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Jeff Rubin: Oil Prices Caused the Current Recession

Posted by Gail the Actuary on November 5, 2008 - 9:40am
Topic: Economics/Finance
Tags: cibc, jeff rubin, oil prices, original, peak oil, recession [list all tags]

Jeff Rubin, Chief Economist at CIBC World Markets, in a recent report, is now saying that the current recession is caused by high oil prices. Defaulting mortgages are only a symptom of the high oil prices. We should be blaming the underlying cause--higher oil prices--rather than the symptom. These higher oil prices caused Japan and the Eurozone to enter into a recession even before the most recent financial problems hit. Higher oil prices started four of the last five world recessions; we shouldn't be too surprised if they started this one also.

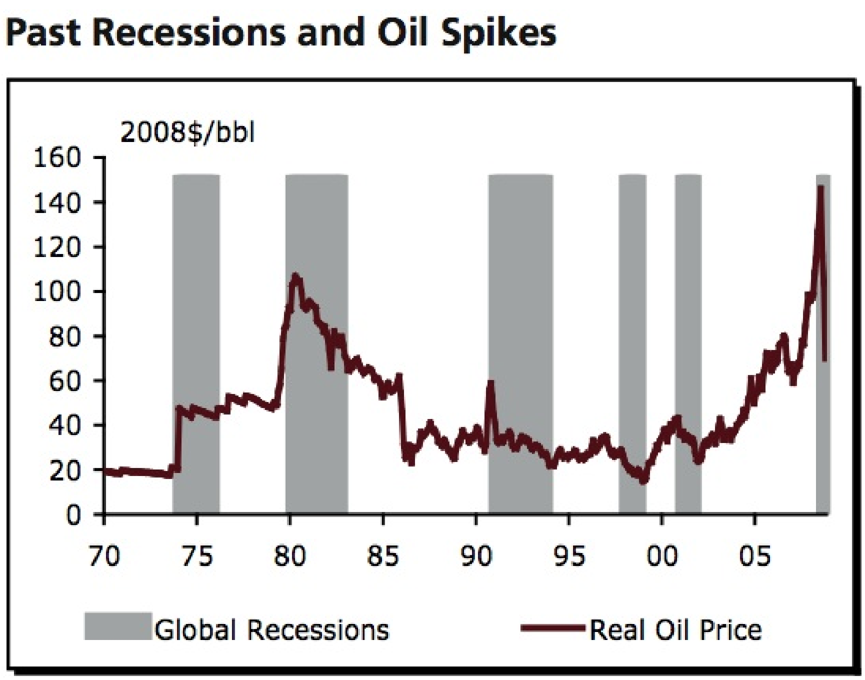

Figure 1 - Shows that four out of the past five recessions have followed spikes in oil prices

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According to Rubin:

> Oil shocks create global recessions by transferring billions of dollars of income from economies where consumers spend every cent they have, and then some, to economies that sport the highest savings rates in the world.
>
> While those petro-dollars may get recycled back to Wall Street by sovereign wealth fund

> investments, they don't all get recycled back into world demand. The leakage, as income is transferred to countries with savings rates as high as 50%, is what makes this income transfer far from demand neutral.

One of the reason that Rubin doesn't feel that real estate problems are the cause of the current recession is because the geography isn't right. How could real estate prices in Cleveland cause a recession in Japan and the Eurozone? Also, the dollars involved in the oil price shock are much greater than the real estate would have on the economy. According to Rubin:

> By any benchmark the economic cost of the recent rise in oil prices is nothing short of staggering. A lot more staggering than the impact of plunging housing prices on housing starts and construction jobs, which has been the most obvious brake on economic growth from the housing market crash. And those energy costs, unlike the massive asset writedowns associated with the housing market crash, were borne largely by Main Street, not Wall Street, in both America and throughout the world.

According to Jeff Rubin (and his co-author Peter Buchanan in part of the material), the recent price spike, measuring from 2002 to the $147 high in 2008 was 500%+, far greater than any of the past price spikes.

