Restructuring World Economic Power Relations through High Oil Prices -Unintended Consequences of the Iraq War

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Why Oil Prices Matter

- If the Iraq War was about oil, it is no success
- Low price elasticities make short-term oil demand resilient to price changes, so that effects are stronger on inflation rates, trade balances and levels of economic activity
- The oil price rise since 2004 has not been sufficient to curb oil demand growth
- The oil price rise has redistributed economic power to the major oil exporters and large industrial exporters that serve them
- The oil price increase has aggravated the US trade deficit, which in turn undermines the position of the US dollar, also in oil trading

The Weak Point – the US Dollar

Three functions of a currency:

1. A means of accounting (pricing)
2. A means of exchange (trading, payment)
3. A means of value storage (banking)

- The US dollar currently fills all three functions
- Stability as a storage of values is critical
- Inflation and exchange rates matter

Why and how oil prices rose

- Unexpectedly high oil demand growth in 2004 in China and the United States coincided with US failure to stabilise Iraq and tension with Iran
- The oil industry was restructuring, not investing
- In spite of rising demand and falling supplies from the North Sea and the US GoM, there was no shortage of oil, as inventories increased
- Major reason: supply risk in the Middle East due to the Iraq War and Iran crisis
- Forward pricing ”contango” indicative of markets discounting the risk of future oil supply shortfalls

The Risks to the United States and the World

- The United States has a deficit in both energy and capital
- Crude oil trading is exclusively done in US dollars, facilitating oil market transparency and efficiency through simple forward and futures trading
- The United States has the privilege of being able to issue its own currency to pay for oil
- Privilege abuse undermines confidence in the US dollar
- The risk is a disorderly collapse of US dollar oil trading, with a loss of transparency and efficiency

