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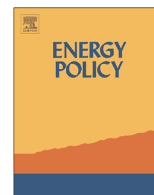

Financialisation, oil and the Great Recession

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HIGHLIGHTS

- We study the oil price and its effects on the Great Recession.
- We approach oil as a financial asset class.
- We observe the transformation of oil through deregulation.

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ABSTRACT

This article addresses the role of world oil price hike of 2007–08 in serving to transform the financial and banking crisis into what is commonly referred to the Great Recession. Existing literature on the global crisis of 2007–09 tends to view it as a financial or banking phenomenon, with analyses focusing mainly on state policies, governance mechanisms and market dynamics in transforming the banking crisis of 2007–08 into the economic recession of 2008-12/13 Although often attributing the global meltdown to wider phenomenon of financialisation, rarely do existing perspectives delve into the role of the commodity sector in the global credit crunch. In this paper, we aim to fill this gap, by inquiring into the role played by oil as a financial asset class in the political economy of the global crisis.

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1. Introduction

In this article, we enquire into the role the financialisation of the oil market has played in amplifying the 2007–09 crisis and contributing to the Great Recession of 2008–2012/13. Focusing specifically on the 2007–08 oil price hike, we analyse the role of the oil market as a transmission mechanism of the financial crisis into the real economy. In discussing the impact of financialised oil on the economy, we seek first, to advance the body of knowledge on the political economy of the 2007–09 financial crisis that to date, has not analysed the role of the primary sector in depth; and second, to extend the developing literature on the financialisation of commodities.

The academic literature on financialisation has developed as a reflection of the problems and processes brought up by the globalisation and liberalisation of markets and economies since the late 1980s. This evolution is reflected in the continuing ambiguity of the very concept of 'financialisation', typically assumed to denote a series of finance-led changes in the economy and other spheres of human activity. While to date, the phenomena of financialisation have attracted researchers from a wide variety of the social sciences, the scholarship on financialisation of the commodities markets, and of the oil market in particular, is only beginning to develop.

Part of the reason for such a lag is historical. Prior to the 1980s, the oil market was largely physical, being detached from the financial sphere, as oil-derived financial products had not yet been introduced as a tradable commodity in international exchanges. When, during the early 1980s, these products were first launched, they remained unpopular with actors outside the oil market, mainly due to the constraints of physical delivery implied in them, as well as because of the strict provisions prohibiting financial institutions from engaging in commodity trading (Kerckhoffs et al., 2010). More recently however, developments in the international financial and commodity markets, have stirred up greater interest in the controversies of commodities financialisation (Clapp, 2010; Gibbon, 2013, 2014; Cheng and Xiong, 2013). In particular, the 2007–08 oil bubble and its burst, or what is known in the literature as the 2007–08 oil price hike, has opened up a debate on the

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role of speculation in the oil market vis-à-vis its more traditional determinants such as geopolitics and market fundamentals (e.g. Krugman, 2008).

In this article, we critically engage with this debate. Our analysis shows that in late 2007, market sentiment, permissive regulations and the erosion of value in other financial assets drove increased amounts of liquidity into the oil market. The ensuing liquidity bubble in 'financial oil', including its peak in 2007 and its burst in 2008, served to amplify the downturn in the levels of economic activity, thus aggravating the unfolding recession. Our main argument is two-fold. First, over the second half of the 20th century, the oil market and institutions trading in oil have become part of the financial system. As a result, the impact of conventional macroeconomic factors, associated with supply and demand, are being amplified by the financial mechanisms of oil pricing, financial innovations and expectations of 'non-physical', financial actors. Second, the oil price hike in 2007–08 serves as a good demonstration of this general trend. Led by capital flight out of financial assets in 2007, the price hike amplified the initial waves of a financial meltdown, and through the institutional changes in the economy associated with financialisaton, become a major factor that served to spread a seemingly financial phenomenon into the deeper economic crisis of 2007–09.

This article is organised as follows. Section 1 traces the financialisation of oil in a historical context. Specifically, two critical junctures in the evolution of the financialisation of oil are identified. First, the 1980s liberalisation and the institutional changes in the market triggered by the launch of commodity indexes by financial institutions in the early 1990s. Second, the more recent market developments spurred by the introduction of permissive regulations in 2000 with the launch of the Commodities Future Modernisation Act (CFMA) in the US. Two broad conclusions emerge from this survey: on the one hand, during the second half of the 20th century, oil has become an increasingly popular asset class with investors, which widened the opportunities for hedging but also for financial speculation in oil. On the other hand, the advance of financialisation in the first decade of the 21st century, and the integration of financialised markets through indexification, has produced endogenous dynamics in this market, thus creating new sources of fragility and risk.

