sup>23</sup> A key difference from Kilian and Murphy (2014) is that Baumeister and Hamilton, like Caldara et al. (2019), define the impact price elasticities of oil supply and oil demand in terms of the parameters of the matrix  $B_0$  rather than as functions of impulse responses. Elasticities in their VAR framework are defined as the response of the variable in question to an exogenous demand or supply shift, holding constant the responses of all other model variables. Since extraneous elasticity estimates typically do not control for these responses, it is not possible to appeal to these estimates in motivating elasticity priors within this framework. In contrast, Kilian and Murphy define the impact price elasticity allowing for other model variables to respond to the shock in question, which matches the

The seeming advantage of Baumeister and Hamilton's method is that we can impose nondegenerate priors on the parameters of the model. Rather than imposing that some element of  $B_0$  is positive, for example, we can impose an explicit prior distribution of how the probability mass is distributed in the positive region. The problem is that, in practice, the existing literature provides little guidance about the nature of this prior. Baumeister and Hamilton therefore tend to rely on priors such as truncated Student-t distributions with no explicit economic rationale.

It is important to recognize that the alternative Bayesian approach proposed by Baumeister and Hamilton suffers from exactly the same problem of potentially inadvertently informative impulse response priors as the conventional approach (see Inoue and Kilian 2022b). The reason is that the impulse responses in this case are defined as a nonlinear function of the structural parameters,  $B_0, \dots, B_p$ , much like the impulse responses in the conventional approach are defined as a nonlinear function of  $A$ ,  $\Sigma$ , and  $Q$ . The same point applies when putting additional priors on elements of  $B_0^{-1}$ . Thus, there is nothing to choose between their approach and the conventional approach on a priori grounds. If the impulse responses is what we care about, it becomes essential to assess the impulse response prior implied by Baumeister and Hamilton's approach using the tools developed in Inoue and Kilian (2022b) and to defend that prior.<sup>24</sup>

Three other studies have tried to directly address the problem of potentially

way extraneous elasticity estimates are constructed. The fact that this elasticity concept does not match the textbook definition of an elasticity does not detract from its usefulness for imposing identifying restrictions on the structural VAR model. It only means that we must not interpret these elasticities as measuring the slopes of the short-run demand and supply curves (see Kilian 2022a).

<sup>24</sup> Inoue and Kilian (2022b) show that the central tendency of the impulse response prior implied by Baumeister and Hamilton's (2019) prior on the structural parameters of their baseline oil market model is highly economically implausible, unlike the impulse response prior in the Kilian and Murphy model. For example, Baumeister and Hamilton's prior implies that an unexpected exogenous expansion of global real economic activity lowers the real price of oil, contrary to the implications of standard economic models (see Hamilton 2009).

unintentionally informative priors for  $Q$ . None of these approaches has been employed in the oil market literature to date. One approach is to adapt the prior on the reduced-form parameters, given a uniform prior on  $Q$ , to ensure that the implied prior on the structural impulse responses is flat (see Arias, Rubio-Ramirez and Waggoner 2015). Of course, a flat impulse response prior may not be an economically sensible prior in practice. Another approach is to directly specify a possibly informative prior on the structural impulse responses, as proposed by Plagborg-Møller (2019). The latter approach dispenses with reduced-form priors, but the construction of economically sensible joint priors on the structural responses is nontrivial in general. Finally, Giacomini and Kitagawa (2021) propose an alternative impulse response estimator that avoids taking a stand on the prior for  $Q$ , allowing users to assess the sensitivity of the estimates to the universe of alternative priors for  $Q$ . Their approach leaves unanswered what the joint impulse response prior is and whether it is economically sensible.

### **3.4. How Credible Are Time-Varying Coefficient Models of the Oil Market?**

A long-standing question is whether to allow the coefficients of global oil market models to vary over time or not. There is a multitude of reasons to expect smooth structural change in the coefficients of models of the global oil market. Examples include temporary capacity constraints in storage and production, transportation bottlenecks, changes in market structure and contract structure over time, changes in the share of oil in value added reflecting conservation and diversification away from oil products, and possibly the development of oil futures markets in the 1980s. This does not necessarily mean that the linear model is a poor approximation, but it raises the question of whether we need to consider the possibility of smooth structural change.

Baumeister and Peersman (2013a,b), in particular, made the case for estimating global oil market models as time-varying coefficient (TVC)-VAR models, building on Primiceri (2005).

The coefficients in TVC-VAR models are typically expressed as latent random walk processes and estimated using Bayesian methods. The error covariance matrix is also allowed to change over time. Impulse responses in TVC-VAR models are dependent on the history of the data and the magnitude of the structural shocks and have to be evaluated by Monte Carlo integration.<sup>25</sup> The use of TVC-VAR models is restricted to the construction of impulse responses and counterfactual histories (see Kilian and Lütkepohl 2017). Historical decompositions and variance decompositions are not well defined, making it more difficult to interpret the model estimates.

