Countdown to $200 oil meets Anglo Disease

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One of the more interesting things about this Friday's economic news was the very obvious connection between the unemployment number and oil prices. What links the two is debt, the defining feature of what I have called the Anglo Disease, ie the highly unequal economy whereby the rich and the financial sector (almost the same thing these days) capture most of the income but hide it by providing cheap debt to the middle classes so that they can continue to spend.

Oil has played a fascinating side role in my Anglo Disease series, allowing the debt bubble to go on for much longer than expected. But now, instead, it is accelerating the crash. Let me take you through the whole cycle.

Anglo Disease diaries

Countdown to $200 oil diaries

A good summary of what the Anglo Disease is about can be found in this diary, written up as an Op-Ed text, but let me take you through the concept again:

- the name mirrors that of the "Dutch disease", which was coined to describe the impact of the rapid development of the oil&gas sector in the Netherlands on therest of the economy: the high profitability of the new sector captured a high share of investment, thus weakening other parts of the economy, which were partly neglected; in addition, the fact that it created a large boost to exports pushed the currency up, thus further making other industrial activities uncompetitive in what was a largely export-oriented economy. The "Dutch disease" describes that shrivelling of the rest of the economy as money flowed to oil&gas producers.
- in today's economy, the cannibalistic sector is not oil&gas, but finance. Bankers, through debt, have the ability to convert future cash-flows into immediate profits. Such immediate returns attract more capital, talent and resources (which cannot go to other sectors) and impose an iron discipline on the rest of the economy: those that provide the debt want to ensure that the future cash-flows will indeed materialize, and move in to ensure a relentless focus, in the underlying activities, on profitability at the expense of all other criteria. The immediate contribution of the financial world to measured GDP and growth makes it a popular industry, thus reinforcing its influence - and spreading out its way of thinking, focused on monetary gains and financial "efficiency." So not only the rest of the economy gets squeezed for any extra drop of profitability, but the language of financial analysts becomes the dominant one of not only economic discourse but also political discourse;
- one of the more attractive features of the financial world, for its promoters, is its ability to concentrate huge fortunes in a small number of hands, and promote this as a good thing (these people are said to be *creating* wealth, rather than **capturing** it). Making money, lots of it, is the ultimate arbiter of not just success, but also morality;
- of course, the reality is that such wealth concentration is created by squeezing the rest, as is obvious in the stagnation of incomes for most in the middle and lower rungs of society. This

is not so much wealth creation as wealth redistribution, from the many to the few. But what has made this unequality (the fundamental feature of the Anglo Disease) tolerable is that the financial world itself was able to provide a convenient smokescreen, in the form of cheap debt, provided in abundance to all. The wealthy used it to grab real assets in funny money, and the rest were kindly allowed to keep on spending by tapping their future income rather than their insufficient current one;

- in a nutshell, the debt bubble hid the class warfare waged by the rich against everybody else, conveniently trapping those that could not or would not live within their means in the system, by making their livelihood increasingly dependent on not rocking the boat.
- but the debt bubble was (duh) a debt bubble, and it is now bursting, as it inevitably would. What matters is how the pain is shared, and, right now, it does not look as it will be shared the same way the loot was on the way up. The whole cycle was just a way to permanently transfer wealth from the many to the few. It was wilfully created by the combination of ultra low interest rates as set by the Fed (thus my moniker of "Bubbles" Greenspan), tax cuts for the rich (Bush's helpful but hardly invisible hand) and the permanent propaganda for liberalisation, deregulation, "reform" and "freedom."

The outside world had a role in this bubble, because part of the squeeze on the working classes was made possible by the threat of outsourcing and offshorisation to China, India et al (which kept wages in check and workers tame), and a lot of the bubble was in turn funded by the surplus cash generated by these countries through their exports and their policies to keep their currencies weak (to maintain their price competitivity), which had them accumulate huge amounts of dollars which they then lent back to the US via the purchase of Treasurys.

This is where oil shows up for the first time in the story: the growing demand from China, India et al. started pushing prices up as this happened at a time when supply was suddenly become tighter.

