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MACROCOSM

$40 Crude

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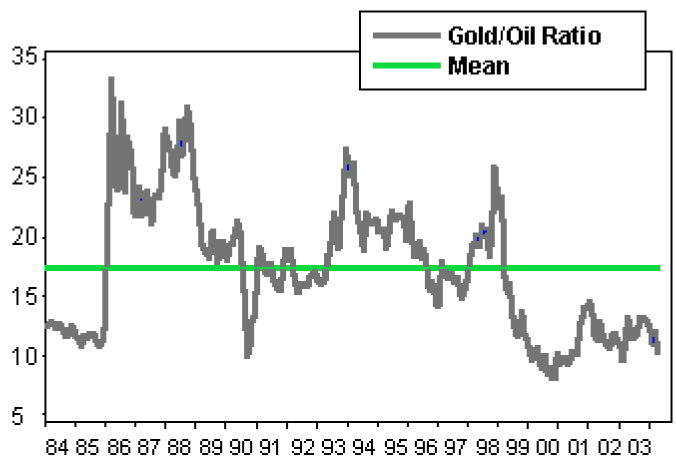
This isn't the 1970s -- today's oil prices don't have to be an obstacle to expansion.

Whether or not crude oil prices have seen at least a near-term top, the hysteria generated by the recent price climb has been significantly overdone. No doubt, equities today were whipped around by the meanderings of the **NYMEX** front-end crude contract. After rallying by more than 100 points in concert with crude opening weak and briefly trading below $40, stocks sold off as the day wore on and oil prices backed up and came close to challenging Monday's intra-day high of $41.85. Though hardly alone, oil prices have been among factors contributing to recent market uncertainty. Continuing uncertainty about whether or not crude has crested will make it difficult for the market to absorb that element of the risk premium.

We don't minimize the economic risks presented by rising petroleum prices. Certainly a stable, predictable energy price environment would be optimal. In the real world, however, economies more often than not are required to adjust to non-optimal conditions of one sort or another. The relevant question is whether the economy is capable of absorbing and adapting to the exogenous shock posed by higher oil prices. Barring sustained price acceleration at rates seen over the past six weeks or so, or an inappropriate policy response, this episode is unlikely to seriously threaten the positive forces now at work propelling growth forward. Long-term historic relationships suggest that downside risks to current crude prices significantly outweigh the likely upside.



To a considerable extent, it seems the trauma of the energy shocks of the 1970s and early 1980s continue to shape perceptions of the risks arising from the oil price environment. The world, however, is a very different place, and the **US** economy far less vulnerable to rising oil prices than it was in that earlier era. For one thing, energy input per unit of economic output is now less than half what it was 20 years ago. Moreover, though in nominal terms current prices are comparable to their highest levels of the early '80s, any economically relevant comparison must gauge the real burden by taking into account the cumulative change since then in the overall price level. By that standard, crude prices would have to rise to about $80 per barrel in 2004 dollars to equal their levels in 1981 dollars.

It also should be borne in mind that in the last three years the dollar has transitioned from a deep deflation to incipient inflation. Measured against gold, the commodity with the most stable real purchasing power over time, crude at above $40 with gold at $380 is only slightly more expensive than it was three years ago, when a barrel fetched $28 and gold stood at under $270.

But the fact is, throughout this period -- largely for reasons involving geopolitical risks and other non-economic factors -- crude's value relative to gold has held significantly above its long-term average. Over the last 20 years, for example, a little more than 17 barrels of oil could buy an ounce of gold on average. At today's prices, just 9.3 barrels would buy an ounce of gold. As the chart of the gold/crude ratio on the previous page suggests, however, this relationship has shown a clear tendency to revert to the mean over time. That downside risk, in fact, likely is one of the key reasons the **OPEC** cartel continues to manipulate quotas and attempts to impose production limits on its members. Current gold prices suggest an equilibrium crude price based on long-term averages of about $22 per barrel. TM