



High Oil Prices and Rising Interest Rates Spell Trouble

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Oil prices hit thirteen-year highs last week and have settled just below \$40 per barrel. Unfortunately, for a variety of reasons oil prices are not likely to drop significantly anytime soon – this despite the recent announcement by Saudi Arabia that it would increase its output by 1.5 million barrels per day.

First, the economic recovery in the U.S., China, and India in particular is putting demand pressure on the marketplace. Second, oil inventories are low, making us subject to price shocks. These inventories will remain lean, because oil companies believe that eventually prices will fall, and they don't want to have a lot of expensive inventory on hand when the prices crack. Third, there is a substantially higher risk today in the oil business, and this is a real cost of doing business. Unfortunately, the global market is ever more dependent upon supplies coming from politically unstable areas. Attacks on oil facilities in Iraq and in Saudi Arabia are a reality, and it costs more to do oil business around the globe as a result. So don't look for prices to fall much anytime soon.

That said, higher oil prices will slow – but not stop – the U.S. and global economic recovery. Higher oil prices alone rarely cause recessions. Higher oil prices have in fact predicted more than twelve out of the last six recessions! In addition to the threat of oil prices, the economy faces the inevitability of higher interest rates. Higher rates will also slow the economy somewhat. But here, too, higher interest rates alone are not likely to cause a recession. Higher rates have predicted fourteen out of the last six recessions! The danger this time is that a period of higher interest rates is coming at the same time that oil prices are high. The combination of rising interest rates and high oil prices has predicted eight out of the last six recessions!

So there are some escalating dangers on the horizon for 2005. Fortunately, it does appear that oil prices have peaked out. Saudi Arabia will help stabilize prices and put them on a downward path after the summer driving season ends.

The fed will push U.S. interest rates up but, as I have argued, if the fed moves vigorously, then long term rates may actually stabilize even as short term rates increase. If I'm right about this, then we will weather this bout of rising rates and high oil prices. However, if oil prices spike up again later this year when the fed is raising rates, the economy could run into real trouble.

This is Hank Fishkind for 90.7 FM, WMFE News.

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