

Economic SYNOPSES

short essays and reports on the economic issues of the day



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Gas-Price Inflation

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During April 2006 the retail price of gasoline increased from \$2.73 to \$2.97 per gallon.¹ Analysts sometimes play down consumers' concerns about the high prices of gas by noting that in real terms, i.e., relative to other goods and services, gas is still relatively cheap compared with prices in the late 1970s and early 1980s. However, the recent increases in the prices of oil and gas undermine this argument.

The consumer price index (CPI) for all items provides a measure of prices of all goods and services. The Bureau of Labor Statistics also publishes consumer price indices for expenditure categories, including one for gasoline. The green line in the chart tracks the real price of gasoline since 1967, i.e., the ratio of the CPI for gasoline to the CPI for all items. Even disregarding the September 2005 spike due to Hurricane Katrina, it is clear that gas has become more and more expensive with respect to other goods since 2003. The real gas price has not yet reached record high levels, but it is above the long-run average and comparable to mid-1980s levels.

Gasoline price inflation tracks closely the growth rate of the price of oil, and the price of oil in the week of April 21 crossed the \$70 per barrel threshold.² The high oil price is the result of sustained world demand, at a time when several factors restrain the supply of oil. The world demand for oil is fueled by sustained growth in oil-hungry China and India, sustained demand from the United States, and Japan's recovery. On the supply side, the oil industry does not have much spare capacity. Any disruption, due for example to the war in Iraq, rising tensions with Iran, civil unrest in Nigeria, risk of expropriation of foreign oil companies in Venezuela or Bolivia, would be reflected immediately in higher spot oil

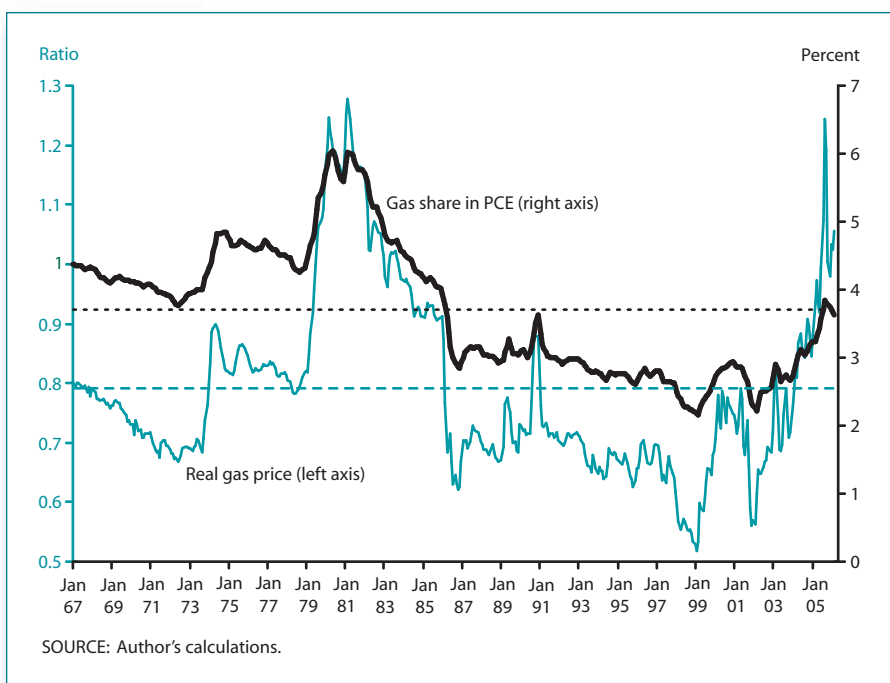
prices. Futures prices suggest that the prices of oil and gasoline are likely to remain high in the medium term.

Even if the real price of gasoline is high by historical standards, and trending toward record levels, the trend will have to be sustained for quite some time before U.S. consumers trade in their existing stock of vehicles for smaller and more fuel-efficient cars. The fraction of personal consumption expenditures spent on gasoline (as shown by the black line in the chart) is on the rise, but close to its historical average (3.7 percent) and much lower than the 6 percent peak in the early 1980s.³ ■

¹ Weekly data for gasoline prices (all grades) from the Energy Information Administration: http://tonto.eia.doe.gov/dnav/pet/pet_pri_gnd_dcus_nus_w.htm.

² Domestic spot market price: light sweet crude oil, WTI, Cushing. Source: *Wall Street Journal*/Haver Analytics.

³ See also Cashin, David and McGranahan, Leslie. "Household Energy Expenditures, 1982-2005." *Chicago Fed Letter*, June 2006, (227).



Views expressed do not necessarily reflect official positions of the Federal Reserve System.