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SUBPRIMING THE PUMP

Oil wealth used to hurt only those who had it. Now, it's hurting everyone.

By Mahmoud A. El-Gamal and Amy Myers Jaffe

The resource curse has gone global.

For years, oil wealth was mostly a danger to those, paradoxically, who possessed it. Resource-rich Middle Eastern countries, and their labor-exporting neighbors, failed for decades to invest adequately in their people or to diversify their economies. A massive influx of oil receipts and worker remittances discouraged investment in sectors conducive to steady long-term growth, fostered corruption and patronage, inflated regional real estate and stock markets, and provided irresistible incentives for governments to spend with wasteful, shortsighted abandon.

But today, the Middle East's resource curse is spilling over into the international financial system. Unanticipated petrodollar flows are fueling financial bubbles, financing a Middle Eastern arms race, and damaging the global economy through speculative oil-price feedback loops. All the elements of previous boom-and-bust cycles in the 1970s and 1980s and again in the past decade remain in place.

What's happening is both comfortingly familiar and terrifyingly new. Sudden surges in oil-revenue flows to and from the Middle East—known as "petrodollar recycling"—have certainly been a problem before. But in the last few years, they have become critically destabilizing. Today's Great Recession has generally been understood as a story about real estate excesses and regulatory shortcomings. But it's also a cautionary tale about the increasingly pernicious role that oil is playing in the global economy.

Into the middle of this decade, economists' worries were focused on global imbalances between China and the United States. For Harvard University economist Lawrence Summers, now a top White House advisor, the world was caught in the grip of "a balance of financial terror." Deutsche Bank researchers argued that this temporary imbalance, wherein Chinese excess savings financed excess consumption in the United States, constituted nothing less than an informal sequel to the Bretton Woods international financial system, one they thought would be sustainable for a few more years.

But this optimistic analysis overlooked a major piece of the global economic puzzle: oil receipts. Leading into 2006, the capital exiting Saudi Arabia and Kuwait alone matched the funds leaving China (approximately $200 billion per year). For five years, from 2003 to 2008, the Middle East's massive petrodollar outflows, combined with excess liquidity due to low interest rates and a

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voracious appetite for credit risk, fueled bubbles in global financial markets, including real estate, credit derivatives, and ultimately commodity prices. The investment frenzy pushed markets into what the late economist Hyman Minsky called "Ponzi finance." Unsustainable serial financial bubbles distorted incentives toward the financial sector and away from investments more conducive to long-term economic growth, such as infrastructure and research and development, especially for alternative-energy fuels.

In this way, interconnected financial markets have globalized the resource curse, and all countries with relatively open economies and limited capital controls are now exposed to energy-market risks as a result—even ones as diverse as Britain, Russia, and the United States, which are blessed with their own plentiful supply of fuels. As we saw last year in spectacular fashion, financial contagion feeds back and amplifies demand-driven spikes in oil prices, exacerbating the eventual real-economy slowdown that economist James Hamilton and others have noted.

How did this happen? Capitalist economic systems, as Minsky, Charles Kindleberger, and other economists have argued, are intrinsically unstable. Prolonged periods of economic growth invite growing appetites for risk, as optimism about rising profits and lower rates of bankruptcy lull investors into a false sense of security. Optimism ultimately grows into euphoria, which former U.S. Federal Reserve Chairman Alan Greenspan famously called "irrational exuberance," as investors bid up asset prices with ever increasing leverage. Meanwhile, financial-sector lobbyists convince legislatures to ease or underexpand prudential regulations and "unleash the power of laissez-faire capitalism." Myopically, the seeds for financial disaster are sown.

Today's Great Recession is a cautionary tale about oil's pernicious role in the global economy.

During boom times, as we saw in the years leading up to 1973 and again after 2002, the rise in oil demand strengthens oil producers, which reap massive profits by intentionally underinvesting in oil-production capacity. Oil prices continue to rise, filling their treasuries with a sudden influx of capital that cannot be absorbed at home. Petrodollars flow out, seeking returns in already inflating financial markets and pushing bubbles to dangerous levels.

As the business cycle turns, the euphoria begins to wane. Investors assess financial risks more accurately. Interest rates rise, further feeding the downswing. The irrational exuberance that amplified the boom quickly reverses course, accelerating the bust. Demand for oil collapses, causing oil prices to crash. Petrodollar flows dry up, hitting financial markets and real-sector growth still harder. Then, reduced liquidity and credit prevent oil exporters from investing sufficiently in productive capacity during the recession, and our story eventually repeats, each time more dramatically than before.

The geopolitical component of this mega-cycle is equally insidious. As oil-producing countries amass substantial financial reserves, they tend to allocate investment and expenditure disproportionately less to oil-production capacity and more toward areas that benefit the ruling elites. In the Middle East, significant portions of oil receipts have been spent on arms purchases, which protect the ruling class from both external threats and internal challenges—indirectly, by appeasing military leaders who might pose a threat, and directly, by stifling opposition through robust internal security spending. (Military personnel as a percentage of the labor force is a very high 3 percent in the Middle East and North Africa, and military expenditures as a percentage of GDP are also consistently high, for example 9 percent in Saudi Arabia.)

Oil-importing advanced economies such as France and the United States, which eagerly sell weapons as a means of recycling petrodollars, cannot escape their own complicity in this game. Middle Eastern arms races boost not only the arsenals of national militaries, but also of subnational militias and even terrorist organizations. Iran's long-standing support of Hezbollah, for example, is well documented. The flow of weapons increases geopolitical risks, once again increasing oil prices as fears grow that military conflict or terrorist threats will disrupt supplies. Put bluntly, a little bit of terrorism is good for oil exporters.

