
The Credit Crunch and International Energy Markets – What Now?

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Two years ago, oil prices were on their way up to the peak of \$144 on 3 July 2008 – which was followed by a spectacular collapse to a low of \$35.5 on 23 December. At the time of writing, they are now up again to about \$85 – having been trading in an implicit band of around \$70–80 for several months. Clearly, the most important driver of these extreme swings in the oil price has been the world economy – or more accurately, perceptions about the financial crisis and anticipations about the likely course of the ‘great recession’ and the recovery.

This article takes stock of some of the lessons and, tentatively, tries to draw out implications for the, still very uncertain, future. It starts with a brief recap of the history of the great recession, focusing on the policy response. The next section looks forward at the domestic and international policy problems and the final section concludes with some general remarks about the interactions between global macroeconomic developments and the markets for oil and gas.

The Great Recession

Before the financial crisis, the big question was why rising oil and other commodity prices – which delivered a shock comparable to (or larger than) the big oil crises of the 1970s – did not lead to world slowdown or recession, which would have moderated the demand for oil and checked or reversed the price rises. Essentially, the reason for the difference was that the recent rise did not lead to general inflation, especially in industrial countries. Second round effects, on inflation and on nominal wage rises were almost entirely absent. With (flexible) inflation targeting policies in most OECD countries, any recessionary effects from rising oil prices (which act like an increase in indirect taxation in consumer countries) would be offset as Central Banks sought to meet their mandates.

The USA and some other countries were clearly slowing before the credit crunch. With low inflation in the OECD – despite soaring oil and other commodity prices – the prospective recession was a recession that central banks thought was neither necessary nor wanted. The response was predictable – offsetting cuts in interest rates (early and aggressive in the USA) to head off the recessionary forces. At the same time, the nature of the financial problems, which started in the summer of 2007 with the sub-prime crisis in the USA, were becoming apparent; but it was widely assumed that the impacts on the real economy would be limited – i.e. that offsetting policies and bail outs would do the trick. This all changed in September 2008, with the bankruptcy of Lehman Brothers and rescue of the US insurance giant, AIG. The decision not to bail out Lehman Brothers was a huge shock to the system – and the world economy seemed to ‘fall off a cliff’ in the last quarter of 2008 and into 2009.

An interesting indicator of the robustness of confidence in the efficacy of offsetting policies is the behaviour of oil prices – which, despite the developing financial crisis and the stream of bad news during the first half of 2008, continued to rise to their peak in July 2008, before beginning their rapid fall. The low point for spot prices, around the beginning of 2009, coincided roughly with the maximum degree of pessimism about world prospects – and the upturn since correlates closely with developing confidence in global recovery.

The V-shaped Pattern of Recession and Recovery

As noted, there was considerable confidence during the early stages of the financial crisis that policy responses would be sufficiently powerful to limit the downturn in global output. After Lehman Brothers collapsed, confidence that policy would, or could be, powerful enough evaporated. Dire comparisons were made with the great depression of the interwar years. In an influential study, Barry Eichengreen and

Kevin O’Rourke showed, early on, that the initial phases of the downturn were worse than interwar – though with the important caveat that policy would be different this time (see Figure 1).

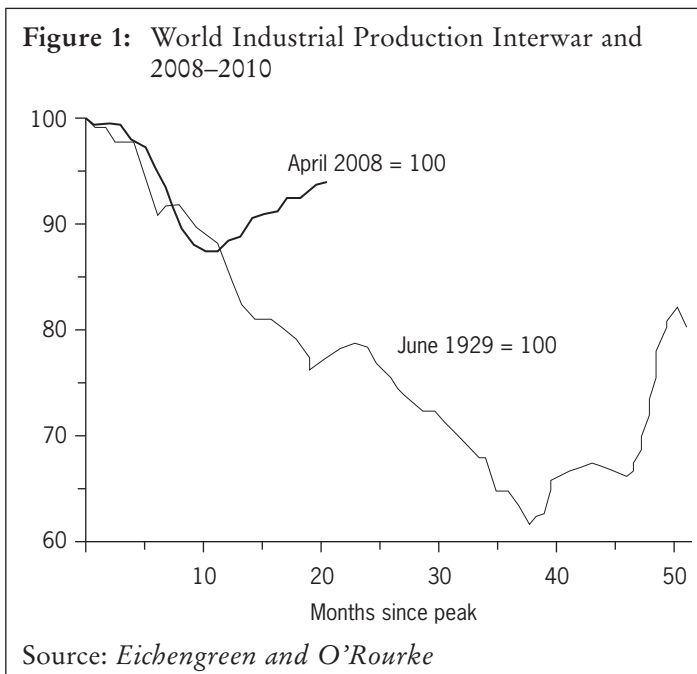
In fact the recession, though very deep, was V-shaped – with recovery setting in during the first quarter of 2009. Three features help to account for the V-shaped pattern.