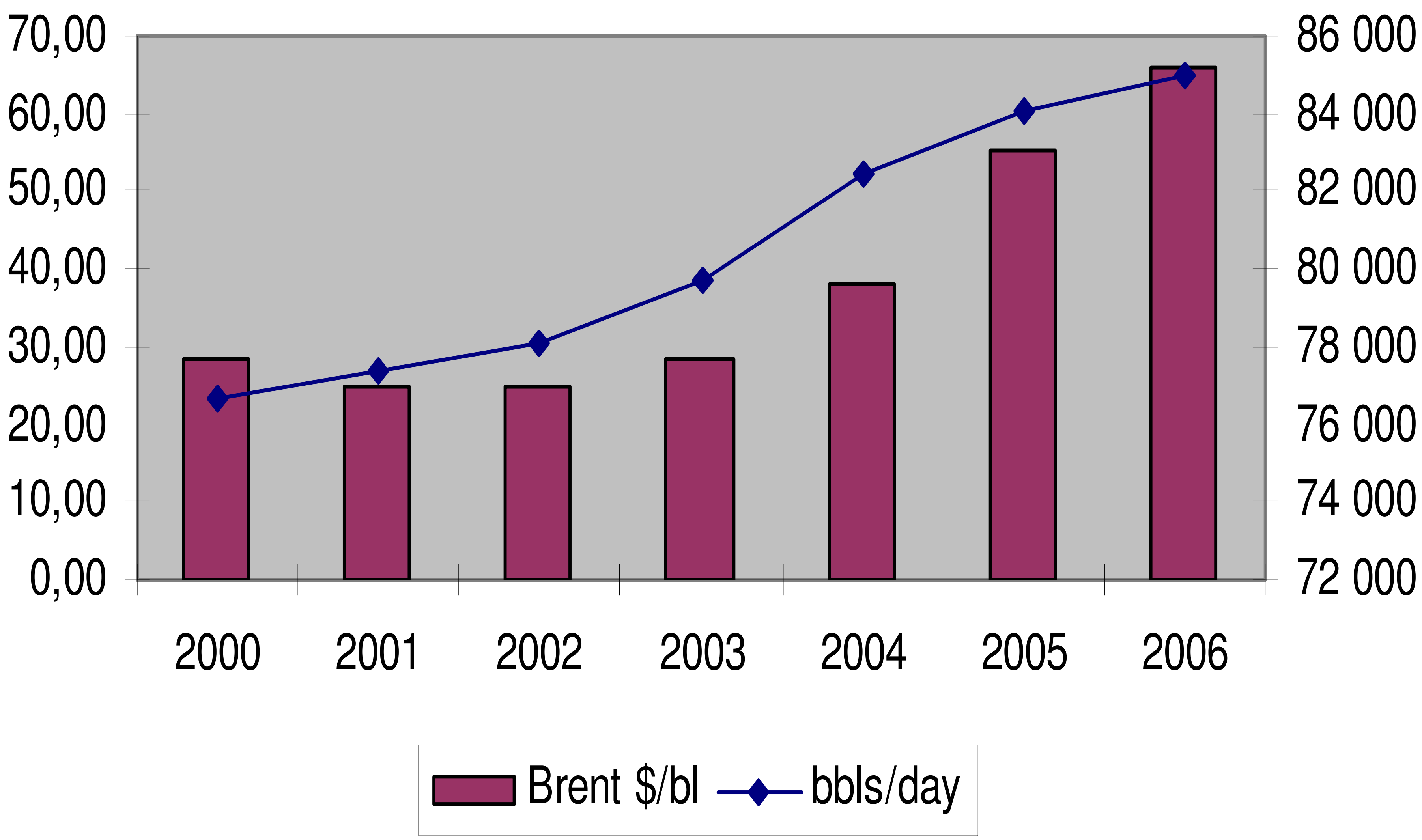
The Shifting Balance

- Huge transfer of resources to oil exporters
- Russia has a huge potential for energy conservation and for raising exports
- The world markets will increasingly depend on Middle East oil and gas, whose instability enhances Russia's position
- China's energy efficiency is a major determinant for world oil and natural gas demand
- Europe will increasingly depend on oil and natural gas imports from Russia, the Middle East and North Africa
- For natural gas, Iran is potentially a key supplier

Market stability

- The common interest is in stable markets with predictable prices, but at what level?
- There is a fundamental conflict of interest over the division of the economic rent, exacerbated by prospects of “peak oil” and CO_2 duties
- There is an equally basic conflict over the control of the industries and the markets, which is pertinent to the rent division
- If security of supplies has any meaning, buyers should be willing to pay a premium, in money or in political favours

