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Could a surge in the price of crude oil trigger a recession?

- Based on past events, fears are flaring up with the Russia-Ukraine conflict

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FOR decades, recessions have often been linked to a sudden surge in crude oil prices.

Post-World War 2, at least six incidents of oil price shocks have occurred and in almost all the cases, economic downturns have ensued.

This includes the 2007-2008 Great Recession, which is often attributed to the subprime mortgage crisis that started in the United States.

There are theories that the oil price run-up of 2007-2008 had partly triggered the Great Recession.

Given the impact caused by oil shocks in the past, it is not surprising that recessionary fears flared after the Russia-Ukraine conflict erupted.

Global stock markets tumbled, with investors seeking refuge in less risky assets such as gold.

The market's panic is understandable. After all, Russia is the world's third biggest crude oil producer, providing about one of every 10 barrels the global economy consumes.

A disruption in the Russian oil production could leave a significant gap in global supply and further push the oil price.

To be sure, global crude oil prices have been on the rise since 2021, but the Russian invasion of Ukraine sent the prices skyrocketing to above US$100 (RM419) per barrel.

In slightly over two months, both Brent and West Texas Intermediate grade crude oil prices had jumped by almost US$50 (RM209) per barrel.

The sudden surge in oil prices has sparked a million-dollar-question, will the world face a double-dip recession?

Just as the global economy is recovering from the debilitating effects of the Covid-19 pandemic, another recession in a short gap would be disastrous for the world.

In January 2022, prior to the Russia-Ukraine conflict, the World Bank had predicted the global economy to expand slower by 4.1% in 2022, as compared to a growth of 5.5% in 2021 and a contraction of 3.4% in 2020.

OCBC Bank economist Howie Lee cautions that the probability of a double-dip recession is rising.

"So, we would have one in 2020 over the pandemic, and then one now as we grapple with runaway inflation.

"Untamed inflation leads to lower consumption and productivity, which softens economic activity and may lead to a recession," he tells *StarBizWeek*.

Socio-Economic Research Centre (SERC) executive director Lee Heng Guie says that Russia's invasion on Ukraine has triggered negative supply and oil price shocks, which pose a double-blow to the world economy by further denting growth prospects and driving higher inflation.

He also adds that the risk of stagflation and recessionary conditions have risen in some advanced economics, especially in the US and European countries.

High inflation and soaring fuel prices have dented consumer spending and businesses' margin.

"The United States Federal Reserve's resolve of containing a surge in inflation pressure through possibly aggressive interest rate hikes could slow the US economy sharply and may tip it into recession," he says.

Echoing a similar stance, economist Dr Geoffrey Williams of the Malaysia University of Science and Technology (MUST) points out that a recession in oil dependent countries might follow a prolonged increase in oil prices.

However, for oil rich countries like Malaysia, higher oil prices will raise gross domestic product (GDP) and government revenue, he says.

"So it is not so simple to say the oil price rise will cause recession.

"If there is a sharp increase in US and European interest rates to try to slow inflation, which wouldn't work, then this could stifle growth but I don't think it would cause recession because their economies are rebounding strongly," he says.

Nevertheless, Williams adds Malaysia could still be harmed, if global trade contracts severely because of weaker economic conditions in the US and European economies.

"In a nutshell, recessions are more commonly caused by bad policy overreaction rather than oil price rises.

"That's why Bank Negara should keep its head, tie itself to the mast like Ulysses and resist the siren calls for higher interest rates," according to him.

Malaysian Rating Corp Bhd (MARC) chief economist Firdaos Rosli also thinks that the probability of a double-dip recession is "very remote" for Malaysia.

This is considering the fact that the local economy is restarting from a very low base while reopening has been progressive thus far.

"For now, we continue to expect 5.7% growth in 2022," he says.

A sudden surge in oil prices causes panic as it leads to increased costs for businesses and households.

If the government and central banks do not step in fast enough to remedy the situation, the production of businesses will be disrupted and the higher business costs will be passed on to the consumers.

The impact will be worse for oil importing nations.

The surging oil price trend has somewhat cooled down in the last three days, although prices remain elevated at US$112 (RM469) per barrel yesterday as at press time.

Where Malaysia stands?

In the case of Malaysia, high oil prices are a double-edged sword. On one hand, thanks to nationalised petroleum ownership, the government benefits from high crude oil prices and the taxes related to petroleum.

Malaysia's Tapis crude oil, which was long known as the world's most expensive grade, hit its record-high of US$133.79 (RM560) per barrel on March 9.

In comparison, the global benchmark Brent crude oil reached a multi-year-high of US$127.98 (RM536) per barrel on March 8.

