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978-0-521-89614-6 - Oil, Dollars, Debt, and Crises: The Global Curse of Black Gold

Mahmoud A. El-Gamal and Amy Myers Jaffe

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## Oil, Dollars, Debt, and Crises

### *The Global Curse of Black Gold*

*Oil, Dollars, Debt, and Crises* studies the causes of the current oil and global financial crisis and shows how America's and the world's growing dependence on oil has created a repeating pattern of banking, currency, and energy-price crises. Unlike other books on the current financial crisis, which have focused on U.S. indebtedness and American trade and economic policy, *Oil, Dollars, Debt, and Crises* shows the reader a more complex picture in which transfers of wealth to and from the Middle East result in a perfect storm of global asset and financial market bubbles, increased unrest, terrorism and geopolitical conflicts, and eventually rising costs for energy. Only by addressing long-term energy policy challenges in the West, economic development challenges in the Middle East, and the investment horizons of financial market players can policy makers ameliorate the forces that have been causing repeating global economic crises.

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**Mahmoud A. El-Gamal**

*Rice University*

**Amy Myers Jaffe**

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*Foreword by James A. Baker III*



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## *Foreword*

The current economic and financial crisis – by all appearances, the worst since World War II – has already generated a vast amount of commentary. Some have been polemical. Some have been measured. Analysis has ranged from the well-informed to the superficial. But most have, understandably, focused on the immediate causes of the crisis. An unsustainable real estate bubble, shoddy credit standards, disastrous risk management by major banks, counterproductive incentives for managers, the rise of esoteric and unregulated financial instruments, and broad-scale failure by regulatory agencies are just a few of them. All are important. And all will need to be addressed by policy-makers and financial executives as they forge strategies to avoid similar crises in the future.

Yet there are even larger factors at work. A number of observers, for instance, have stressed the role of structural global imbalances in creating an environment conducive to the world-wide financial turmoil witnessed in 2008. Surely, the perverse Sino-American financial relationship – under which, essentially, relatively poor Chinese loan their savings to relatively affluent American consumers – played an important part in fostering the loose credit that helped precipitate the current crisis.

*Oil, Dollars, Debt, and Crises* by Mahmoud A. El-Gamal and Amy M. Jaffe addresses another structural global imbalance. Their subject is the huge transfer of resources from energy-importing to energy-exporting countries. This transfer, prompted by the rise in petroleum and natural gas prices that began in the late 1990s and sharply accelerated in the middle of the present decade, created giant reserves of petrodollars that, in turn, helped to overheat financial markets in the United States and elsewhere.

The book is remarkable on several counts. First is its timing. Begun in 2006, before today's financial turmoil exploded into public consciousness, *Oil, Dollars, Debt, and Crises* is impressively prescient in highlighting the risks associated with major imbalances in the global financial system.

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Second, the book moves well beyond economic analysis to assess other factors that shape production decisions by major energy exporters. These factors include institutional weakness, domestic constituencies, internal opposition movements, and, not least, an often harsh geopolitical environment. The last is particularly salient. The world's most important energy producing region – the Middle East – is one long characterized by simmering animosities and outright conflict.

Third, El-Gamal and Jaffe detail the role of international energy markets – largely denominated in dollars – in sustaining the United States' unique role as supplier of the world's reserve currency. Ironically, the current crisis has seen a flight *to* the dollar, as international investors lower their exposure in riskier currencies. But the long-run viability of the dollar as the *de facto* reserve currency of the world (absent a sustained increase in our national savings rate) is for the first time beginning to be an open question.

Above all, the authors continually – and rightly – stress the *global* nature of the challenges confronting us. Even so large an economy as the United States can no longer be analyzed in isolation. Chinese fiscal policy matters. So do European interest rates. And so does military conflict in major energy producing regions such as the Persian Gulf. The integration of the world economy has led to substantial gains from increased trade and investment. But it has also raised the risk of financial contagion. And it has made international coordination all the more important *and* difficult. Such cooperation was hard enough when I was U.S. Secretary of the Treasury from 1985 to 1988. Today, with immensely greater capital flows, critical new players like China, and a plethora of opaque financial instruments, the task is even more daunting. The hard reality – rather than the easy rhetoric – of globalization infuses *Oil, Dollars, Debt, and Crises*.

I know and admire both the authors. Mahmoud is a brilliant scholar with an impressive background that includes work as the International Monetary Fund's desk economist for the West Bank and Gaza. Amy is one of the nation's top energy experts, with decades of experience with oil and gas markets. Together, they give *Oil, Dollars, Debt, and Crises* a richness of analytic texture rare in books of its kind. Both, I am proud to say, are affiliated with the James A. Baker III Institute for Public Policy at Rice University.

