

From the desk of Chief Economist Beth Ann Bovino

Oil, guns and butter: The war with Iran

News of the U.S.-Israel attack on Iran reminded many of the 12-day conflict last year. But the similarities stop there. And since nine of 10 U.S. recessions since WWII were preceded by sharp oil price spikes, the concept of “Guns and Butter,” first used in WWII, needed ‘Oil’ added to the phrase.

The geopolitical risk premium on a barrel of oil climbed higher (up \$18 for Brent crude) on concerns that the war will be long, with the principal tail risk in Iran’s capacity to disrupt shipping through the Strait of Hormuz. Current market estimates are \$120 per barrel, or higher, depending on escalation dynamics. Oil supply shocks would cause significant economic losses in net energy importers, and emerging markets with high energy intensity and fewer buffers, likely leading to recession.

Not for the U.S. economy. In our analysis, if oil prices reach \$120 and remain there, recession in the U.S. would still not be likely. Even in this scenario, consumer spending and GDP growth would be reduced by 50 and 60 basis points (bps), respectively, technically a soft landing that may not feel like one for many.

Why? The U.S., now the largest producer of fossil fuel energy in the world and a net exporter, is much more insulated than 45 years ago. The U.S. has also become less dependent on oil. Currently, household spending on energy as a share of after-tax income is 5.7%, near a 40-year low and well below its 1980 10% peak. In 1970, the average U.S. car on the road got 12 miles per gallon (MPG). Today the average car gets 25–26 MPG. That insulation provides the U.S. economy protection.

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Beth Ann Bovino, chief economist, U.S. Bank

Why today's threshold is higher than in the 1970s

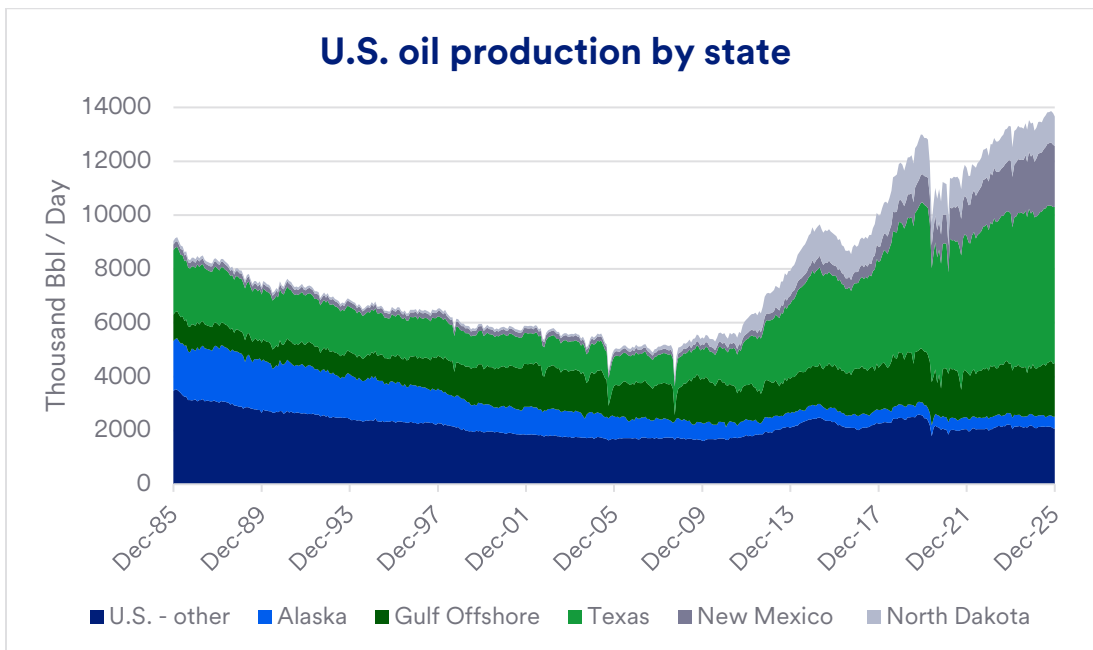
Metric	1970s	Today
Oil use per \$ of GDP	Very high	~1/2 of 1970s
Vehicles MPG	~13 mpg	~25-26 mpg
Domestic production	Low	High (shale)

Sources: Energy Information Administration (EIA), Dallas Fed, Pew Research

However, the costs in the U.S. are not spread out evenly. The lowest income quintile spends 15-18% of their income on energy (while higher income's share is less than 2%). This war also comes at a time when U.S. household affordability is already squeezed by still-high and sticky inflation (PCE is now at 3.0%) and high borrowing costs.

Still, I expect the impact to be less than what the U.S. economy faced 45 years ago. This time spillovers to U.S. core inflation and overall economic activity is expected to be limited unless price increases are both large and sustained. Even a sustained 10% increase in oil prices would reportedly only raise core consumer inflation by 20 bps. I don't see that materially altering underlying inflation dynamics, which gives the Fed reason to stay on the sidelines as events unfold. A much different outcome than 45 years ago.

That's the best of a bad situation. But if oil price gains are much higher and sustained longer, the Fed may be forced to take a page from 1980 to tame inflation with the U.S. expansion as collateral damage.



Sources: Energy Information Administration (EIA)

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