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American Account: Can America’s recovery survive sky-high oil?

If the Libyan valves reopen, the oil price spike will be temporary. But if the upheavals spread and rates rise — recovery, RIP

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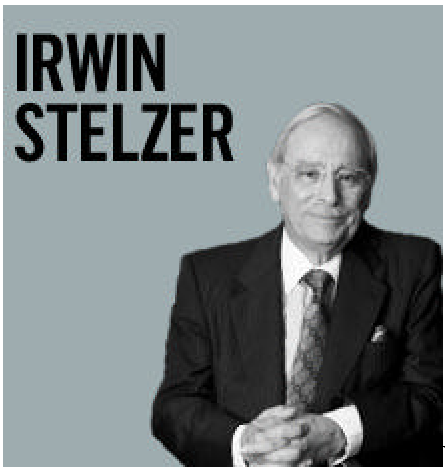
Libyan crude is sweet and easily refined into petrol and diesel (Getty)



While political analysts engage in the morally elevated task of appraising the effects of events in Libya on the spread of democracy, economists are engaged in the grubbier task of figuring out the effects on the economies of their countries. In America, this means guessing what impact higher oil prices will have on the nascent recovery.

This is no easy chore. For one thing, it is difficult to determine just how much of Libya's 1.6m-1.7m barrels of daily production, only some 2% of the world total, has become unavailable.

The International Energy Agency puts the figure at 850,000 barrels, but Eni, the Italian firm active in Libya, says that 1.2m barrels a day have been lost.

Saudi Arabia has about 4.7m barrels a day of excess capacity and has already increased its output by 400,000 barrels a day to offset some of the Libyan losses. Saudi oil minister Ali Naimi says his country will again "meet any shortage".

So were it not for other factors, the loss of Libyan production would not be a serious matter, especially since it may prove short-lived. Libyan crude comes primarily from Cyrenaica, an area of Libya in which the tribes now in control are hostile to Colonel Gadaffi and eager to increase their oil revenues.

The American economic recovery is under threat. The seriousness of this depends on the survivability of the House of Saud But there is oil and there is oil, just as there is coal and there are diamonds, almost chemically identical products but somewhat different in value. Libyan crude, known as Es Sider, is sweet — low sulphur, light oil easily refined into high-end products such as petrol and diesel, while Saudi crude is sour — heavy and high in the sulphur content that environmental regulators frown upon.

Even though it is somewhere between difficult and impossible to get a fix on the supply consequences of the Libyan upheaval, it is possible to imagine a best, a bad, and a worst case.

In the best case, whatever government emerges from Libya's chaos will need the revenues from resumed production and will promptly open the valves, in which case the price spike will prove no more than that — a temporary increase.

In the bad case, the trouble spreads to Algeria, removing some 2m barrels a day of high-quality crude from the market, driving excess capacity down to levels not seen since the Gulf war. Then, say the economists at Nomura, we will have to adjust to oil at above $220 a barrel.

In the worst case, the upheavals spread to Saudi Arabia. King Abdullah's decision last week to donate a $36 billion (£22 billion) "royal gift" to finance a trickle down of benefits to civil servants, students and the unemployed, and to build infrastructure, fails to satisfy dissidents, and the country's brutally repressive secret and religious police forces are overwhelmed by protesters. Production is interrupted. If that happens ... well, maybe it won't.

One thing seems certain: the American economic recovery is under threat and the seriousness of this depends on the odds you place on the survivability of the House of Saud. Professor James Hamilton, a member of the economics department at the University of California, has studied the effect of oil shocks from 1859 to 2010. He finds that "all but one of the 11 post-war recessions were associated with an increase in the price of oil. The correlation between oil shocks and economic recessions appears to be too strong to be just a coincidence."

The best attempt at a back-of-the- envelope calculation of the effect of higher oil prices on the recovery comes to me from Marc Sumerlin of the Lindsey Group consultancy. Every $10-a-barrel increase costs the American economy $46 billion in real income a year. That would offset about 38% of the stimulus effect of the $120 billion payroll tax cut agreed by President Barack Obama and the outgoing Congress at the end of last year, and knock about 0.3%-0.4% off the growth rate.

Since most forecasters are guessing that the economy will grow this year at somewhere between 3.5% and 4% — or at least they were before the estimate of the fourth-quarter GDP growth rate was revised down from 3.2% to 2.8% late last week — the recovery would continue, but at a somewhat reduced rate.

Unless inflation accelerates, of course. Even the cut-price retailer Wal-Mart is estimating that the price of its mix of goods will increase by 4% this year. If you don't eat, drive, wear clothes, or take any medication, you will believe the Fed's assertion that inflation is tame. Otherwise, you probably won't.

If inflation does force the Fed to stop buying Treasury IOUs, if Republicans and Democrats frighten investors by failing to agree on a deficit-reduction package, if rising commodity costs cut into profits and cause share prices to drop, if inflationary expectations increase in response to what consumers are experiencing in the real world of the supermarket, and if oil prices stay high, interest rates will rise. That would have a calamitous effect on the federal budget, driving interest costs on the national debt to recession-inducing levels. And add to the pressure consumers feel from higher petrol prices, causing them to cut purchases of cars, clothes and a host of other goods. Recovery, RIP.

But these "ifs" must be weighed against a contrary set. If Libyan production is quickly restored, if the Saudi regime survives and ramps up production even more, if refineries adjust to the kingdom's heavy crude, if the Fed's economists are right to believe that inflation is minimal, or that if its threat emerges they will be wise enough to see it immediately and turn off the printing presses, if the International Energy Agency is right that "both consumers and producers have the tools to deliver adequate oil to the market", then a semblance of calm will be restored.

The important question will remain: has the uproar in oil markets persuaded the Obama administration to lift the blocks on the development of domestic sources of oil? My guess is that the ideology that supports uneconomic subsidies for wind and solar power, which have nothing to do with the transport needs of America, will trump the reality of the nation's continuing need for oil.

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