Blame oil, not banks, for recession

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In his state-of-the-economy speech last week at Georgetown University, President Barack Obama explained the global markets meltdown of 2008 as an exclusively U.S. dysfunction – caused solely by Wall Street's "excessive debt and reckless speculation." He cited government as a malefactor only for its failure to stop the corporate pillaging. The economic calamity began, he said, with dubious mortgages in the housing market. The reason for these dubious mortgages wasn't a decade of easy credit; rather, it was that "Wall Street saw big profits to be made." The U.S. recession went global only after Wall Street packaged the dubious mortgages and peddled them worldwide.

Mr. Obama's explanation probably reflects the American, and indeed global, consensus. This is important politically because U.S. responsibility for the global havoc would provide cover for Mr. Obama's proposals to dump 20th-century capitalism for a tamer, government-managed 21st-century capitalism ("to ensure," he said in his Georgetown speech, "that we never find ourselves here again").

But a consensus judgment isn't necessarily a correct judgment. What if the consensus is wrong? Doesn't Mr. Obama run the risk of fixing the wrong things?

Writing in the New York Post, economist Alan Reynolds (senior fellow at the Washington-based Cato Institute and author of *Income and Wealth*) subjected the Made-in-the-USA argument cited by Mr. Obama to statistical analysis – and concludes that the timing shows it is "all wrong" to blame the United States for the global meltdown.

By the fourth quarter of 2008, Mr. Reynolds noted in the April 9 article, U.S. real GDP was only 0.8 per cent smaller than it was a year earlier. In Canada, the contraction was essentially the same, down by 0.7 per cent. Yet it was already twice as deep in Germany (-1.7 per cent) and almost three times as deep in Britain (-2.0 per cent). It was six times deeper in Sweden (-4.9 per cent) and 10 times deeper in Taiwan (-8.4 per cent).

By the end of February, 2009, U.S. industrial production was down 11.8 per cent from a year earlier – but other major economies were down much more. Industrial production in Singapore was down by 22.4 per cent, in Sweden by 22.9 per cent and in Japan by 38.4 per cent.

"U.S. industrial production only started to decline from its peak after January, 2008," Mr. Reynolds says. "[This was] long after production began to slow in Canada (July, 2007), Italy (August, 2007), France (October, 2007), and the euro zone as a whole (November, 2007). ... Japan's industrial production peaked in October, 2007."

By January, 2008, when the U.S. and European recessions are deemed to have begun, OECD leading indicators – guides to future economic performance – were lower by 0.8 points from the previous year in the United States but 2.3 points lower in Sweden, 2.8 points lower in Japan, 2.6 points lower in South Korea and 4.1 points lower in Ireland. Monthly stock prices, the most famous leading indicator of them all, peaked in October, 2007, in the United States, four months after stocks peaked in Japan and the euro zone.

"What was the mechanism by which U.S. problems were supposedly spread to other countries?" Mr. Reynolds asks. "It wasn't by international trade. The dollar value of U.S. imports didn't start to fall until August, 2008, and imports of consumer goods didn't fall until September – many months after Japan and Europe fell into recession." Further, U.S. bank failures didn't occur until September, 2008, almost a year after Europe slipped into recession.

Mr. Reynolds does not deny the U.S. housing boom, and eventual bust, of 2002 to 2008. He simply argues that it wasn't the housing boom that set off the global meltdown. "What really triggered this recession should be obvious," he says, "since the same thing happened before every postwar U.S. recession save one (1960)." The real cause, he says, was the spike in the price of crude oil.

The connection between oil price spikes and recessions was first advanced in 1983 by economist James Hamilton of the University of California at San Diego. He showed that almost all U.S. recessions have been preceded by spikes in the price of crude.

Using the Hamilton template, Mr. Reynolds notes that 10 spikes occurred between 1947 and 2007, each followed by recession. On this basis, Mr. Reynolds predicted that, writing in the Financial Times on Jan. 3, 2008, "the U.S. economy is likely to slip into recession because of higher energy costs alone, regardless what the Fed does."

From this perspective, bank failures in Britain and the United States were as much a consequence of recession as a cause. As Mr. Reynolds puts it, recessions turn good loans into bad. As for crude, he says simply that recessions lessen demand for oil – and end the spikes in oil prices.

Mr. Obama proposes to tax crude oil at progressively higher rates as part of his campaign to switch the United States to renewable energy. But the price that induces significant conservation could well be the price that also induces recession. This will make it harder for the President to keep his promise – a crude promise, indeed – to abolish recessions for all time.

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