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INTELLECTUAL AMMUNITION

More Thoughts on $40 Crude

Wednesday, May 26, 2004

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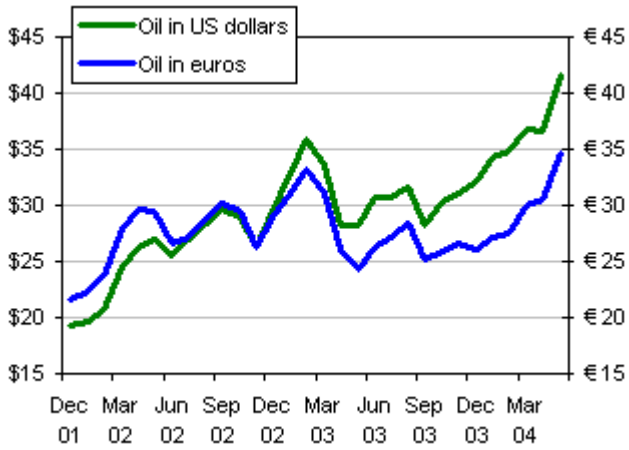
This time it really is different: today's high oil prices don't have to mean a rerun of "That 70's Show."

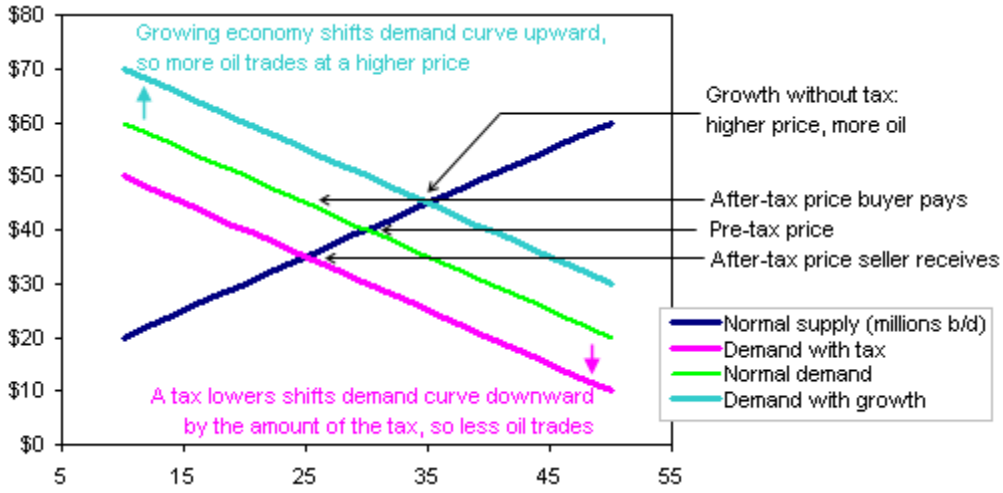
We don't for one minute wish to minimize the challenges and dislocations arising from today's high oil prices. But at the same time, we strongly caution against reflexively viewing the current situation as though it were another "supply shock" like the oil crisis of the mid-1970s. Today's situation is very different, and should be evaluated on its own terms and in its own context.



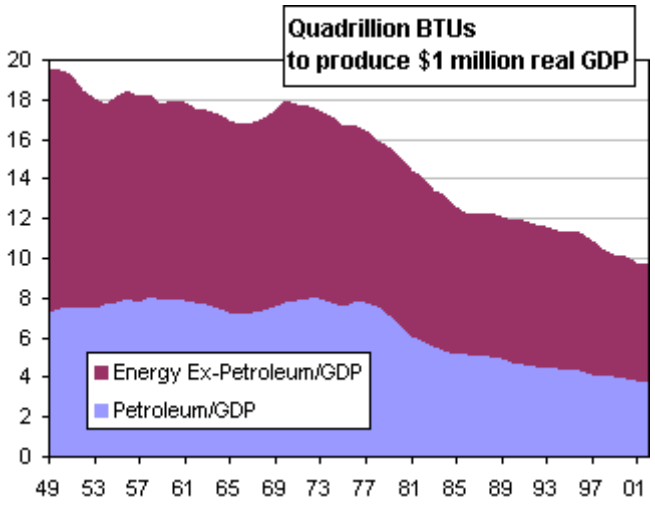
THE MONETARY CONNECTION While today's high oil prices are the result of supply-and-demand dynamics that we will examine more closely in a moment, it would be a mistake to ignore the monetary context in which they are occurring. A large component of today's seemingly high prices can be explained by the revival of inflation and inflationary expectations that are the result of **the Fed** maintaining a too-easy liquidity posture for too long. The proof is that today's high oil prices are largely a dollar-based phenomenon. As the chart above shows, from the bottom of the recession in 2001, oil has double in dollar terms, but risen only by 50% in euro terms -- thanks to the dollar's sharp inflationary depreciation against the euro. Today, in euro terms, the oil price is barely higher than it was 15 months ago, while in dollar terms it has soared to new highs. It would be useful here if the public hue and cry over high gasoline prices could play a role in shocking the Fed into seeing the inflation risk they have unleashed. But professional economists have a limitless capacity for self-deception, including the use of so-called "core" inflation measures that deliberately ignore energy costs. And today's Fed is so bent on micromanaging economic recovery that it may well do precisely the wrong thing, by "accommodating" high oil prices through keeping rates unnaturally low even longer than they already have.

