Oil and recession

GLOBAL ECONOMY

Mauro Guillen
Wharton School professor of management
Emilio Ontiveros
Universidad Autónoma de Madrid professor

The price of oil has become once again a global problem. Even if it does not increase from current levels, chances are it can bring about a double-dip global recession, adding to the uncertainties surrounding the evolution of the advanced economies in the coming months. The eurozone, which is a net importer of oil, would be hit particularly hard.

During the second quarter of 2012, the price of oil has increased by approximately 15 percent compared to the first quarter, reaching a level dangerously close to that of 2008.

Right now, at a time when both the advanced and the emerging economies are seeing their growth rates on the decline, it is not demand that is driving higher oil prices. Rather, the hikes have to do with geopolitics. The epicenter is Iran, with a tighter Euro-American, and the increasing possibility of an Israeli surgical attack on its nuclear sites. While Iranian exports account for only 3 percent of the world's total, there is little slack capacity elsewhere to make up for the shortfall.

In contrast with the oil crises of the 1970s, the threat from higher prices is not greater inflation but slower growth. Other commodity prices are showing signs of moderation, and continued soft monetary policies around the world represent another signal that oil is unlikely to generate price instability.

It is, however, contributing to the current account and financial imbalances in the world, with massive amounts of foreign exchange reserves being accumulated by the oil exporters. The counterpart to that wealth accumulation is the reduction of the real income of oil importers, precisely those economies that right now are in great need of an increase in domestic demand in order to accelerate growth.

In the United States, for instance, a 10 percent increase in the price of oil reduces GDP growth by between a quarter and half a percentage point, something that makes it harder for other parts of the world to recover as well. The effect is much larger in Europe. In the U.S. the outcome of the presidential election could well be decided by the price of oil.

The stakes are thus very high. Low levels of strategic oil reserves in the advanced economies coupled with little slack capacity among oil producing countries pose a severe risk to the global economic recovery.

This in turn, could make financial deleveraging and restructuring harder. Europe needs to think carefully about what to do if the price of oil were to skyrocket.

The International Energy Agency estimates that the European Union will pay some $502 billion for oil imports this year, compared to $475 billion last year. East Asian economies such as South Korea and Japan will also be hit by higher prices.

The impact of geopolitical tensions on oil prices is not a new phenomenon. Oil-dependency is a recurring problem afflicting oil importing countries in ways that create volatility and uncertainty for countries around the world.

In oil exporting countries, price hikes are often associated with increases in corruption, with the average citizen rarely benefiting from the boom. At current and likely future prices, more oil deposits in less-accessible locations can add to global supplies.

But the growth of the emerging economies and the likely recurrence of geopolitical turmoil make technological innovation and the development of renewable energy sources a top global priority.

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Rising oil price challenges Asia

KOREAN ECONOMY

Gu Bon-sung
Research fellow, Korea Institute of Finance

Unexpected sharp rise of crude oil price has spread over to global concerns and emerged as an imminent challenge after the global crisis in 2008, not just from the economic perspective but also for the political leaders.

Rising oil prices may badly impact the economic recovery in many aspects as well as through different channels. Especially, as it had already experienced during the oil shock during the 1970s and 1980s, the current movement of world oil prices appears retrospectively threatening.

The upward trend of crude oil prices has a direct effect, unsurprisingly on the Asian economies. In the case of Korea, the street oil price per liter has already surpassed 2,000 won on average.

Also considering the trend of inflationary pressures in the recent years across Asia, it may be necessary to take both precautionary and preparatory measures against unintended impacts from the high oil price.

Even though there exists widespread consensus that the current situation would not result in the oil shocks similar to those in the 1970-1980s, it is still timely and necessary to examine both structural and mid- and long-term challenges that may be caused by the future oil price for the Asian economies.

One of the potential challenges is the nexus effect from globalization. The global economy has continued to broaden and deepen in the geographical aspects such as China and India.

Especially, the oil demand not just for corporate production, but also for individual consumption is likely to accelerate despite the development of new energies and technological innovations.

Such a demand may be effectively managed through price mechanism or the consorted efforts for releasing emergency reserves or increasing the daily productions in the short-term.

However, for the long-term it will be necessary to improve energy efficiency through technological innovation and preemptively enlarge energy investment which will broaden the base of renewable energies in the whole economy.

Also the growth pattern of Asian economy including Korea may be more vulnerable to high oil prices compared to other countries such as Brazil or Australia.

The export-driven economy may lose its growth momentum if the high oil prices lead to dampen the global demand and the rising energy prices cause the fall in productivity. On the other hand, the structural rise in the oil prices demand may require that the Asian economy be more susceptible to energy efficiency.

The financial market may be broadly hit by the negative outlook and by the monetary tightening if the rising oil prices cause to increase speculative inflationary pressures. Since the global crisis in 2008, the monetary policy such as quantitative easing has been very lenient and proactive.

