

## WHY WE NEED \$60/BARREL OIL

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### Oil prices and economic growth

The US economy attained its highest-ever postwar growth of real GDP, achieving what today would be the completely unthinkable, and certainly impossible rate of 7.5%, in the Reagan re-election year of 1984. At the time, in dollars of 2003 corrected for inflation and purchasing power parity, the oil price range for daily traded volume crudes was \$57-\$65/barrel. Despite this simple fact of economic history, Cheap Oil is still regarded by the uninformed and biased as a passport to economic growth. Almost any fit-to-print analyst or commentator will find the place, in their weekly columns, to repeat the basic myth that 'High oil prices hurt growth'.

Apart from *regime change* in the Mid East, which is not producing an oil bonanza in Iraq, there is little avail and remedy on the supply side, to force down oil prices. Energy conservation and transition to a low energy economy, habitat and society is the real alternative, but is discarded as utopian or unworkable by political decision makers. This leaves 'demand destruction', through economic destruction by *the interest rate weapon*. The last time this was done, in 1980-83, the impact was surely to reduce oil prices (in today's dollars from \$100/barrel in late 1979 to around \$60/barrel in 1984), but the collateral economic damage was awesome. In addition, the world economy, and especially the OECD economy started from a position of growth, with balanced budgets in many countries including the USA, in 1979-80. The world economy could and did take the horse medicine of sky-high interest rates without imploding into a sequence like that of 1929-31, after which no way out from endless recession was possible.

Things are very different in 2003. While oil prices as high as \$60/barrel would do little to harm the world economy – they would entrain increased growth at the 'composite' world economy level within a few months - any attempt at raising interest rates to *double digit* levels in the OECD countries would most surely have fast and devastating impacts. Extreme interest rates, today, would certainly entrain complete collapse of world stock markets, runaway 'domino effect' bankruptcy of many major service and finance sector corporations, mass layoffs and unemployment, and grave problems for financing the *structural* trade deficits of especially the US and UK. The US, also facing an all-time record deficit of its public finances (\$455 Bn in 2003) and around \$4 Bn per month costs from its 'non performing oil colony' in Iraq would expose itself to runaway flight from the dollar as the interest rate weapon firstly produced stock market collapse and possible inflationary recession. The currently weakening US dollar, subjected to 'benign neglect' in its unequal struggle with the Euro, could perhaps suffer uncontrollable flight and fall to below 0.75 Euro. The declining *petromoney* status of the GB pound would unlikely shield the UK economy from the sequels of using *the interest rate weapon*.

All European Union countries, and Japan would also face severe national budget financing difficulties, as tax revenues collapsed and spending to limit economic damage, including unemployment compensation, spiraled up as the crisis deepened. Financing of increased state spending through borrowing would then *lock on* the upward spiral in interest rates, the higher cost of borrowing itself intensifying recession and increasing the inflation itself due to constantly falling economic growth. The bottom line could be a short period of inflationary recession, followed by runaway deflationary economic recession. Current near-zero economic growth in the OECD countries would be replaced by something akin to the 1929-31 sequence, or like the 1980-82 sequence of entry to economic slump but this time with no way out.

### The upward trend

For a number of reasons, underpinned in final analysis by the approach of the ultimate peak in world oil production capacity and output, oil prices are on an erratic but upward trend since their 1998 most

recent low (around \$10/barrel). The *interest rate weapon* for reducing oil prices through entraining a so-called 'soft landing' or controlled fall in economic activity leading to a fall in oil demand, at this time, is out of the question. Thus the 'very high price of oil' that has held, off and on since 1999, of about \$30/barrel or about one-half the real oil price in 1984, will likely be tolerated and accepted by economic and monetary deciders for the simple reason they have no other choice. In addition, the supposed 'inevitable inflationary impact of high oil prices' has certainly not appeared with \$30-per-barrel oil. The general economic environment at this time is highly, even dangerously deflationary.

