



Jeff Rubin: Oil and the End of Globalization - ASPO-USA

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One of the keynote speakers at the recent ASPO-USA conference was Jeff Rubin, former Chief Economist with CIBC World Market. Rubin talked about why he believes high oil prices caused the recent recession. He also talked about how high oil prices are likely to vastly reduce globalization. He views this as a positive situation, because he expects this will change supply curves in such a way as to make American-made products more competitive. He believes that we will find our new smaller world much more livable and sustainable.



The video can be viewed at [ASPO.TV](#). A transcript can be found below the fold.

You know, knowing the nature of the disease is usually an essential first step to finding a cure. And so too, it is with a recession. Knowing the true nature of a recession goes a long way in helping us to avoid falling into another one. Particularly when the recession we are just coming out of happens to be the deepest global post-war recession on record.

Conventional wisdom, as espoused by central bankers, finance ministers, and the pundits that you watch on TV would have you believe that the recession that we are still feeling here in America, and, indeed, throughout the world, was all about a financial crisis, whose roots lie in the failed sub-prime mortgage market in the United States. In other words, a whole bunch of boarded up, repossessed unsalable houses and depressed property markets in places like Cleveland, all financed with easy credit and subprime mortgages, hit financial markets like some toxic hydrogen

bomb, and then all of a sudden, a property market crash in the United States, somehow morphed into a deep, global recession.

Gee, I never knew that Cleveland was that big. No one has to tell me about the impact of the subprime mortgage market on financial markets. Why do you think I am an author now? But there is a big difference between blowing up the bonus pools of investment banks, and blowing up Wall Street, and what happened.

If you are wondering why risk-averse institutions like the bank that I used to work for had to write down almost \$10 billion of assets of things called Collateralized Debt Obligations that were funded by pools of subprime mortgages, the reason is pretty simple: they were rated AAA, which meant that rating agencies assigned the risk of default with the same probability that the US Treasury would default. What the banks lost sight of is how rating agencies get paid. Rating agencies don't get paid by investors; they get paid by issuers. In Economics, we call this moral hazard problem. In investment banking, we call it, "Shit happens."

It is easy to see how sub-prime mortgages blew up Wall Street; it is a little more challenging to see it as the author of the global recession. Why were there economies that had no sub-prime mortgages that experienced even deeper recessions than the United States? Why did those economies go into recession even before the US economy went into recession? Maybe, just maybe, there was something more important going on--more important to the global economy than Wall Street or sub-prime mortgages, like \$147 barrel oil, for example. If we know anything about watching the global economy in the last 40 years, we know this: feed it cheap oil, and it runs very smoothly. All of the sudden, give it expensive oil, and it stops in its tracks.

Every major recession in the post-war period has oil's fingerprints all over it. The 1973 first oil shock led to what was then the deepest post-war recession, at the time. The second OPEC oil shock led to no less than two recessions: 1979 and 1982. And then when Saddam Hussein invaded Kuwait, and left half of its oil fields on fire, and oil spiked to the then unheard-of price of \$40 barrel, lo and behold, the industrialized world again fell into recession.

Gee, I wonder what happened to oil prices before this recession. It seems to me that oil prices went from about \$30 barrel, at the beginning of 2004, to almost \$150 barrel by 2008. Even in real terms, that is, inflation-adjusted, that price increase was over double the price increase of either the first or the second OPEC oil shock. If they had led to devastating recessions, why would not the biggest oil shock of them all, be the obvious culprit for what has been the deepest recession to date?

There are many ways in which oil shocks create global recessions. First, the transfer of income. When oil went from \$30 barrel, to about \$147 barrel, over \$1 trillion of income was transferred from the industrialized oil consuming world to OPEC. Now, that was not neutral for the economy, because the savings rates from which money was coming from, like the United States, was virtually 0%, meaning that consumers spent everything they made. And where the money was going to, places like Saudi Arabia, or Kuwait, or the United Arab Emirates, had savings rates of almost as high as 50%, so it certainly was not demand neutral.

