



Countdown to \$100 Oil - No Normal Recession

Posted by [Euan Mearns](#) on October 17, 2011 - 6:02am

Topic: [Economics/Finance](#)

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David Cameron describes the economic downturn as "[no normal recession](#)" UK Prime Minister David Cameron to party conference, 5th October 2011.

This is the fourth post in the series following the oil price, markets and general health of the global economy examining the simple theory that OECD recession may result from annual average oil price exceeding \$100 / bbl.

The annual average price (AAP) of Brent went through \$100 on around 16th August 2011 and the AAP stood at \$105.3 on 12th October. The AAP high point in the 2008 price spike was \$104.8 on 9th October that year.

Below the fold are observations and commentary on debt, economic growth, interest rates, commodities prices and government policy. This is not intended to be quantitative analysis but instead is intended to provide a platform for discussion in the comments.

***Figure 1** Data for Brent from the [EIA](#), 1 year moving average roughly equals 5 trading days per week divided by 7 days per week = 261 days. FTSE 100 data from [Yahoo](#). Back in 2007 – 09, the top of the London FTSE 100 index was 6731 on 12th October 2007 (1). The top of the oil price spike was \$143.95 on 3rd July 2008, 8 months after the market top (2). Both oil price and markets had declined substantially by the time the Lehman induced crash came in October 2008. The recent high in the FTSE 100 was 6091 on 8th February 2011 (3). The top of the recent oil price spike was \$126.64 on 2nd May 2011, 3 months after the market top (4). Data at 12th October.*

No Normal Recession

When the UK Prime Minister calls the current economic crisis "[no normal recession](#)" and The Governor of The bank of England has said "[this financial crisis could be the worst the UK has ever seen](#)" it should be clear to all that we are living through exceptional times.

Ask any financial commentator or the political and economic elite and they will tell you that the cause of this crisis lies in the Euro Zone and that the straight jacket of the single currency is causing stress in peripheral nations that are in deep recession and unable to service their crippling debts.

In 2011, the **European Union had a GDP of \$16.3 trillion**. Tiny Greece contributed just \$0.3 trillion or 1.8% of the total. Can it really be the case that the risk of default in this tiny economy is threatening to topple Europe and with it the global economy? Is it this risk that is threatening stagnation of economic growth? Or is it stagnating economic growth that is raising risk of Sovereign defaults? It is of course the case that triggering settlement on credit default swaps on Greek debt may multiply the problem enormously.

Figure 2 *David Cameron may believe this is no normal recession, but it has been following a path remarkably similar to the 1979 / 83 recession that followed the Iranian Revolution that caused the first \$100 (adjusted) oil price spike. But there are some ominous differences this time that may well make this recession exceptional. We are currently in territory between the 79 / 83 recession and the Great Depression. [Chart from The Guardian](#).*

This chart from The Guardian illustrates the problem. 13 quarters have passed since the 2008/09 recession began but the UK economy has only recovered 2% of the 6% lost and is not on any trajectory to recover all 6% any time soon. While Cameron may think this is no normal recession, thus far it has evolved rather similarly to the first oil price recession back in 1979 / 83. However, there are four key differences this time:

1. In 1981 interest rates stood at 17%, raised to squash oil price inflation, could then be lowered to stimulate recovery. In 2011, UK base rates stand at 0.5%, cannot be lowered any further, and the Bank of England has effectively lost control of inflation and the economy.

Figure 3 *Bank of England (BOE) base rates show significant variance but it is striking to note how the baseline has declined steadily since the 1979 Iranian revolution oil price shock. With interest rates now effectively at zero, the BOE has effectively surrendered economic policy to the vagaries of international energy prices. Economies that cannot afford to pay rent on savings are doomed to fail in their current form. Data from [The BOE](#).*

2. The 1979 oil price shock brought on by the Iranian revolution was artificial and new supplies stood ready around the globe that could be brought on stream to alleviate scarcity and bring down prices. Oil prices continued to fall until 1998. In 2011, global oil production has stood on an 82 mmbpd plateau for 7 years despite record high oil prices. There is little prospect that global supplies can be increased sufficiently to satiate demand and bring down price.

Figure 4 *Annual average global oil production and price. The 1979 Iranian revolution caused the first spike in annual average price over \$100 per barrel that sparked a recession in the UK (and else where). This recession followed a track similar to the one we are now in. The 1979 price spike was followed by a 20 year bear market for oil prices. The reason for the 2008 price spike is fundamentally different - the proximity of global peak oil production - which is a problem that will not go away. The 2011 price spike will match that of 2008. The global economy currently needs much lower oil and energy prices. The only way this will be achieved is by significant increase in oil supply or by significant decrease in demand that will only take place if we have another recession - or if OECD governments see the light and put in place emergency energy efficiency measures. Data from [BP](#)*

3. In 1979 / 83 governments recognised the cause of recession to be high oil prices and a range of measures to boost supplies (North Sea, North Slope) and reduce demand for oil (fuel economy and substitution in electricity generation) took place. In 2011 the recession is blamed on The Credit Crunch, sub-prime mortgage defaults, the Eurozone problem and Greece. The UK government, failing to recognise the key energy problem, has penalised North Sea oil producers

with increased taxation and somewhat amazingly is contemplating a rise in the speed limit on the country's motorways from 70 to 80 miles per hour.