We may be certain that economists and historians will be assessing today's crisis for years to come. Indeed, the current turmoil has revealed the extent to which, seventy years after the event, informed observers still differ sharply on the causes of the Great Depression. In short, the debate about today's crisis has just begun. *Oil, Dollars, Debt, and Crises* will surely hold an early and estimable part in it.

James A. Baker, III, Honorary Chair  
Baker Institute for Public Policy, Rice University

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## *Preface*

We began to work on this book in late 2006. At the time, we felt that the problem of petrodollars was not receiving sufficient attention, a short presentation by Saleh Nsouli of the International Monetary Fund (IMF) on “petrodollar recycling and global imbalances” in March 2006 notwithstanding. Discussion of global trade and financial imbalances and the sustainability of the Dollar-centered international financial system were still mainly concerned with accumulated reserves in Asia, especially China. As we show in this book, both groups who thought that the system was sustainable for another decade and those who thought that it wasn’t seemed to ignore the role of petrodollars in accelerating systemic instability.

As we started to work on the book project, we discovered a bigger problem yet: the literatures on energy markets, financial markets, and Middle-East geopolitics were highly compartmentalized, with few notable exceptions that are cited in this book. Our focus therefore turned to integrating all three domains of investigation and showing that all three spheres integrate to perpetuate, and potentially to amplify, a cycle that we were witnessing for the second time in our own lifetimes. We were both struck by the remarkable similarities between the events that we were observing in 2006–7 and those that we had earlier witnessed in 1979–80, and reached the conclusion that we are likely to see a steep spike in oil prices followed by a crash and severe global recession.

We knew enough to know that history does not repeat itself exactly. Therefore, we spent considerable effort trying to understand the cycle and its consequences, in part to address skepticism in 2007, including by Cambridge University Press referees, regarding our claims of fragility of the financial system. The book in your hand contains some of the facts and analysis that we accumulated to justify the assertions that we made in our initial book proposal. However, in the interest of brevity, we deemed it best to tone down our lengthy arguments of why “Peak Oil” theories were overstated and we were in fact in the midst of a speculative bubble in oil futures. Fragility of the global financial system hardly requires much

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proof at this point in time, and indeed previous authors who have analyzed this fragility, such as Hyman Minsky, have become posthumous best sellers as their views have gained currency anew. We may, of course, have been simply lucky in making those assertions, but we leave it to the reader to decide.

If we are at least partially correct in our analysis, then the cycle is likely to repeat, with most of its characteristics intact, at least one more time. Global economic recovery from the financial meltdown in late 2008 and early 2009 may take a few years, but low interest rates, moderate oil prices, and probable avoidance of 1930s-style breakdown of international trade suggest that the recovery will be vigorous when it arrives. Our analysis, presented in the pages before you, suggests that even the best efforts in migrating to alternative fuels will not be sufficient to wean the world economies from dependence on fossil fuels during this phase of the cycle. The other forces that we discuss in this book, geopolitical and financial, are also likely to remain intact, therefore forcing the world through at least one more upswing and downswing of the cycle – the third such phase of the cycle since the early 1970s.

Many of the ways that the world has changed – especially globalization and proliferation of weapons of mass destruction – make the downswings of the cycle potentially catastrophic, especially in light of the geopolitical interactions with energy and financial markets that we analyze in this book. Consequently, we slowly converted this project to produce a “policy book” focused on those interconnections that have not been systematically analyzed by other authors. Policy books often focus on mechanics of solutions, but we explicitly aimed to show that there are cycles in such policy mechanics, for example in regulating various markets, which are themselves part of the bigger cycle. The book has therefore become what we may consider a meta-policy book, one that focuses on the general framework and urges policy makers and analysts alike to be cognizant of “unanticipated consequences” of their policy advice that may in fact be possible to anticipate.

We would like to thank the James A. Baker III Institute for Public Policy and the Institute for Energy Economics of Japan for their generous support for this research, which grew out of the Baker Institute’s study: “The Global Energy Market: Comprehensive Strategies to Meet Geopolitical and Financial Risks – The G8, Energy Security, and Global Climate Issues.” We would also like to acknowledge the following Baker Institute research staff, research assistants, and interns who assisted us in this project: Basil Awad, Jareer Elass, Ibrahim Ergen, Lauren Smulcer, Adnan Poonawala, Devin Glick, Julie Chao, and Matthew Schumann.

Mahmoud A. El-Gamal and Amy M. Jaffe  
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