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$4 Gas Could Put Brakes on Growth

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With remarkably little commentary, gasoline prices have risen, almost back to their highs of last spring. Such a move, whether or not noted in the headlines, will nonetheless affect the economy, especially if the new, higher prices stick. The experience last spring offers a model of what to expect. If the spike is short-lived, as it was then, the economy will show brief signs, but then quickly correct. If prices stay at their current, elevated levels for a period of months, or if they rise still farther, the pace of real economic growth, already anemic, will suffer. In time, the impact on general price levels could constrain the Federal Reserve's ability to consider further monetary ease.

The immediate picture is far from pretty. In the past few weeks alone, the national average retail price of a gallon of gasoline has risen almost 11.0%, from a low of $3.36 late last June to about $3.75 more recently. That price is only 5.5% below the $3.94 high of last April. In higher-tax states, such as Connecticut and California, the price per gallon has already topped $4.00, as it did last spring. Since this increase in retail prices so far has failed to keep up with the 20% rise in wholesale gasoline prices and the 27% jump in crude oil prices, chances are the price at the pump will move up still more in coming weeks.

Against this less than encouraging backdrop, there is reason to expect only short-term pain. Certainly, the immediate pressures on gasoline prices would seem to have a transitory character. For example, the storm Isaac, in the Gulf of Mexico, has disrupted production, but the effect will not likely last long. So, too, a fire at a San Francisco refinery that created a shortage of the particular blend sold on the West Coast will find repair relatively soon. A pipeline rupture in Wisconsin that interrupted supplies flowing into the large Chicago market is already being rectified. Another temporary factor includes the fact that refineries in general have slowed production as they anticipate the season and retool from the distillation of gasoline to the distillation of heating oil.

Nor is there any hint of either fundamental supply shortages or demand excesses. Although the American Petroleum Institute (API) reports a 15% drop in American crude inventories, ample new supplies are becoming available, in the United States with the new fracking technology, through new finds in the South Atlantic, and in the applications of new technologies to existing fields. Saudi Arabia, for instance, is pumping more oil today than at any time in the last 30 years. While supply picks up, the sluggish global economy has prompted the International Energy Agency to reduce its 2013 forecast of world oil demand to 89.6 million barrels a day (mbd) from 89.9 this year. The American Petroleum Institute notes that demand in the United States in July averaged 18.1 mbd, down from 18.6 mbd during the same month a year ago and the lowest level since 1995.

Still, two wild cards remain in this deck. One is the latest round of financial negotiations in Europe. If the Europeans fail to reach an accommodation with Greece, and talks of expulsion from the euro become something more than just talk, the consensus, anticipating crisis conditions, will downgrade growth forecasts for Europe and the world and, accordingly, for oil demand as well. Global crude futures would then retrace some of their recent rise, and actual spot prices would, as always, fall in tandem. But if, as is likely, Europe avoids this extreme, growth prospects, if still anemic, would improve at the margin, prompting oil prices to rise still more or, at the very least, hold their recent gains.

The second wild card is Iran. The tension over Iran's nuclear ambitions has hung over the world oil supply outlook for some time now. It was such tension that prompted last spring's price spike. It is a renewed concern about action in the Persian Gulf that has contributed to this most recent price rise. Should Israel strike Iran, as some suggest it will, even before the American elections this coming November, supplies from that important oil region would stop flowing—not just from Iran, which already has lost most of its markets, but also from Iraq, Kuwait, Bahrain, Qatar, and

the oil-producing emirates, all of which ship through the Persian Gulf. Even matters far short of an Israeli strike could disrupt supplies. If a desperate Tehran, for instance, declares the Strait of Hormuz closed, the supply could stop as surely if there were actual fighting. Even if Iran's navy could not enforce such an order, the threat could still shut down oil flows by prompting insurers to back away.

Though such geopolitical events are by nature unforecastable in any sense typically used in finance, they are nonetheless real. What is more, should such problems in the Persian Gulf, or even less dramatic events, such as calm in Europe or a pickup in the pace of growth anywhere in the world, sustain or extend recent price increases, the effects on the U.S. economy are all too predictable.

Because the average American dedicates some 8% of his or her household budget to fuel, at least according to the Labor Department, the recent gasoline price surge, if it lasts for even a few more months, could divert as much as $100 billion, or almost a full 1.0% of consumer spending. The overall nominal retail and consumption spending numbers would stay up, since gasoline sales are a form of consumption. But the need to spend more at the pump would take from other sorts of purchases. Because other forms of consumption better serve the purposes of a general economic expansion and hiring than does spending on fuel, the effect on balance would slow the economy's overall pace of expansion and hiring as well. By itself, the strain could, all else equal, trim half a percentage point off the economy's overall real growth pace, which is not an insignificant amount, with a real gross domestic product growing at less than a 2.0% annual rate so far this year.

The strain would show in other ways as well. To the extent that households slowed their pace of saving in order to heat their homes and meet the needs of their gas tanks, the price hike would also slow the pace of financial healing that has proceeded since this recovery began in 2009. Since households still have a long way to go to reduce their debt overhang, any such interruption in their efforts would delay still longer the time when the consumer could again become a robust growth engine in the economy.

Further, the inflation effects could eventually impact Fed policy. Initially, policymakers would ignore the general price effects of oil price hikes, noting, as they usually do, that their natural volatility makes them as likely to reduce inflation as add to it. But if the energy price hikes stick, policymakers would eventually filter through other costs into those "core" inflation measures to which Fed policymakers do pay attention. Given the slack in the U.S. and global economies, it is doubtful that the Fed would revise policy. But since some Fed board members and regional Fed bank presidents already have voiced concerns about the long-term inflationary consequences of the Fed's present, very easy monetary policy, such energy-based price pressures could, at the margin, dull the central bank's willingness to take yet another easing step.

The trend is far from sure. Indeed, likelihoods still suggest that the recent oil and gasoline price run-up will reverse, as in last spring's short-lived experience. But the possibility clearly is there for something more substantive and long-lived, with all the attendant economic, financial, and policy effects. Investors and businesspeople need to prepare for the contingency, especially since some of the factors are fundamentally unpredictable.

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