Finance and business commentators can console themselves, and any readers or listeners who believe their 'forecasts' that oil from Liberated Iraq, like some mythic White Knight, is shaping up to 'inundate' markets on the horizon of perhaps 2008 or 2010, restoring the manna of Cheap Oil at perhaps \$15 or \$18-per-barrel. In the present and real world trends are not shaping that way. World oil demand, conversely, is at around 78 Mbd and growing at about 2.25% annual, that is far above the 'long-term trend rate' of 1.4% annual that held through 1989-99.

The special case of the US natural gas market, now exposed to a wealth of disinformation seeking to hide the essential *fact* of depletion, the simple fact that the US is 'drilled out', is a harbinger and outrider for a depletion triggered shift to deficit overhangs on natural gas markets in Europe, and the world. Where gas pipelines cannot be constructed – through cost, geopolitical or time constraints - supply to compensate localized depletion will have increasingly to switch to LNG from exotic locations. Prices for this *lifeline gas* will also be exotic relative to \$2/million BTU for gas and \$15-per-barrel oil that underpinned or enabled the now long dead Clinton Boom of 1992-2000. Inside national energy markets, led by the USA, fuel switching away from expensive gas to cheaper oil will, by 'contagion effect' ratchet up the oil price.

Real world oil prices are relatively firm but the price outlook is at best opaque, because OPEC, under any scenario, will most certainly play a growing role but has no replacement for the supposed, current gameplan of an 'ideal price range of \$22-\$28/barrel'. During the Cheap Oil 1990s much was made of OPEC continually losing market share. With depletion the bottom line of who holds the majority of remaining oil resources become a lot more important than market share, and close to 60% of the world's remaining oil is held by OPEC. The war of communiqués between OPEC (understating both production and demand), and the big consumer nation economic and energy agencies like IEA and EIA (overstating demand, and especially production to incite 'desolidarization' among OPEC countries) can surely go on, but the degree of unreality in this now ritual game can only increase. An open shift to the Euro by more members of the cartel, no doubt *without* Saudi Arabia in the very near term, will by the magical irony of the oil market, quickly translate to *higher* oil prices. At present the only bottom line of which we can be sure is that almost no credible scenario re-enables oil prices at the 1990s 'target price' of \$18/barrel (or about Euro 15.50).

### **Oil price crashes can spark stock exchange routs**

Through 1986, from December 1985 through August 1986, oil prices were nearly divided by three, that is fell by about 65% in 8 months, to a low of around \$11.50/barrel in dollars of 1986, for many light blends. Expressed in dollars of 2003 the price fall was from a year peak of about \$52-per-barrel to around \$19.50/bbl. Absolutely no spontaneous, self-reinforcing and of course non-inflationary increment to economic growth was recorded in any OECD country.

Conversely, unrestricted double-digit growth of stock market 'value', without corresponding growth in the real economy certainly has strong impacts. While the 1986 oil price crash, and that following Desert Storm in 1991 were non events in economic growth terms, the 1985-86 oil price crash underpinned unrealistic growth of stock market indices, fuelled and comforted by the myth that cheap oil would or could enable 'Belle Epoque' economic growth to return. Nothing was further from the truth. Both in bourse mythology and in fact any bull market always has its Dark Twin waiting when economic growth and company earnings turn south for too long, and this took the shape of the October 1987 US, and then world stock market crash. Bourses experienced their largest one-week falls in index numbers since the 1929 Wall street crash with capitalization losses estimated at around \$ 2 400 Billion, in today's dollars. This remained a record until the losses of around \$ 6 000 Billion

triggered by the dotcom-telecom and hi-tech crash that started in early 2000 and continued through 2002. If there is a Sept-October 2003 crash, perhaps through an oil shock trigger, many factors suggest it could set yet another record for loss of notional value.

It is unlikely that regular grade finance and business analysts will or can understand the irony that any large oil price falls, now, may in fact destroy the last line of defence for the world economy, right on the brink of a runaway deflation spiral - that itself could give the trigger for a classic October (2003) bourse crash. Deflation in nearly all OECD economies, recession openly admitted in some, and a wilting dollar with the real US economy weakening (inevitably impacting its NYSE fantasy twin in a certain future), all create a perspective of vintage bourse meltdown never being so plausible or possible. While the flimsy rationale for 'growth fed by cheap oil' never translated to reality in the past, and will not in the present, an oil price collapse at this time could enable or accelerate not a treble-dip recession, but a difficultly reversible collapse of world bourse indices. This could be followed by a real economy collapse.

