Gas Prices Driven By Economics, Not Politics
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The average price of regular gasoline in the United States rose to $3.83 in mid-March, with prices much higher than that on the West Coast. Nevada prices easily topped $4.00 a gallon. As somebody who needs to drive a lot, I can attest that it is painful.

Is this a record? It depends. The current price is higher than any past annual averages, even if you adjust for inflation, including past highs in both 1980-81 and 2008. But these annual averages disguise a lot of price movement. Monthly average prices were even higher in the summer of 2008, but prices crashed by the end of that year, pulling down the annual average. Perhaps an effective strategy to reduce the price of gas would be to have another catastrophic recession, though I would not recommend it.

Gasoline is only one of several sources of energy produced with petroleum, and unless there is a disruption in refining or distribution, a gallon of regular unleaded gasoline usually sells for about 4% of the price of a barrel of oil. Oil prices vary by grade, but for West Texas Intermediate (WTI) Light Crude in Cushing, OK, the price reached almost $110 at the end of February, still significantly less than the $128 price reported in July, 2008.

Why is the price of oil so high? To understand this, we need to consider both supply and demand.

Oil is first and foremost a global market. Even though we buy almost half of our oil from domestic producers, and import the rest from Canada, Mexico and Venezuela, the price of oil is driven by international more than domestic events. The market is “fungible,” as economists say, and oil flows to where the demand is.

Oil is also a forward-looking market, so that the expectation of future price increases will increase price now. The futures market allows airlines and other big oil consumers to contract for stable future prices, and speculators often try to get there first to make money from their predictions. Contracted prices for June delivery are slightly lower than current spot prices, so markets are telling us prices may have peaked for now.

With less than 5% of the world’s population, the U.S. consumes almost a quarter of the world’s oil. U.S. oil consumption fell significantly with the recession, so now that our economy is finally recovering (I mean nationally, not in Nevada), speculators expect more upward pressure on prices. As the world’s largest importer by far, our country’s consumption really matters.

China, meanwhile, is beginning to compete with us to buy some of this oil, especially over the last decade. With 23% of the world’s population, China consumes a little less than 10% of the world’s oil. More and more Chinese are buying automobiles and air conditioners, however, so this share is expected to keep rising. India has been growing too, but its growth in oil consumption still remains far behind China’s. Oil and gas prices have been rising since 2004, and China’s increased demand is a major reason.

Western Europe has not been much of a factor, for their total oil consumption has remained restrained over the last thirty years or more, and their share of the global market has fallen significantly. Europeans generally pay twice what Americans pay for gasoline, due primarily to high taxes, and this has naturally led to much more conservation.

On the supply side, it’s another story. Saudi Arabia exports 10% of the world’s oil, followed closely behind by Russia, while other countries in the Persian Gulf export another 10%. Recent fears that Israel or the U.S. might go to war with Iran over its alleged nuclear ambitions, disrupting oil supplies traveling through the Persian Gulf, have been a major factor in the oil futures market.

Meanwhile, America’s production of oil has much less of an impact than either its consumption or its potential actions in the Mideast. We produce only 10% of the world’s petroleum, with Texas still accounting for the
lion’s share (but California not far behind). U.S. oil production has steadily declined ever since the early 1980s, falling 45% from 1985 to 2008.

Since 2008 this decline has begun to turn around, with oil booms in Texas and North Dakota increasing the nation’s field production in 2011 by 14% over 2008. However, this new production has had little impact on oil prices, compared to the growth of China or the expected economic recovery of the United States.

Could rising prices of gasoline push us back into recession? Though we know now that the Great Recession was well underway before gas prices rose so dramatically in the summer of 2008, many think that this increase at the pump could have been a tipping point in consumer confidence, exacerbating the financial crisis that came that fall. Certainly, gasoline prices are one economic indicator that most people can observe firsthand.

Spending on gasoline is a large share of the average American’s budget, and the share is even larger the poorer you are. In a typical year, Americans on average spend about $2400 on gasoline, almost as much as they spend on actually purchasing cars, and they spend another $2000 or so on electricity, natural gas, and fuel oil, where prices also tend to follow the price of oil. A big increase in the price of oil can thus have a large impact on the average person’s budget.

But Americans can adjust, given time. When oil and gas prices jumped up from 2004 to 2008, they had been low for almost two decades, lower than they been any time since 1919 (at least in inflation-adjusted prices). Americans bought big vehicles, and had grown used to cheap gas. Since then, however, Americans have had time to change some of their habits.

High gas prices are thus a little less of a shock than they were four years ago. Still, if they remain high, they could weaken consumer confidence -- particularly in an election year when they are used as a tool of political warfare. Predictions, as always, vary.

Economic recovery depends on robust consumer and investor confidence. It is not likely that high gas prices alone will push the economy back into recession, though they can offset the positive impact of other policies, such as the recent extension of the payroll tax cut. Still, we should remain careful to do not add more straws to this camel’s back, and not take other actions at this time which could imperil the national economic recovery.

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