High price also create recessions by crowding out non-energy expenditures. Two years ago, when gasoline cost us \$4 gallon, low-income Americans were paying more to fill their tanks than they were to fill their stomachs.

But by far, the most important mechanism, the most important path, by which oil prices cause recession is through their impact on inflation, and their impact on interest rates.

There is no shortage of people to blame for the subprime mortgage crisis. We could start with fraudulent mortgage companies that approved mortgages, then quickly sold them to financial institutions. We can blame financial institutions who played Russian roulette with depositors money, and of course we can blame rating agencies who assigned AAA ratings to this. And we can blame regulators, who were asleep at the wheel, like the Securities Exchange Commission, who were either blind or indifferent to Wall Street's systemic risk to subprime mortgages.

However, the real culprit behind subprime mortgages was the very low cost of capital and 0% interest rates. All the greed in the world could not do what the Fed's easy money made possible. The subprime mortgage rates were created by interest rates and the subprime mortgage market was pricked by interest rates. Everybody would agree with that. What people don't seem to ask is, "Just why did interest rates go from 1% to 5.5% from 2004 to 2006?"

Well, any central banker, even Alan Greenspan, will acknowledge that your borrowing cost is a mirror image of your inflation rate. We had 1% federal funds' rate in 2004, because we had a 1% inflation rate. All of the sudden, in 2006, inflation was over 5.5%, the highest it had been in America, since, coincidentally, 1991, when we just happened to have the last oil shock. All of the sudden, money wasn't free any more. All of the sudden, you weren't getting credit cards in the mail any more that you never applied for. And all of the sudden, people who held negative amortization sub-prime mortgage rates had to start paying 7% or 8%.

Well, if interest rates hadn't risen, that wouldn't have occurred. Why did inflation move up? Virtually all of the increase in inflation came from one component of the US consumer price index basket--the energy component. By the end of 2006, energy inflation was running at 35%, because of one price: the price of oil. The price of oil went from \$30 barrel, which incidentally, every oil analyst at the time said it was going to stay at that level, to over \$70 barrel. If oil had stayed at \$30 barrel, inflation would never have spiked; neither would have interest rates. All of those good folk in Cleveland would probably still be there, in their homes financed by 0% interest rate sub-prime mortgages. Lehman Brothers and Bear Stearns would probably still exist, and I'd probably still be the chief economist at CIBC.

But that is not what happened. Why did oil prices go up to \$147 barrel? Somewhere where virtually every economist said it could not go. Well, there were two reasons that economists said that oil prices could not get into triple digit range, and that was the cherished principles of supply and demand. First, the theory of the upward sloping supply curve--higher oil prices would bring new supply, just like it did after the OPEC oil shocks, where oil gushed from Prudhoe Bay and the North Sea. And not only did that break OPEC's strangle-hold on the market, but sent oil prices tumbling down.

Unfortunately, as you all know, there are no more Prudhoe Bays or North Seas to come on tap. Yes, there are tar sands, and there is deep water, and the upward sloping supply curve did bring new sources of supply, but only at prices that we at the end couldn't afford to burn.

What about the cherished principle of demand? Would not triple digit oil prices quash demand? Well, it did, in certain places. It did in the United States. It did in Canada. It did in Japan. It did in Western Europe. Fifteen years ago, if those economies suddenly cut back their appetite for oil, oil prices would have fallen, because 15 years ago, those countries would have accounted for almost three-quarters of world oil consumption. Today, they account for barely half. Tomorrow, they will account for less than half. It wasn't the US consumer that drove oil demand to \$147 barrel in the last cycle, and it certainly won't be the American consumer that drives a barrel of oil to \$147 and higher in the next cycle. We have already seen peak demand, in this economy, and in the

Where do you think oil demand has been growing the strongest? Many of you will probably be saying China, and indeed it has. It's grown from around 2 million barrels a day, to about 9 million barrels a day. But I know a place where the demand for oil is growing even faster than in China. And it is the same place your politicians have told you your supply is coming from in the future. Last year, OPEC and two non-cartel producers, Mexico and Russia, consumed 14 million barrels a day. That is almost two Chinas.