But with oil prices rising and inflationary pressures mounting, the current expansionary monetary policy would be challenged or restricted. And the shift into tightening monetary policy may reduce the overall liquidity in the global financial market.

Furthermore, it may momentarily reverse the capital flows from emerging markets to advanced markets as well as from the export-driven economies to the resource-affluent ones.

That is to say, the financial market might be heavily hit by squeezed liquidity and rebalanced portfolio of investment on the global basis.

The potential impact caused by rising oil prices would neither be confined nor excluded for certain regions.

Rather, the rising oil prices will become more challenging over time and more comprehensive for the Asian economies.

The Asian economies require more conservative and reserved approaches for shielding themselves from the upward pressure on energy prices in two respects. First, the Asian economies have been a true engine for growth of the world economy through higher productivity, better skills and fast-catching technology.

To maintain such competitiveness, the overall economy should be promptly prepared for future energy prices by improving energy efficiencies and investing in low-cost, renewable and environment-friendly energies. Second, the Asian economies need to excavate energy resources both internally and externally by expanding a level of emergency reserves and strengthening strategic partnerships with energy-rich countries in order to alleviate the side effects from any potential price shocks in the future — although it may be better that those do not become a reality.

Issue Focus

Can the poor save the world?

By Jean-Michel Severino and Olivier Ray

Events in 2012 so far have confirmed a new global dissymmetry. Caught between unprecedented financial insecurity and a somber economic outlook, the rich OECD countries and their middle classes fear geopolitical weakening and downward social mobility. In much of Asia, Africa and Latin America, however, optimism reigns.

Among developed countries, this unexpected shift of fortune has incited protectionism. Meanwhile, among emerging economies, pride has sometimes manifested itself as conceit, tinged, after decades of Western arrogance, with schadenfreude. But because the world's economies are now so closely linked, they will either dog-paddle out of this crisis together or enter into a danger zone unseen since the 1930s.

After World War II, a new global economy emerged, in which a growing number of developing countries adopted export-led growth models, thereby providing industrialized countries with raw materials and household goods. This new economy was an undeniable success: more people left poverty in the twentieth century than in the preceding two millennia.

But this model also weakened rich countries' social structures, widening inequalities and excluding a growing proportion of their populations from the labor market. Moreover, it is responsible for the financial imbalances that besiege us today: to counter the effects of widening inequality and slowing growth, OECD countries have boosted consumption by rushing into debt.

In a remarkable reversal of history, the world's poor now finance the world's rich owing to large foreign reserves. Indeed, the hypertrophy of today's global financial sector largely reflects efforts to recycle emerging-market countries' rising surpluses in order to plug the rich countries' mounting deficits.

Until recently, this dynamic was considered transitory. Emerging countries' growth would necessarily lead to convergence of global wages and prices, thus halting the erosion of manufacturing in the OECD countries. The demographic transition in the world's emerging countries would encourage the development of their domestic markets, a fall in their saving rates, and a rebalancing of global trade.

That might be true in theory, but the length of this transition period has been badly underestimated. The "inversion of scarcities" — the new abundance of men and women actively participating in the global economy, combined with a once-abundant natural world's increasingly visible limits — risk prolonging the transition indefinitely, for two reasons.

First, from a macroeconomic perspective, we can no longer count on declining prices for raw materials, one of the economic stabilizers in times of crisis. Given rising demand in emerging countries, the cost of natural resources is bound to be a growing constraint.

Second, from a social perspective, after a doubling of the workforce in the global labor market during the twentieth century, another "industrial reserve army" has arisen in China, and among the three billion inhabitants of the world's developing countries.

A rapid rebalancing of global growth by reducing financial imbalances between OECD economies and their emerging-market creditors is risky, because it would cause a major recession for the former — and then for the latter.

If this analysis is correct, a new global rebalancing strategy will need to begin somewhere other than the wealthy OECD economies. The implementation of new growth models in the developing world can provide at least part of the missing demand that the world economy urgently needs.

The success of this scenario depends on a combination of three dynamics. First, interstate trade between emerging-market and developing countries must accelerate, thereby building the same kind of consumer-provider relationship as that between emerging and advanced countries.

Second, domestic markets in the world's poorest countries must be developed in order to foster more home-grown growth. And third, financial flows to developing countries, both official development assistance and foreign direct investment, must rise, and must come not only from industrialized economies, but also from emerging and oil-exporting countries.

Recycling global surpluses through the world's "bottom billions" presupposes a complete overhaul of standard economic models, which essentially assume that the Asian economic miracle can be replicated. After all, even if the world achieves significant economic growth between now and 2050, two billion of the world's nine billion people will still live on less than two dollars a day, and a further billion will have little more than that.

Jean-Michel Severino is director of research at the Fondation pour les Etudes et Recherches sur le Developpement International (FERDI), and manager of Investisseur et Partenaire. Olivier Ray is a development economist at the French Ministry of Foreign Affairs. They are the co-authors of "Africa's Moment." For more stories, visit Project Syndicate (www.project-syndicate.org).