Rex Features

Central banks worsen the global downturn

Quantitative easing – governments' injection of huge sums of money into the global financial system – is putting upward pressure on oil prices

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Chemical markets are suffering from the 'unintended consequences' of the efforts by the world's central banks to kick-start growth in the Western economy.

This is because the chosen policy of massive cash injections, know as Quantitative Easing (QE), into financial markets has instead helped to push oil prices to levels which have always led to recession in the past.

This "unintended consequence" is due to QE having led investors to become concerned about currency risk for both the US dollar and the euro, and about inflation risks. Crude oil markets have thus been seen as a potential "store of value".

Some now even believe oil markets should be seen as part of a broader commodities-based asset class, rivalling equities and fixed interest markets.

Oil markets have proved unable to absorb these one-sided flows of money. Those value investors who attempted to realign the market with the fundamentals of supply and demand were swept away. More central bank liquidity injections, as currently planned, can only make the situation worse.

As the chart shows, oil prices currently ac-

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count for 5% of global GDP. This compares to the more "normal" level of below 3%, as indicated by the dotted line. The mechanism by which this translates into recession is easily understood.

Consumers have little choice but to pay up for higher transport fuel and heating costs. They cannot simply abandon their cars, or sit shivering in the cold in their homes.

Manufacturers cannot absorb the increased cost of energy in their processes and logistic operations, no matter how efficient they have become.

Employees have generally not been able to compensate for these higher costs via wage increases. Thus the end result has been to reduce consumers' discretionary spending power, and force them to cut back on non-essential purchases. In turn, this reduction in demand makes it impossible for manufacturers to pass on their own higher costs, causing their profit margins to fall.

What is not so well understood is why the downturn only occurs after oil prices have risen sharply. Today, as in 2007/2008 and previous episodes of high oil prices, many observers assume that higher oil prices are a sign of strong demand. "How else would they continue to rise," they ask themselves?

Those of us in the industry who have lived through previous oil price hikes in 1979/1980, 1990/1991 and 2007/2008, know that the reverse is actually true.

Manufacturers are unable to adjust their prices on a daily basis to reflect higher oil prices. They are locked into fixed-price contracts with their end-user customers, often for six months or more.

When oil prices start to rise, they cannot simply sit back and see their future margins disappear. Instead, they are forced into the market to buy as much as possible before product prices rise.

This process continues until it becomes apparent that prices have plateaued. Then companies seek to destock again, but find this difficult as their immediate customers are also destocking.

At the same time, of course, end-consumers have been reducing their purchases, due to the loss of discretionary income. This then creates a double whammy for producers.

Essentially the issue is one of a lack of visibility down the often complex value chains that exist between manufacturers and end-consumers. Initially, as oil prices rise, rising inventories hide the fact that end-user demand is slowing. Everyone, including those involved, assume that "this time is different" and that demand is actually robust. Sadly, however, this is only perception, not reality.

Markets are no longer reliable forward indicators. The sad fact is that recent episodes of QE have sent false signals about the health of the economy and have confused policymakers, as well as company executives on the ground.

THE RULES HAVE CHANGED

Central bank liquidity has also reversed the previous rules of investment. In the past, higher oil prices were seen as bad news for stock prices, as they would increase the trade deficit and cause central banks to raise interest rates to reduce consumption. But since 2008, stimulus measures have instead fuelled high levels of correlation across the major financial markets.

A key result of this is that no single market now knows what it is meant to be pricing. In oil markets, there have been no major shortages of product on the scale of the 1979 OPEC embargo, or similar, to cause prices to rise. And production has actually been rising. US output, for example, has reversed years of decline, and is now back at 1996 levels. Similarly, inventories in the US and elsewhere have often been at near-record levels.

Since 2009, analysts have therefore been reduced to inventing explanations for these historically abnormal price rises. But with the benefit of hindsight, it is clear that none of the most prominent arguments – such as the inevitability of sustained growth in China's demand, or the potential for massive supply disruption due to the fall of the Gaddafi regime in Libya – have so far proved valid.

Oil markets have proved unable to absorb these one-sided flows of money

The underlying issue is that central banks appear to be missing the key factor behind the current slowdown in Western growth rates. To paraphrase a slogan from Bill Clinton's successful 1992 presidential campaign: "It's the demographics, stupid."

DEMOGRAPHICS AT PLAY

The western Baby Boomers, those born between 1946-1970, are the largest and wealthiest generation that the world has ever seen. As they entered their wealth-creating period, aged 25-54 years, they powered an economic "supercycle" between 1982-2007. This is when people normally settle down, have children and move ahead in their careers. But since 2001, the oldest Boomers have been leaving this period of their lives and joining the New Old 55+ generation.

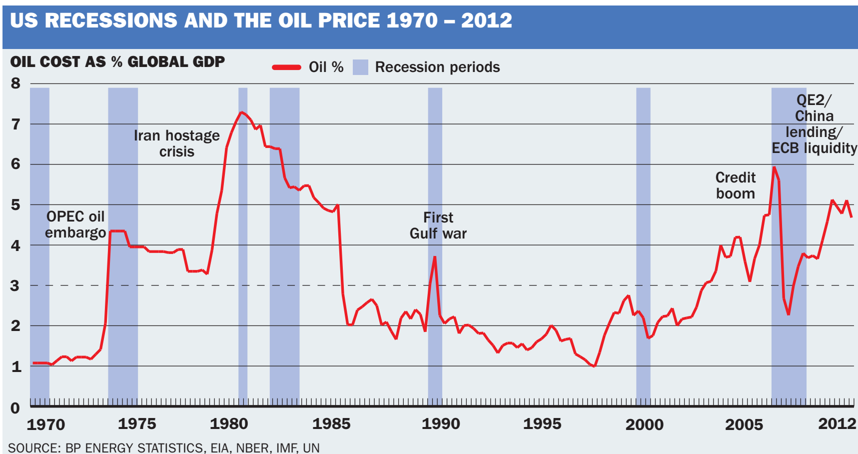
Official government data, such as the US Consumer Expenditure Survey, shows that the over-55s typically spend much less than when they were younger. The children have usually left home, so they have little need for new consumer durables such as autos and household goods. Instead, they only buy on a replacement basis, when the old refrigerator or washing machine breaks down.

This trend is likely to intensify with the Boomers. They can look forward to a decade or more of active life compared to previous generations, thanks to increasing life expectancy. But the failure to properly anticipate this change means that people have to spend less, and save more, in order to finance their extended lifespan.

Statistics show that 29% of the Western population (272m) are already in the New Old 55+ generation, and their numbers are increasing year by year. Thus it is inevitable that the West will see slower growth in the future.

Central banks are therefore pushing on the proverbial string with their efforts to stimulate the economy via QE programmes. The West's ageing population means the days of perpetual growth and pent-up demand are over. Even worse, their efforts have already increased oil prices to levels that make it more likely we are now on the verge of a new recession. ■

US RECESSIONS AND THE OIL PRICE 1970 – 2012



SOURCE: BP ENERGY STATISTICS, EIA, NBER, IMF, UN

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