Paradoxically, the oil price increases provided an additional boost to the debt bubble: while they started biting into consumer spending, they also generated a new round of cheap liquidity, as oil producing countries suddenly found themselves with huge amounts of money, in dollars, which they could not, or chose not to, spend right away - presto, these were invested into Treasurys, ie loaned to the US. This provided the liquidity to finance consumer spending in the US (including for gas) and kept the interest rates on long term debt very low (demand for bonds pushes the price for bonds up, and thus brings the yield, is the interest rate, down). This happened at a time when the Fed had finally decided to increase its short term rates as it could no longer justify the extravagantly low rates of 2001-2004 and created what Greenspan called his "conundrum" - that apparent disconnect between short term and long term interest rates. It was just the bubble going on afterburner, thanks to oil prices.

Effectively, the liquidity created by high oil prices **hid for two years** the fact that the bubble was bursting.

But now, everything is aligned - in the wrong direction:

- the debt bubble is bursting, as long announced by observers not blinded by greed or ideology, with all the expected pain: the real estate crash, the banking crisis, the foreclosures, and the coming inevitable recession;
- the income capture mechanisms set up during the bubble have not been reversed, so the pain is falling disproportionately on the poorest, and the finance world (ie the rich) is being bailed out. The rescue of Bear Stearns may have inflicted pain on shareholders, but it saved bondholders, which is unprecedented and ominous. Public discourse is still largely about "reform", tax cuts and "letting the market" solve things;
- and oil prices are still going up, and are biting increasingly hard into people's incomes. They are going up because of global trends (oil production from friendly regions are

inconveniently declining now, after a couple of decades temporarily hiding the reality of global scarcity; the countries that piggybacked on the US debt-fuelled growth have prospered and are consuming more, oil producing countries are booming and using more oil themselves, and their growing prosperity makes them more assertive and less willing to listen to Western pleas to produce more and/or to let oil majors have access to their resources: thus, for a combination of political and geological reasons, oil supply is stagnant), and our own economic woes will not be enough to bring them down: they will thus worsen the economic outlook here;
- an additional factor that comes in is that an alternative to the dollar exists: the euro. For the first time, the rest of the world has the possibility to store value elsewhere than in dollar-denominated instruments. The debt bubble was largely a dollar phenomenon, and the easiest way to deflate it is to lower the value of the dollar. Gold played that role in the past, but it's not that convenient a tool; now the euro is the perfect outlet to express skepticism about the value of the dollar. As this makes investors less keen to hold dollars able to actually do something about it, it WILL drive interest rates up in the US, after many years of flows the other way round keeping them down.

Yesterday was a perfect demonstration of these links. Beyond the bellicose words against Iran coming from Israel, what drove the markets yesterday was the announcement that the unemployment rate had gone up a lot more than was expected (to 5.5% instead of the 5.1% predicted by analysts). That announcement, in turn, made the markets brutally change their expectations about future Fed rate changes. They had been expecting increases in the coming months, to fight inflation, but increases are impossible, politically, at a time when unemplyment is going up rapidly. The expectation of lower short term rates in turn drove the dollar down (especially as this came the day after the European Central Bank said that it would increase rates itself this summer). The flight away from the dollar then pushed commodities up, and in particular oil. As speculators had been betting on oil prices going down, they were wrongfooted and had to abandon their positions brutally to avoid further losses, thus magnifying the price increase (*an aside here: speculators were betting on oil going **down** not up*).

So there you have it: wage stagnation (Anglo Disease) and oil production stagnation (the fundamental driver of the Countdown diaries) combining in a perfect storm. But hey, the financiers are still sitting pretty, and will say that more "reform" and "deregulation" and tax cuts are needed.

Maybe it's time to stop listening to what is highly self-interested drivel, and take back what they grabbed: it's not theirs. And maybe it's time to actually worry about using lots less oil (and gas and coal).

And, wonderfully, a programme to invest in housing and vehicle energy efficiency, renewable energy, and infrastructure, paid for by massive tax hikes on the rich, will help solve the current recession and the oil crisis.

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