There are a number of other caveats about the use of TVC-VAR models. First, there is evidence that the error bands for the nonlinear impulse responses in this class of models tend to be so wide that they convey essentially no information (see, e.g., Herrera and Rangaraju 2020).

Second, a common misperception in applied work is that time-variation in the estimated coefficients of a TVC-VAR model is evidence of time variation in the real world. This view is mistaken because the parameters that govern the smooth structural change in the model coefficients are not identified when there is no time variation. In fact, evidence of time variation is expected due to overfitting, even when the linear model is correct.<sup>26</sup> There does not appear to exist a formal statistical test for the absence of time variation in TVC-VAR models.<sup>27</sup>

Third for computational reasons, TVC-VAR models of a given dimension can only be estimated allowing for a small number of autoregressive lags. Baumeister and Peersman (2013a), for example, restrict the maximum lag order of their VAR model to four quarterly lags. Since it

<sup>25</sup> A common mistake in applied work is to report the impulse responses of the TVC-VAR model conditional on the date  $t$  estimate of the model coefficients without accounting for the expected evolution of the model coefficients.

<sup>26</sup> The degree of overfitting can be controlled to some extent by choosing the prior. However, this makes the estimates of TVC-VAR models sensitive to the specification of the prior distribution. This sensitivity is rarely reported in applied work.

<sup>27</sup> An informal diagnostic would be to compute the 95% joint error band for the responses to a one-standard deviation shock from the corresponding linear VAR model. This allows us to assess whether the nonlinear response functions generated by the TVC-VAR model are contained within this error band. If so, time variation is not likely to be important.

is well known how important including a sufficiently large number of lags is for accurately estimating the impulse responses in global oil market models, this raises the question of whether any differences from the response estimates in linear VAR models reflect departures from linearity or unreasonably tight restriction on the largest autoregressive lag order.

Fourth, the specification and identification of the Baumeister and Peersman oil market model is superficially similar to that in Kilian and Murphy (2012). It should be noted, however, that Baumeister and Peersman (2013a) had to relax the oil supply elasticity bound in order to obtain any solutions at all for their econometric model. Their upper bound for the quarterly supply elasticity ranges from 0.6 to 1, respectively, which is unrealistically high compared with the consensus view that the quarterly oil supply elasticity is close to zero.

In defense of their approach, Baumeister and Peersman (2013a) suggest that the impact supply elasticity may have declined since the 1970s and early 1980s. Upon reflection, this argument is not compelling. The cost constraints that discourage oil producers from substantially adjusting production within the quarter do not vary much over time. Baumeister and Peersman present no argument for why the supply elasticity in the 1970s and 1980s would have exceeded conventional benchmarks. Thus, even if we take Baumeister and Peersman's arguments for a decline in the elasticity at face value, the question remains of how to explain their incredibly large estimates of the supply elasticity in the 1970s (with posterior median values as high as 0.85). Likewise, their estimates of the one-quarter price elasticity of oil demand for the 1970s and early 1980s (with posterior medians as low as -0.65) strain credulity.<sup>28</sup>

#### **4. Recent Controversies About Modeling Oil Markets**

Recently, some studies have claimed to have overturned the consensus based on mainstream oil

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<sup>28</sup> A partial explanation may be that the impact elasticity of oil demand in Baumeister and Peersman (2013a) is incorrectly defined in that it omits oil inventories (see section 4).

market models that oil supply shocks have not been an important determinant of oil price fluctuations. These claims are closely linked to the definition of the impact price elasticities of oil demand and oil supply in global oil market models and the choice of the elasticity priors.

#### **4.1. How to Define the Impact Price Elasticity of Oil Demand**

Some researchers have uncritically applied to the oil market a textbook definition of the price elasticity of demand intended for goods that are not storable. Since crude oil is storable, the amount of oil produced in a given period may be consumed in a refinery or put into storage, (see Kilian and Murphy 2014). Thus, defining the oil demand elasticity based on an accounting identity that equates oil production with oil consumption at each point in time without accounting for the change in oil inventories, as in Baumeister and Hamilton (2019), for example, is incorrect. This observation applies when using the elasticity concept underlying Kilian and Murphy (2014), which focuses on the change in the use of oil in response to the oil price increase caused by an exogenous shift in oil supply. It also applies when using the textbook definition of the oil demand elasticity in Baumeister and Hamilton (2019), which holds constant the response of all other model variables in defining the elasticity.

