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Market Beat: Rise in oil prices threatens economic recovery

By Tom Petruno

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You wouldn't like these odds in Las Vegas.

As oil prices have surged amid the escalating turmoil in the Middle East and North Africa, Wall Street has been reminded of an inconvenient truth: All five U.S. recessions since 1973 either followed or coincided with a spike in energy costs.

It's still early to be calling for a new recession this time around, but the $12 jump in crude prices last week has left every economic optimist at least somewhat unnerved

Since the brutal recession of 2008-09 officially ended, the U.S. economy has been struggling to gain enough momentum to reach "escape velocity," meaning a growth rate strong enough to become self-sustaining.

On Friday came word that we were further from escape velocity than we thought. The government revised its figure for inflation-adjusted growth in gross domestic product in the fourth quarter to a disappointing 2.8 percent annualized rate from the previously estimated 3.2 percent.

Now, rising oil prices make faster growth that much more difficult to achieve. Every extra dollar in crude prices is a tax on consumers, many of whom can't afford another drain on their income.

The sudden leap in energy costs also has exposed the cold reality facing

governments and central banks: After providing trillions of dollars in aid to the global economy and financial system since 2008, policymakers have limited means left to offset a sustained oil shock.

For now, however, many economists are warning against overreaction, despite the increasing pain at the gas pump.

After rocketing Tuesday and Wednesday, crude prices leveled out as the week ended, despite the continuing revolt in Libya. The benchmark U.S. price closed Friday at $97.88 a barrel in New York, up 60 cents for the day. The peak for the week was reached early Thursday, at $103.41.

The stock market also stabilized after selling off early in the week. The Dow Jones industrial average on Friday gained 61.95 points, or 0.5 percent, to 12,130.45. For the week, the Dow lost 261 points, or 2.1 percent - not steep enough to suggest that most investors fear the economy soon will fall off a cliff.

On paper, at least, some scenarios for crude prices suggest the economy may bend but not break.

If oil stabilizes around $99 and stays near there for the next year, it would siphon about $76 billion from non-oil spending in the U.S., said Ian Shepherdson, a partner at High Frequency Economics in Valhalla, N.Y. That would reduce economic growth by about a half-percentage point, he said. So instead of the minimum 3 percent growth rate most analysts now predict for 2011, real gross domestic product would rise 2.5 percent, down from 2.8 percent last year.

That would be an "unwelcome but not catastrophic" slowdown, Shepherdson said, echoing many other economists.

Yet Wall Street analysts admit that it's difficult to provide hard-and-fast advice about what the upheaval in the oil market will mean for the economy, because there's no clarity on key variables - including how high the price might go, how long it would stay up, and whether significant production from exporters such as Libya will be shut off indefinitely.

What's more, in a hot market, speculators can become a bigger factor than fundamental supply and demand issues. Last week's jump in oil revived

memories of the wild run-up in the first half of 2008, when speculators were accused of playing a huge role in pushing crude to an all-time high of $147 a barrel.

"Prices are being driven up by hedge funds" and investment pools created to buy commodities, said Tom Kloza, chief analyst at Oil Price Information Service in Wall, N.J.

Rising oil prices put an obvious damper on the recovery by forcing consumers to divert some spending from things they want, such as clothing or dining out, to cover energy costs instead. The national average gasoline price hit $3.29 a gallon last week, which means fill-ups are costing drivers 4 percent more than the week before and 22 percent more than a year ago, according to AAA.

The jump in oil prices also could prompt U.S. companies to put off hiring, scotching hopes for accelerating job growth, which has been the missing link of the nearly 2-year-old economic recovery.

In December, a survey by the Business Roundtable, an association of chief executives of major U.S. firms, found that 45 percent of its members expected their domestic employment rolls to increase in the next six months, up from just 19 percent a year earlier.

But last week, **Bernard Baumohl,** managing director of Economic Outlook Group in Princeton, N.J., said he had already heard from corporate clients who were balking at new spending and hiring because of the worsening unrest in the Middle East.

For company managers, "the most defensible position is just to delay decisions," **Baumohl** said. "Why hire if fewer people are going to be shopping?"

That risks fueling a vicious circle: If hiring delays become widespread and job growth fails to materialize, consumer confidence could soon reverse after hitting three-year highs this month. Sinking confidence could further depress consumer spending. Escape velocity for the recovery would be even further out of reach.

Baumohl worries that, with memories of the recession so vivid, the ugly

surprise could be how quickly many Americans retrench if oil stays elevated. "Consumers may pull back on discretionary spending sooner than they have in past business cycles," he said.

Still, fears that the economy could unravel might dissipate in a hurry if oil prices stabilize or fall back soon.

Although higher pump prices are biting, many consumers in effect got a 2 percent pay raise beginning Jan. 1 with a Social Security payroll tax cut. Economists at Deutsche Bank estimate that crude would have to reach $110 a barrel to wipe out all of the extra income gained from the lower payroll tax.

As for job growth, it may help that many companies have been reaping a profit boom over the last year. That has left them in far better financial shape than in the first half of 2008, when soaring oil prices worsened the outlook for an economy that already was in recession.

The worrisome difference between 2008 and now is that governments and central banks worldwide were poised three years ago to ride to the rescue bearing fiscal and monetary stimulus.

Today, with the Republican majority in the U.S. House insisting on spending cuts to pare the federal budget deficit, no further fiscal stimulus seems likely from Congress, even if oil prices keep rising.

Ditto for much of Europe, where budget austerity is the order of the day.
As for the Federal Reserve, higher energy costs pose a double-whammy: slower economic growth and higher inflation. The problem for the Fed is that committing to another round of monetary stimulus could just worsen the inflation threat.

Oil at $98 probably isn't enough to halt the recovery, but it significantly reduces the economy's margin for error.
"We're on a bumpy road, and we're out of spare tires," said Mohamed El-Erian, chief executive of money management giant Pimco.