

The Economy at Midyear: How the Price of Oil Tells Everything There is to Know about the American Economy

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There's a terrific new book out, Freaknomics, that tells you all you need to know (as if you wanted to) about how economists think. I mention it here because the authors take the approach of relating seemingly unrelated phenomena to answer interesting and off-beat questions. Inspired by this, I'd like to take a look at the economy in midyear using the concept that the price of oil encapsulates all that's encouraging and troubling about the American economy.

First, where are we now? In many ways, this economy is just fine. Interest rates have remained low, and this is fueling a raging real estate market (more about this later). GDP is growing at a three percent rate after inflation, again a sign of basic health. And we are creating jobs at a vigorous, if not spectacular rate. In other ways, the economy appears less robust. We are in the midst of a sequence of interest rate increases by the Fed; these have raised short term rates by 2.25 percentage points and will likely continue through the balance of the year. The trade deficit and the Federal budget deficit are stretching our credit limits. Consumers don't feel very good about their futures and the Index of Leading Indicators has been trending downward all spring. In sum, the signs are mixed even though the economy is healthy.

To clear up the ambiguity and the conflict among the various statistics that are coming at us, let's look at one number, the price of oil. As I write this, the price of oil has breached the magic \$60 a barrel number. It may remain there, go higher or retreat somewhat and you can find experts to stand behind each of these eventualities. But the fact that the price has reached this height suggests the type of things that will be forming the U.S. economy over the next six to twelve months.

1. The dual deficits are coming home to roost. One of the reasons that oil prices have risen is the falling value of the American dollar. Although the dollar rallied in May and June against the Euro, it's still down substantially. Since the revenue OPEC generates from oil sales is in dollars, a less valuable dollar must be offset by receiving more dollars. Hence the price of oil goes up. The dollar, in turn, has fallen in value because they are a glut on the market. They are so plentiful because we have chosen to live beyond our means and are using the savings of the rest of the world to do it, paying them with dollars and other American debt. Usually, we need to pay them more as we ask them to finance more of our lifestyle, but this has not happened, leading Mr. Greenspan to label

long-term rates a “conundrum”. If history holds, we will see long term rates rise in the second half of the year because of the dual deficits.

2. China is here to stay. One of the other reasons why the price of oil has risen is that demand is expanding—and not because of the United States. In fact, we have done quite well in conserving resources, driving down the petroleum necessary to produce a dollar of GDP. No, the expansion of demand for oil is coming from the booming Chinese economy. Owing to both its size and its growth rate, China is a glutton for the world’s resources, including oil. This has driven up the price of oil. And since the United States is China’s biggest customer, we are promoting that growth, and in the process are making China our biggest creditor. So if the Chinese want to buy Unocal, we are in a tough position trying to oppose the control of a strategic resource by a rival country.
3. It may be a cold winter. Even if the price of oil retreats to the \$50-60 range, a highly probable—but not certain—development, fuel oil will be more expensive this winter. Well before that, the price of gasoline will rise some more. This will increase air fares, shipping fees, taxi rates and the price of just about any economic event that requires transportation. The American consumer will have to make choices, so consumption spending will probably decline in the second half of this year and the first half of next. The alternative, validating these price increases by expanding the money supply, is unthinkable to the Fed and simply will not happen. Doing so will court inflation and threaten to lead us back to the bad old days of the late Seventies and early Eighties.

With all this brewing in the world economy, it appears very likely that the second half of 2005 will see a slowing economy with rising interest rates. Again, the price of oil is a pivot point. If the price continues to rise, the economy will slow dramatically; if oil prices retreat, the slowing will be mild. At \$60 a barrel, this economy will grow at 2.5-3 percent over the second half; add or subtract three-quarters of a point for every \$10 the price deviates from the \$60 mark.

Finally, let’s look at real estate. There is no national housing bubble, despite the publicity. The demographics of the market are too strong, interest rates are too low, the economy is growing and the major price increases have been concentrated in relatively few markets. But there is a speculative element in specific metropolitan areas. Speculators push prices up, but they also sow the seeds of correction. When they find their expectations unfulfilled, they sell off and the market stalls. So, to figure out whether your market is bubbling, look at speculator activity. Where it makes up a significant portion of the market (10 percent or more), a down market is coming. Then take a good, hard look at your loan portfolios.