What makes OPEC so thirsty for its own fuel? Well, if you ever filled your tank up in Caracas, you would get some sense of it. It is 20 cents a gallon. And if you go to Riad, in Saudi Arabia, it is a little bit more-it's 40 cents a gallon. And it's 40 cents a gallon, whether oil costs \$20 barrel, or whether oil costs \$150 barrel.

If you think drivers have a good deal in OPEC countries, they don't have anything as good a deal as power users. What's the coolest thing to do in Dubai? Ski, of course. I love skiing; I'm Canadian. But going skiing in an area where it's hot enough to fry an egg on the pavement uses up a whole lot of energy. In fact, one day at Ski Dubai uses the equivalent energy that a North American would consume in a month's worth of driving. So the question isn't really how much productive capacity that OPEC has. How much export capacity is the real question, and every year that is less and less, because every year, more and more is consumed at home.

Now, it's their oil and gas, and if they want to consume their oil and gas going skiing in one of the hottest deserts in the world, that is their right. All I'm saying is, chances are, your future oil supply ain't coming from OPEC, and chances are, it ain't going to be cheap.

Now sure, oil prices fell to \$40 barrel during the recession. And for many folk, that was evidence enough that it never had any business being in triple digit range in the first place. But what a lot of those folk forget is that in the last recession, world oil demand actually fell. It fell for the first time since 1983. Such was the severity that the recession was.

Peak oil is not a problem if the economy that it is powering is shrinking. Peak oil is only a problem if the economy we are in is starting to grow. The first thing you know about an economic recovery is that economies start burning more oil. The next thing you know about an economic recovery is that oil prices start rising. Where is oil trading today? It is trading at over \$80 barrel. With the exception of Germany and Canada, every other economy in the G7 is still miles below the level of GDP that they were at before the recession began.

And yet, where oil is trading today, turn the clock back to three years ago, and that would have been a world all-time record high. Now, it is where oil trades in the shadow of the deepest global post-war recession. Where do you think oil prices are going?

I will tell you where I think oil prices are going. Even in this most anemic of economic recoveries, we are going to see triple digit oil prices. We are not going to see triple digit oil prices in 10 to 15 years. And it is certainly not clear to me that the global economy is better able to handle that than in 2008. Now, a lot of people will say, "Jeff, economic history tells us that scarcity is the mother of invention. Give us 10 to 15 years of adjustment, and we will develop alternate technology, so we won't be carbon-dependent."

And they are right. Give us 10 to 15 years, and we will solve this on the supply side. But as I say, our rendezvous with triple digit oil prices is not in 10 or 15 years; it is in 10 or 15 months. So instead of trying to turn cow-shit into high octane fuel, we are going to have to learn to get off the

road, and that is just what happened. In 2009, there were 4 million fewer cars on the road than there were the year before. In the next ten years, 40 million North Americans will be taking the exit lanes. The question is, "Will there be a bus to get on?" Instead of giving \$40 billion to General Motors, what we should have done is spend \$40 billion on public transit, so there would be a bus to get on.

In a world of triple digit oil prices, all of the sudden the economy's speed limit changes. And that is one of the problems that we have here in America, is that we don't recognize that our economy's speed limit has changed. What the economy could grow at when oil was \$20 to \$30 barrel is a whole different speed limit than what the US economy can grow at when oil is \$80 to \$150 barrel.

And that is something that I don't think the Administration recognizes. Because what President Obama cannot bring is cheap oil. He can get expensive oil. We can build a pipeline from the Canadian tar sands down to the Gulf refineries, and we can get oil. But in order to get the kind of oil that will be required, that will require the triple digit oil prices that we can't afford to pay. But trying to pump-prime the economy with fiscal stimulus is not a substitute for cheap oil. It won't make the economy grow any faster. It will just make the deficit that much bigger.