This point has important implications in practice. First, the impact price elasticity of oil demand is not explicitly defined in oil market models such as Kilian (2009) or Kilian and Murphy (2012) that do not include oil inventories. Attempts to estimate this elasticity anyway, without accounting for changes in oil inventories, will produce spurious estimates. Second, the claim that a low price elasticity of oil supply necessarily implies an unrealistically high price elasticity of oil demand, which is central to the analysis in Baumeister and Hamilton (2019) and Caldara et al. (2019) is sensitive to how the elasticity is defined (see Kilian 2022a). Third, the four-variable oil market model specification proposed in Baumeister and Hamilton (2019)

mismeasures oil consumption growth, invalidating their estimate of the price elasticity of oil demand, as shown in Kilian (2022a).

#### **4.2. Is There Evidence for a Much Higher Impact Price Elasticity of Oil Supply?**

Kilian and Murphy (2012) established that the effect of oil supply shocks on the real price of oil is necessarily modest, if the impact price elasticity of oil supply in model (2) is close to zero, as suggested by economic theory and extraneous evidence. A low impact oil supply elasticity ensures that oil demand shocks are the primary determinant of the variability in the real price of oil. This point has been reaffirmed in the context of model (3) by Herrera and Rangaraju (2020).

Baumeister and Hamilton (2019) propose an alternative model of the global oil market that allows the impact price elasticity of oil supply to be unbounded from above. Their posterior median oil supply elasticity estimate of 0.15 is 22 standard errors above the extraneous elasticity estimate in Newell and Prest (2019) for the United States, for example. They show that, not surprisingly, given this large supply elasticity value, the response of the real price of oil to oil supply shocks is larger in their model than in conventional oil market models.<sup>29</sup> Herrera and Rangaraju (2020) establish that this conclusion is not robust. In particular, under any prior that bounds the impact price elasticity of oil supply in line with conventional views of the magnitude of this elasticity, the response of the real price of oil to oil supply shocks in Baumeister and Hamilton's model is similar to that obtained in Kilian and Murphy's model.

Thus, the magnitude of the upper bound on the value of the one-month oil supply elasticity is central for this controversy. Baumeister and Hamilton (2019) argue for not imposing any upper bound, citing evidence in Bjørnland, Nordvik and Rohrer (2021) that this elasticity

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<sup>29</sup> It should be noted that there are other concerns about their model specification and data, as reviewed in Kilian and Zhou (2020b) and Kilian (2022b), but these features are not the main driver of their results and hence can be ignored here.

could be as high as 0.9. They also cite a study by Caldara et al. (2019) that produced estimates larger than conventional elasticity bounds. Kilian (2022a) discusses the limitations of these studies and reviews evidence from other studies, concluding that there is no support for a global oil supply elasticity as large as claimed in these studies.<sup>30</sup>

#### **4.3. Is the Price Elasticity of Oil Demand Positive?**

Most oil market VAR models including Kilian and Murphy (2014) impose the assumption that the impact price elasticity of oil demand is negative. Sockin and Xiong (2015) make the striking claim that these models are inherently misspecified because, according to their own analysis, the price elasticity of oil demand actually is positive rather than negative. This view is based on a theoretical model of informational frictions. In short, Sockin and Xiong's premise is that rising oil futures prices signal a stronger global economy. Their theoretical model postulates that economic agents have no other means of detecting whether the global economy is booming but to observe the change in oil futures prices. This friction ensures that agents in their model habitually confuse increases in the oil price driven by oil supply shocks or storage demand shocks with increases driven by flow demand shocks.

Sockin and Xiong show that the informational content of increases in oil futures prices in their theoretical model can be so strong that it offsets the dampening effect of higher oil costs on manufacturing activity, resulting in a positive impact price elasticity of oil demand. In other words, Sockin and Xiong argue that higher oil prices induce manufacturing firms to buy more oil. Since standard global oil market VAR models impose a negative oil demand elasticity, they

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<sup>30</sup> There is also indirect evidence against the high oil supply elasticity estimate in Baumeister and Hamilton (2019). Braun (2021) shows that when exploiting the non-Gaussianity of the error term in Baumeister and Hamilton's (2019) four-variable oil market VAR model for the identification, the importance of the oil supply shock is greatly reduced and their model produces conclusions similar to Kilian and Murphy (2014). Similarly, Carriero, Marcellino and Tornese (2021) find that the Baumeister and Hamilton (2019) model supports an oil supply elasticity below 0.0258, when incorporating the heteroskedasticity of the errors into the identification.

are misspecified under Sockin and Xiong's assumptions.

