

**Terre Haute Tribune-Star, Progress Monthly, July 21, 2004**

**Why I'm Glad My Car Doesn't Run on Coffee**

Dr. Kevin Christ

Assistant Professor of Economics

Rose-Hulman Institute of Technology

Twenty three years ago this month – in July 1981 – I was a new college graduate with a new job and a new car. Unleaded gasoline cost about \$1.40 per gallon, and one could get a reasonably good cup of coffee for about a dollar. Today that gallon of gasoline costs about \$1.75 – 25% more than in 1981. That's something to think about as you shell out \$2.00 for coffee at Starbucks.

When gasoline prices peaked in late May at about \$2.00 per gallon, we heard a lot about how such prices were the highest Americans had ever paid. This was true in simple dollar terms. But the same is true for a lot of things we like to buy. It's not uncommon today to see people pay more for bottled water than for gasoline. From an economic perspective, what really matters is what happens to the *relative* prices of things. When economists think this way, we are distinguishing between nominal and real prices, and on this count, gasoline really looks like a relative bargain.

The consumer price index tells us that, on average, the prices of things that consumers need and want have doubled since the summer of 1981. By that standard, even a rise in the price of unleaded gasoline to \$2.80 per gallon would have represented only an average increase since 1981.

That the price of gasoline in the U.S. today stands just 30 to 50 cents higher in nominal terms than a generation ago is really quite remarkable considering that some

other parts of the world, China in particular, are increasingly demanding more and more energy to fuel their growing economies. The International Energy Agency, for example, reported in May that growth in world demand for crude oil in 2004 is expected to be the strongest since 1988. Given this, we really should not be surprised to see gasoline prices rise, and perhaps should instead be expressing amazement that gasoline prices have remained so low for so long.

But surely, you might say, such increases in fuel prices will be harmful to the U.S. economy. Here again, some historical perspective is helpful. There are at least three reasons why the recent run up in crude oil prices is not likely to hurt the U.S. economy the way oil shocks shook our economy in 1973 and 1979. First, as I've already shown, from a long-term perspective, the price increases in crude oil and gasoline are not actually that significant in real terms.

Second, the current run up in crude oil prices has not been as abrupt as in those two cases. In January 1979, the spot price of crude oil was about \$13 per barrel. 24 months later, in January 1981, it was about \$35 per barrel. In other words, the price of crude oil almost tripled in two years' time. Interestingly, this past May, crude oil was again about \$35 per barrel. But two years ago, in May 2002, it was about \$25. On a chart, the oil price shocks of 1973 and 1979 look like vertical spikes. In comparison, the path of oil prices over the last two years look like a gentle upward slope.

Third, and perhaps most importantly, crude oil does not play as significant a role in our overall economic activity as it did in the 1970s. Its relative importance as an input into many production processes is far less significant today, perhaps because we have a much more service-oriented economy. This does not mean that some companies don't

feel the pinch – airlines, delivery services, and chemical producers for example. But overall, a price increase in crude oil today just does not create the same negative impacts on our economy as it did in 1973 or 1979.

All of this is not to say that there's no chance of a truly destabilizing oil shock. With world demand for oil increasing as it is, the effects of political upheaval in Saudi Arabia, for example, could be very significant. But from a historical perspective and in comparison to other things we like to buy, gasoline prices today are surprisingly low. Perhaps we should be more concerned about what has happened in the last few years to prices for coffee or bottled water.