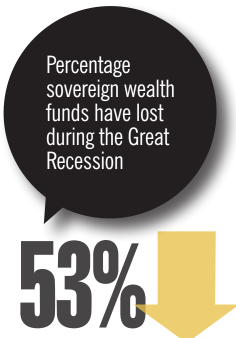
And the links between oil and terrorism don't stop there. As oil exporters mimic the consumption behavior of advanced economies during booms, young populations develop highly unrealistic expectations, premised on a sense of entitlement to oil wealth. It's these frustrated expectations that drive youth toward radical and militant ideologies, not poverty per se. In Saudi Arabia, for example, real per capita income in the early 1980s was higher than that of the United States. Saudi nationals were accustomed to free housing, guaranteed incomes, and subsidized electricity and gasoline until low oil prices caused budget cutbacks in the mid-1990s. The Sept. 11, 2001, hijackers, after all, were mainly educated middle-class men. They were undoubtedly influenced by the arguments of Osama bin Laden, who in the 1990s was raging against "the greatest theft in

A Hole in the Bucket

By Veljko Fotak and Bill Megginson

What a difference 18 months can make. As recently as the beginning of 2008, sovereign wealth funds owned by governments flush with massive oil revenues appeared to be the rising titans of global finance, leading some commentators to decry the rise of a "sharecropper economy" in the United States.

Buoyed by high oil prices and the bubbles they fueled, the funds purchased massive equity stakes in several Western investment and commercial banks, such as Abu Dhabi Investment Authority's $7.5 billion purchase of a 4.9 percent stake in Citigroup in November 2007 or Qatar Investment Authority's decision in October 2008 to increase its stake in Credit Suisse to 8.9 percent, becoming the company's biggest shareholder. The 32 funds we studied (13 of them tied to Middle Eastern petrostates) collectively made 12 very large stock purchases, totaling $63.33 billion, between November 2007 and February 2008—and 11 of the deals in this period, worth $61.33 billion, involved direct purchases of stakes in distressed Western financial institutions. Surprisingly, these stock purchases were for the most part cheered by European and American governments and investors; the funds were even hailed as saviors for "rescuing" banks from the financial fallout of the subprime mortgage crisis.



But the good times came to an unhappy end by the beginning of this year. The sovereign wealth funds' listed stock investments plummeted in value as the financial crisis wiped several trillion dollars in market capitalization off the world's markets, with banking stocks by far the worst hit. At the same time, fund managers made some disastrously bad choices about the stocks they picked, clustering their purchases within a small handful of moribund Western companies. According to our research, sovereign wealth funds lost a staggering $66.88 billion on their publicly disclosed investments and experienced a total return of negative 53.23 percent from the date the investments were made through March 27, 2009. The $42.67 billion of losses on the 11 ill-timed financial investments of late 2007 and early 2008 accounted for two thirds of this total.

It's not simply the managers' fault. These are, after all, state-owned investment funds. As our data suggest, poor stock picking could have been the result of pressures that forced managers to invest in distressed industries and firms for political reasons. Whatever the case, it's clear that the next time a Western company needs bailing out, the Abu Dhabis and Qatars of the world won't be so quick to show up with a bucket.

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history," arguing that the real price of oil in late 1979 should have persisted for the next two decades.

Needless to say, military spending, distribution of oil rents to favored segments of society, and the resulting culture of consumerism do little to ensure long-term economic development. When oil revenues shrink in the downturn of the cycle, unemployment and reduced rent redistributions feed anger, just when the state's ability to spend on security and population appeasement is waning.

How can we escape the global oil curse? Diversifying and developing Middle Eastern economies to create employment opportunities and absorb occasional petrodollar flows is crucial. Oil exporters also need to think more strategically by investing in oil-production capacity during recessions and amassing aboveground reserves when prices are low to sell when prices are high.

Oil consumers also have long-term options. Large economies such as the United States, Japan, and China can reduce their oil consumption by investing in alternative energy, fuel-efficient technology, and public transportation. They can also wield their strategic oil stockpiles as a cudgel against speculators—as U.S. President Bill Clinton did with success in the 1990s. During economic downturns, they can restock those reserves to stabilize oil revenues for producers, in the process selling high and buying low. Careful regulation of oil derivatives markets can help to curb harmful speculation.

These sorts of technocratic policy fixes, however, are not nearly enough to address the larger problem. We need high-level international coordination, in part through platforms such as World Trade Organization and G-20 summits. Over the past 50 years, oil importers and exporters have repeatedly sought temporary advantage by treating their mutual relationship as a repeated zero-sum game. Major consuming countries limit access to refining, marketing, and retail fuel outlets and lecture producers on the virtues of free markets when prices are low. In turn, producers invoke nationalism and curb supply when prices are high (while giving the same lectures on the virtues of free markets). Invariably, however, as the cycle has continued to rage on, the resulting gains for one side or the other have been fleeting. Worse, globalization has ensured that economic, geopolitical, and security problems in one part of the world now spill quickly into others, further negating any short-term benefits of myopic self-interest.

Without a change, the next phase of the cycle could be catastrophic. The next banking crisis, for example, might be accompanied by a currency crisis for the U.S. dollar, which has been the linchpin of the international financial system since World War II. Or conventional Middle Eastern arms races could easily turn into unconventional ones, increasing the chances that terrorists will get their hands on weapons of mass destruction. Today's problems will look trivial in comparison. FP