Lower oil prices are “good news” for the world economy

Lower oil prices are “good news” for the world economy, said the Executive Director of the International Monetary Fund (IMF) Christine Lagarde this week in the wake of OPEC’s decision not to cut production: “There will be winners and losers, but on a net basis, that is good news for the global economy,” said Lagarde during a panel discussion in Washington. Crude oil prices have fallen dramatically and lost about 30% since June, and currently stand at around 70 dollars a barrel, its lowest level in five years. They are poised to drop further still. Oil prices have risen to such an extent in the past decade that the public may have forgotten the concept of low oil prices being good for the economy. Indeed, high oil prices have always been considered a good predictor of future economic difficulties. The Yom Kippur War of 1973 and the Saudi led oil embargo, the Iranian revolution of 1979 and, more recently, the record increase in oil prices in 2008 have all paved the way for periods of great economic difficulties. The question is, then, why have people and the markets responded in a lukewarm or even concerned manner to what would normally have been the kind of news worth celebrating with expensive fermented beverages?

Some analysts had even warned that were oil prices to increase recorded they would have caused new problems to an already unstable international market. Compared to the difficulties 70s, mainly due to abnormalities in the supply, the current ones rely exclusively a problem of global demand, suggests the Nobel laureate economist like Paul Krugman. Since the amount of hydrocarbons present on earth is limited (but not as limited as the ‘peak oil’ preachers have led us to believe), rising imports from developing countries like China and India have created a difficult to eliminate imbalance. Nevertheless, high oil prices only benefit countries that have few other resources at their disposal. For most, they cause everything to be more expensive from food to cotton and any other commodity that requires transport. In fact, Krugman had warned in 2011 that high oil prices would hurt international economic recovery and generate yet another recession precisely because of excess demand for consumer goods and primary resources.

It comes as no surprise that Christine Lagarde says that the recent oil price collapse will benefit the major economies of the world and bring growth on the globe. “When you have a 30% decline …, this should result in a surplus (growth, note) 0.8% in most advanced economies which are oil importers,” a- she said. Of course, if she were addressing an audience in heavily oil reliant Russia, Saudi Arabia, Qatar and Kuwait, she would be speaking in less enthusiastic terms. Adding fuel to the fire, Lagarde spoke of ‘facts and figures’: the lower oil prices next year will push US GDP from 3.1% forecast last October to at least 3.5%. Similar benefits will come for the Eurozone, relieving a stagnant economic situation characterized by slow growth, low inflation and a high unemployment rate. Until the low oil prices, it seemed as if Europe was in a situation from which there is was no escape. Now, there is more impetus also for European leaders to take on structural labor market reforms along with a monetary policy that, according to Lagarde is “more aggressive and innovative”

Consumers are the big winners as the almost 40% drop in crude oil (and 35% for gasoline), will have an effect equivalent to a tax cut, because so much of their monthly budget (which is estimated as 4% for Americans and double that for Europeans) can now be directed to consumer discretionary spending. Saudi Arabia, OPEC’s undisputed leader, has been pursuing a tactic of bringing down prices up to render tar sands and shale oil, as well as renewable energy technologies, ‘inconvenient’ because of the latter’s much higher production costs than the traditional technologies employed in the traditional oil producing countries represented by OPEC and a few others like Russia. However, this strategy will not be very effective in the long term because, despite its efforts to discourage the growth of alternative oil and energy sources, OPEC will fail to disrupt investments in clean energy. Indeed, ‘green energy’ technology will be the target of 60% of the USD$ 5,000 billion worth of planned investments in the next decade, following the policy of the US, China and the EU to cut greenhouse gas emissions by promoting wind, solar, geothermal and other renewables – not to mention the dozens of thorium and traditional uranium powered nuclear reactors that China plans to build in the next decade. Green energy investments have been dictated by policy, which is hardly going to change course just because fossil fuels have become cheaper – for the time being – even if these same fossil fuels will still be an important source of the world’s energy mix for decades.