Sockin and Xiong apply their model to the period of the sustained commodity price boom between 2003 to mid-2008. They argue that an exogenous increase in speculative trading in oil futures markets that was reflected in higher oil futures prices caused manufacturing firms to increase their demand for raw materials such as crude oil in anticipation of an economic boom. Such a nonfundamental demand shift would look like a flow demand shock in the Kilian and Murphy (2014) model rather than a shock to speculative demand.

There are many reasons to be skeptical of the Sockin-Xiong model. First, even if we accept the premise that manufacturing firms may at times be confused about the state of the global economy, the argument that manufacturing firms collectively increased their demand for commodities and their output based on the false premise of a booming global economy for five years without realizing that there was no demand for their products is not credible. A model in which agents are confused for five years at a time and do not learn from their mistakes is a model of irrational expectations. In the real world, firms that make such systematic mistakes go out of business.

Second, there is no extraneous evidence that the one-month price elasticity of oil demand is positive. Nor is there evidence that economic agents predicted a sustained economic boom between 2003 and mid-2008, as maintained by Sockin and Xiong. In fact, Kilian and Hicks (2013) document that professional real GDP growth forecasters systematically underestimated global growth between 2003 and mid-2008.

Third, the very existence of the informational friction postulated in Sockin and Xiong's model is suspect. It is by no means necessary for economic agents to directly observe oil demand and oil supply shocks in order to detect a global economic expansion or decline. There are many

indicators of global real economic activity that are readily available to economic agents and allow them to learn whether there actually is an economic boom or not without having to rely exclusively on industrial commodity prices (see Kilian and Zhou 2018). This makes it implausible that manufacturing firms would ever blindly rely on industrial commodity prices as indicators of the direction of the global economy. If they do not, then the mechanisms described by Sockin and Xiong (2015) is irrelevant.

Finally, it should be noted that there is no support for Sockin and Xiong's premise that the increased participation of financial traders in oil futures markets was an exogenous event, as opposed to an endogenous response to fundamental demand or supply pressures and rising expected returns on oil. Nor is there support for the premise that these financial traders necessarily took positions that raised the oil futures price. For a comprehensive review of this debate the reader is referred to Fattouh et al. (2013).

#### **4.4. Has the Shale Oil Revolution Undermined the Stability of Global Oil Market Models?**

An important question is whether the U.S. shale oil revolution that took place after 2008 has undermined the stability of global oil market models.<sup>31</sup> Kilian (2017) directly addresses this question by constructing a counterfactual for global oil production in the absence of U.S. shale oil production. The study notes that the shale oil revolution can be represented as a sequence of classical shocks to the technology of producing crude oil. Kilian (2017) shows that the sequence of global flow supply shocks that would be required to remove the shale oil component from global crude oil production involves shocks that are neither unusually large nor unusually serially correlated by historical standards. Thus, there is no reason to expect these shocks to have undermined the stability of the coefficients of the structural model.

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<sup>31</sup> For a review of the U.S. shale oil revolution the reader is referred to Kilian (2016).

Another common misperception is that the shale oil revolution must have increased the value of the one-month price elasticity of flow supply. Not only is shale oil only a small fraction of global oil production, limiting the effects of the shale oil supply elasticity on the one-month price elasticity of oil supply in global oil market models, but Newell and Prest (2019) provide independent microeconomic evidence that the one-month price elasticity of supply for shale oil is close to zero, much like the corresponding elasticity for conventional crude oil. This conclusion is also supported by direct evidence from industry sources (see Kilian 2022a).

#### **4.5. How to Measure the Global Business Cycle in Oil Market Models**

An important question in models of the global oil market is how to measure the global business cycle at monthly frequency. Kilian (2009) proposed a widely used measure of global real economic activity that is based on a proxy for the volume of shipping of industrial raw materials. It is well known that changes in trade volumes need not line up with changes in real output, as measured by world real GDP or world industrial production (see Kilian and Zhou 2018).<sup>32</sup> Not only is the relationship between global industrial production and the volume of shipping potentially unstable over time, but the timing of these indices differs because industrial commodities tend to be shipped before changes in industrial production take place. Funashima (2020) confirms that the Kilian index is a leading indicator for global industrial production. The evolution over time of these indices also differs, because the Kilian index embodies an expectational component that is missing in indices of global industrial production because the decision to ship these raw materials is made in expectation of future industrial production (see Kilian and Zhou 2018; Kilian 2019). Thus, there is no a priori reason for these indices to behave

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<sup>32</sup> Alternative proxies for global real economic activity that recognize that industrial commodities are globally traded are indices of global real industrial commodity prices (e.g., Alquist, Bhattacharai and Coibion 2020, Delle Chiaie, Ferrara, and Giannone 2022).

similarly, although it has been shown that most of the substantive results in Kilian and Murphy are robust to replacing the Kilian index by the OECD+6 industrial production index created by the OECD (see Zhou 2020).<sup>33</sup>

