

The impact of the surging oil price on the us economy essay example

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Introduction

The United States economy refers to all the means through which goods and services are generated, distributed and utilized by individuals and businesses in the United States. It is made up of approximately three hundred million consumers and more than twenty million businesses. In 2005, the annual Gross Domestic Product amounted to twelve and half trillion US dollars (Schmidt, 2003). Such high scales of production and consumption have made the United States undoubtedly the greatest economy of the world regardless of the fact that some other nations have more land, people and other resources notwithstanding (Engdahl, 2004). However, this economic superiority is highly dependent on oil as its primary source of energy.

Energy to power the US economy i. e. to provide fuel for the automobile industry, electricity, furnaces, machinery and appliances is obtained predominantly from petroleum, coal and natural gas. Using the heat-producing capacity measure (Btu- British thermal units), forty one percent of the total energy consumption is derived from petroleum (Clark, 2005). Nearly all the energy needed to power the country's transportation system and heat for factories and houses is chiefly provided by petroleum. With such heavy reliance on oil as a principal source of energy, any price fluctuation affecting it is bound to have far-reaching impacts on the economy.

The economic effects of oil price fluctuations are issues that have attracted considerable attention for a long time, particularly at this time, when the prices of oil have been on the rise over the past three years. Lofholm (2007) observes that a historical study of more than thirty years has revealed a lot

about the devastating nature of the economic impact and the magnitude of damage that accompanies such fluctuations. In this paper, I shall seek to explore the economic impact of the escalating oil prices on the US economy. To best understand the resultant impact of high oil prices on the economy, it is imperative to explore the connection between oil prices and the economy of a nation.

The correlation between oil prices and the nation's economic activities

Production functions that are utilized by many economic theories use nets of the consumed inputs and thus energy in any of its several and sundry forms is never taken into account (Engdahl, 2004). Moreover, until 1973, the price of oil was significantly cheap and its long-run availability was considered to be so ample that its future seemed to be well taken care of. However, since 1973, the severe effects of the fluctuating oil prices on the economic wellbeing of any country have proven impossible to ignore. As a result, the interaction between oil prices and economic activities of a county has generated massive literature among economists in the arena of applied economics.

Clark (2005) observes that there is a complex relationship between oil prices and economic activities of a country. For instance, an oil price rise can lead to a recession while on the other hand; a continued phase of economic growth can result in an increase in oil prices as it was witnessed with the run-up which culminated with one hundred and forty seven dollars per barrel in 2008.

When there is change in the oil price that effects on the economy rather than

the vice versa, usually there is a non-linear and asymmetrical impact i. e. the opposite direction impact of a dollar-per-barrel rise at one time is not the same as a dollar-per-barrel cut-back at a future time. In simpler terms, when it comes to oil prices, whatever goes up, often never comes down with the same magnitude (Engdahl, 2004). As it can be inferred from this complex relationship between the price of oil and the economic activities of a country, a change in the oil price produces inevitable ripple effects on the economy especially for oil importing nations like America. When the backbone of the economy is hoisted on an energy resource whose prices remain notoriously unpredictable, then the uncertainty of economic stability of such a nation becomes a reality that people have to live and dread each day. Furthermore, when excessive addiction to petroleum does not threaten the environment, then the volatility of oil prices is busy deranging economic growth and development. And what exactly causes these oil price spikes? This has been attributed to a number of recurring factors.

Reasons for the current surging oil prices

One of the most obvious reasons is a supply cutoff. Political instability and tension in the Middle East are always the major contributing factors to sudden cutoffs in oil supply (Clark, 2005). For instance, Iran has always used oil as a weapon. For example, in 1979 after the Iranian revolution overthrew Shah Pahlavi who was friendly to the US, the US economy faced some grappling southward trend. With Iranian current daily export of approximately three million barrels, a sudden cutoff would most certainly send the oil prices skyrocketing.

Another factor that contributes to a price spike is the ever growing demand for oil. The general global demand for oil that stands at eighty five million barrels per day (approximately one thousand barrels per second) is quite alarming and sometimes the high prices are meant to deter our current overdependence on crude oil as the chief source of energy and promote energy conservation. For example, after a rise in oil prices in 1970s, the US oil consumption actually dropped since people practiced conservation and developed more energy efficient appliances and automobiles.

However, the ever fluctuating oil price is not a mere function of supply and demand forces. Of course these two traditional price variables also come in play at some moment, but other concrete and critical factors also lie elsewhere. Engdahl (2004) points out that lack of spare capacity is another major reason behind sudden rise in oil prices. This is because with a constrained reserve capacity, we become vulnerable since our storage gets depleted fast even in the event of a short disruption in supply. We can therefore be held hostage of sudden supply cutoffs, something that can easily be avoided if we have enough stockpile to last us through rough times. With the vagueness that surrounds cartel's production data, it is never clear whether the oil output will grow fast enough to keep up with the growing demand in the future (Seebach, 2005).

There is also the issue of investor demand. The oil industry has proven to be a “growing” and booming sector. As a result, more and more investors have channeled millions of dollars in this industry whereas others are still contemplating joining it. What better strategy to impress potential investors than a price spike? And on the other hand, the easiest way to prevent

massive speculators bail out is to avert any possible price pullback in the oil market. As a result, the prices are left with only one place to go; up! This is ironically contrasted with the issue of investment slowdown in some other areas. Investors have been shying away from some regions with significant oil reserves due to political instability and political turmoil. For instance, Iraq production capacity can be increased considerably if its oil infrastructure was upgraded. More investments in countries such as Nigeria and Venezuela could as well increase production (Lofholm, 2007).

