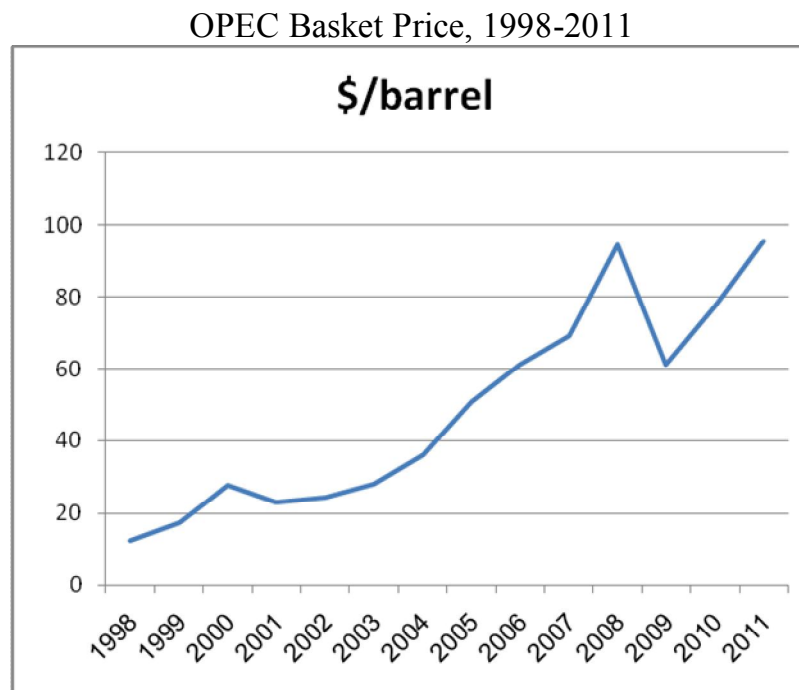


## High Oil Prices and the Middle East Strategic Balance

**Paul Rivlin**

Since the beginning of 2011, the OPEC basket price of crude oil has risen by \$22, reaching \$112 on March 10th. This represented a rise of over 30 percent in six months, more than double the 2005 average and over four times what it was ten years ago. (See Table 1)

Table 1



The director of the International Energy Agency (IEA) has warned that oil prices of over \$100 per barrel, if sustained for the rest of the year, could send the global economy back into a repeat of the 2008 economic crisis.

The reasons for the rise in oil prices are different from those that prevailed in 2008. Between 2007 and 2008, due to rising international demand against a background of supply constraints the OPEC basket price rose by 37 percent. OPEC had little extra capacity to meet strong demand and so prices increased. Demand was mainly fed by the booming Chinese economy. The price rises that are now occurring are the result not only of strong demand - again led by China - but also by worries about the stability of Middle East supplies and even about the accessibility of the Suez Canal. The flow of Libyan oil has been interrupted and there are anxieties about the stability of Algeria and Saudi Arabia. The instability in Bahrain has the potential to threaten supplies of oil from the Persian Gulf as a whole. Although Bahrain produces little oil, its strategic importance derives from its location in the Gulf, where 18 percent of the world's oil is transported to the Far East as well as to Europe. Bahrain is also the base for the US 5th Fleet, which polices the Gulf.

To be sure, oil is more global than it was during previous crises. In the 1970s, production was concentrated around the Persian Gulf. Since then, non-OPEC oil has hit markets from fields in Latin America, West Africa and elsewhere. In 2009 Russia overtook Saudi Arabia as the world's biggest crude supplier; OPEC's share of production has gone from around 54 percent in the mid-1970s to just over 40 percent now.

However, the globalization of oil supply has not diminished OPEC's clout as the marginal supplier of crude. Markets are tight at the moment. Bumper inventories, built up during the downturn, are running down as the rich world recovers and Asia puts on a remarkable growth spurt. Demand rose by 2.7m b/d last year (over three percent), according to the International Energy Agency, and is set to rise by another 1.7m b/d this year.

The fact that OPEC has a spare capacity of five million barrels a day, as compared to two million barrels a day in 2008, has not

reduced anxieties, at least as expressed in spot prices. One reason is that the spare capacity is available in heavy, high-sulfur - or sour - crude, which is more expensive to refine. Libya's light sweet crude oil, which is currently not available, is of a different, higher quality. The other reason is that the spare capacity is in Saudi Arabia, and there is increasing anxiety about the stability of the Kingdom.