An important question, in practice, is whether to express indices of global real economic activity in deviations from trend or in growth rates. The Kilian (2009, 2019) business cycle index is stationary by construction (see Kilian and Zhou 2018). It therefore does not make sense to difference this business cycle index.<sup>34</sup> When using alternative indicators of global real activity such as the index of OECD+6 industrial production originally created by the OECD, it has been common to express this index in deviations from a log-linear time trend. This approach is natural if we are interested in capturing the global business cycle. The alternative of expressing indicators of global real activity as month-by-month growth rates eliminates long cycles in the real price of oil that are characteristic of commodity markets. It also overemphasizes the high-frequency variation in the data. As a result, log-differencing tends to downplay the importance of flow demand shocks.<sup>35</sup>

#### **4.6. How to Transform the Real Price of Oil**

A recurring question among applied researchers is whether to express the real price of oil in global oil market models in log-levels or in growth rates. There has been no apparent trend in the log real price of oil since 1974. Thus, the conventional approach of expressing the real price of

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<sup>33</sup> Not all models are robust to the choice of the index. For example, the estimates in Baumeister and Hamilton (2019) are sensitive to replacing their industrial production index by the Kilian index (see Herrera and Rangaraju 2020).

<sup>34</sup> Hamilton (2021) suggests that there is statistical evidence against the data transformations applied by Kilian (2009, 2019) and that the raw data underlying this index should be log-differenced. This claim has been refuted in Kilian (2022b).

<sup>35</sup> An alternative is to express indices of global real activity as cumulative growth rates over one year, as discussed in Kilian and Zhou (2018), or over two years, as proposed by Hamilton (2021). It is unclear what the rationale of the latter procedure is, except as a descriptive statistic. By construction, cumulative growth rates do not provide a good measure of the business cycle at a given point in time.

oil in log-levels has the advantage that standard frequentist inference about the estimates of the impulse responses under weak conditions will remain asymptotically valid at short horizons, even when the underlying process contains one or more unit roots (and the variables are possibly cointegrated) (see Inoue and Kilian 2020). The same is true for forecast error variance decompositions at any finite horizon. In contrast, differencing the real price of oil when it actually is stationary causes these estimates to be inconsistent and inference to be invalid. Likewise, from a Bayesian point of view, inference remains valid whether the real price of oil is I(0) or I(1). Only the construction of historical decompositions requires the user to take a stand on the order of integration of the real price of oil.

Unit root tests (or for that matter so-called stationarity tests) are not able to discriminate between the I(0) and the I(1) hypothesis for realistic sample sizes, but the fact that the real price of oil has ultimately reverted back to its mean for almost four decades, defying predictions of permanent highs and permanent lows time and again, is suggestive of a slowly mean-reverting I(0) process.

## **5. Non-Traditional Approaches to Identifying Oil Demand and Oil Supply Shocks**

While the bulk of structural oil market models seeks to recover structural shocks based on the information set provided by a VAR model, there is a smaller literature seeking to exploit extraneous estimates of oil supply and oil demand shocks. Such extraneous shock measures may be used as an external VAR instrument, as an internal VAR instrument, or as regressors in distributed lag models or local projection models (see Plagborg-Møller and Wolf 2021).

### **5.1. Historical Counterfactuals for OPEC Events**

Given the importance attached to OPEC actions in the early oil market literature, there has been much interest in identifying exogenous oil supply shocks in OPEC countries. For example,

Hamilton (2003) proposed a simple measure of OPEC oil supply shortfalls caused by exogenous geopolitical events. Kilian (2008b) observes that not all of the events considered by Hamilton are plausibly exogenous and points out that Hamilton's OPEC oil supply shock measure is based on indefensible assumption about the timing and magnitude of the OPEC oil supply disruptions. Kilian (2008b) proposes an improved measure that articulates explicit counterfactuals about how the production of other OPEC members would have evolved in the absence of geopolitical events in selected OPEC member countries. Kilian's (2008b) exogenous OPEC oil supply shock series has been updated by Bastianin and Manera (2018).<sup>36</sup> Kilian (2006) uses Kilian's (2008b) OPEC oil supply shock measure as an internal instrument within an extended version of the Kilian (2009) oil market model and shows that explicitly modeling OPEC oil supply shocks provides no value added. Montiel Olea, Stock and Watson (2021) establish the robustness of the results in Kilian (2009) to using the same OPEC oil supply shock measure as an external instrument.