The first is the world stock-building cycle. Really large and rapid movements in the world economy are usually the result of the stock-building cycle. World trade, especially in manufactures (and particularly autos) simply collapsed in the last quarter of 2008. To many observers’ surprise, the worst hit countries were not those that depended on financial services, but those that depended on manufacturing – countries like Germany and Japan and also China. But a stock cycle has a natural dynamic: when stocks have been off-loaded, it naturally reverses. Moreover, the bigger and quicker the downturn, the more likely it is that there will be a rapid reversal. Essentially, this is what happened. Both the fall and the recovery have been bigger than expected and a large part of the explanation is the virulence of the international stock-building cycle.

Policy

The second was, indeed, policy. The scale of the crisis, especially after Lehman Brothers collapsed, was not generally foreseen. But the response, though muddled at times, was, in broad terms predictable. Interest rates were, in stages, cut to the bone – to near zero in the USA and in many other countries. As the zero bound for interest rates was approached, fiscal packages were announced – spectacularly large in China, large in the USA and more minor but significant in Europe. At the same time, asset relief schemes, liquidity provision and quantitative easing added up to an extraordinary international policy package. And, eventually, it was large enough. Meltdown was avoided. Financial markets were stabilised – as indicated, for example, from data on interest rate spreads. And the perception that policies were actually working and that recovery would occur spread across financial and commodity markets. Major stock markets recovered – by about 40 to 50 percent. Important too, especially for oil and commodity markets, were the data coming out of China. Their offsetting policy, based on fiscal, credit and administrative measures (and directed largely to infrastructure) resulted in average GDP growth for 2009 of about 8.7 percent – with the economy growing at over 10½ percent in the last quarter of the year and 11.9 percent per year in the first quarter of 2010.

The conventional view is that policy put a floor under the contraction of the world economy and sparked recovery. There is a worry that as stimulative policy measures fade (some are temporary and time limited) and as the boost from the stock-building cycle goes away, the world recovery will falter – leading to very low growth or even to a double dip (or a W-shaped profile). This misses an important part of the dynamics at work – namely, the influence of budget deficits in major countries.



The cumulative effects of budget deficits

In fact, the largest difference between the present cycle and the great depression of the interwar years is the toleration of rising budget deficits. In many countries these have risen to extraordinary levels. The OECD estimate for the *average* (General Government) deficit in 2009 was 8.2 percent of GDP – a deterioration from 2007 of 7 percent of GDP. (The estimate for the USA is 10.7 percent of GDP, and for the UK it is 13.3 percent of GDP). The swing to deficit far exceeds the discretionary fiscal stimulus applied by industrial countries and reflects the ‘automatic stabilisers’ (reduced taxes and increased expenditures) as the economy fell into recession. This is a powerfully stabilising force. This toleration contrasts with attempts by governments in the interwar period to avoid budget deficits by raising taxes or cutting expenditures.

The significance of the rise in budget deficits can be put a different way. It is widely agreed that the financial crisis, the credit crunch and the swing to pessimism about economic prospects delivered a massive shock of a balance sheet kind to the private sectors of most countries. Businesses and households in the private sector needed to get out of debt: they needed to invest less or to save more. In the jargon, they needed to ‘deleverage’. As a matter of accounting, however, this is only possible if some other sector moves into deficit.

In a closed economy (i.e. ignoring the external current account position) the mirroring would be exact – the improvement of the private sector balance would exactly match the deterioration in the budget deficit. For an open economy, the public sector deterioration would equal the private sector improvement minus any swing toward surplus in the current balance of payments.

There are a number of implications for an assessment of the current situation and macroeconomic prospects – some optimistic and others more worrying, especially for the longer term.

