

*In an article in our last issue, global strategist Philip Verleger predicted a coming scenario of \$100 oil, 5 percent inflation, and a coming recession. Question: How disruptive would \$80-\$100 oil be to the U.S. and global economies? TIE asked three important experts.*

# Sky-High Oil

The economic impact of oil at \$100 a barrel would depend on the source of the price increase. If, as some experts foresee, prices rise as a result of continued buoyant growth, combined with limited oil production and refining capacity, a price increase will damp the boom but is unlikely to reverse it. A redistribution of purchasing power from consumers to producers (including governments in oil-exporting countries) will arrest the growing demand

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may simply borrow to cover their desired expenditure, as American and British homeowners have shown a willingness and ability to do.

for oil and damp growth in demand for other goods and services, as gainers are likely to spend more slowly than losers retrench. Still, in a vigorous economy expected to remain so, losers

In contrast, if the \$100 price is brought about through serious disruption in supply—through terrorist action, civil war, or natural event—and if the disruption is seen as likely to persist for some time, oil-consuming losers are more likely to contract their non-oil spending and thereby to produce an economic slump.

One characteristic of the 1970s, still a possible danger but much less likely in today's economic environment, is that actual or feared attempts by organized labor to restore their real wages will lead to a significant tightening of monetary policy to head off inflation, thereby bringing on a recession.



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The answer depends on the source of the increase in the oil price. The implications might actually be good for the economy if it were the result of rapid economic growth in China and elsewhere in the world. But it would be bad for the economy if it were the result of disruptions such as new terrorist attacks, or political instability in Nigeria or the Gulf, or aggressive moves by the heads of state of Venezuela or Russia, or military conflict with Iran or—the most disruptive nightmare of all—a genuine democratic election in Saudi Arabia. Of course a sudden shock to oil prices would be more disruptive than a gradual rise.

The more interesting question is, “What would good U.S. public policy be?” Good policy, in pursuit of the triple goals of national security, environmental quality, and economic stability, would be to increase overall U.S. energy conservation and switch the composition of energy away from fossil fuels. The slogan of decreasing dependence on imported oil is prone to misuse, but roughly captures the idea. Then the country would be less vulnerable to future disruptions.

The most efficient way to put such a policy in place is to raise the price of oil (and coal) to U.S. consumers and firms, gradually over time, for example through a tax on fossil fuels. The revenue could be

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used for some combination of federal deficit reduction, reducing the marginal tax rate on lower-income workers, and intelligently chosen spending programs, for example, to reduce the security dangers from nuclear proliferation. Of course such a tax has always been considered politically unacceptable to the American people. But they would have accepted it the day after September 11, 2001, and they would accept it the next time—the military option having been discredited in the meantime.

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It is tempting to conclude that \$100 per barrel oil would drive inflation up and growth down. But then, that's what I said about \$60 per barrel oil two and one-half years ago, when the price was \$30. Looking at that experience, we can say that U.S. household energy costs rose by nearly 50 percent, accounting for 20 percent of the increase in total household expenditures (roughly \$175 billion). But the relatively low energy-intensity of the economy meant that the impact was muted. Today, 6 percent of a typical American household budget goes for

energy, so a 30 percent price increase will cost nearly 2 percent of consumption.

In 2004, interest rates were low and housing prices were rising, so people could absorb the blow by increasing indebtedness. Today there is absolutely

no cushion left. As a result, purchases of non-energy goods and services will have to fall and growth will go down with it. What we have learned from the last few years experience is that oil price increases don't seem to create inflation in the way that they used to. This will leave policymakers some room to maneuver. We'll have to see if it is enough. As for the rest of the world, the high taxes that they have in place already will buffer the impact. I see the primary impact being on the western side of the Atlantic.

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