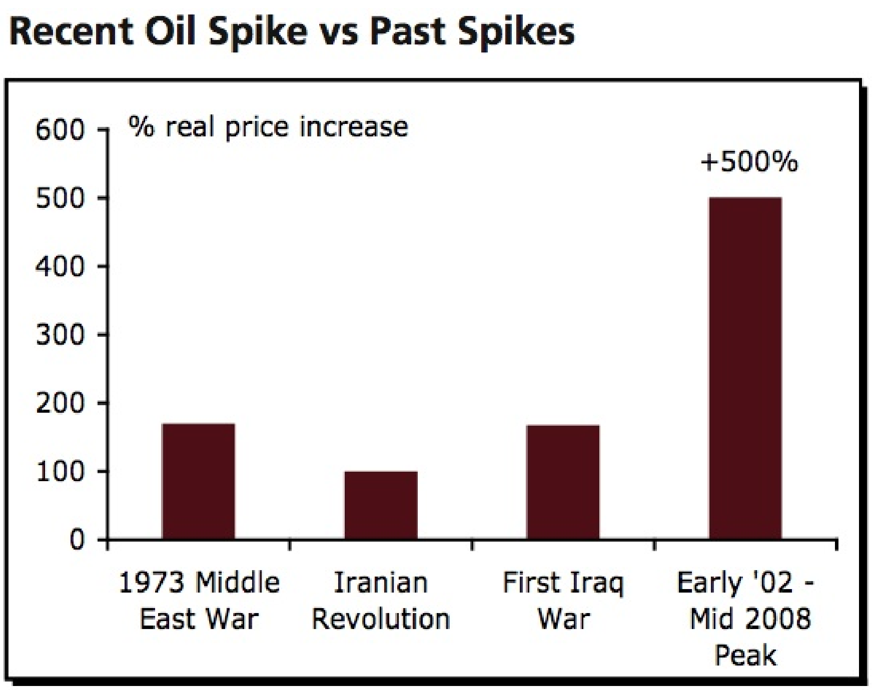

Figure 2 - Recent price spike is far larger than prior price spikes

This big increase in oil prices has caused the annual fuel bill of OECD countries to increase by more than $700 billion a year, with $400 billion of this going to OPEC countries. He asks:

> Transfers a fraction of today's size caused world recessions in the past. Why shouldn't they today?

Another issue is timing. As mentioned previously, Eurozone and Japan entered a recession in the second quarter of 2008, which was before the spike in LIBOR rates that is associated with the current financial crisis.

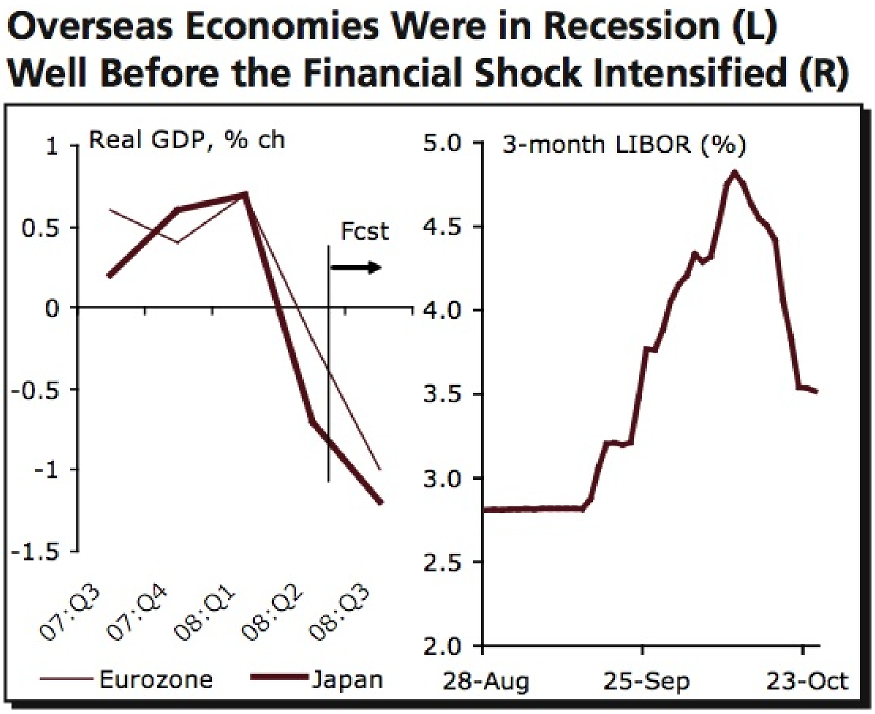

Figure 3 - Recession timing isn't right

Rubin observes that it isn't surprising that Eurozone and Japan entered into recession before the United States did. The United States is less sensitive to oil price spikes because it is itself an oil producer (5 million barrels out of 19 million barrels the US consumes are produced in the US), so it receives some of the benefit of the higher prices. An IEA analysis also indicated that it should be less affected by oil price shocks.