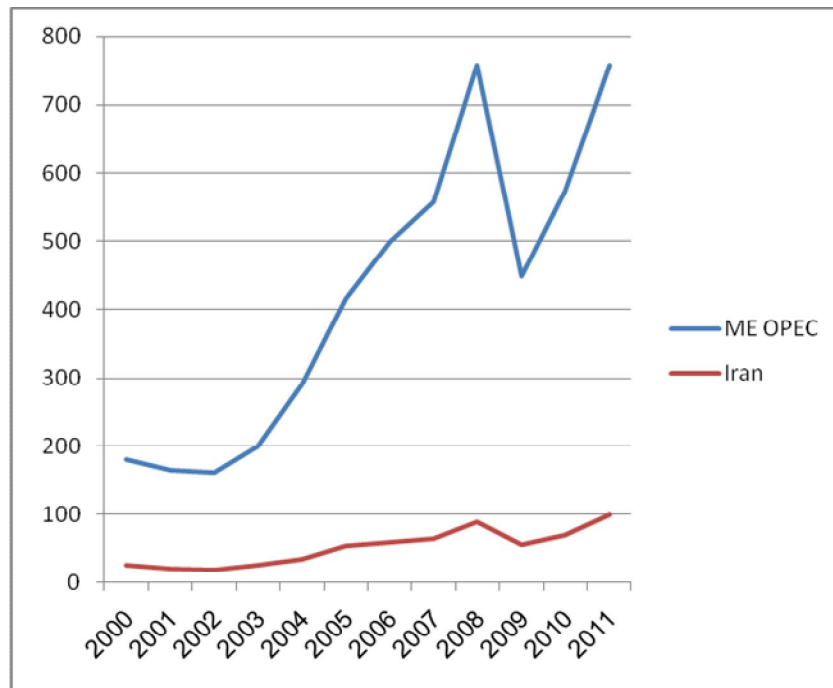
The international economy is now much less well placed to cope with sustained high oil prices than it was in 2008 because of the legacy of the 2009 crisis (although it is much better off than in the 1970s, because of the development of much more energy-efficient technologies). This left many countries with huge debts, budget deficits and some with faster inflation rates. In January 2011, before the dramatic events in the Middle East and North Africa, the IMF summarized the international economic situation in the following terms: in advanced economies growth remains subdued, unemployment remains high, and renewed stresses in the Euro-area periphery are contributing to increased risks of recession. By contrast, in many emerging economies, activity remains buoyant, inflationary pressures are emerging, and there are now some signs of overheating, driven in part by strong capital inflows.

In this connection, the unrest in Libya - a significant oil exporter - obviously holds greater significance for the world economy than that in Tunisia, Egypt, Yemen or Bahrain. Libya produces 1.7m b/d of oil, just under two percent of world supply. Most of it is sold to Europe, especially Italy, and also to China. Analysts estimate the turmoil in Libya has added \$15-20 to the price of a barrel of oil, and that prices are likely to quickly drop back down if and when the fighting ends, although that may be an over-optimistic assessment in light of possible instability in Saudi Arabia.

Every \$1 increase in the price of a barrel of oil adds nearly \$23 million a day to Middle East OPEC revenues (Libya is not included in this calculation). On an annual basis, this is equal to about \$8.4 billion. In light of the \$22 increase since the beginning of 2011, the daily revenues of Middle East OPEC countries have increased by \$506 million, which will amount to \$185 billion at year's end if the price remains stable. Table 2 shows the development of OPEC and Iranian oil export revenues between 2000 and 2011. The figure for 2011 is an estimate based on the current high price being maintained throughout the year.

Table 2

**Oil Export Revenues of Middle East OPEC states, 2000-2011**



The changes in revenues have been more dramatic because Saudi Arabia has increased its production by at least an estimated 700,000 barrels a day (b/d) since January 2011, with production now reaching over nine million b/d. According to the Saudis, the country also possesses much spare production capacity. At a price of \$111 a barrel, the extra 700,000 b/d would add a further \$28 billion to annual revenues. Already, the rise in revenues has made it easier for King Abdallah to announce large welfare benefits for his subjects, a palliative measure designed to forestall the cascading protests in the region from reaching Saudi shores. It also made such an announcement more necessary. After all, one of the most powerful slogans of those in revolt throughout the Arab world was the rhetorical question, “What are they doing with our money?”