Section 2 focuses on the role of the oil market in transmitting the impact of the 2007–09 crisis to the wider economy. Our analysis suggests that the price hike of 2007–08 played a major role in transforming a financial and banking crisis of late 2007–08 into an economic recession of 2008–09. The oil price bubble in turn, was caused by inflows of capital into the financial products and positions based on oil. We acknowledge however, that the inflow of liquidity and ensuing speculation were only possible due to the permissive regulatory environment in commodity derivatives, mainly in the US.

With this premise, Section 3 discusses the regulatory and policy context that enabled the financialisation of oil, and draws lessons from the 2007–09 crisis and post-2008 regulatory moves. The major policy lessons being drawn from the 2008–09 crisis suggest that over the past few decades, the financialised oil market has become correlated with other commodities markets, a trend that contributes to the emergence of new nodes of potential systemic risk and financial fragility. And while it is financial speculation through derivatives and other complex financial products that has come into regulatory focus in the wake of the 2007–09 crisis, policy attention should also be directed at the wider sources of systemic risk and instability in the financial system, which now includes the primary sector.

2. The 2007–08 crisis and the financialisation of oil

Having started in August 2007 as a liquidity crunch, by autumn 2008, the financial meltdown had evolved into an international banking crisis. By 2009, the world economy was facing its biggest economic crisis since the 1930s. Across an array of regions, countries and economic sectors, broad market averages were down approximately 40% on their end of 2006 levels (Bartram and Bodhar, 2009). The crisis would require multi-billion dollar support lines from governments around the world.[1] The *Great Recession* of 2009–13 was unfolding against policy background that had been shaped by the economists' and policymakers' ideas of a 'Great Moderation' (Bernanke, 2004), a newly found economic balance of low unemployment and low inflation, and the end of the era of 'boom and bust' economic cycles (Brown[2], 2007).

In the diverging theorisations of the crisis (Akerlof and Shiller, 2009; Fahlenbrach and Stulz, 2011; Wade, 2008; Crotty, 2009), it is the nature of the transmission mechanisms of financial fragility to the wider economy that ultimately determines the diagnosis of the crisis, its political–economic impact and regulatory response. Several such transmission channels can be identified: market liquidity, wealth erosion, international trade and the price dynamics in the commodities sector. While the first three of these channels have been subject to academic and policy analysis (Acharya and Schnabl, 2010; Brunnermeir, 2009; Borio and Zhu, 2012; Claessens et al., 2010; Griffith-Jones and Ocampo, 2009; Hesse and González-Hermosillo, 2009; Lysandrou, 2013), the literature focusing on the role of the commodities market in precipitating the Great Recession has been limited.

Although most observers agree that price speculation enabled by new financial techniques of trade has amplified the effects of crisis, there is a debate in the academic and policy realm as to the precise nature of speculation in oil (e.g. Fattouh, 2011; Fattouch and Mahadeva, 2012; Khan, 2009; Kilian and Murpy, 2010). Notwithstanding the disagreements, the economy-wide contraction that ensued in late 2008 led many theorists to argue that far from being a mere banking phenomenon, the crisis signified a structural breakdown of debt-driven consumer capitalism of Anglo-Saxon economies (Wade 2008; Konzelmann et al., 2014), or a crisis of financialisation (Foster, 2008; Stockhammer, 2013; Tridico, 2012).

Academically, financialisation remains an ambiguous term. While research on financialisation has grown rapidly over the past few decades, the precise content and contours of this phenomenon remain vague. Equally, although a variety of conceptual approaches to financialisation have emerged, there is still no cohesive theory of this phenomenon (Nesvetailova and Palan, 2013). Stockhammer (2013) observes that with no agreed definition of financialisation, broadly, the term is used to capture and analyse a range of transformations *within* the financial sector as well as *in the relations* between finance and other areas of human activity (emphasis added). Importantly for the argument of this paper, the proliferation of financial products such as derivatives and their infrastructure are invariably seen as central elements in the complex set of processes of financialisation (Wigan, 2009). Financial derivatives, in turn, are seen as either the manifestation of the new dynamics of growth and logic of political economy in general (Bryan and Rafferty, 2006; Wigan, 2010), or as the very nucleus of financialisation itself, defined in this instance as the ability to trade risk (Hardie, 2011, 2012).

Therefore, the term financialisation, and the proliferation of financial derivatives products specifically, captures a series of

[1] According to one estimate for the US economy, by late 2011 the US Federal Reserve alone had spent $29.5 trillion in total in liquidity support lines to the financial system (Felkerson, 2011).

[2] Gordon Brown, then Chancellor of the Exchequer in the UK.

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