On the optimistic side, if public deficits are seen as offsetting (or allowing) ‘deleveraging’ by the private sectors of recession-hit economies, they provide a powerful and cumulative force for recovery. The reason is simple. The requirement for ‘deleveraging’, though it may be large, is finite. An indebted consumer, for example, who succeeds in saving, does get out of debt – and is then likely to start spending again. Similarly, a deleveraging firm or financial institution, if it succeeds in running a surplus, improves its balance sheet – and is likely to return to more normal behaviour. Essentially, there is a financial stock/flow cycle – which has analogies with the stock-building cycle referred to above (though it is likely to be slower). Also, the process of balancing private sector ‘deleveraging’ with public sector deficits is cumulative. If the required amount of private sector deleveraging were (say) 10 percent of GDP, one year’s public deficit of a similar size would be sufficient. If the required deleveraging were 20 percent, then two years deficits would suffice, and so on. One can add that, once the recovery is seen to be underway, the pressure for private sector deleveraging will abate – as expectations turn more positive.

In fact, the typical pattern after financial crises is a very large swing to surplus by the private sector – which then comes back as private sector balance sheets adjust. For example, in the UK, in the early 1990s, the private sector swung from a deficit of about 4 percent of GDP to a surplus of about 6 percent of GDP in a single year (a swing of about 10 percent of GDP). At the time, the public sector deficit rose to 8 percent of GDP. But as the private sector came back (as savings decreased and as private investment expenditure rose) the public deficit was eliminated, and actually moved to surplus within five years. (Tax and expenditure programmes did have to be adjusted to bring about this favourable outcome). The Swedish banking crisis of the late 1980s produced an even larger swing in the positions of the public and private sectors – which reversed as the private sector surplus came down and as the external current account improved.

The Dynamics of Recovery

This brief account suggests that a number of factors account for the pattern of recession and recovery: obviously policy (especially monetary policy but also fiscal offsets limiting the downturn); the natural dynamic of the stock-building cycle, and the cumulative effects of fiscal deficits in allowing private sector balance sheet adjustment (deleveraging). As noted, there is a worry that, as the stock-building effect fades and as temporary fiscal measures (such as cash for clunkers) are taken off, the recovery will falter – with, according to some analysts, the danger of a double dip (or W). The most powerful force making for continuing recovery, however, is the one least discussed – the cumulative effects of the counterpart budget deficits themselves.

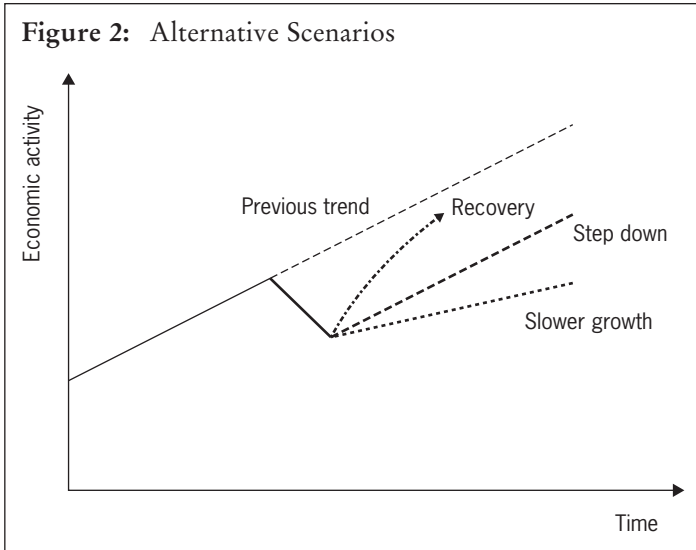
But there is a serious downside to this optimism. This is that mounting concern over budget deficits and debt will lead to premature tax rises and expenditure cuts – before private sector deleveraging has run its course. That would be a reversion to the kinds of policies that led to the Great Depression. The timing of exit strategies is crucial.

Policy Problems Looking Forward

Prospects and Risks

Consensus forecasts – such as those of the IMF – suggest that the recovery will proceed over the next few years at about the same rate of growth (in PPP terms) as before the crisis – that is at about 4 to 5 percent per annum. Though such a V-shaped pattern sounds good it involves a large step down from the previous trend. The downward ‘level effect’ is probably about 6 to 10 percent of global GDP.

There are upside and downside risks compared with the ‘consensus’. On the upside, ‘deleveraging’ may proceed quickly and the perceived need for it will diminish as confidence improves. This could lead to a period of above average growth (there is plenty of capacity) and a move some way back towards the previous trend. The downside risk is that growth will be slower due, for example, to continuing problems and restraints emanating from the financial sector. A double dip – a further shift down in the recovery path – is most likely to result from premature fiscal or monetary tightening.

