Mythbusting In A Time of High Gasoline Prices

By: Andrew Brod

Brod, Andrew (2008). Mythbusting In A Time of High Gasoline Prices. *The Business Journal.* Jul 25 – 31 2008, 39

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Article:

Oil prices have been rising steadily for six years, but only recently has the reality sunk in with consumers, business owners and politicians. Forking over $4 for a gallon of gasoline will do that. And now the media seem to be able to talk about little else. Mixed in with the keen insights are a few misconceptions.

We must conserve oil!

Nothing does a better job of revealing our collective ignorance about markets than calls for increased conservation when prices are really high. And yet that's precisely what well-meaning people are doing. Sen. John Warner, R-Va., has even called for the reinstatement of the federal 55-mph speed limit as a way to conserve gasoline.

This is silly. Calls for conservation fall on deaf ears when prices are low, and they're redundant when prices are high. For example, per-capita gasoline consumption in the first four months of this year was 17 percent lower than in the first four months of 2002, when prices had just started their upward trend.

To be sure, 17 percent is small compared to the near tripling of gasoline prices since 2002, but that's what happens with goods that are perceived as necessities. President Bush wasn't wrong when he said the nation is addicted to oil. But addicted or not, we are conserving, thanks to high prices.

The market isn't working!

Do high prices imply that oil markets are dysfunctional? We're hearing the usual populist accusations that Big Oil is preying on us, even though the oil companies would rather profit quietly and handsomely at $75 per barrel than deal with angry politicians and consumers.

Complaints about Big Oil are old hat. The new twist is claims that speculators are messing up oil markets. The CEOs of 12 major airlines recently sent e-mails to their frequent fliers asking them to lobby Congress to "stop oil speculation now!" Congress is listening and is looking into ways to limit "excessive" speculation in oil markets.

But oil prices are high precisely because markets are doing what they always do. Supplies are tight and demand is growing, especially in emerging economies, and the result is rising prices. Sometimes it's that simple.

Given low oil inventories, it's hard to justify blaming speculators. Speculation is pretty much defined as buying and holding in hopes of selling later at a higher price. This has to show up in rising inventories. But it's not.

In general, speculation promotes price discovery, i.e. it helps markets zero in on the right price. The airline executives claim the opposite, that the problem is oil futures getting traded and re-traded at ever higher prices. If so, they're describing a bubble. And the thing about bubbles is that they always burst. If the airline executives are correct, this problem will soon right itself.

We must start drilling!

There's no question that one solution to the problem of tight supply and burgeoning demand is more supply. But depending on the location, new offshore drilling may not produce significant quantities for 15 years. Similar lags apply to investments in oil shale and tar sands. Does that mean those resources shouldn't be developed? Of course not. But none of them is a quick fix.

Besides, the amount of oil that will ever be produced by the United States is relatively small and will have little effect on globally determined oil prices. When you consider that we consume more than twice as much oil per person as other industrialized countries, it's clear that the real frontier is conservation. Fortunately, high prices are just the tool to make that happen.