A note on UK speed limits

The speed limit on main highways in the UK is currently 70 miles per hour (MPH) and has been for many years. Back in the 1970s following the first [Yom Kippur oil shock](#) the government reduced the speed limit temporarily realising this was a good way to improve energy efficiency and reduce liquid fuel consumption. Somewhat astonishingly today, the government is considering [raising speed the speed limit to 80 MPH](#). From this it seems quite clear that there is no perception within the corridors of power that the current economic crisis is part linked to an energy crisis.

4. Debt levels throughout every level of the economy are much higher now and the economy cannot support higher interest rates to squash inflationary pressure **and** the higher energy prices that are causing inflation. With interest rates effectively at zero, economic health has been handed over to the fluctuating and highly volatile global oil price. When the oil price fell in 2008 / 09 growth resumed but with the oil price rise (stimulated by QE) in 2010 / 11 growth is stalling throughout many of the major economies. It is this stalling growth superimposed upon high debt burdens that is the main threat to sovereign solvency.

The September 2011 commodities price crash

Figure 5 Copper front month future showing major price correction in September 2011 reminiscent of the price crash of October 2008. Chart from the [Financial Times](#)

The September 2011 crash in the price of copper (and other commodities) was reminiscent of the October 2008 price crash. Copper, along with oil, would normally be considered a bell weather of the state of the global economy and this crash most likely heralds global economic stagnation or contraction. Surprisingly, the oil price barely flinched which may be a sign that oil supplies are more tight than many believe. But if \$100 oil does cause recession then demand will shortly wane and the oil price must surely follow copper down?

A shrinking share of a static pie

Figure 6 The share of global oil consumption divided by three socio-economic blocks. Data from [BP](#). Note that the former Soviet Union (FSU) is shown since BP split this data out as a separate group.

This chart, inspired by one previously posted by Gail, shows how the OECD share of global oil consumption has fallen fairly steadily from the early 1970s. Once upon a time the OECD consumed about 75% and this has fallen to about 53% today. The developing economies have relentlessly increased their share and will soon consume as much oil as the OECD. For many years this mattered little since global oil production was rising rapidly enough to satiate increasing demand in both OECD and Developing Economies. But since the 82 mmbpd plateau was reached 7 years ago the OECD has been getting a shrinking share of a static pie. Should oil production go into decline on the backside of Hubbert's Peak then this situation will become suddenly worse.

It is oil and energy consumption that produces real GDP and creates lasting wealth, not digital

billions conjured out of thin air.

The cart and the horse

[The European sovereign debt crisis that's spread from Greece to Italy and is roiling the region's banks now has another potential victim: energy policy.](#)

This article on Bloomberg sparked some debate on The Oil Drum email list. My own reaction was that they had got this the wrong way around. It must surely be the extremely poor and highly misguided energy policies pursued by most OECD governments that are threatening economic growth and it is this economic stagnation that lies beneath nation's losing ability to service their debts. If we had strong economic growth, the extant debt problems would be less severe.

Failure by OECD governments to recognise that it is growing supplies of cheap energy that have oiled the wheels of economic growth for decades lies at the heart of the problem. The notion that we can have an economy based on magic money that can be used to support mad cap energy policies like carbon capture and storage, hydrogen cars and temperate bio-fuels must be put to bed. Energy policy must be re-formulated with some urgency with focus on providing society with adequate supplies of affordable energy.

A day of reckoning and acceptance of harsh reality looms. The OECD will most likely continue to lose share of global oil consumption to developing economies who manage to deliver more energy service per unit of energy consumed enabling them to pay a higher price and secure that ever higher share. Should that lower share of static supply turn into lower share of decreasing supply then severe economic hardship will follow with employment levels, social and health services and pensions hit first and hard - it is already happening!

There is no simple solution. But a personal belief is that if the population understands the cause of the trauma they will be better equipped to cope and accept the consequences. Blaming bankers and Greece alone will leave the feeling of pointless suffering that might have been avoided. With little to no control over global oil supplies the OECD must develop an obsession with energy efficiency in an effort to get their demand down ahead of the price curve. Speed limits on UK motorways should be reduced to 60 miles per hour and enforced. Inefficient means of energy production should be discouraged not subsidised.

Earlier posts in this series

[Oil prices and recession](#) June 1 2011

[Countdown to \\$100 oil - a date with history?](#) July 11 2011

[Countdown to \\$100 Oil - Deja Vu?](#) August 26 2011

[Commenter Pasttense](#) asked if I had ever documented my views and recommendations on energy policy. I gave a talk on this subject at ASPO 9 in Brussels earlier this year. The slide deck is [here](#) and the video is [here](#).



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