THE WALL STREET JOURNAL.
The Wall Street Journal, March 29, 2011

Oil Prices Won't Kill the Recovery

By Donald L. Luskin

Will the spike in oil prices emanating from instability in the Middle East be enough to derail the U.S. economic recovery, just when it's finally building up a head of steam? Surely it's not helpful. But while our collective memory and intuition about oil shocks may cause us to fear the worst, a clear-eyed look at the data suggests that oil prices may have to rise considerably higher to trigger a U.S. recession.

The oil shocks of the 1970s and early '80s, which caused deep recessions, were so epochal that we're conditioned to assume that any rise in oil prices is bad for growth and any fall is good. Yet historical data tells us that most oil-price changes are not correlated with future changes in real output growth. For example, oil prices rose steadily throughout the mid-2000s while growth remained strong.

Where oil prices do matter to growth is in extremis, in those rare cases when an extraordinary and rapid oil-price change creates an economic shock. But it's difficult to come up with a simple rule that tells us when an oil shock is enough to cause a recession—or not. Crude oil prices as high as $147 a barrel in the summer of 2008, for instance, aren't seen as the cause of the Great Recession. Most observers would cite instead the fall of Lehman Brothers and the banking crisis that immediately followed, events that occurred at roughly the same time.

Let's just accept that oil shocks matter. Is today's oil price of about $104 a barrel in the U.S. (and $115 globally) a shock? To be a shock, it has to be big. And "big" is a matter of context. Yes, today's oil prices are more than 30% higher than they were a year ago. That sounds big. But at the same time, they are more than 30% lower than they were less than three years ago. That's big, too, but in the opposite direction. Which context counts?

Research by economist James Hamilton of the University of California, San Diego suggests that oil prices imperil the economy when they reach a new three-year high. Steven Kopits, managing director of the energy consulting firm Douglas-Westwood, says the overall economy is threatened when the 12-month average oil price exceeds the year-ago 12-month average price by more than half. Below those levels consumer and investor expectations aren't sufficiently disrupted to make a difference. Both conditions are very far from being triggered at today's prices.

To be a shock, it has to be a surprise, and in one sense the current situation is: Despite all the pessimistic narratives that have overhung the economy during the last six quarters of recovery—housing double-dip, insolvent states and municipalities, collapse of the euro zone, real estate bubble in China, and so on—virtually nobody was predicting that the Middle East would be swept with contagious regime change spread via Facebook and Twitter.

That said, should anyone really be surprised to learn that the Middle East is politically volatile? No, and things there might get crazier. But if the history of the region has taught us anything, it is that whoever controls the oil always eventually ends up selling it to the developed world, often despite their ravings about the developed world's imperialist evils.

In the meantime, Saudi Arabia has committed to make up for any transitory shortfalls. Pumping an additional one million barrels a day would not be a stretch for the Saudis—doing so would merely bring the Kingdom's production levels back up to mid-2008 levels. So even if we now face a shock, it will be transitory, and it will be buffered. That's why, for all the uncertainty, oil is now $104 a barrel, not $1,000 a barrel.

More importantly, the U.S. economy is today well-positioned to absorb an oil spike without experiencing it as an oil shock. First, we're nowhere near peak oil consumption, which we hit in August 2005 at 21.7 million barrels per day. We're now 9% below that, even though consumption has recovered substantially since its worst levels of the Great Recession in September 2008. The last three recessions—those that started in 1990, 2001 and 2008—began only after oil consumption reached new peak levels.

Economies in the early stages of recovery, like ours today, are less vulnerable to oil shocks than those in the late stages of expansion. As a business cycle matures, the economy experiences diminishing returns from any given factor of production—labor, credit, oil or anything else. When a recovery is still new, large gains can be levered from relatively modest increases in inputs, so the economy can afford to pay more for those inputs.

We've also grown much more efficient when it comes to energy consumption. It may come as a surprise to many, but today in the U.S. we're consuming the same amount of crude oil that we did 12 years ago and real output is more than 25% higher. For all the talk of our being the planet's most villainous energy hog, we've become remarkably oil efficient.

Finally, this oil spike is coming at a fortuitous moment in American politics. President Obama, tacking to the political center after his party's self-described "shellacking" in last year's midterm elections, said earlier this month that he wants to "increase domestic oil production in the short and medium term." That may be the most shocking thing about this oil spike.

Mr. Luskin is chief investment officer at Trend Macrolytics LLC and the co-author with Andrew Greta of "I Am John Galt," out in May by Wiley & Sons.