BUSINESS

Economy slides if oil prices stay high

By Rajeev Dhawan

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Warren Buffet recently said on CNBC that he wasn't worried about high oil prices, now topping $100 per barrel and making gas expensive. I've been quoted in this newspaper as saying that oil prices staying at $120 per barrel will cause a mild recession.

Is this a case of his cheery optimism versus my perceived pessimism?

It's not if you realize how oil prices impact the economy.

First, let's see what consumers do when gas prices rise. Textbook economic theory says we should find a substitute for this high-priced item. That's difficult in practice: few alternatives to gasoline exist in the short run. People won't change their gas guzzlers for hybrids or move closer to work. It's not economical.

What consumers can do, but don't do enough, is cut back on discretionary spending, such as clothing and footwear (yes, that is a category by itself in GDP calculations), eating out and travel, among others. In the middle of 2008, when oil reached a high of $147 per barrel, consumers were forced to spend about $100 billion extra on gas. However, the dent in discretionary purchases was a fraction of that value, and total spending numbers kept growing in the first half of 2008.

How did consumers fund this extra spending in the face of no paycheck increases?

They borrowed from future assets by reducing current savings. That gas habit had to be fed. Consumers did the same after Hurricane Katrina in 2005 disrupted the gas supply. Katrina's aftermath was a boom. By contrast, the economy went bust in 2008.

Why the different outcomes?

Shifts in spending do not cause recessions, which is what the sage of Omaha implied in his statement about the high price of oil. My concern is about prices remaining high,

choose to pass along or not. Typically, companies don't. If profit margins are healthy they tend to absorb these costs, resulting in lower profits but no rise in consumer price inflation.

Yet if high oil prices linger — for example, a six-month hike at $120 per barrel — the nasty dynamics of the second round begin. High input costs get passed on (remember the fuel surcharges by airlines and freight companies in 2008) to the consumer, who either will demand fewer products or use their savings to maintain spending at current levels temporarily, but eventually will fold.

This is commonly observed as a drop in consumer sentiment or in confidence. This won't be enough to cause a recession, just a sharp deceleration in growth rates of real GDP for a few quarters. Business will scale back operations and lay off people as the economy realigns its resources from oil-intensive industries to other areas.

The hit to business confidence, leading to a drop in capital spending or investment, is what will really hurt us. This could happen for many reasons that have happened before: The oil supply is not available (similar to the 1973 oil embargo, interest rates rise with the Fed fighting inflation oil prices that rose during the early 1980s) or the future looks uncertain (Saddam invading Kuwait in 1990).

Investment, especially in equipment, software or technology, is the leading predictor or generator of jobs. In stage three, scaled-down businesses won't replace aging stuff and will shy away from big deals. If this were to happen in an isolated sector, such as the airlines or hospitality, it's manageable. When everyone scales back simultaneously, it becomes a recession.

We haven't reached that stage yet. We're in the first stage of the substitution effect. Vehicle sales reported this week were much better than previous months but will suffer in coming months. Profit margins are healthy at large corporations, so they will absorb the price increases for now (at least I hope so). That reduces the inflation threat. But small businesses will have a tough time absorbing these costs.

However, the longer Libyan oil, which is 2 percent of the world supply, is off the market, the sharper the hit to consumer confidence. That makes the second round more likely, but perhaps not devastating. It will be bad news for our local hospitality sector and our largest private employer, Delta. If the House of Saud takes 10 percent of the world oil supply offline or even a fraction of it, stage three will begin. Oil prices will go north of $120 per barrel and get stuck there. Confidence levels will collapse, hurting growth.