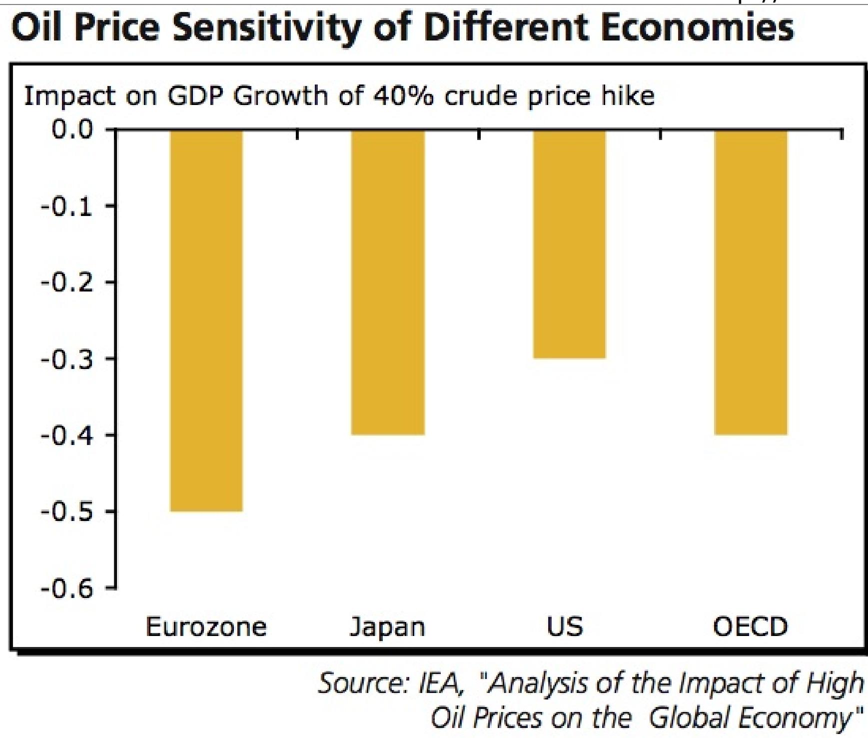

Figure 4 - IEA analysis indicates US should be less sensitive to price spikes

Rubin observes that a delay in timing is expected between an oil price hike and a recession:

> Some of the best research indicates that it takes about a year for an oil price shock to have its maximum impact on US GDP. Leading macro and energy economist James Hamilton notes these lags fit the experience of past shocks, including the OPEC-induced recessions of the 1970s. Among other factors, the unwinding of an involuntary buildup of autos and other durables is a key determinant of the lag structure involved. It has also been found that a similar lag structure holds for the impact of large declines in oil prices. The virtual collapse in oil prices to $12/bbl in 1986 was a key driver behind a rebound in US economic growth to a 4%-plus pace, even in the face of mounting financial costs from the Savings and Loan crisis.
>
> Given that oil prices really took off in the third quarter of last year, after several years of more gradual increases, we should expect to see its maximum hit on the economy right about now. By the same token, however, the impact from the even larger decline in oil prices over the last two quarters should give its maximum boost to the economy moving into 2009.

Jeff Rubin then concludes:

> If triple-digit oil prices are what started the recession, then $60 oil prices are what will end it.

Elsewhere he says:

> Of course the bad news is, where do you think oil prices will be once the economy recovers?

Comments

Based on the last two observations quoted, I would conclude that Jeff Rubin expects the economy to zig-zag in the future, first hitting a low point, and then a new high, and then a low point again. If peak oil is part of the equation, I would expect the height of the highs to gradually decline, and the depth of the lows to get progressively lower.

The question I have is with respect to his statement, "If triple-digit oil prices are what started the recession, then $60 oil prices are what will end it." I would agree that lower oil prices are *necessary* to end the recession, but it is not clear to me that they are *sufficient*.

It seems to me that we have a different problem at this time--a barely functioning financial system that governments around the world are trying to bail out. We also have a vastly oversized financial services industry that needs to collapse to a more reasonable size. In addition, there is a problem with non-availability of credit.

It seems to me that the problem with non-availability of credit, particularly long-term debt, is ultimately tied in with peak oil. It is difficult to have more than a tiny amount of long term debt once an economy is no longer growing. Repaying long-term debt is relatively easy in an economy which is growing, since funds available to pay back debt are greater in the future than they are at the time the debt is incurred.

In a declining economy, it is likely that either there will be many defaults, or that the debt will be paid back with dollars that are worth much less than when the loan was taken out. Because of these issues, lenders will raise interest rates to such a high level that few projects will generate a high enough rate of return to justify taking out these loans. I believe that ultimately long term debt will essentially disappear--but perhaps not for several years.

Unless we can get world's financial problems worked out, it seems to me that it will be difficult for the economy to get back to business as usual. Instead, we will find more workarounds like Thailand's recent rice for oil deal or China's $25 billion loan to Russia in return for oil. Without a solution, we are likely to have a continued recession. If the financial problems suddenly take a turn for the worse--say, the US dollar is no longer the reserve currency, the US economic situation could take a sudden large step downward.