Our View: Oil Producers Are Pushing on a String

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I first heard the phrase "pushing on a string" from my grandfather's friend Chester Davis. Mr. Davis had been my grandfather's roommate at Grinnell College in Iowa. He was later the first administrator of the Agricultural Adjustment Administration (AAA) under President Franklin Roosevelt. (The AAA ordered farmers to dump milk in ditches to raise prices.) In 1937 he became a member of the Federal Reserve Board and then president of the Federal Reserve Bank of St. Louis.

Mr. Davis explained that the Federal Reserve found itself "pushing on a string" in 1937 as it tried to revive the US economy. The phrase, now found widely in the economic vocabulary, is defined as follows:

> Pushing on a string is a metaphorical expression that states that influence is more effective when it works in one direction. In macroeconomics, pushing on a string is a strategy that reduces the effect of the central banks and the monetary policy in an economy.
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> The pushing a string strategy often means that the government must resort to borrowing to stimulate the economy, especially when there is little or nothing that can be done to stimulate it. Pursuing a string maintains that borrowing would be the last resort after monetary policy and other efforts by central banks are ineffective.[1]

Today, I would argue that oil exporters were pushing on a string when they announced production cuts to raise prices. The July 3 news that Saudi Arabia will continue its cuts into August and that Russia will reduce exports is meaningless because global oil demand is declining more rapidly than production.

In addition, the central banks' determination to raise interest rates further incents private-sector companies to hold fewer barrels of oil. Refiners with contracts to buy crude from Saudi Aramco must be secretly saying thank you for the production cut because of their need to always take their allotment from the Saudis to avoid the kingdom punishing them for not doing so.

Meanwhile, almost all analysts and many reporters following oil are clueless. An analysis published by Rystad Energy on June 22 *really* catches the obliviousness of those in the oil universe, who expect China will address the industry's economic problem:

> Oil demand is expected to grow by more than 2 million bpd in the second half of this year, of which just over 1 million bpd is due to the global aviation industry recovery and around 1 million bpd due to China's economic recovery.[2]

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[1] Jason Gordon, "Pushing on a String (Economics) – Explained," The Business Professor, March 29, 2023 [https://tinyurl.com/dzmx95pr].

[2] Claudio Galimberti and Jorge Leon, "Oil fundamentals are about to turn decisively bullish," *Rystad Energy Insights*, June 22, 2023 [https://tinyurl.com/2p8t9tj8].

The Rystad authors add that they expect inventory reductions to tighten oil balances and push markets into backwardation. Their article's title is "**Oil fundamentals are about to turn decisively bullish**."

A **wide chasm** exists in the forecasting arena. Those focused on oil operate in an optimistic haze and foresee growth. Those concerned about the economy have the opposite view. The oil optimists are in for a huge, painful surprise if the economic pessimists are correct. As we noted in the title of the July 3 *Notes at the Margin*, "It's the Economy." The title is a shortened version of the statement used by James Carville to elect Bill Clinton as president: "**It's the economy, stupid**."

The economic situation in China poses a serious threat to the oil optimists. Many articles have been written about the deteriorating circumstances in the country. The oil forecasters must have been sleeping for the last few months to miss these developments.

Richard Koo, the chief economist at Nomura Research Institute, has even suggested that China is entering a "balance-sheet recession":

> "People are no longer borrowing money," due to concern about asset prices and the outlook for economic growth, and are instead "trying to reduce their debt" — a key element of the condition Koo defined decades ago.[3]

A balance-sheet recession occurs when households and businesses divert income to pay down debt rather than investing it or using it to buy goods and services. In a 2014 paper, Koo explained that monetary policy was largely ineffective in a balance-sheet recession because those in debt will not increase borrowing at any interest rate. Thus, the interest rates cuts proposed by Chinese authorities recently will probably have no impact, which leaves China with one option:

> This means the only thing the government can do to offset the deflationary forces coming from private sector deleveraging is to do the opposite of the private sector, i.e., borrow and spend the unborrowed savings in the private sector. In other words, fiscal stimulus becomes absolutely essential during this type of recession.[4]

Koo adds that the government must sustain the fiscal stimulus for years. Withdrawing it prematurely would unleash deflationary forces as it did in the United States in 1937, Japan in 1997, and the Eurozone in 2010.

An article in *The Wall Street Journal* reports the Chinese government is reluctant to "pump large amounts of credit into the economy, in part because "**demand for loans has been feeble as more households and companies shift to paying down debt instead of spending and making new**

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[3] Tom Hancock, "Inventor of 'Balance-Sheet Recession' Says China Is Now in One," Bloomberg, June 29, 2023 [https://tinyurl.com/mum92w9s].

[4] Richard C. Koo, "Balance sheet recession is the reason for secular stagnation," in Coen Teulings and Richard Baldwin (eds.), *Secular Stagnation: Facts, Causes and Cures* (London: Centre for Economic Policy Research (CEPR) Press, 2014) [https://tinyurl.com/ckbkczm3], p. 135.

investments" [emphasis added]. [5] A July 1 Bloomberg report indicates that underlying growth in China is only three percent rather than the five percent cited by most forecasters.[6]

Global oil demand will likely decline if China's government continues to **push on the string** rather than stimulate. The consequence will be lower oil prices.

Following the July 3 announcement that Saudi Arabia and Russia would extend their production cuts, Paul Horsnell of Standard Chartered said this to Bloomberg: "There's little now for speculative shorts to justify the extreme negative position they've taken, so the Saudi measures should help normalize positioning in the market."[7] Horsnell is about to learn a lesson from monetary economics: **It is very hard to push a string.**

[5] Stella Yifan Xie, "China's Economy Shows New Signs of Weakness," *The Wall Street Journal*, June 30, 2023 [https://tinyurl.com/ycytfn3h].

[6] Chris Anstey, "Why China looks Increasingly on the Back Foot," Bloomberg, July 1, 2023 [https://tinyurl.com/2skkwccw].

[7] Grant Smith and Dana Khraiche, "Saudis and Russia Extend Oil Supply Cuts to Prop Up Market," Bloomberg, July 3, 2023 [https://tinyurl.com/5dnfnwhj].