For 2022, the government's petroleum-related revenue is forecast to register RM43.9bil or 18.8% to total revenue, with dividends from Petronas accounting for more than

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half of the total.

The projection is based on the Finance Ministry's budgeted average crude oil price at US$66 (RM276) per barrel.

Since March, crude oil prices have stayed above US$100 (RM419) per barrel, much-higher than the government's earlier forecast.

According to the Asean+3 Macroeconomic Research Office, for every US$1 (RM4.19) increase in Brent oil prices, Malaysia's annual fiscal revenue would rise by about RM339mil and the real GDP would increase by approximately RM646mil.

However, MARC's Firdaos expects the net impact of high global oil prices on Malaysia is likely to be neutral.

"Fiscal policy will do most of the heavy lifting to cushion cost-push inflation to consumers. The government will keep inflation at bay as we move closer to the 15th General Election.

"Having said that, the muted impact would also mean the urgency to push for structural reforms is absent," he says.

Similarly, Must's Geoffrey also says that the impact from high oil prices will be "muted" for Malaysia, considering the huge blanket fuel subsidies given at the moment.

For example, for RON95 petrol, consumers in Malaysia only pay RM2.05 per litre. although the actual cost in March has reached RM3.70 per litre.

Meanwhile. for diesel. consumers only pay RM2.15 per litre, while the actual cost has exceeded RM4 per litre.

The cost differences are subsidised by the government.

Finance Minister Datuk Seri Tengku Zafrul Tengku Abdul Aziz recently told the Parliament that the government is subsidising as much as 45% of the total fuel price. With the recent price increase, he said, the subsidy for petrol, diesel and liquefied petroleum gas was expected to reach RM2.5bil per month.

For the full-year of 2022, he said the government could be paying up to RM28bil in fuel subsidies.

Considering the sharp rise in oil prices, Tengku Zafrul said that the current fuel subsidy will be reviewed in favour of a targeted programme for the needy.

"Therefore, the government will review the fuel subsidy mechanism in order to implement a more targeted and focused aid and subsidy to the vulnerable and those really in need," Tengku Zafrul said on March 10.

MUST's Geoffrey thinks that there is no need to remove the fuel subsidy.

"If the subsidy was removed it would have huge negative welfare implications on all Malaysians, whether they drive or not and especially on lower income drivers who often depend on fuel for work and would be hardest hit if prices rose.

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"We have to ride out the storm, keep the fuel subsidy, keep interest rates on hold, control prices of food and remove the utilities price hike on businesses introduced last month. This will help keep inflation down," according to him.

In recent months, more Malaysians have been complaining about the rising inflationary pressures, including among many necessity items such as poultry products.

Earlier this month, Bank Negara has said that the country's underlying inflation, as measured by core inflation, is expected to normalise to around its long-term average as economic activity continues to pick up amid the environment of high input costs.

"Nevertheless, core inflation is expected to be modest, with the upside risk partly contained by the continued slack in the economy and labour market.

"The inflation outlook continues to be subject to global commodity price developments amid risks from prolonged supply-related disruptions," it says.

On the global front, OCBC's Lee opines that inflationary pressures will continue, moving forward.

"Short of Russia reaching a peace deal with the West, I cannot think of a scenario where inflation won't continue rearing its ugly head.

"The question now is really how high would the pace of inflation be," he says.

Amid the threat of inflation, SERC's Lee believes that a viable approach is to raise the fuel price gradually and eventually move towards a managed float regime for RON95 and diesel.

"The managed float regime will be accompanied by a targeted fuel subsidy for the low-income households," he says.

Meanwhile, HELP University's economist Dr Paolo Casadio says the government has to think in terms of cross-subsidies, redistributing costs and benefits among the government linked companies as well as not keeping a neutral stance in allowing the additional business costs to be passed onto the consumers.

"With the right policy Malaysia can cope with this crisis, overperforming the other countries and increasing its competitiveness.

"These are all important factors conditioning the potential growth over the long run," he says.

By allowing fuel prices to adjust upwards, Casadio says it would expose the Malaysian economy to more negative effects on growth and inflation.

"The rise in the energy tariff would be, in this scenario, a tragic mistake to avoid at all costs," he says.

"If there is a sharp increase in US and European interest rates to try to slow inflation, which wouldn't work, then this could stifle growth. I don't think this would cause a recession because their economies are rebounding strongly."

Dr Geoffrey Williams

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All-time high: A worker on a drilling rig at an oil field. Global crude oil prices have been on the rise since 2021, but the Russian invasion of Ukraine sent the prices skyrocketing to above US$100 (RM419) per barrel. -- Reuters