Energy Prices, Business Cycles, and Financial Crises
The Argument for Cycle Attenuation

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Frequency and Causes of Crises
Globalizations Past and Present

Reckless Lending Era 1850s–1870s: Major currency and banking crises
Gold Standard Era 1880–1913: Some currency and banking crises
Between Wars 1919–1939: Numerous currency and banking crises
Bretton Woods 1945–1971: Many currency crises but no banking crises
Dollar Era 1973–present: Numerous currency & many banking crises

Trade surpluses, Reckless Lending, and Recent Crises 1980–present:

1980s Scandinavia & Latin America: Reckless lending fueled bubbles that collapsed with oil prices, leading to currency and banking crises

1990s Japan, Asia: Supporting the Dollar and reckless lending fueled bubbles, which burst with tightened monetary policy, banking crisis

2000s Contagion + record U.S. debt pose substantial global-systemic risk
Coincidence of High Oil Prices with Financial Crises
Crises Severest 1850s-70s (before gold standard), and 1970s– (after Bretton Woods)

Brent Oil Price in 2006 Dollars

1860 1880 1900 1920 1940 1960 1980 2000
Asian Savings Glut and The Return of Recycled Petrodollars
Contagion + Petrodollar Flows Have Contributed Substantially to Bubbles & Inflation

Capital & Financial Accounts net Outflows (U.S.$, IMF BOP)

China
Kuwait
Saudi Arabia
Cyclical Petrodollar Recycling and Financial Crises

- Feedback mechanism during booms
  
  \[
  \text{growth (lag) } \Rightarrow \text{oil price } \uparrow \Rightarrow \text{Petrodollar flow } \uparrow \Rightarrow \text{interest rates } \downarrow \Rightarrow \text{growth}
  \]

- Hubris (80’s: countries don’t go bankrupt; 00’s: house prices don’t fall !)
  
  \[
  \text{Petrodollars } \uparrow \Rightarrow \text{interest rates } \downarrow, \text{ asset prices } \uparrow \Rightarrow \text{leverage } \uparrow \Rightarrow \text{asset prices } \uparrow
  \]

- Eventually (Minsky moment; Ponzi finance)
  
  \[
  \text{high cost } \Rightarrow \text{slowdown } \Rightarrow \text{bad loans } \Rightarrow \text{Crisis, interest rates } \uparrow \Rightarrow \text{recession}
  \]

- Feedback mechanism during busts
  
  \[
  \text{recession } \Rightarrow \text{oil price } \downarrow \Rightarrow \text{Petrodollar flow } \downarrow \Rightarrow \text{interest rates } \uparrow \Rightarrow \text{recession}
  \]

- Low cost of production + monetary and fiscal policies (lag) \Rightarrow
  economic growth + geopolitical strife (lag) \Rightarrow \text{oil price } \uparrow
Lag in Oil-Price Responses, Lag in Capacity Development
Declining Real Oil Prices Precede Jumps
The Absence of Automatic Exchange-Rate Cycle Attenuation
Trade Deficits, Debts, Debased Dollars, and Oil

Crude oil price (left axis)

U.S. trade deficit (right axis)
Self-Perpetuating Cycle, Magnified during Financial Crises
Amy’s Presentation Will Cover Current Decline in Demand
China’s Dependent Business Cycle
The Dangerous Mirages of “Economic Miracles”
Beginning of the End for the Dollar Era?
Compare to British Pound A Century Ago

Total Official Reserves (millions of SDRs)

Percentage of Official Reserves in U.S.$
Upswing amplifiers: Cheap-money driven bubbles and financial crises
Amplification catalyst: Amnesia/hubris: “This time is different”
Downswing amplifiers: Socioeconomic & geopolitical costs

Saudi vs. U.S. Real Per-Capita GDP

Real Per-Capita Egyptian Worker Remittances
Paradox 1: Middle-East Sovereign Wealth Funds invest pro-cyclically (data collected by Chhaochharia and Laeven, 2008)
- Focus on private equity deals in Middle East
- Focus on oil & gas (ADIA), financials (KIA), utilities (QIA)
- U.S. exposure too much (KIA) or too little (ADIA)

Paradox 2: Banking crisis flight to safety led to Dollar appreciation!

Attenuate: Invest in fuel-production capacity during recessions

Diversify: Invest in alternative energy, green technology, etc.

Balance: America & Middle East need to consume less and invest more, Asia needs to consume more and save less