Other external factors such as weather and the weak dollar also have a share in the surging oil prices. Severe weather conditions such as the ruinous Hurricane experienced in the Gulf of Mexico always leads to destruction of oil productions facilities and infrastructure. The unpredictable destructive actions by Mother Nature often lead to huge losses and the ultimate destination of the cost to be paid is at the pump. Clark (2005) states that the weak dollar is rather an indirect impact whereby as the value of dollar decrease, the price of oil in dollar rises since the cost of oil is priced in dollars. The last five years have witnessed a fall of the value of the dollar against the euro and if this persists, the surging pressure on oil prices will linger. The resultant effect i. e. high oil prices of the above discussed factors always have enduring impact on the US economy. The nature and magnitude of this impact is explored further in the next section.

The economic cost of high oil prices

A close scrutiny of future energy market conditions exposes the consequences of oil prices on economic variables that shape oil demand, in

specific, and energy requirement in general. These variables include employment, inflation, real GDP growth, interest rates and exports and imports. The fact that high oil prices negatively impacts on US macroeconomic variables is widely agreed upon although the duration and the magnitude of the effects remain uncertain. For instance, sudden rise in crude oil prices have preceded a number of major economic slumps in the United States. Despite the fact that other factors were involved, the high oil prices substantially contributed in derailing economic growth in many of these cases (Engdahl, 2004). The demand for crude oil end-products especially diesel fuel, jet fuel, gasoline and heating oil has for many years influenced the high demand for crude oil and usually changes in the price of crude oil are always forwarded to the consumer in the cost of the processed petroleum products. The US economy is affected in five major ways by any increase in crude oil prices.

In the event that the oil prices shoot up, according to Clark (2005), consumers are forced to dig deeper into their pockets in purchasing petroleum products which they cannot do without. The ripple effect of this is that their spending power on other goods and products goes down due to their constrained income. The beneficiaries of the extra amounts spent on purchasing these petroleum products goes to domestic and foreign oil producers and in cases where wholesale margins are high, to oil refiners. In some cases, domestic oil producers may benefit the economy by paying more dividends or even spending more on finding more oil, production and distribution of petroleum products. In addition, the foreign producers may spend part or all their extra earned revenue on purchasing locally produced

goods and services. However, the goods and services that they purchase are quite different from those which could have been purchased by domestic consumers. The US economy has not been an exception. Therefore, for the US economy to recover the “lost” revenue, the amount and frequency of both foreign and domestic oil producers’ spending power becomes a major determining factor. Thus, the high oil prices “locks up” part of the US revenue in inaccessible sectors which are controlled by a few players as compared to the large population of domestic consumers.

Oil is a critical input in the production process of varied types of other goods and services. This is because it is used to drive nearly the entire transportation system of all types of businesses. As such, any increase in oil price will directly lead to an increase in the cost of input. Consequently, if this cost cannot be forwarded to the consumers for one reason or the other, reallocation of other economic inputs such as capital stock and labor will be inevitable. The immediate spread of consequences of such a reallocation would be the dismissal of workers and stalling of plants (Clark, 2005). This leads to widespread unemployment and declining economic output. The United States of America has witnessed such layoffs resulting in massive rates of unemployment and, consequent stalling of different plants.

The United States of America is a net importer of oil. Thus, the purchasing power of American income is affected by high oil prices through their influence on the global terms of trade. As such, any increase in the price of the imported oil forces American businesses to direct most of their products and services to exports rather than satisfying the domestic demands even when the quantity of the consumed foreign oil does not change (Smith,

2006). This creates an imbalance in the economy's equilibrium in terms of imports and exports.

Fluctuations in oil prices have also caused economic losses. This happens when macroeconomic conflicts avert swift adjustments in nominal prices for finished products or for essential inputs like wages. More often than not, workers will always resist any decline in the sum of their wages. Thus, any increase in the price of oil typically leads to mounting pressure on nominal wage margins (Seebach, 2005). In addition, the nominal price “adhesiveness” is non-linear given that organizations, firms and unions are more willing to raise the wages they receive and nominal prices than they are willing to lower them. Hence, when the purchasing power is threatened by a nominal raise in oil, the process of adjustment is slowed resulting in multiplier effects all over the economy (Lofholm, 2007). These effects derail the economic growth and inhibit expansion. This has been a characteristic of the US economy.

Other extended impacts of high oil prices have included the widespread uncertainty that sudden price rise have created concerning the suitable production techniques, wage and price negotiations as well as the purchase of consumer durable goods such as automobile and new equipment. Such uncertainty has derailed the American economic growth since potential investors tend to shy away in the face of unpredictable economic future (Clark, 2005). As household and firms adapt to new conditions of high oil prices, one thing is definite; the ultimate goal will be to generally cut down cost by reducing consumption. The resultant effect of this move will be a decrease in the purchasing power of consumer. Smith (2006) observes that

on the part of the businesses, the decreased purchasing power of their consumers will add the final nail to their coffin given that the high cost of oil is already crippling their production output. And when fate turns it back on them, consumers on the other hand will turn out to be the laid off employees of the idling plants and sized down businesses.

Conclusion

There has been more damage to the American economy as a result of the rising oil prices than meets the eye. The looming havoc of a derailed economy characterized by low exchange rate, high inflation, lower real output and higher unemployment is clear warning that there is need for the formulation of sound economic policies that will at least moderate the adverse impacts of surging oil prices discussed above. We have developed an insatiable addiction to the use of petroleum products and we cannot let our economy suffer the adverse effects of the swelling oil prices. Clearly, the potential impact of the oil high prices is being underestimated. As Schmidt (2007) has noted, certainly, the typical belief that oil price would have to go much higher for a prolonged period before the economy suffers any serious effects understates downside risks.

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