The other important player in the political game is Iran. Unlike Saudi Arabia, Iran is unable to increase oil production, but at current high prices is not in need of doing so. Iran’s oil minister,

Massoud Mir Kazemi, the current president of OPEC, has said that oil was not overpriced at \$100 a barrel and he ruled out any need for OPEC to discuss changing quotas, even if the price hit \$120.

Every \$1/barrel price rise brings in \$3.6 million, or \$1.3 billion a year for Iran. The \$22 price rise this year is yielding an extra \$79 million a day or \$29 billion a year. One of the most serious strategic consequences of the rise in oil prices has been to undermine the effects of US-led economic sanctions against Iran. Prior to the latest price hike, it was becoming clear that sanctions were affecting the economy.

Iraq will also benefit from rising oil prices. As with Iran, its oil production is constrained (although the reasons for those constraints are different) and it will welcome obtaining more for each barrel produced. The increase in revenues may mean that the different factions within Iraq have more incentives to agree on a division of the oil revenues between them. The main conflict over the issue is between the Kurds and the central government in Baghdad.

Some Arab countries are oil importers, including Egypt, which also produces a relatively small quantity of oil. These states are now paying much higher bills that will affect inflation rates and the balance of payments. They are not well positioned to cope with the extra strain. Egypt has suffered massive losses as a result of the uprising: revenues from tourism have plummeted and production throughout the economy has been hit by strikes and demonstrations. Jordan's economy is always delicately placed: unemployment and inflation have already resulted in demonstrations. Tunisia and Morocco are negligible oil producers and the political situation in both countries will be affected by rising fuel costs that worsen socio-economic conditions. All countries in the Middle East will suffer from any worsening of the global economy that results from the rise of oil prices and this will eventually act as a restraint on the price of oil. It is, however, a very costly mechanism.

All of these developments are yet another reminder of the dangers of relying on oil to fuel transportations systems and other sectors of the economy. The United States uses about one-quarter of the world's oil production. In 2010, for the first time, China surpassed

the US in overall consumption of energy from all sources and for all uses, although its per capita use is much lower than the US. Large numbers of Chinese continue to migrate from the countryside to the city and increasingly use motor vehicles, hence their consumption of energy has risen sharply. Today China consumes about one-tenth of the world's oil production, and according to British Petroleum it will surpass America in 2030.

The Chinese demand for petroleum, more than any other factor, will dictate developments in the global energy market. Most of the oil from the Middle East is already being exported to Asia, mainly to China and Japan. Until now, America has been in control of most sources of supply, as a result of its defense treaties with Saudi Arabia and the Gulf states, as well as the military occupation of Iraq. Competition for Middle East oil between the US and China is increasing and that is one reason why the latter is opposed to the imposition of harsher sanctions on Iran.

Global oil consumption is now at a record peak of about 88 million barrels a day. The two largest producers are Russia and Saudi Arabia, which together supply about one-quarter of the market. The largest proven reserves are also in Saudi Arabia. That is the only country with a large surplus production capacity. The extent of Saudi Arabia's reserves and its production abilities have been the subject of doubt. Largely, it is expectations that determine the price of oil, and the behavior of consumers. The powerful earthquake and tsunami that have just struck Japan and threaten its nuclear power reactors cast doubt on the nuclear alternative to hydrocarbons worldwide. This will increase the pressure on oil prices still further.

Does it make sense for the US and other Western countries to reduce oil consumption? High oil prices will do this automatically if they are maintained, because they will encourage the use of alternative fuels and technologies that use less fuel. Stimulating this by government action would reduce exposure to oil price rises/shortages and would encourage the development of new technologies. These could help to stimulate economic growth and be exported to China and other fast growing, oil importing countries. They would also have beneficial environmental effects. It is too late to avoid the effects of the current predictable and predicted crisis; any measures undertaken now would only affect the demand for oil in the medium term.

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