

# THE GLOBE AND MAIL

Web-exclusive commentary

## First, there was expensive oil

If indeed oil, and not subprime mortgages, lies at the heart of our current economic malaise, we may be sicker than we know

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Knowing the nature of a disease is usually a precondition for finding a cure. Similarly, identifying the cause of a recession goes a long way in defining what type of recovery is likely to follow.

Conventional wisdom ascribes the current downturn, which in many ways is already the postwar's deepest one, as a financial-market crisis with origins in the bursting of a U.S. real estate bubble. But how did the demise of the American subprime mortgage market create earlier and much deeper recessions overseas than in the U.S. economy itself?

Maybe there was something else going on, like triple-digit oil prices for example.

If past oil shocks, like the two OPEC ones, created deep world recessions, why wouldn't the biggest oil shock of all be a logical suspect for triggering today's recession? The increase in oil prices that preceded the current recession, even in inflation-adjusted terms, was more than twice as large as the OPEC shocks.

It's not just the money that it takes out of Western consumers, although that is pretty staggering in its own right. Between 2005 and 2007, soaring oil prices transferred roughly a trillion dollars from consumers' wallets throughout the OECD to OPEC producers. And when gasoline prices were \$4 per gallon last Memorial Day weekend (or as much as \$1.50 per litre in Canada), many North American households found themselves paying more to fill their gas tanks than feed their families.

But it's also about where the money is going. After all, the world economy isn't just about oil-consuming countries, it's also about oil-producing countries. Record oil prices transferred billions of dollars from American households, who until very recently spent every cent they made, to Middle Eastern oil-producing economies with saving rates approaching 50 per cent. That's hardly demand neutral as far as the world economy is concerned.

Of course, failing financial institutions in the U.S. and indeed elsewhere around the developed world didn't help. But it's important to distinguish between cause and effect. While Lehman Brothers and Bear Sterns were obviously brought down by the impact of rising interest rates on mortgage defaults, it was oil prices, not home prices that caused interest rates to rise in the first place.

Thanks to steadily rising oil prices, energy prices as measured in the U.S. Consumer Price Index rose by less than 1 per cent in 2004 to as much as 35 per cent in 2006, sending the headline inflation rate to almost 6 per cent - the hottest reading in a decade and a half. Ask any central banker what your interest rate will be and he will tell you the mirror image of your inflation rate. All of a sudden the federal funds rate was heading toward 6 per cent as well, and all that leverage in Wall Street's derivative market started pulling the other way. The subprime mortgage crisis wasn't the cause of the today's economic crisis. Instead it was a symptom of a much bigger crisis - an energy crisis.

If indeed oil, and not subprime mortgages, lies at the heart of our current economic malaise, we may be sicker than we know. If the U.S. Treasury Department writes a big enough cheque, Washington can bail out Wall Street and all those troubled financial institutions across America whose bank vaults reek of rotting mortgage-backed assets. And if the Federal Reserve Board cranks up money supply enough, it can reflate the economy and even resuscitate depressed home prices. But there can be no energy bailout.

If the recession is really about triple-digit oil prices, then the recovery is going to be a lot more challenging.

No magic tandem of fiscal and monetary policy can boost world oil production, or for that matter alter our seemingly insatiable appetite for the stuff.

But that doesn't necessarily imply a gloomy economic future. While we won't be able to keep oil prices from printing triple digits again, we can take steps to make sure that those prices don't have the same devastating effect on the economy again. We can wean GDP off its dependency on oil. And that's not about the policy choices made by central banks or finance departments, but about the decisions each one of us makes every single day.

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