In practice, the usefulness of both the Kilian (2008b) and the Hamilton (2003) measure of exogenous OPEC oil supply shocks and related shock measures is limited for two reasons. First, Kilian (2008b) stresses that all such measures lack predictive power for the real price of oil. This not only contradicts Hamilton's (2003) claim that these oil supply shocks explain major oil price fluctuations, but means that these shocks are weak instruments for the real price of oil, which complicates estimation and inference. This point has been reinforced by more formal evidence in Kilian (2008a), Montiel Olea, Stock and Watson (2021) and Kilian (2022a).<sup>37</sup>

Second, Kilian (2006, 2009) emphasize that OPEC members such as Saudi Arabia and to

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<sup>36</sup> Unlike Hamilton, Kilian allows OPEC oil supply shocks to be negative as well as positive. He draws attention to the fact that political events such as wars paradoxically may stimulate oil production rather than necessarily curtailing it. For example, during the Iran-Iraq War, both of these countries sought to increase their oil exports in order to finance purchases of military equipment from abroad.

<sup>37</sup> The same concern applies to the oil supply shock series constructed in Caldara et al. (2019), as shown in Kilian (2022a).

a lesser extent Kuwait and the UAE have had a history of responding to exogenous production shortfalls in other OPEC countries by expanding their own production, so the net shortfall of oil often is much smaller than it seems at first sight. Examples include the Iranian Revolution of 1978/79 and the invasion of Kuwait in 1990. Moreover, the importance of OPEC has changed since the 1970s. OPEC oil production shortfalls since the 1980s have been increasingly offset by production increases in non-OPEC countries, making it important to measure oil supply shocks at the global level rather than at the OPEC level. This evidence, along with the increasing recognition that OPEC oil supply shocks are weak instruments at best, has led to the demise of the literature on OPEC oil supply shocks caused by geopolitical events. There have been a number of other efforts in the recent literature, however, to construct extraneous estimates of oil demand and oil supply shocks.

## **5.2. Oil Supply News Shocks**

One increasingly popular approach has been to rely on event studies. For example, Käenzig (2021) uses changes in the 6-month oil futures price on days of OPEC announcements as an instrument to identify what he calls an oil supply news shock. His premise is that a change in the oil futures price at high frequency reflects a shift in oil price expectations rather than in the risk premium. These daily shocks are aggregated to monthly frequency by summing the daily shocks over a given month. An increase in oil price expectations (referred to as negative supply news by Käenzig) is associated with an immediate increase in the spot price of oil, a gradual fall in oil production and an increase in oil inventories.

It can be shown that the oil supply news shock discussed in Käenzig (2021) is a special case of a storage demand shock driven by the change in oil price expectations, as discussed in

Kilian and Murphy (2014).<sup>38</sup> Käenzig's approach is not without limitations, however. For example, the assumption of no change in the risk premium around OPEC announcements need not be correct in practice. Likewise, the temporal aggregation of the daily shock measure to monthly frequency is ad hoc. Nor is it clear which horizon of the term structure of oil futures we should focus on in constructing this shock. Finally, Degasperi (2021) shows that Käenzig's shock measure captures revisions in expectations about oil demand based on the OPEC news release. A more natural interpretation of this shock thus would be as a shock to oil price expectations.

This comment also applies to other oil supply news measures discussed in the literature. For example, Arezki, Ramey and Sheng (2017) treat large oil discoveries as news shocks about future oil output. Oil discoveries by construction leave the flow of oil production unaffected for years to come. Instead, they matter because they shift expectations of future oil production and hence expectations of future oil prices. Thus, these shocks do not represent shocks to the flow supply of oil, but to storage demand. It is worth pointing out that oil supply news measures such as giant oil discoveries are poor proxies for exogenous shifts in oil price expectations. The link between oil discoveries and oil price expectations is nonlinear in general. An unexpected giant oil discovery will not move oil price expectations, when expected oil demand is low and the market is well supplied, but may lower oil price expectations substantially, when expected oil demand is high. Just because an oil discovery has a large effect on the economy of the oil producer (and possibly on the real price of oil) in one episode does not necessarily mean that it will do so in another episode. Thus, the coefficients of a regression of changes in the real price of

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<sup>38</sup> This proposition is testable. Since we know that unexpected oil supply disruptions cause a decline in oil inventories, whereas positive storage demand shocks cause an increase in oil inventory holdings, it is immediately clear from Käenzig's impulse response estimates that OPEC announcements that raise oil futures prices affect the real price of oil through storage demand rather than through changes in the flow supply of oil. This conclusion is also consistent with the sharp increase in the real price of oil following the supply news shock. Although Käenzig's shock measure captures only a subset of the storage demand shocks identified in recent structural oil market models, it corroborates the dynamic responses to storage demand shocks uncovered by Kilian and Murphy (2014).

oil on this shock measure will be time-varying. The same concern applies to other oil supply news measures such as indices of attacks on oil shipping. If we force the coefficients to be time-invariant, we obtain a linear approximation, the accuracy of which is sensitive to the unmodeled demand side of the oil market over the estimation period. In contrast, storage demand shocks, as measured in the Kilian and Murphy (2014) model avoid this instability by focusing on the shift in storage demand associated with a shift in oil price expectations. This avoids having to measure oil price expectations or having to model the nonlinear process that generates oil price expectations.