Figure 2: Alternative Scenarios


The Policy Challenge

As recovery proceeds, policy-makers would like to have higher, more normal interest rates, substantially better and more sustainable fiscal positions and enough (internationally coordinated) macro-prudential regulation of the economy to ensure that the problems of the recent past never recur. But is it possible to get all these things right under current circumstances? It is certainly not going to be easy.

The strong pressure is for the fiscal authorities to move first (but not too soon). But with fiscal tightening the implication is that interest rates are likely to remain low – unless the recovery is considerably faster than the consensus expectation. The deflationary effects of fiscal restraint may mean policy interest rates have to remain low for quite a long time.

But policy-makers do not like low interest rates either. If interest rates do remain low whilst there is a revival of global growth, there is a danger of financial instability. Real interest rates would be very low at the short end – and could be negative. (The relationship that matters is actually between real interest rates and growth). Combined with high liquidity, this could set off asset price booms, and encourage high leverage – a repeat of the past, risking boom and bust. It should not set off general inflation if countries are mindful of avoiding generalised excess demand, but asset price booms are increasingly seen as an additional threat to stability.

This is where regulation, and particularly, macro prudential regulation comes into the picture. The idea behind it is to prevent the conditions that led to the recent crisis – by constraining finance. It is not at all easy to design – especially as, to be effective, it would need to be internationally coordinated. But it is probable that a combination of risk aversion (resulting from the crisis) and regulation would at least postpone excessive risk-taking and asset price drifts and bubbles for a number of years.

The dilemmas appear acute. But is there any way of squaring the various circles, or improving the trade-offs? Essentially, the problems arise because of an incipient surplus of savings over investment in the world economy. This means that policy-makers appear to face either continuing fiscal deficits or uncomfortably low interest rates. A more normal picture of fiscal prudence and reasonably high interest rates

would seem to require lower private savings or higher investment and a resolution of the payments imbalances between countries such as the USA and Asia.

What Kind of a Picture Looking Forward?

An essential feature of the macroeconomic background is uncertainty and the continuation of serious policy challenges. Conventional forecasts are not very useful when one of the few near certainties is that the ‘consensus’ is likely to move about – driven by events. Financial and commodity markets will be driven by the same underlying set of forces.

Given the many policy challenges, the key question is whether policy-makers will, in broad terms, succeed in doing what is necessary. The assumption that, with inevitable lags and hesitations, they would succeed in offsetting a potential financial collapse and a world downturn on the scale of the 1930s has proved right so far. But this was crisis management, which tends to concentrate the mind. Looking forward, the problems are more ‘normal’ but still very grave. Exit strategies will be hard to design – and the dilemmas referred to above will be hard to resolve.

For example, the fear of protectionism has, so far, been unfounded. But the threat will continue – and perhaps increase during the recovery period. The best guess, given that the threat is so well understood, is still that it will be largely avoided.

A greater threat arises from the re-emergence of international imbalances and the disparate positions of deficit and surplus countries. For countries with serious medium-term fiscal and financial problems, exchange rate depreciation is an attractive option, even if it arises from the pursuit of domestic policy choices (such as the continuation of low interest rates combined with fiscal consolidation). But such policies only add up if other countries – surplus countries as a group – are prepared to tolerate revaluation.

We have argued above that interest rates may well remain low – due to the imperative for fiscal consolidation in some major countries, including the USA and due to the likelihood that private savings will remain high in the aftermath of the crisis.

Paradoxically, this increases the pressure on regulatory authorities to tighten up and to introduce countercyclical ‘macro-prudential’ measures to stave off asset price rises and potential boom/bust scenarios. There are huge, and so far unresolved, challenges here. But the bottom line may be a situation of low real interest rates combined with tighter regulation and credit restraints.

It is not just forecasters and oil market experts who don’t know how all this will work out. Market operators will closely watch every turn as policy issues come and go and as policy-makers appear likely to succeed or fail. These public signals may have exaggerated importance in a situation of large underlying uncertainty, leading to considerable volatility and swings in the ‘consensus’ – and hence in oil and other energy prices. An overall picture of relatively rapid growth, firm but volatile oil prices, and low interest rates, with considerable downside risks if policy-makers lose their nerve or make mistakes as the world economy remains ‘fragile’. Interesting times!