Oil Price and its Effects on the US Economy

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Executive Summary

Oil prices are going through the roof in past few months due to geo-political reasons like Israel attack on Hezbollah, Iran nuclear stand-off and growing domestic tensions in Nigeria. The American economy has started to feel the heat of the increasing prices and keeping that in view the Federal Reserve has hiked the interest rate to squeeze out liquidity from the system thus protecting the economy from inflation.

Oil prices can affect both the macro-economic as well as micro economic factors in the economy. By slowing down the growth it can create lack of demand in the economy because to rising prices resulting in unemployment and reducing purchasing power of the customers.

On the macro front the rise in price can lead to weakening of dollar and thus resulting in higher trade deficit. The rising fuel prices can also make the American products less competitive against the countries where the fuel prices are regulated to protect the local industry.

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Introduction

Amidst the conundrums of geo political factors like Israel attack on Hezbollah, stand off on Iran nuclear enriching issue and domestic instability in Nigeria the crude touched the record high of $78 a barrel. The situation was aggravated by the global meltdown in emerging markets and increasing rate of interest by Federal Reserve, Japanese Central bank and European Central bank. The increase in interest rates by Federal Reserve was aimed at suffocating excessive liquidity in the secondary market and protects the economy from inflation.

How rising oil prices affect micro economic factors

Oil in present day economic system works like the blood in human being's body, it touches everything and impacts every activity in economy- positively or negatively.

Rising Price Scenario

As the crude prices increase and prices of the fuel at the pump increase too, so the customer has to pay more for the same amount of fuel. In economic terms the demand of the fuel is pretty much inelastic so that means that the rise in the prices of oil doesn't severely impact the demand for the oil. Resulting into increase in fuel cost for the household thus reducing the purchasing power of the customer as now customer has lesser money to spend on other consumptions items such as clothes, luxury items etc. The decrease in consumer spending of other products will lead to slowing down of economic growth because 70% of US GDP comes from consumer spending *(Knowledge@Wharton 2005)*. As there is less demand for goods in the market first there will be fierce competition among sellers to maintain their market share which leads to shake out and weeding out of producers which failed to wither the loss in demand of goods.

Secondly on the production side, the rise in fuel prices will increase the manufacturing and transportation costs of the products. To neutralize this rise in cost the producer has to pass on the costs to customer which results in increasing of goods prices.

Another step which most companies often take when the demand takes southward turn is tightening of belt. Companies try to reduce the costs by retrenching people, reducing operational costs and reducing employees' benefits. This significantly increases unemployment in the economy and deepens the economic slowdown as increasing unemployment will also result in slowing consumer spending as these unemployed people will try to cut down their expenses to the minimum.

Macro Economic effects of Rising Oil Prices

United States is the biggest consumer of oil in the world and any change in the price directly affects the economy. Historically increase in fuel prices has led to slow down in economic growth. As noted in the last major oil crisis of 70's when Arab countries slapped an embargo on US for supporting Israel, the prices shoot up instantly from $3 to $12 *(David. R Baker, 2005)*. The American economy slides down and unemployment rose to unprecedented level of 9 percent. The consumer spending boomed over a decade actually shrunk by a percent. The various macro economic effects resulting from increase in oil prices are -

Gross Domestic Product (GDP) growth rate slow down

As the cost of production increases due to rising fuel prices it directly affects prices of products and thus directly hitting consumer spending as increasing prices reduces the purchasing power of the customer. This whole cycle results in economy start cooling off and growth rate starts declining.

Weakening of Dollar

Slowdown due to the increasing oil prices weakens the dollar in international market as the exports from United States become comparatively expensive to other currencies. For example unlike America, where market forces determine, the price of fuel in China the sector is hugely regulated. Presently in Chinese market the government is maintaining the same price of fuel as it was when the international price is $32 a barrel. This gives the Chinese manufacturer huge advantage over their American counterparts *(Michael Mussa, 2000)*.

Industries which bear the most burnt of rising oil prices

Some industries with in the economy are more sensitive to increase in fuel prices compare to others for example transportation, aviation, automobile and manufacturing industries in which fuel cost is one of a major constituents of operational cost. *(Knowledge@Wharton 2006)*

Aviation Industry

Aviation Industry at present is in transition after 9/11 terrorist attacks and rising fuel prices. The industry is reeling red all over and growing competition of low cost airlines is further rubbing salts in the wounds of legacy carriers. Only this year the number of travelers reached pre September 11 level and the rising prices just nipped the growth of industry.

Automobile Industry

On 5th October General Motors distanced itself from any collaboration with Renault Nissan and declared that it will do the turnover own its own. For years American manufacturers' answer to fuel efficient Japanese cars was building gasoline guzzling Sports Utility Vehicles (SUV's). The rise in the fuel prices has made running SUV's costly and customers demand has slowly shifted towards hybrid cars. No wonder Toyota today is the largest car manufacturer in the world overtaking Ford and General Motors.

Transportation and Logistics

As fuel is major component of Transportation and logistics companies, the rise in prices has affected them adversely. They pass on of these costs to customers thus contributing to the increase in the consumer price index.

Why the economy today is not adversely affected by increase in fuel prices as in 70's

Back in the 70's the rise in fuel is due to the supply side blockage while presently the rise is due to increasing demand from the emerging economies. Today's rise in prices is more due to in-sufficient refinery capacity rather than availability of crude. Secondly the American economy has hugely transformed in these past three decades. In 70's American economy was dominated by engineering and manufacturing sectors relying hugely on crude for production and growth momentum *(David. R Baker, 2005)*. Today the situation is altogether different as American economy now is service oriented and retail dominated that makes it less dependent on fuel for growth. In past five years the price has almost shot up thrice but what has kept it not affecting the economy is efficiency of American economy – today the amount of energy needed to generate a dollar of the nation's gross domestic product has dropped 46 percent compare to that in 1973.

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