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Countdown to $100 Oil - High Energy Prices Suppressing Growth?

Posted by Euan Mearns on November 30, 2011 - 7:43am
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This is the fifth 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 $108 on 22nd November**. The AAP high point in the 2008 price spike was $104.8 on 9th October that year, and so $108 expensive dollars sets a new record. This is a short post updating readers with developments including speculation about why a weak world economy can now sustain record high oil prices.

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 22nd November.*

In his autumn budget statement, UK Finance Minister George Osborne recognised that high energy prices were one of three factors suppressing growth in the UK:

> And in addition to the Eurozone crisis, the OBR (Office for Budget Responsibility) give two further reasons for the weaker forecasts.
>
> First, what they call the “external inflation shock”, “the result of unexpected rises in energy prices and global agricultural commodity prices”.
>
> Their analysis is that this explains the slowdown in growth in Britain over the past 18 months.

The day after delivering this statement, Osborne participated in coordinated action with other central banks to pump even more liquidity into the global financial system sending commodity prices sharply higher. The political and economic elite do not seem to have grasped as yet the links between their economic growth policies and high energy prices that suppress that growth.

Despite the fact that most commodity prices are now in retreat, Brent oil prices remain stubbornly high at over $100. The historical precedent for high oil prices and recession in the UK is illustrated in the slide below, used in a lecture to first year undergraduates at The University of Aberdeen a couple of weeks ago.

Figure 2 *The relationship between oil prices and recession in the UK. Note that countries in the Euro Zone periphery are contending with high energy prices, high interest rates, high € exchange rate and cuts to public spending at present. What chance recovery?*

Three out of the last four UK recessions are associated (not necessarily caused by) spikes in oil price. The fourth was caused by the UK's membership of the Exchange Rate Mechanism (ERM) that preceded the € whereby countries pegged their exchange rate to a basket of European currencies (i.e. the Deutshmark) by adjusting fiscal regimes and interest rates. Defending this policy by ever higher interest rates led to the humiliating exit of the UK from this mechanism on what has become known as Black Friday. Norman Lamont (then Finance Minister) was humiliated and George Soros made a killing and became famous. The UK entered a sharp recession that ended when devaluation and a lowering of interest rates made our economy competitive once again. There is a message in there for the EZ countries. Germany is currently basking in the warm glow of a low exchange rate, boosting exports and growth while much of the European periphery is being barbecued, not just by a strong currency and rising interest rates but at the same time near record high oil prices. Something has to give - and will do quite soon!

And so to a look at a range of reasons for stubborn high oil prices:

1) Whilst is appears that a new AAP has been set, adjusting the previous peak of $104.8 from October 2008 for three years of inflation at 3% per annum provides an adjusted value of $115 in today's money. Thus prices must strengthen considerably from here to match the 2008 peak.

2) Global all liquids demand remains strong as this chart from Stuart Staniford at Early Warn shows. Thus while news abounds on weak growth in Europe and risk of double dip recession rises, it appears that these troubles have not yet affected oil demand at the global scale. Is Europe about to lose more share of the global oil market?

Figure 3 *Global all liquids hit a new high in October 2011 suggesting that global demand is still strong despite near record high AAP for Brent. All liquids = crude+condensate+NGL+refinery gains+bio fuel. Chart from [Early Warn](#).*

3) The Arab Spring has turned to the Arab Fall and tensions in Syria, Iran, Egypt and Pakistan combined with continued unrest across the MENA region may continue to provide a risk premium for oil while other commodity prices fall.

4) The proximity of the back side of Hubbert's peak in crude oil means that the oil market is tight causing relentless pressure on price.

5) The theory that high oil prices lead to recession in the OECD may be incorrect.

I am not yet ready to declare a link between high oil / energy prices and recession as dead and my continued perception is that these persistent high oil prices are suppressing growth throughout the OECD and that it is this absence of growth that is in part responsible for the inability of certain European nations to service their debts. The unsustainable high nature of these debts is of course a major part of the problem too combined with the fiscal structure of the € zone that forbids participation of the European Central Bank in primary bond markets. Even if the € crisis is "solved" I believe we will see the peripheral EZ countries limping on with low or negative growth, burdened by high energy prices.

> "oil is too expensive to support growth and at lower prices supplies will not be sufficient to support meaningful growth."
>
> Rune Likvern

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