### **5.3. Forecast Revisions for Global Growth Forecasts**

Measuring shocks to the flow demand for oil associated with the global business cycle is even harder than measuring supply shocks or storage demand shocks. Kilian and Hicks (2013) construct proxies for global flow demand shocks based on revisions of forecasts of real GDP growth made by professional forecasters, as recorded by the Economist Intelligence Unit. They document that professional forecasters between 2003 and mid-2008 persistently underestimated global growth, mainly because they underestimated growth in emerging Asia. This pattern is consistent with the pattern of flow demand shocks recovered by the Kilian and Murphy (2014) model.

### **5.4. The Narrative Approach to Identifying Oil Supply and Oil Demand Shocks**

An alternative is the narrative approach to identification. An early example is Cavallo and Wu (2012). Their approach involves a manual audit of articles published in the *Oil Daily*, the *Oil & Gas Journal*, and the *Monthly Energy Chronology* between 1984 and 2007. Cavallo and Wu use introspection informed by articles in these industry publications to attribute daily changes in the spot price of oil (or, alternatively, the residual of a regression of the change in the spot price on

the oil futures spread) to a subset of 22 different types of oil-market related events such as OPEC announcements on oil production, U.S. oil inventory announcements, political developments in the Middle East, or oil production and transportation disruptions that are considered exogenous with respect to the oil price. If there is more than one event on a given day, say,  $n$  events,  $1/n$  of the change in the price of oil on that day is attributed to each event. Cavallo and Wu then proceed to construct monthly averages of the daily oil price changes that they attribute to exogenous events. They abstract from inflation in defining their exogenous oil price shocks.

One obvious concern with this methodology is that the events in question are not necessarily the cause of these oil price changes. For example, an announcement about oil inventories (or of OPEC production plans) would be expected to have no effect on the price of oil to the extent that the announcement was expected (e.g., Ye and Karali 2016). Nor is it clear to what extent political events in an OPEC country cause the price of oil to move. Another concern is that many of the events in question are not plausibly exogenous with respect to the change in the price of oil. For example, OPEC production plans are endogenous with respect to the state of the global economy. Nor is there any justification for giving equal weight to different events. Finally, one has to have a lot of faith in the ability of the authors (and, implicitly, in the ability of the oil journalists whose articles form the basis of the analysis) to solve the underlying identification problem. The problem faced by these journalists is little different from that faced by sports commentators or stock market pundits explaining the latest results after the fact. There is a natural tendency to list all possible explanations with little regard to the consistency of the explanation over time. It is these explanations that form the raw material for the analysis in Cavallo and Wu (2012). Many of these problems carry over to more recent narrative approaches to identifying oil demand and oil supply shocks.

## **5.5. Text-Based Measures of Oil Demand and Oil Supply Shocks**

Cavallo and Wu's (2012) analysis focuses on measuring exogenous oil price shocks associated with oil demand and oil supply shocks. It does not provide direct measures of the actual demand or supply shocks, only of their impact on the oil price. The direct measurement of oil supply and/or oil demand shocks based on textual analysis is discussed in Datta and Diaz (2019), who propose using a systematic and fully automated procedure for gathering information from news articles in two oil industry publications by the Energy Intelligence Group. Their objective is measuring the supply- and demand-driven components of oil price movements. By categorizing words in these articles into expressions linked to "oil supply", "oil demand", "increase", and "decrease", they construct oil supply and oil demand indicators, demeaned values of which they treat as proxies for oil demand and oil supply shocks.

Datta and Diaz' (2019) approach is subject to important drawbacks. First, their claim that text searches allow them to circumvent delays in the availability of data on oil production and global real activity is not persuasive. For example, given the six-month delay in the availability of global oil production data, oil industry journalists clearly know as little as economists about the current level of global oil production. They have no advance knowledge of the data.

Second, there is reason to be skeptical of the reliability of these text classifications. Just because the process is automated does not mean that it reads the data correctly. For example, policymakers routinely mislabel oil production as "supply" and oil consumption as "demand". Since oil consumption may drop in response to an oil supply disruption, it is easy to see how a mechanical text search could confuse oil supply with oil demand. Another concern is that Datta and Diaz' method does not accommodate negations such as "not a supply increase", which will be coded as a "supply increase", overturning the meaning of the original text. Another

problematic situation arises with texts such as “OPEC oil production will increase its production next year by less than expected”. The textual search will classify this sentence as a “supply increase”, when in reality it reflects a decline in expected oil production, which, all else equal, causes an increase in storage demand.