LAW OF SUPPLY AND DEMAND STILL IN FORCE To the extent that inflation is to blame, then the often-heard claim that high oil prices represent a "tax on the economy" is true -- because inflation is a tax. But beyond that, it would be a mistake to interpret the rising price of any commodity in the face of increasing global demand and temporarily short capacity as a tax. It is simply the market operating -- and as much as anything else it is the *effect* of economic growth, not a *cause* of economic contraction. In a rare example of genuine insight in the financial media, **Bloomberg's Caroline Baum** pointed out this week that taxes shift demand curves downward, and drive a wedge between buyer and seller. The after-tax equilibrium price is both higher for buyers and lower for sellers, so less oil is produced and consumed -- proof of

the old saying that "if you tax something, you get less of it." By contrast, a pure increase in global demand -- the result of global economic recovery -- shifts the demand curve higher. A higher price is voluntarily and gladly paid, and more oil is produced and consumed. In other words: a demand-driven increase in prices is a productive rationing process, while a tax-driven increase is a dead-weight loss.



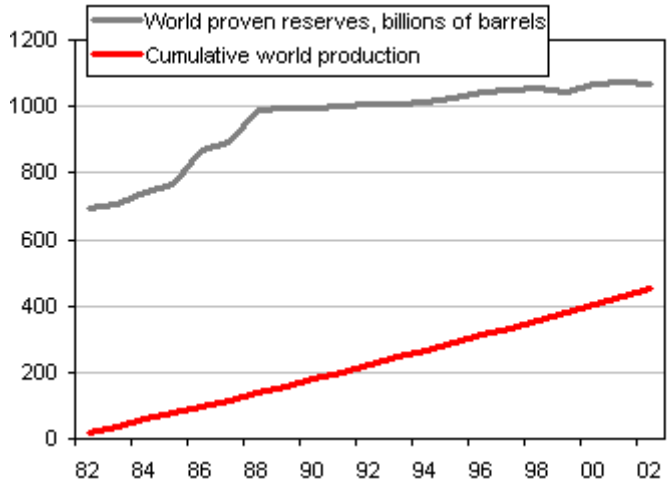
THE CHINA CONNECTION Many commentators have pointed out that rapidly growing **China** is now the oil demand factor at the margin, pushing up prices in a way that is the equivalent of a tax from the **US** perspective. We believe that this is an error. A tax lowers the seller's effective price, and reduces incentives to increase production. Demand, on the other hand -- from whatever source -- leads to higher prices for sellers which increase incentives for production. So while it's true that we are competing with China for oil now, at least the resultant higher prices are likely to succeed in bringing out new supply. At the same time, we must not forget that demand from China is not entirely a bad thing --so higher oil prices that result from it are offset by other positives. First, Chinese demand is partly the result of the relocation of energy-intensive manufacturing processes from the US to China. To that extent, China is demanding energy that we no longer need here in the US, so there's no net increase in global demand (maybe even a decrease, to the extent that new Chinese factors are more energy-efficient than the older US factories they replace). Second, to the extent that China is demanding energy simply as a function of its own economic development, we should recognize that such development is almost entirely the product of mutually profitable global trade -- trade that makes both China and the US more wealthy. As *both* nations become more wealthy, they are both in the happy position of being able to demand -- and pay for -- more oil at higher prices.



IMPACT ON THE US ECONOMY It has been said often in the media that the impact of a given oil price increase on the US economy would less today than it was in the 1970s and 1980s, because the economy is a far less energy-intensive than it used to be. This is true -- even more so than most commentaries suggest, and for reasons that most of them don't mention. We most often hear that only half as much oil is required today to produce a unit of GDP as was required in the mid-1970s, and the reason most often cited is that the oil

shocks of the 1970s and 1980s forced the US to adopt painful and costly conservation, efficiency and substitution measures. What is never mentioned is that the trend toward energy-efficiency has been strongly in place *since the late 1940s*, long before anybody had ever heard of oil crises. Why? First, contrary to the popular caricature of unfettered economic actors as fools who blindly pour gasoline into the bottomless tanks of their SUVs, the reality is that the economy has incentives to move in the direction of energy-efficiency at *any* oil price. Second, and probably just as important, since the late 1940s the US has been in a long-term secular shift from being a predominantly manufacturing economy to a predominantly service economy.

ARE WE RUNNING OUT OF OIL?



Today's high oil prices have given perennial catastrophists the opportunity to yet again warn that the world is running out of oil. The fact that such predictions made so many times in the past have always proven to be false is not in and of itself a reason why they should be wrong this time -- but it should be enough at least to make us deeply question the seeming authority and certitude of the doomsayers. For one thing, such predictions suffer from the inherent weaknesses of all forecasts of an unknowable and non-linear future: they can only be based on patterns of the past. But more important, high prices are highly reliable at bringing into existence things that there used to be too little of. For example, the world has consumed 452 billion barrels of crude oil cumulatively since 1982, an amount equal to about two thirds of world reserves proven at that time. Yet today, reserves are 50% higher than they were then, at over a trillion barrels. And remember -- it's not really *oil* that is at issue, anyway: it's *energy*. Even if we are preordained to run out of oil decades in the future, we will have a long time to convert to other more plentiful forms of energy, such as natural gas sourced from marine gas hydrates, which represents about two thirds of the carbon source on the planet. This and other opportunities to substitute leads to a world in which no one will bid infinity for that last barrel of oil -- there will be no use for it, and no buyers. TM