The global consequences of China’s higher than expected debt

China has recorded 250% debt according to Standard Chartered estimates. This figure, which essentially means that debt is 2.5 times greater than the size of its economy, suggests that China has also found it difficult to reconcile growth with ‘bubbles’. The 250% debt figure is not distressing in itself; what has raised economists’ concerns is the speed with which China’s debt level has risen: the ratio of debt to GDP in the second largest economy in the world was 251% in June 2014, while it stood at 147% at the end of 2008. Such an increase in the ratio between debt and growth in such a short period is worrisome because in other countries, increases of this magnitude in a short period of time have typically been followed by financial turmoil. China’s debt is not good for the world economy, and it is especially troubling for Europe’s economic recovery.

Europe’s recovery, according to recent statistics and to EU officials, is struggling to emerge. Even in Germany the IFO index, which reflects the level of business confidence, at the end of June fell to its lowest level since last fall. This summer, Germany’s recovery has been weaker than expected, despite the fact that it is the strongest economy in Europe. In fact, Germany’s first quarter of solid growth was driven more by domestic demand than exports; now it is starting to suffer from the slowdown of international markets. In particular, China is one of the main culprits accounting for the difficulties now faced by German exporters. The leadership of the People’s Republic seems to have chosen not to artificially inflate the rate of growth – at least not at the extreme levels of the past. In the second quarter, China grew at a respectable 7.5% (annualized), which was better than expected, but there was a reduction in purchases of capital goods – often made in Germany – that will likely not resume in the short term.

Germany now faces weaker import markets in both the emerging markets and the Eurozone, which will no doubt lead to a contraction of the German economy, and with it, demand for goods made in other industrial powers such as Italy, France or the UK. Oh, and as for the United States, it is experiencing a weak economic cycle and the International Monetary Fund has reduced the United States’ growth estimate to less than 2%. The IMF blames the increasing economic polarization whereby only to the richest 1% have seen their income increase, translating to a modest or insignificant increase in consumption. A collapse of the economy such as that seen since

2008 should have, in theory, produced an equally strong rebound, which has been slow in coming.

The tensions of war in Ukraine and in the Middle East may become more severe and further reduce chances for growth. The strong dollar does not help the European recovery and the stabilization of the spread between the weaker EU economies with Germany does not guarantee the low cost of debt. In 2015, the Fed may begin to raise interest rates even Europe and Italy will have to deal with a more expensive Dollar. Of course, in this scenario, commodities such as oil, gold and silver will experience higher valuations. Meanwhile, the recent BRICS (Brazil, Russia, India, China, and South Africa) countries summit in Fortaleza, Brazil, marked a further step towards the construction of a new international monetary architecture intended to break the unipolar dominance of the US Dollar and the old and the Bretton Woods system.

It is not all bad news. Resources and commodities should benefit from the new BRICS initiative designed to promote growth in regions that need it most. The heads of state of Brazil, China, India, Russia and South Africa have officially announced the creation of the new development bank and the Contingent Reserve Arrangement (CRA), namely the creation of a specific money supply fund. This allows the BRICS “to be less dependent on the dollar and more equipped to fend off any turbulence in the currency markets.” The new development bank has an initial capital of $ 100 billion. Its mission is to finance investment not only in the BRICS countries, but above all promote projects and infrastructure in developing countries, particularly in Africa. The BRICS have taken an important political step in the ever more multi-polar global chessboard. However, in this scheme the BRICS intend to become the leading supplier of machinery and other goods, thus giving a boost to their industrial and technological sectors.

In this sense, BRICS countries will try to develop more self sufficient resource bases and some, like China, may become more reluctant to export key raw materials that will be needed for internal use. Of course, these would include rare earths. In this sector, China will continue its policy of getting more foreign companies investing in downstream rare earth activity in China. And it goes without saying that the BRICS are self sufficient in energy resources, also having strong alliances with oil producers beyond the BRICS circle (Iran for instance). In Fortaleza, the BRICS accused the IMF of intervening in the richer industrialized countries (OECD), particularly those in the euro because of their persistent sovereign debt crisis. Thus the BRICS have launched alternative institutions.