Third, an index of the frequency of certain words or phrases in the press, on television, or in social media (say the phrase “decline in oil supply”) is not a shock, but an endogenous variable, calling into question Datta and Diaz’ (2019) interpretation of their word counts. The idea that the unpredictable component of the demand (supply) indicator would be a natural measure of the demand (supply) shock is a misconception that arises from a semantic confusion about the terms “demand” and “supply”.<sup>39</sup> Clearly, there is no reason for the magnitude of this index (or its unpredictable component) to be proportionate to the magnitude of actual oil supply shocks.

Fourth, as the oil market VAR literature has shown, there are many different types of oil demand shocks with different effects on the real price of oil. Lumping all these demand shocks together in textural analysis, as proposed by Datta and Diaz (2019), is not likely to produce a sensible measure of oil demand shocks.

Finally, there is no reason to presume that the press always correctly identifies supply and demand shifts. For example, the oil supply disruption that occurred as a result of Hurricane Rita and Katrina in 2005, when offshore oil platforms in the Gulf of Mexico were shut down, was negligible on a global scale. The main effect of these hurricanes was to shut down the U.S.

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<sup>39</sup> The term “demand” among policymakers and in news reports is short-hand for global real activity or oil consumption. Clearly, a surprise change in these variables could be caused by any combination of oil demand or oil supply shocks. The underlying structural shocks are not identified. The same is true for unexpected changes in the “supply” of oil, which in press reports refers to oil production. Thus, the resulting “supply shock” measure would not be a structural shock either.

refining industry along the Gulf Coast. This shutdown by construction represented a negative supply shock for the U.S. gasoline market, but a negative demand shock for the global oil market. Nevertheless, this event was frequently incorrectly characterized as a negative oil supply shock in the media. Problems such as these are pervasive in textual analysis.<sup>40</sup> Likewise, it has been common in the media to attribute oil price increases (as well as decreases) to actions taken or not taken by OPEC, even when the basis of these attributions is not clear. Similarly, the media attention given to the peak-oil hypothesis in discussing rising oil prices has never matched the empirical support for this hypothesis. Yet another example is the extensive public debate about the role of speculative demand in oil markets in the 2000s, triggered by the so-called Masters Hypothesis, which at no point was supported by hard evidence (see Fattouh, Kilian and Mahadeva 2013).

## 6. Conclusion

As this survey has illustrated, there is a plethora of approaches to identifying oil demand and oil supply shocks and of alternative oil market VAR models, reflecting differences in the data, the reduced-form specification, the identifying assumptions, and the estimation method. What is remarkable about the oil market VAR literature to date is how robust its central findings have been across a broad range of model specifications. There are a few insights in the global oil market literature that stand out because they have been reaffirmed time and again. First, although the economics profession has been preoccupied with measuring the impact of oil supply shocks on the real price of oil for three decades, there is robust evidence that the effect of oil demand

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<sup>40</sup> Another good example is Iraq's invasion of Kuwait in August 1990, which represented both an oil supply disruption and a positive shock to storage demand, reflecting expectations of future oil supply disruptions and hence rising oil prices. The latter explanation received much less attention in the media, yet has been shown to be as important as the oil supply disruption for understanding the spike in the real price of oil in 1990/91 (see Kilian and Murphy 2014).

shocks on the real price of oil is quantitatively more important than that of oil supply shocks. This is true even accounting for the role of the U.S. shale oil revolution in recent years. Second, there is no credible evidence at this point that the oil price fluctuations of the 1970s and early 1980s were primarily caused by exogenous supply disruptions in the Middle East, calling into question the treatment of these episodes in many macroeconomics textbooks. Third, it is not only shocks to the flow demand for oil that matter, but also shocks to the storage demand for oil driven by shifts in oil price expectations. Such expectations shocks were largely ignored by the literature until a few years ago. Explicitly accounting for oil price expectations helps understand how political events have shaped the oil price and provides a fresh perspective on historical events in the oil market.

This does not mean that the current models have resolved these questions once and for all. There continues to be much interest in exploring new identification schemes, new econometric approaches and new identifying information for oil market models. For example, Plagborg-Møller (2019), Lanne and Luoto (2020), Braun (2021) and Angelini et al. (2021) recently proposed innovative approaches to achieving identification in structural VAR models that are relevant for oil market studies. There is also interest in incorporating nonlinearities into structural VAR models of the oil market. Time will tell which of these ideas will stand the test of time and which will remain interesting thought experiments.

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