What's the Real Cause of the Global Recession?

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There is little doubt the world economy is falling into a pronounced slowdown, if not an outright recession. Certainly there can be little doubt that the OECD economies are in recession, including now its largest one—the US. Even growth in China's economic juggernaut is now in question, although the verdict there is far from clear. While most of the world's newfound economic ills are being attributed to the ongoing crisis in world financial markets, and its associated source, the US housing market crash, both the timing and size suggest something else may be afoot.

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.

Certainly oil shocks are no stranger to recessions. Four of the last five global recessions were preceded by one (Chart 1). Yet the recent spike in oil prices doesn't seem to get any credit for what's happening to the world economy now.

That's odd because it should. Curiously, an over-500% increase in the real price of oil gets virtually ignored as a culprit behind today's economy, eclipsed by the ongoing crisis in financial markets. Yet the run-up in real oil prices this cycle is over twice the spike in oil prices that occurred during the first or second OPEC oil shock (Chart 2). And those oil shocks produced two of the deepest recessions in the entire post-war period, including the 1980-82 double dip.

Income Transfers to High Saving OPEC Countries Are Not Demand Neutral

In the past, oil shocks have triggered global recessions by transferring billions (or now trillions) of dollars of income from OECD economies with typically very low savings rates to OPEC economies with typically very high savings rates (Chart 3). For example, the transfer of income from US consumers to Saudi producers involves moving money from basically a zero-savings-rate economy to one in which the savings rate is around 50%. While many of those petro-dollars get recycled back into the financial assets of OECD countries, many of them never get spent. In effect, the income transfer from American motorists to Saudi Aramco means that more and more of the world's income gets saved and less and less spent. That demand leakage shows up in a weaker world economy. Hence,

Chart 1

Past Recessions and Oil Spikes

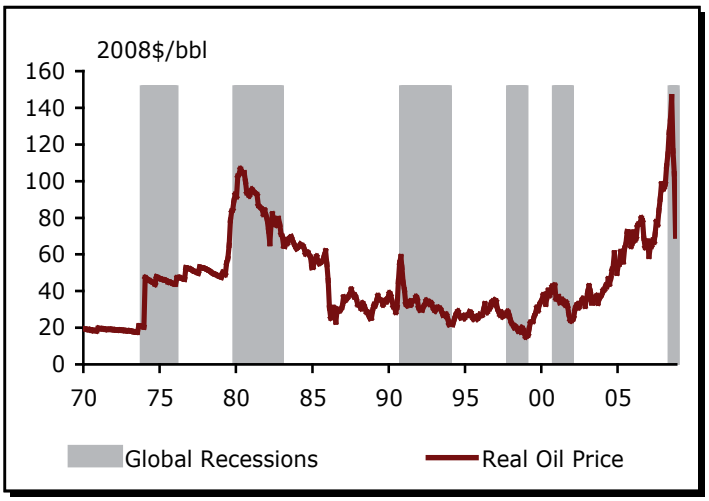


Chart 2

Recent Oil Spike vs Past Spikes

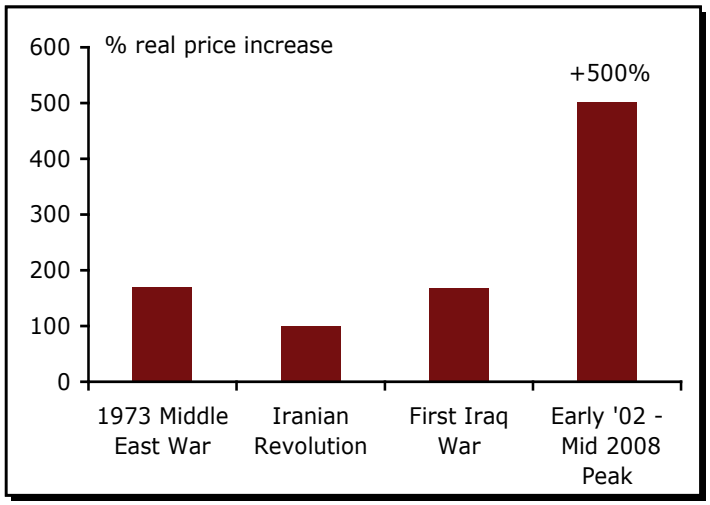
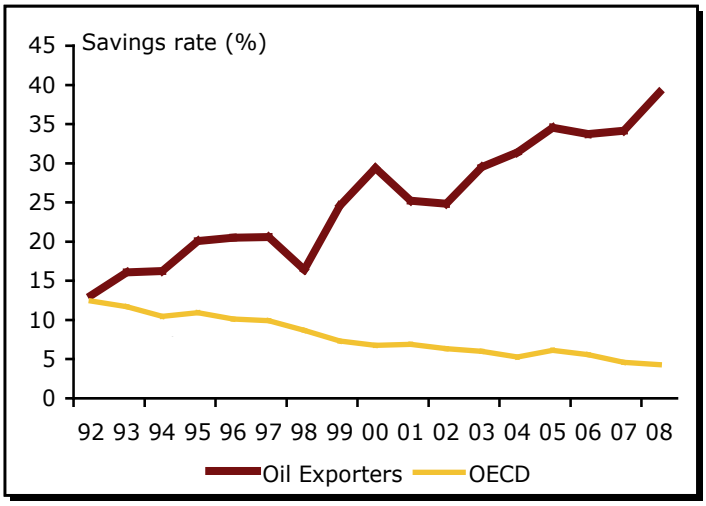


