

Run-up in price of oil is partly Fed's fault

by Dean Calbreath - CNS

Back in the days when Lawrence Welk was still banging out polkas on the accordion, an off-stage bubble machine would add some effervescence to his "champagne music."

These days, of course, Welk wouldn't need the machine. All he'd have to do is hire the Federal Reserve and he'd be able to produce the biggest, costliest bubbles his waltzing fans could ever hope to see.

Over the past decade, the U.S. economy has lurched from one bubble to another, ranging from the hedge fund investments that imploded in 1997 and 1998 to the dot-com stocks that crashed in 2000 to the housing prices that are continuing to fall at this moment.

After each implosion, the Federal Reserve has faithfully stood by to slash interest rates and print fresh reams of crisp cash, inadvertently laying the groundwork for the next bubble.

"Going from bubble to bubble has become part of our economic lifestyle," said Tapan Munroe, a director of the Law and Economics Consulting Group in Emeryville.

Now, it seems, the bubble machine is adding a bit of froth to the worldwide petroleum market. With the price of oil hovering near \$100, it seems likely that we're heading for another bubble - this time in commodities. And even if this bubble is short-lived, which hopefully it will be, it's still going to cause a bit more pain as we fill up our gas tanks.

Over the past year, the price of gasoline has jumped 36 percent from \$2.42 to \$3.30 per gallon in San Diego County, for example. In the meantime, other potential bubbles are developing as well, ranging from gold, currently selling at nearly \$835 per ounce, to building materials, which will add to the expense of people rebuilding their homes after the recent wildfires.

"As the dollar slides, it encourages people to hold real assets of all sorts: gold, platinum, oil, metals," said Stephen Leeb, president of Leeb Capital Management and author of "The Oil Factor."

There are plenty of reasons that oil prices are rising: growing demand for fuel in China and India, fluctuating oil reserves in the United States, the threat of open conflict with Iran, and so on.

Each of those factors has added a few dollars to the price of oil over the past couple years. But they still don't explain why oil is around the \$100 mark.

Part of the blame for the run-up lies with the Fed.

Let's go back to 2003, a year not so far away. After the stock market crashed in 2000, then-Fed Chairman Alan Greenspan pulled out all stops to keep the economy from going into recession. In the period from Jan. 3 to Dec. 11, 2001, he slashed the federal funds rate from 6.50 percent to 1.75 percent.

By 2003, it was down to 1 percent, well below the rate of inflation. Greenspan was, in effect, paying people to take money off his hands. And he had plenty of takers. The financial industry lined up at the trough, turning the money into risky new mortgage vehicles that fueled an unprecedented housing boom.

Home buyers were so happy with their purchases that they failed to notice that their dollars were getting cheaper by the minute. As Greenspan pumped in more and more money, the value of the dollar declined, which in turn meant it made commodities and most foreign currencies more expensive.

The euro was worth as little as 95 cents when Greenspan began slashing rates and pumping more money into the economy in 2001. By mid-2003, it was at \$1.15. Today, it's at an all-time high of nearly \$1.50.

Similarly, oil rose from \$28 a barrel in 2001 to \$29 in 2003 to \$98.62 at a recent high point, before sliding down a couple of bucks later.

Oil was undoubtedly fated to rise anyway, especially with increasing demand from China and unrest in the Middle East. But without the easy money from the Fed, it would probably not have risen at that rate.

"Oil prices and the value of the dollar are definitely connected," said Keitaro Matsuda, senior economist with Union Bank in San Francisco. "Oil prices are growing for Americans because our dollar buys less and less goods."

In addition, the Fed's loose monetary policies mean there's plenty of money on the market for speculators to play with.

As they did with the run-up in the stock market in the late 1990s and the housing market in the early 2000s, speculators are pumping money into the investment vehicle with the greatest growth potential. And for the time being, that appears to be oil.

"Of course it's a bubble," said Judy Dugan, a specialist on oil issues at the Foundation for Taxpayer and Consumer Rights in Santa Monica, Calif. "Of course it's driven by speculators. It's insane for an economy our size to be held hostage by unregulated speculation."

Although some analysts have tied oil-price rises to negative headlines from the Middle East and the North Sea oil fields, Dugan says there is little difference between the fundamentals of the market today and two years ago, when oil prices were about \$60 per barrel.

She assumes that prices can't get much higher, but she's been wrong before.

"People thought it might bust at \$85 and then \$90 per barrel, but it's kept going," Dugan said.

The bright side of that is that the soaring price of oil may turn out to be a bubble, too. There's a good possibility that the price could pop after the speculators pump it up and then dump their holdings.

But judging from past experience, if the oil bubble pops, we will likely see yet another price spike form in another area of the economy, as the Fed dips its bubble wand into its bottle of soap mix and blows some fresh froth into the market.

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