Worse than that, triple digit oil prices will not only take millions off the road, it will send our economy right back into recession, unless of course, the economy changes. We can't do a whole lot about triple digit oil prices. That is where the supply curve lies. And if you doubt that, just look at the Canadian tar sands. Like sure, there is 170 billion barrels of it there, and there is 500 billion barrels in the Orinoco heavy oil belt, but that is not the issue. Depletion is not just the geological concept, it is more fundamentally an economic concept. Because if the cost of extracting that oil from the tar is greater than we can afford to burn, it doesn't matter how many billion barrels of oil there are in the tar sands.

So how do we adapt? How do we grow in an economy of triple digit oil prices? We change the nature of our economy. In a world of triple-digit oil prices, distance costs money. The global economy, where we produce one thing at one end of the world, to be sold at the other end of the world, doesn't make any economic sense, because in too many cases, what will be penny-wise, will soon become pound-foolish. The wage "arb", what we save on wages, we will more than squander on bunker fuel.

Take the steel industry, for example. Just before the recent recession, some very curious things were happening in the US market. When oil prices got to be over \$100 barrel, all of the sudden, Chinese steel exports to the US fell at double-digit rates. And all of the sudden, US steel production was up. And all of the sudden, US Steel Corp., which was one of the biggest dogs in the market, all of the sudden its share price doubled.

What was going on? I'll tell you what was going on. For the first time in 20 years, it was cheaper to make steel in the United States than to import it from China. Why? Consider what China has to do to send you steel. First, it has to ship iron ore from Brazil, across the Pacific Ocean, turn it into steel, which is itself a very energy-intensive process, then ship it back, across the Pacific Ocean, to you. At \$20 barrel, that works. At \$100 barrel, that doesn't work. It added on \$60 to \$70 dollars, to the cost of a ton of hot-rolled steel. How much labor time do you think there is in making steel these days? One and a half to two hours. The transit costs all of a sudden exceeded the labor costs. Who would dream that triple digit oil prices would breathe new life into our hollowed-out Rust Belt? But in a world where distance costs money, that is exactly what is going to happen.

Take food. Last year, China exported \$6 billion of food to America, everything from apples to frozen chicken wings, bringing a whole new meaning to having your Chinese food delivered. Steel

doesn't have to be refrigerated. Hopefully, frozen chicken wings do. What do you think powers that refrigeration unit? Bunker fuel! The same thing that is powering the boat. The world of triple digit oil prices--it won't matter that farm labor is cheaper in China than in the United States, because the cost of bringing those frozen chicken wings to us will be too expensive.

it's not like we are going to stop using steel in America, and it is certainly not like we are going to stop eating. What we are going to have to do is make our own steel. What we are going to have to do is grow more of our own food. Unfortunately, much of our agricultural land has been paved over with suburban sprawl. Just as triple digit oil prices will breathe new life into our hollowed out Rust Belt, triple digit oil prices will turn those far-flung suburbs and exurbs back into the farmland they were, thirty to forty years ago. The very same economic forces that gutted our manufacturing sector, that paved over our farm land, when oil was cheap and abundant, and transport costs were incidental, those same economic forces will do the opposite in a world of triple digit oil prices. And that is not determined by government, and that is not determined by ideological preference, and that is not determined by our willingness or unwillingness to reduce our carbon trail. That is just Economics 100.

Triple digit oil price is going to change cost-curves. And when it changes cost curves, it is going to change economic geography at the same time. I know that the world of triple digit oil prices has been the domain of the apocalypse. For many people, the advent of peak oil and triple digit oil price means the end of our economy. For some, civilization as we know it. I don't share that pessimism. I don't share that outlook. I'm an economist. I believe in the power of prices.

Sure, if we continue to want to get our frozen chicken wings from half-way around the world, where labor is cheap, if we want to get our steel from half way around the world, if we want to commute back and forth eighty miles to work in our SUVs, peak oil won't just be a recession, peak oil will be peak GDP, and that will be apocalyptic. But as I say, I am an economist, and I believe in the power of prices. I believe we are going to change. I believe that we are not going to end up importing food from half-way around the world, or steel from half-way around the world. I don't think we are committed, irrevocably, to suburban sprawl.

And we might just find that that new smaller world around the corner is a whole lot more livable, and a whole lot more sustainable, than the big "oily" one we are about to leave behind.

Thank you very much.



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