Chart 3

Savings Rates: OECD and OPEC



the redistribution of global income from oil-consuming countries to oil-producing countries is far from demand-neutral insofar as the global economy is concerned.

Those same transfers are occurring now, and at recent triple-digit oil prices, they have been occurring on an even more colossal scale than ever before. The annual US oil import bill has risen by a staggering $200 billion since 2005. That's bigger than Congress' recent fiscal stimulus package (Chart 4).

And, of course, it hasn't just been American consumers who have been socked with mounting fuel bills. It's been true for households from all OECD countries. Over the last five years their annual fuel bill has grown a staggering $700 billion. Of this, $400 billion annually has gone to OPEC producers.

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

Properly diagnosing the disease is always a good first step to finding a cure. If the global meltdown is all about defaulted subprime mortgage debt, a global recovery will have to wait until we see a bottom in US housing prices. But if the global recession is primarily about the recent oil price shock, then the subsequent halving of prices from $147/bbl to little over $60/bbl now, and not a pick-up in Cleveland property values, is the real road to recovery.

Not only is scale a problem with the subprime mortgage explanation for a global recession, but the rise in oil prices also provides a better fit with the timing of the downturn. If the credit crunch was to blame, one would have expected the European and Japanese economies to have slipped into recession after the financial crisis sent LIBOR rates soaring. Instead, both economies tanked well ahead of the worst news for credit spreads. (Chart 5).

And both the Japanese and Euroland economies are far more vulnerable to oil price spikes than the American economy. While the US economy may consume 19 million barrels per day it also produces 5 million. That part of the American economy gets a boost from soaring oil prices. Japan on the other hand must import nearly all of its oil.

Chart 4

Stimulus Package Less Than Recent Rise in US Oil Payments

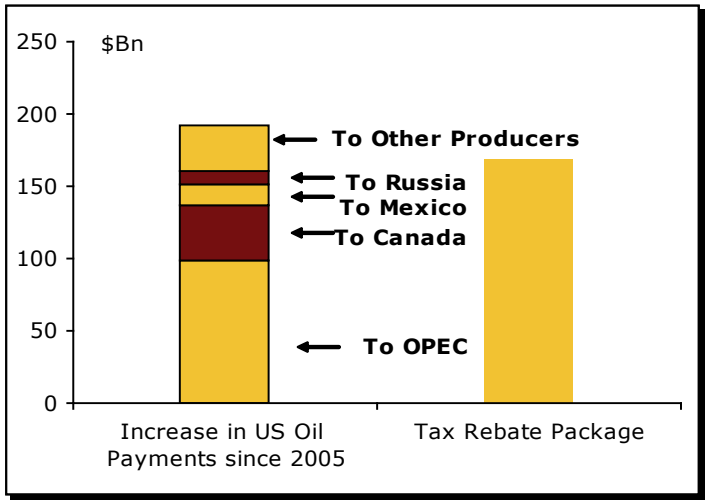


Chart 5

Overseas Economies Were in Recession (L) Well Before the Financial Shock Intensified (R)

