



## Spoiler

*'Let the fear of danger be a spur to prevent it; he that fears not, gives advantage to the danger.'*

Francis Quarles (1592 - 1644)

With qualms around a Euro catastrophe waning, fears about oil prices are again waxing. It may be no bad thing. Memories are still haunted by what the rising price of crude did for the global economy in 2008.

There are a number of reasons why the oil price has spiked upwards recently. Today's oil price is a consequence of a mixture of fundamental supply and demand factors, some positive (emerging market growth & US recovery) and some negative (Arab 'Spring' disruptions & quantitative easing - printing money to buy bonds). Stocks are also low and production has been below expectations in a number of countries around the world.<sup>1</sup>

Against this backdrop of factors, the geo-political situation has become particularly worrisome. The fear is understandable given the prospect of an Israeli strike on Iran's nuclear installations. (Why does Iran need to bury underground the development of 'medical isotopes'?)

Recently, the idea of using oil as a weapon has gained traction: instead of relying on Iranian sanctions, which have multiple loopholes, bring Iran to heel by making the oil market itself less profitable.<sup>2</sup>

There are several ways this could happen. The first is by reducing Iran's market share. In 2007, Iran exported about 2.6 millions of barrels per day (mbpd) and since then sanction efforts have succeeded in reducing Iran's oil exports by about 12%.

The second way to make the oil market less profitable is if the Strait of Hormuz, at the entrance to the Persian Gulf, could be eliminated from the diplomatic, economic and military equa-



tion. The only way to do this is by having alternative means of transporting regional oil. Pipelines circumventing the Persian Gulf might be one answer. But this will take time and money.

And Israeli Prime Minister Netanyahu has warned that time is running out. A particularly disconcerting analysis by Nomura, a bank, suggests the most likely timing of an Israeli attack is September.<sup>1</sup>

What might be the consequences of an attack on Iran? With 40% of the world's seaborne oil travelling through the Strait of Hormuz, a spike in the oil price would be one consequence, espe-

cially if Iran succeeded in restricting supplies through the Strait of Hormuz or if insurance on vessels entering the Gulf was withdrawn.

Other consequences are less predictable. As well as an increase in terrorist attacks on Israeli, American and other Western targets, Nomura points to the increasing instability of Iraq following the US withdrawal from that country. A slide towards civil war is a real possibility if Iran and Saudi Arabia decide to face off against each other by proxy in Iraq.

An oil price spike would be particularly damaging with the global economy in such a fragile state. Though America is further along the path out of the financial crisis than is Europe, and while China has its own struggles, a higher oil price would retard world growth and lower consumer confidence.

The past decade has seen a number of enormous shifts, not only in supply and demand, but in market perceptions about spare capacity.

For decades, demand by the American economy largely controlled the price of oil. But this dynamic began to break down in 2005-2007, when US oil demand (because of rising prices) began its current decline. Now that US oil demand is down over 12% from its mid-decade peak, the fluctuation of oil inventories in the US no longer drive prices. Demand is now subordinate to numerous other factors, most notably supply.<sup>3</sup>

One fact learned during last year's

## Spoiler cont'd

Libyan civil war is that Saudi Arabia may not necessarily possess the 2-3 mbpd spare capacity which most have assumed for years. Indeed, Saudi Arabia made no initial production response to the loss of Libyan oil last spring and by the time it had lifted production five months later, the OECD countries had already decided to release oil from official inventories. Paradoxically, lowering OECD inventories, in combination with the marginal Saudi production increase, has only made the global oil market even tighter as spare capacity shrinks further.<sup>3</sup>

Nearly 60% of global oil supply comes from non-OPEC countries such as the US, Brazil, Mexico, Norway, Canada, the UK, Australia, and Russia. There is no spare capacity in this non-OPEC grouping and there hasn't been for years. To be sure, there is oil to be developed in these non-OPEC countries but it is not production supply that can be brought online quickly. Moreover, in the past two years, Russia - the world's top producer since 2006 - has seen its production growth taper off and flatten to just shy of 10 mbpd. The deceleration in Russian oil supply growth has unnerved the market.<sup>3</sup>

That leaves the oil market, tasked with the job of pricing, to figure out the "true" spare production capacity in

OPEC. That it took 4-5 months for Saudi Arabia to increase production is a concern. Although the US Energy Information Administration, a Washington think-tank, currently judges OPEC spare capacity to be higher than during the lows of 2003-2008, its historic figures show that spare capacity has indeed been declining since a 2009 high.<sup>4</sup>

The problem now is that the oil market is losing faith in OPEC countries' ability to increase supply.

Production supply growth is stagnating while demand continues to increase. Consumption of petroleum by China alone was 0.8 mbpd higher in 2007 than in 2005, meaning the rest of the world had to decrease consumption over this period.<sup>5</sup>

Reducing discretionary demand is now the primary function of the oil market in an age of flat supply growth.

Globally, the damage from price increases to date have been modest. A rule of thumb is that a sustainable 10% rise in the price of oil shaves around 0.2% off global growth in the first year and around 0.5% in the second year.<sup>5</sup>

But it is supply shocks that damages world growth. Supply is now the

dominant factor in the oil price. However, the developed world is still largely operating on the classical economic view that higher prices will make new oil resources available.

While higher prices have brought new supplies online, these resources have been slow to develop, are more difficult to extract, and generally flow at lower rates of production. Since 2005, for instance, a lot of new production in the Americas and Africa has come online but global oil supply has been held at a ceiling of 74 mbpd. As the older oil fields of the world decline, the price of oil must reflect the economics of the supply constraints.<sup>3</sup>

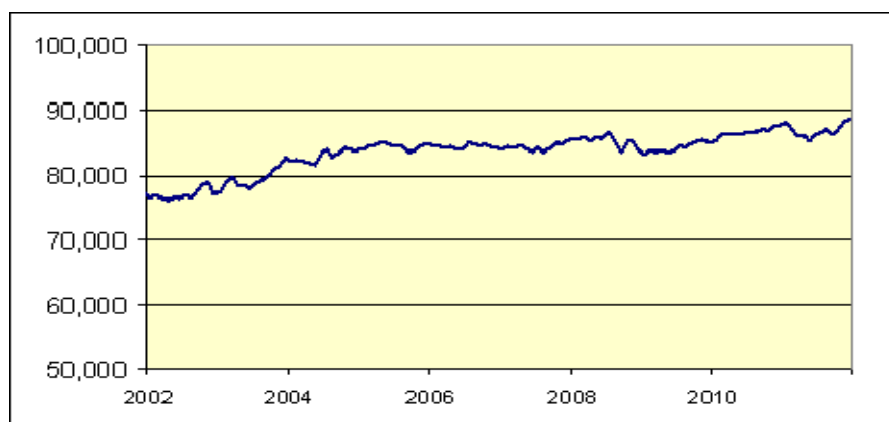
The prospects of vast, new oil supplies that will come online in the near future to negate existing global declines are not promising.

The price of oil has finally started to price in this new reality.

A permanently higher and more volatile oil price could yet be a spoiler of the global recovery.

## Sources:

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4. Simon Johnson & James Kwak, "A rational reason for high oil prices", 28 March 2012
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6. Front picture of oil barrels, Gregor Macdonald, "Understanding the New Oil Price", Gregor.us, 13 March 2012
7. Chart, US Energy Information Administration, Simon Johnson & James Kwak, "A rational reason for high oil prices", 28 March 2012



**Global oil production, thousands of barrels per day, monthly, Jan 1994 to Dec 2011. Includes lease condensate, natural gas plant liquids, other liquids, and refinery processing gain. Data source: [EIA](#).**