Is Recession 2000 in the Pipeline? A Non-Technical Paper

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Andrew Oswald
University of Warwick

Oil prices have now trebled in just over a year.

Predicting the future is difficult. But it seems to me increasingly likely, as argued last year in Low Real Oil Prices not a New Paradigm, which was written when the oil price had merely doubled, that the seeds of the next recession have thus been sown. As a proportion of our nation's GDP, profits are already falling.

Even a sharp reversal of petroleum prices in the next few weeks would probably leave some kind of recession making its way through the western economies. We know that the lag from an oil price movement to an output or unemployment movement is probably around 18 months (Carruth, Hooker and Oswald, Review of Economics and Statistics, November 1998).

I expect the unemployment rate to run flat fairly soon. There are already some signs -- as in the tiny drops now visible in each Labour Force Survey -- that the secularly dropping joblessness of the last few years is close to its end. Thus unemployment will probably begin to turn around the Summer of the year 2000. Once the first gentle turn comes, history suggests that rises in joblessness will continue for a couple of years. In other words, it is likely that we are close to the bottom of the familiar U-shape in unemployment over the business cycle. The claimant count may fall a bit further; but that measure suffers from its ability to be altered by governments' choices.

Historically, sharp rises in the price of energy are our best predictor of a slump to come. This happened in the mid 70s, late 70s, and early 90s. No doubt it will happen again. Energy is a key input. When inputs become more expensive, cost curves rise. Firms begin to go out of business. Petroleum is also the life-blood of transport and delivery. It governs electricity prices too. This process cumulates.

I do not subscribe to the 'new economy' view. That is the idea that thanks to Bill Gates and modern technology a new epoch has begun – computers and all these things have changed our lives and lowered forever the rate of unemployment. When you hear young men and women saying that this is a new era in the economy and the stock market, and that the old-timers do not know what they are talking about, it is best to pull on your crash helmet.

The surge in 1990s profits helped produce plenty of cash for innovation and R&D labs. That is assisting productivity growth now in the US. But I am unconvinced that this will for long survive an upturn in the price of oil.

In 1998, the real price of crude oil reached its lowest level in post-war history. For a short time at the end of that year it was actually one half of the real price of oil in the 1950s, and one fifth of the real oil price that prevailed at the start of the 1980s. The price of petroleum has been unusually low throughout most of the 1990s.

The logic of the ensuing boom in the western democracies is not complicated. Profits have been terrific because energy became so cheap. This was a good time, therefore, to hire workers or to be a new entrant if you were an entrepreneur. Employment rose and unemployment fell.

Some argue that, because of the nature of changes in technology, black gold does not matter as much these days. But oil prices mould all other energy prices, and in fact the industrial nations use more oil than ever before. Everything in the world is made using energy and people. When energy becomes dearer, something has to give. Caveats aside, it has to be the price of people. More unemployment brings that about.

Of course we still have an underlying problem of structural unemployment in Europe. That is a deeper issue than what is happening to the business cycle of this year or next year. Structural problems are hard to cure. Spain, for instance, is going through a kind of boom. Yet it has unemployment of 15%. That is structural. Workers are not getting to the vacancies.

The conventional view is that the unshakeable unemployment levels of countries like Spain, Finland and Italy are due to labour market inflexibilities. Benefits are too high; unions are too strong; taxes and hiring and firing costs distort firms' decisions. Although there may be something to all this, the cool-headed evidence is not great.

A more plausible explanation is that the housing market has gone wrong in most European nations. Young people and low-skill workers are too often stuck in the wrong place, because the private rental housing market has been extinguished in most of Europe. The nations that have the largest rental housing markets, like Switzerland and the Netherlands, have the least joblessness. Spain has Europe's highest home ownership and its highest unemployment. In the US, the state of West Virginia has the highest home ownership and the highest unemployment.

I suspect that we need to rekindle private renting – to get our people moving around instead of stuck in one place. Then the

whole economy will function better. Draining away private renting is like draining the oil from an engine: the machine does not run properly after that. There is too much friction. High levels of home ownership have ossified the economies of Europe. Let's bring back renting.