Oil Prices and Oil Demand



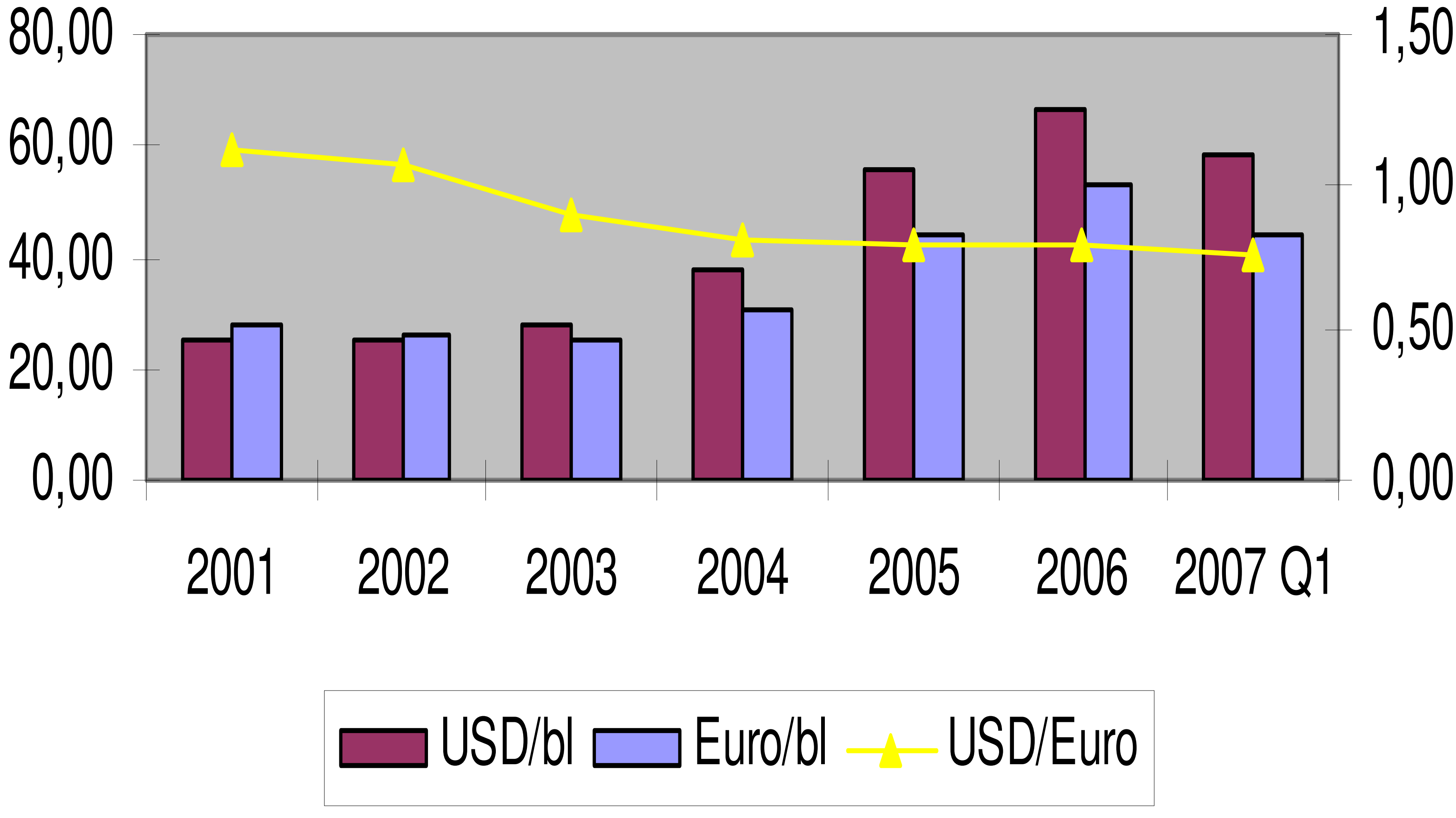
Oil Prices

Brent spot

	USD/bl	Euro/bl	USD/Euro
2001	24,90	27,89	1,12
2002	25,00	26,50	1,06
2003	28,00	24,92	0,89
2004	38,00	30,78	0,81
2005	55,40	44,32	0,80
2006	66,10	52,88	0,80
2007 Q1	58,20	44,23	0,76

Oil Prices and Exchange Rates

Brent spot



OPEC Current Account Balances

Billion USD

	1998	2002	2006
Algeria	-0,9	4,4	27,9
Angola	-1,9	-0,3	4,6
Indonesia	4,0	7,8	9,7
Iran, Islami	-2,1	3,6	14,3
Kuwait	2,2	4,3	41,4
Libya	-0,3	0,7	24,4
Nigeria	-2,9	-5,4	14,1
Qatar	-2,2	3,8	6,1
Saudi Arab	-13,2	11,9	95,5
Sudan	-1,7	-1,5	-5,4
United Aral	0,9	3,8	27,4
Venezuela	-4,4	7,6	27,2
OPEC	-22,6	40,5	287,2

Other Oil Exporter Current Account Balances

Billion USD

	1998	2002	2006
Canada	-7,7	12,6	21,5
Mexico	-16,0	-14,1	-1,5
Norway	-0,5	24,2	56,1
Oman	-3,1	1,4	3,0
Russia	0,2	29,1	95,6
5 Non-OPE	-27,1	53,3	174,7

Other Countries' Current Account Balances

Billion USD

	1998	2002	2006
Brazil	-33,4	-7,6	13,6
China	31,5	35,4	238,5
France	38,6	14,5	-46,3
Germany	-16,3	40,6	146,4
India	-6,9	7,1	-19,3
Japan	119,1	112,6	170,4
United Kinc	-5,3	-24,8	-68,1
United Stat	-213,5	-472,4	-856,7

Oil Market Power

- The power to set oil prices through volume control today rests squarely with OPEC, with the lowest costs and the largest potential
- The oil exporters have, so far, been more cautious in their spending than was the case in the late 1970s and early 1980s: they may keep large surpluses and the ensuing economic power
- A surplus on the current account represents an ability to keep more oil in the ground if needed to defend prices; the 2006 surpluses represent an ability to cut at least one half of oil exports and still be in balance

OPEC Surpluses Money and Oil 2006

assuming $60/bl.

