Oil Price Shocks: Past, Present and Future

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Unexpected Price Changes Hurt

- Price Increases Obviously Hurt Because
  - Many budgets are squeezed
  - Fuel inefficient capital stocks made obsolete
- But Price Drops Can Hurt too
  - A California utility almost went broke because OIL PRICES FELL!
  - Mexicans borrowed too much when I told them in 1981 oil would sell for $86/bbl.
  - Oil exporters generally fared poorly because they over borrowed expecting rosy futures.
Import Payments by U.S. to Mexico for Crude Oil
Actual and Projected in Billions of U.S. Dollars
Why Current Oil Price Shock is NOT Causing a Recession

♦ Oil price increases are smaller in the current episode than in 1973-1981.

♦ Last time *income tax rates were rising rapidly* as general inflation was pushing people into higher brackets; this time the *Bush tax cuts* have more than *offset the higher energy costs*. 
Real Price of Crude Oil (2000$/bbl)
2 Episodes of Oil Price Shocks  
*(Year 2000 $ per barrel)*

<table>
<thead>
<tr>
<th>Year</th>
<th>Price 2000 $ per barrel</th>
<th>Description</th>
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<tbody>
<tr>
<td>1973</td>
<td>$12.21</td>
<td></td>
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<tr>
<td>1981</td>
<td>$53.74</td>
<td><em>Four-fold increase</em></td>
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<tr>
<td>1988</td>
<td>$16.62</td>
<td><em>Drop to one-third</em></td>
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<tr>
<td>1998</td>
<td>$11.27</td>
<td></td>
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<td>2004</td>
<td>$34.36</td>
<td><em>Three-fold increase</em></td>
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<tr>
<td>2008</td>
<td>$20.71</td>
<td><em>Drop to two-thirds</em></td>
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Tax Cuts have Eased the Oil Price Shock This Time

Average Effective Income Tax Rates
Federal, State and Local Combined

Past Oil Price Shock came when tax rates were rising rapidly

Bush Tax cuts have absorbed energy price shocks
Favorable Factors in the Outlook

♦ Energy costs have become a smaller share of our budgets

♦ We *can* quickly start saving energy:
  – Drive slower can start today, save 20%
  – Drive less, ride a bike, stop skiing
  – Turn down thermostats

♦ But habits won’t change without proper incentives--so raise U.S. gasoline taxes like they do in Europe
Fuel Economy vs Speed

Slow down
... save fuel

Mileage: Miles per Gallon

Speed: Miles per Hour

55  60  65  70  75

Milage:
35  30  25  20  15  10  5  0
Taxes Make Gasoline Prices Higher in Europe

Unfavorable Factors

♦ Greater dependence on imported crude oil
♦ World oil reserves will become even more concentrated “near Baghdad”
♦ Developing Asian countries (e.g., China) will demand a much larger share of Persian Gulf oil in 20 years.
Falling Production and Rising Demand Create Increased U.S. Dependency on Imports

Source: EIA, Annual Energy Review 2002
World Oil Reserves Concentrated in the Middle East
Risks in the Outlook:  
Bin Laden’s Game Plan

♦ Al-Qaeda bombs WTC, stirs anger in U.S.
♦ Provokes U.S. to attack a terrorist-supporting country, viz., Iraq.
♦ Militant Islamists throughout Middle East rally to support bin Laden; he leads overthrow of Saudi royal family, other Persian Gulf sheikdoms.
♦ Then he helps insurgents win war in Iraq; conquers Kuwait.
♦ Becomes “King” of countries with 400 billion barrels of oil reserves, valued at $40 trillion.
♦ Is worth 1000 times Bill Gate’s fortune.