Get Used to It: There's No Going Back to Cheap Gasoline

By Andrew Brod

Greensboro *News & Record*, September 4, 2005

Whoa!

I've never before channeled Keanu Reeves when writing about economics, but the Reevester's signature line is the natural reaction to what's been going on with gasoline prices. Last week at this time, retail prices were up nearly 50 percent since January. At times this summer, a new record high was set each day.

And then came Hurricane Katrina. In addition to the human cost and the blow to the overall economy, the hurricane will probably affect energy markets for quite a while.

Last week, oil prices rose slightly but gasoline prices soared. This is because oil prices are determined globally, and a cut in oil production in the Gulf of Mexico just isn't enough to move global markets. But the market for gasoline is more regional in nature, and reports indicate that the extensive array of ports and refineries along the gulf coast suffered heavy damage.

Before Katrina, the average price of regular self-serve gasoline in the U.S. was a bit over \$2.60 per gallon. Prices had stabilized and were growing only slightly. By Friday morning, most sources put the national average somewhere between \$3 and \$3.10 per gallon. And so now it's official: the U.S. has finally broken its own record high for gasoline prices, even in inflation-adjusted terms.

The old record was from the early 1980s, when a gallon of gasoline cost just under three of today's dollars.

In Greensboro, the average price for regular gasoline was \$2.50 back on Monday. And it had actually fallen a bit since the week before. But as of Friday morning, according to GreensboroGasPrices.com, the price had shot up 74 cents to \$3.24 per gallon! A year ago, a gallon in Greensboro cost \$1.75, an amazing dollar and a half less.

The effects of Katrina will diminish over the next few weeks, and gasoline prices will start falling back toward \$2.60. But even when that happens, the long-run issues will remain. The era of cheap oil and gasoline is probably over. Don't expect to see two-dollar gasoline again.

As I noted in April, when I explained why drilling in the Arctic National Wildlife Refuge would do little or nothing to lower gasoline prices, there's no one factor to blame.

One problem is the tightness of refining capacity in the U.S. Even before Katrina, capacity diminished over the last 25 years while the American economy—and our demand for oil—increased dramatically.

But the biggest reason that the era of cheap gasoline has ended is the rising price of crude oil. Prior to Katrina, oil was trading at around $65 per barrel, a level that few of us thought we'd ever see. By Friday it had risen to over $70.

In a way, however, the price of oil isn't the *real* culprit, because it's being caused by something else: the burgeoning global demand for oil. Economic growth around the world has restructured oil demand, probably permanently.

In a world of 6 billion people, demand is no longer being driven by the 1 billion people in developed economies like the United States, but by those 1 billion people *and* the 3 billion people in the world's emerging economies, especially India and China. Greater demand means higher prices.

There's never a good time for a "price shock" (as economists like to call events like these), but this might be an especially bad time. Since late 2001, the U.S. economy has technically been in an expansion, but the real story is a tale of two economies. Indicators on the production side of the economy (Gross Domestic Product, corporate profits, productivity) have been strong, but the employment side has shown much weakness.

It took 46 months for U.S. employment to recover to its pre-recession level; previously it had never taken more than 31 months. In North Carolina, it's 54 months and counting, which means that there are still fewer people employed in the state than before the 2001 recession.

Will the surge in fuel prices derail this half-strong-half-weak expansion? It may not be the strongest expansion we've ever seen, but it's the only one we've got.

So far, the economy has taken some punches but is holding up. GDP continued to grow at a healthy pace in the second quarter of this year, and the government's measure of "core inflation" that excludes energy prices is still fairly low. We're less energy-dependent than we were in the 1970s, and hence the economy can more easily bend without breaking when faced with these price spikes.

But taking one punch is different than taking a barrage of them. And now Katrina has thrown the biggest punch yet. Even after the effects of Katrina dissipate, the higher fuel prices will eventually filter through the entire economy. Businesses have resisted passing those costs on to consumers, but they will soon start doing so. And then even core inflation will rise.

In the medium term, the prospects for the economy aren't bright.

As an aside, retail sales may not take as big a dive as some commentators believe. After all, when you buy gasoline, you've made a retail purchase. We'll buy fewer DVDs and dress shirts and instead buy more gasoline, but overall retail spending won't change much until overall inflation heats up.

As a friend of mine put it, “There are many things I’d change in my life before I start driving less.”

And that’s the challenge we face. Even though we had no right to expect cheap gasoline forever, we’ve been lulled into believing that it was possible. And so we bought SUVs and guzzled gas. We opted for long commutes in order to live in just the right subdivision. We lobbied for low-density suburban living even though that makes it nearly cost-prohibitive for governments to set up mass-transit systems. To the extent that our economy does depend on energy, it depends on relatively cheap energy. Now the oily chickens have come home to roost.

The good news is that high oil and gasoline prices will lead businesses and consumers to make changes in the long term. Nothing else does that like prices, and we’ve seen it again and again. The U.S. economy is much more energy-efficient than in the 1970s, but *not* because of foresight and good intentions. The improvements in efficiency happened as businesses and consumers adjusted to steadily increasing oil prices throughout the 1970s. Energy markets in 1980 were very different than they were in 1970. I expect we’ll find that energy markets in 2010 will be very different than they were in 2000.

As high prices stay with us, look for fuel efficiency to matter again and for hybrid engines to become more popular and more available. Look for people to start factoring fuel costs into myriad decisions, including where they live, where they shop, and how they vacation. Look for businesses to make similar adjustments in their operations. And look for more investment in the development of alternative fuels and technologies.

The ability to make adjustments like these is the real benefit of the price system. And therefore, the high oil and gasoline prices we’re seeing right now are actually good news. They’re not fun, but they bode well for the future.

Part of the economic pain of the 1970s was due to the way the government restricted domestic energy prices. Remember gas lines? When prices couldn’t rise, gas lines were the only way to parcel out the restricted supply. Federal price controls were eliminated years ago, which is why we don’t see lines at gas stations and why the economy hasn’t tanked (yet). The current high prices are a sure sign that adjustments will come and that the pain will be near-term rather than long-term.

This is why I’m unconcerned by gloom-and-doom pronouncements that global oil production has peaked or will soon peak.

According to some experts, oil will become scarcer and scarcer, with dire implications for economic growth and vitality. Some commentators see an impoverished future, as oil-addicted economies like ours are forced to go cold-turkey.

The problem with these predictions is that they tend to underestimate or even ignore the role of prices. It doesn’t really matter whether oil production has peaked or not. All that matters is the price of oil.

If oil production *has* peaked, then these high oil prices are a darned good thing because nothing else will be as effective in getting us ready for a future of scarce oil. In contrast, nothing would be as effective in impoverishing our future as laws that would keep gasoline prices artificially low. When the dam finally burst in five years or 20 years, we'd be much worse off than if we start now to restructure our lives and businesses.

Recently, *New York Times* columnist John Tierney recounted his bet with a prominent oil doomsayer. The doomsayer bet that in 2010, a barrel of oil will cost over $200, even after adjusting for inflation. Tierney took that bet on the strength of our economy's demonstrated ability to find new technologies and efficiencies. We've done it before, and now, thanks to high oil prices, we'll do it again.

I'd take the same bet.