	USD billior	Million bbls
Algeria	27,9	1,3
Angola	4,6	0,2
Indonesia	9,7	0,4
Iran	14,3	0,7
Kuwait	41,4	1,9
Libya	24,4	1,1
Nigeria	14,1	0,6
Qatar	6,1	0,3
Saudi Arat	95,5	4,4
Sudan	-5,4	-0,2
UAE	27,4	1,2
Venezuela	27,2	1,2
OPEC	287,2	13,1

Non-OPEC Surpluses Money and Oil 2006

assuming $60/bl.

	USD Billion	Mill. bbls/d
Canada	21,5	1,0
Mexico	-1,5	-0,1
Norway	56,1	2,6
Oman	3,0	0,1
Russia	95,6	4,4
5 Non-OPE	174,7	8,0

A Matter of Incentives

- The oil exporters are comfortable, so far
- Their risk is a major demand decline together with new supplies and release of inventories
- Therefore, the incentive to invest in new capacity is weak; also for Russia
- Integration downstream might provide stronger incentives for upstream investment
- Iran and Mexico have resources, large populations and corresponding investment needs, but politics impede expansion

Potential Political Consequences

- Oil and natural gas become economically and politically more important
- Competition over Middle East oil and markets, and divergence over Iran are risks for relations between Europe and the United States
- Europe has incentives to seek energy security through closer economic cooperation with Russia
- Japan, dependent on Middle East oil, runs a high economic risk through US policy on Iran
- China and Japan, financing the US deficit, face a dollar dilemma: how much more?
- Russia could emerge as a winner, as a secure supplier of energy to Europe and East Asia

The United States – a Key Problem

- Large and rising consumption and imports of oil and natural gas, little political backing for energy saving
- Rising trade deficit threatens world economy
- Confrontation with leading oil exporters, also Russia
- War in the Middle East, unconditional support for Israel
- War is an implement in US foreign policy – also in energy policy?
- Unilateral policies, disregard for treaties and agreements

The US Trade Deficit

- The United States runs a rising deficit against the rest of the world, not only China, Japan or OPEC
- Energy is the largest import item
- Household indebtedness compromises monetary policy; in 2005 energy and debt service took about 20 per cent of household disposable income
- The trade deficit compromises the position of the US dollar

The Dollar Problem

- Warnings:
  - The World Bank warns developing countries
  - The IMF expresses concern
  - The Asian Development Bank is concerned
- The US dollar is the leading currency by default
- The ECB and the Euro are not ready to take over, but could be forced to
- OPEC targets overall terms of trade, observing the euro, the yen and the yuan
- Iran and Russia have expressed an interest in euro oil pricing and trading

A System under Stress?

- Position of US dollar dependent on stability and acceptance
- Europe, Russia, Iran and North Africa have an interest in trading energy in euros
- China and the Middle East could have an interest in trading energy in a future convertible yuan
- Spot oil trading easy in multiple currencies easy; future and forward oil trading high risk

The Options

1. Dollar stabilisation, by a lower US trade deficit, reduced military spending, lower oil imports and lower oil prices (Middle East stability)
2. Crisis of confidence, by rising US deficits, higher oil prices through Middle East instability; oil trading in euros
3. Dollar erosion, contracts and forward trading hedging in currency, gradual and uneven transition to oil trading in other currencies

Oil in Middle East Politics

- The 2006 Lebanon War and Iran's support for Hamas, Hezbollah and Syria have caused Saudi engagement in Palestine
- The outcome, a unity government, has been snubbed by the US (and the EU), showing that in Washington, Israel has the upper hand
- Saudi compromise with Iran facilitated the February 2007 OPEC agreement
- An understanding between Iran and Saudi Arabia may be a way to stabilise Iraq
- The price is likely to be in oil prices