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WILL RISING OIL PRICES DERAIL OUR IMPROVING ECONOMY?

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It was only 12 short months ago and gas was $2.84 a gallon on average. Today it is $3.82, a 34% increase. We all know the painful feeling of filling up our vehicles, but what is the actual impact of higher oil prices to our economy? And how long will these high prices last? The first question is somewhat easier to address then the second. However, history can give us some perspective on both these issues.

The first thing to understand is that the US spends about 8% of GDP (Gross Domestic Product) on energy. Of that 8%, about 3.5% is spent on oil related products, according to the Energy Information Administration (EIA). This has dropped over the last 30 years due to changes in the economy and to increases in energy efficiency. In order to better understand the impact on oil prices on our economy, the EIA studied oil prices from the period of 1997 to 2001. From 1999 to 2000 oil went from $11 per barrel to $29 per barrel, almost tripling in price. Based on their study, they estimated the higher cost of energy created about a .7% drag on the economy. When looking at the US economy as a whole, a 3 fold increase in prices resulted in a less than 1% reduction in growth.

Doug Ramsey, an experienced money manager with the Leuthold Group in Minneapolis, provides another perspective. He disagrees with the assertion from some economists that "every $10 increase in the oil price reduces GDP growth by X". He believes that when the economy is in an acceleration phase, such as now, then higher oil prices have little impact on GDP growth. He states that the impact of oil prices depends on whether the economy is expanding or contracting. When the economy is struggling, then rising oil prices can have a much bigger impact on growth. So there are different points of view out there, however the consensus appears to be that higher oil prices shouldn't have a significant impact on the growing US economy.

How long prices stay high is another important factor. There is no shortage of forecasters offering their opinion on this subject. Last month JP Morgan raised its forecast by $6 to $99 as an average price for 2011. The average price last year was $71. On the other hand, Goldman Sachs actually lowered their forecast by $15 a barrel. While forecasting actual price targets is tricky at best, we have seen that historically prices don't stay at these elevated levels for very long. The thing to keep in mind with oil is the price is quite volatile. History has also shown us wide price swings in oil. A recent example occurred in 2008 -09. Oil went from $145 per barrel in July, 2008 to $40 in April, 09 and then back up to $70 in August, 09. Yesterday the price of a barrel of oil was $111. So the likelihood of oil going to $120 or $130 in 2011 and staying there is rather small. Conventional wisdom is that "the remedy for higher prices is higher prices". The thinking is that when prices reach elevated levels, households and businesses alter their consumptive behavior and begin to consume less. As demand falls, supplies increase and shortly thereafter prices fall.

As a consumer, be patient and you're likely to see gas prices get back closer to $3 than $4. And as an investor, oil prices should have minimal impact on the near term growth of the US economy, which should allow the US stock market to continue to climb higher.