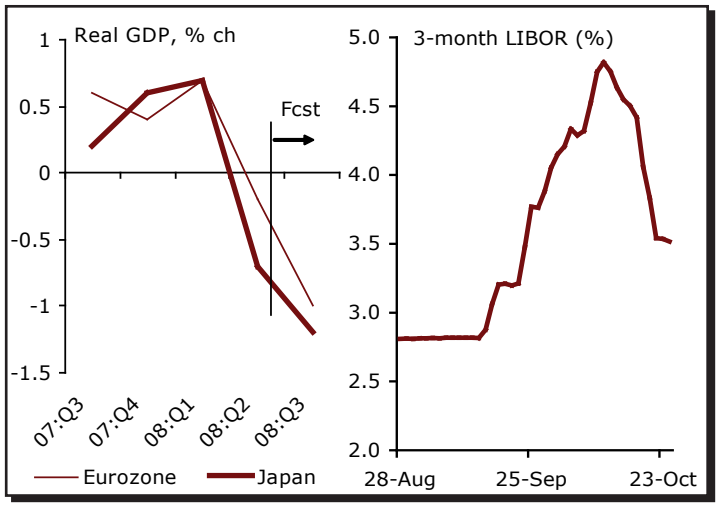
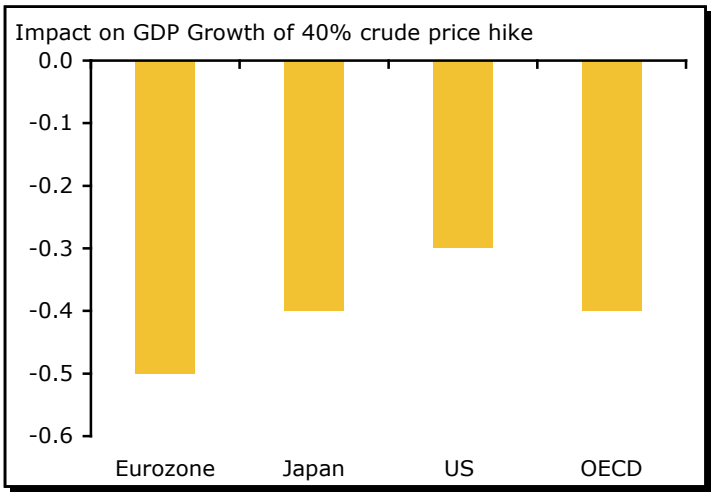


Chart 6

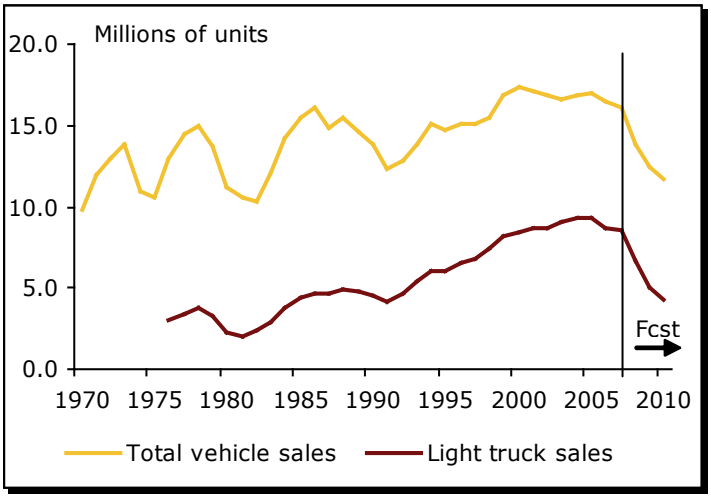
Oil Price Sensitivity of Different Economies



Source: IEA, "Analysis of the Impact of High Oil Prices on the Global Economy"

Chart 7

US Auto Sales Projected to Continue Falling



And with the exception of Russia and a few North Sea states, Europe is essentially in the same boat. That's why these economies have almost twice the sensitivity of the American economy to an oil shock (Chart 6).

But even the American economy is hardly immune. The one-two punch from record fuel bills and end of the tax rebates saw consumer spending plunge at a 3.1% rate in the third quarter, the largest decline in over a quarter century. Significantly, the last drop in household spending occurred in a previous energy shock, caused by the 1990 Iraq war. Plunging motor vehicle sales accounted for the largest single component of the drop in Q3 spending.

And the risk is that the damage there is far from done (Chart 7). The past year's high pump prices have not only decimated sales but sparked a discernable, potentially lasting reduction in miles driven. Nor is the damage from high oil prices limited to automobiles. Four-fifths of GDP shows a strong negative relationship to high energy costs. That includes the negative effect on a wide range of industries, including travel and agriculture, which increasingly just turns petroleum into food.

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 in1986 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.

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