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The Oil Trap: The Devastating Economic Impacts of Spiralling Oil Prices

By [Mike Whitney](#)
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Rising oil prices threaten to derail the recovery. Oil at $106 per barrel (Monday's price) is not a problem, but oil at $160 is. With fighting increasing in Libya and social unrest spreading across the Middle East, no one knows where prices will settle. That leaves Fed chairman Ben Bernanke with a tough decision. Should he call off QE2 prematurely and let the stock market drift sideways or go-til-June and hope for the best? If the Fed tightens too early, deflationary pressures will reemerge further straining bank balance sheets and consumer spending. Housing prices will fall sharply and foreclosures will mushroom. But if Bernanke holds-firm with his zero rates and bond buying program–especially when the ECB is raising rates–he could trigger a bond market rout and send the dollar into freefall.

Bernanke has shrugged off the inflationistas saying that core inflation is still hovering at a safe 1 percent. But if oil keeps climbing, consumers will have to cut back on spending just when Obama's fiscal stimulus is winding down and just as the states are trimming their budgets. That will be a drag on economic activity and slow growth. Business investment will shrink, hiring will sputter, stocks will retreat, and the economy will head back into negative territory. It all depends on the price of oil. Here's Gluskin Sheff's David Rosenberg providing a little context to the fact that oil has "doubled" in just two years:

> "There have been only five times in the past 70 years when this has happened within a two-year time frame: January 1974, November 1979, September 1990, June 2000, and August 2005. And now, December 2010. . . .
>
> Of the five instances cited above, all but one involved a recession for the U.S. economy and that was in 2005 during the height of the credit and housing boom, which acted as a huge offset. But oil prices did keep rising and managed to outlast the euphoria in credit and residential real estate, so the recession

> may have been delayed at the peak of the 'growth rate' in the oil price, but it was not derailed as history shows." (The Big Picture)

So spiking oil prices and recessions go hand-in-hand. Accordingly, bond yields have been trending lower anticipating deflation while the shriveling dollar has been steadily slipping for more than a month. All of this is adding to investor anxiety. Wall Street is on tenterhooks waiting to see whether Obama will tap the National Oil Reserve to stop the bleeding or just cross his fingers and hope that the violence subsides before the economy nosedives. And then there's Bernanke. What will Bernanke do?

Most likely, the Fed chair will stay-the-course as long as possible convinced that deflation is still enemy Number One. But he's bound to take a lot of heat from critics who point to the tumbling dollar and higher prices at the pump. If the troubles in Libya spread to Saudi Arabia, as now seems likely, all bets are off. Bernanke will have to pull out all the stops to keep the economy from tanking.

Bernanke does have alternatives, although none that assure that the smooth transfer of wealth from worker to banker. (like QE2) He could, for example, appeal to congress for a second round of fiscal stimulus to increase employment, reduce the output gap, and show trading partners that the US is eager to generate more demand for global exports. That would increase goodwill among US allies while building a stronger foundation for growth. To hell with the deficits. When the economy is firing on all 8 pistons and revenues are poring in, the deficits will vanish by themselves.

And there are other options, too, even if Bernanke chooses to stick with monetary policy alone. Here's a clip form a recent report by Richard Wood titled "Deflation, Debt and Economic Stimulus":

> "The US, Japan, and Ireland are suffering from deficient private demand, rising debt, and a tendency to deflation.....The alternative approach (to quantitative easing) involves the central bank printing new money to directly finance fiscal stimulus. This neglected policy option – apparently largely overlooked by officials during the global economic crisis – is likely to be appropriate for countries where prices are falling (or inflation drops toward zero), private demand is deficient, interest rates are already too low and where public debt is excessive.
>
> If monetary policy is considered on its own then there could be a case for terminating current quantitative easing programmes. This would steer Japan and the US away from the shoals of triple jeopardy (Leijonhufvud 2011).
>
> Quantitative easing could be replaced with a policy of printing new money with an explicit objective to assist in the financing of future budget deficits (see suggested money-financed tax cut: Bernanke 2002 and analysis by Corden 2010). The deployment of new money creation in this manner would take some pressure off the need for severe fiscal austerity measures (at a time when continued stimulus is still required); minimize further increases in public debt; provide clear signals of policy intent (in relation to interest rate objectives, the method of financing deficits and the approach to delivering economic stimulus); and be more effective, have fewer adverse side-effects, and deliver stronger economic stimulus than further quantitative easing." ("Deflation, Debt and Economic Stimulus", Richard Wood, VOX)

Ahh, the dreaded monetization of the debt. It's a bad choice compared to fiscal stimulus, but vastly superior to QE2.

Ask yourself this question: Who benefits from QE2? Bernanke even admitted in an op-ed in the Washington Post that the program was aimed at boosting stock market prices. And former Fed chairman Alan Greenspan was even more explicit in an article that will be published in an upcoming issue of International Finance. Here's what Maestro has to say:

"I still embrace the view I held a couple of years ago, that '[w]e tend to think of fluctuations in stock prices in terms of "paper" profits and losses somehow not connected to the real world. But, the evaporation of the value of those "paper claims" can have a profoundly deflationary impact on global economic activity. … [such] that much of the recent decline in global economic activity can be associated directly and indirectly with declining equity values….

> 'When we look back on this period, I very much suspect that the force that will be seen to have been most instrumental to global economic recovery will be a partial reversal of the $35 trillion global loss in corporate equity values that has so devastated financial intermediation. A recovery of the equity market driven largely by a receding of fear may well be a seminal turning point of the current crisis.'…
>
> Equity values, in my experience, have been an underappreciated force driving market economies. Only in recent years has their impact been recognized in terms of 'wealth effects'. This is one form of stimulus that does not require increased debt to fund it….
>
> Despite the surge in corporate cash flow over the last two years and expectations of security analysts of continued gains in profitability, equity premiums remain near a half-century high. This indicates an exceptionally large and presumably unsustainably high discount rate applied to expected future earnings. If the latter holds up, and activism recedes, stock values, of course, would move higher and carry with them a significant wealth effect that should enhance economic activity.
>
> Short of a full-blown Middle East crisis affecting oil prices, a euro crisis and/or a bond market (budget) crisis reminiscent of 1979, the 'wealth effect' could effectively substitute private 'stimulus' for public." ("The costs of government activism", Alan Greenspan, EurekAlert)

There you have it; Fed policy in a nutshell. If you want to reverse deflation and ignite a "global economic recovery"; pump up stock prices. In other words, if we just make the rich even richer, our problems will be solved. What could be simpler?

How is this any different from "trickle down" economics? It's the same thing, which is to say that QE2 is the same thing. The goal is to increase the "wealth effect" for the investor class to such an extent that the spillover lifts the rest of the economy back to prosperity and growth. It's baloney. QE2 has done nothing to increase demand or help consumers patch their battered balance sheets. The economy is more vulnerable than ever and skyrocketing oil prices could be the shock that sends the economy skittering back into recession.

Bernanke has other options. It's just a matter of whose interests he chooses to serve.

Mike Whitney lives in Washington state. He can be reached at: fergiewhitney@msn.com.

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