### **No easy alternatives**

Some analysts argue the highest-ever one-year growth of the US economy in 1984 was due to equally extreme budget deficits operated by the Reagan administration with the aim of securing Reagan's re-election. The current Bush administration now seeks re-election of its leader, and is pouring on deficit financed spending like any good Keynesian demand-sider but this has done little or nothing to restore or redynamise economic growth. The federal deficit in 2003 will easily attain \$455 Bn, an all-time record. One major difference with 19 years ago that few policy gurus will mention is oil and other real resource prices. Nevertheless, oil price rises to levels close to those of 1984 are either probable or at least possible within the next 12 months, and will almost certainly lever up world or 'composite' economic growth, even if these rises come too late to save Candidate Bush.

In real terms oil prices are still comfortably 60% below their level of 19 years ago. Real limiting factors on faster economic growth in most OECD countries include personal debt, fears of job losses, terrorism, climate change and other worries in what are essentially *consumption saturated* economies. There are ever fewer possible strategies for restoring conventional economic growth. Lower interest rates at this time, and apart from symbolic playacting with quarter-point cuts, can be discarded as any kind of rational, or even possible strategy for the simple reason that US, European and Japanese base rates are at *historic lows*. Most OECD countries, in 2003, have their lowest, or close to their lowest nominal (but not real) interest rates for 50 years! Further cuts in US interest rates (to base rates of *zero percent per year!*), as suggested by Federal Reserve governor Ben Bernanke, would most surely increase the slow but certain movement away from the dollar, perhaps turning this into classic *flight*. Gold prices would move up, oil could move sideways, but the only sure results would be sharply higher US inflation, and sharply lower US economic growth. Only restored economic growth in the US economy, in final analysis, can underpin the US dollar.

### **Higher oil prices restore world economic growth**

Higher oil prices operate to stimulate first the world economy, outside the OECD countries, and then lead to increased growth inside the OECD. This is through the income or *revenue* effect on oil exporter countries, and then on metals, minerals and agrocommodity exporter countries, most of them Low Income (GNP per capita below \$400/year). Almost all such countries have very high marginal propensity to consume. That is any increase in revenues, due to prices of their export products increasing in line with the oil price, is very rapidly spent, on purchasing manufactured goods and services of all kinds. In the 1973-81 period, in which oil price rises before inflation were of 405%, the New Industrial Countries of that period – notably Taiwan, South Korea and Singapore – experienced very large and rapid increases in demand for their exports. These three countries increased their oil imports in under 8 years through the 1973-81 period, and despite the 405% price rise, by 60% to 80% in volume terms.

This macroeconomic mechanism of higher revenues for fast spending poorer countries quickly leveraging up world economic growth (the very simplest type of Keynesianism, but at the global level) is easily triggered by rising oil and real resource prices, and flatly contradicts the arguments by authorized 'experts' who opine that higher oil prices 'hurt poorer countries the most'. They go on to claim that 'greedy' oil producer countries will also be 'hurt' by the inevitable recession that higher oil prices must inevitably cause, but higher revenues to many low income oil exporter countries may be the only short-term way to stop these countries falling into the black hole of civil and ethnic war.

No immediate and instant recession can occur with oil at \$50 or \$60 per barrel. Vastly higher oil prices than that would be needed to abort the worldwide mechanism of higher oil, energy and real resource prices driving faster economic growth. Conversely, low oil and energy prices entraining low real resources prices, combined with rising population numbers surely aggravate the 'cycle of poverty' in low income commodity exporter countries. Deprived of sufficient revenues, such countries have become 'basket case' indebted countries, subjected to draconian conditions by the Club of Paris, World Bank and IMF for debt refinancing and restructuring. Constant ethnic and civil war in Africa provides the best and most real example of what happens to countries subjected to so called 'structural adjustment'. When or if this concerns oil exporter countries there can be no surprise if this reduces or eliminates exports by the affected countries which, after the 'price taker' stage fall into the bottomless pit of basket case low performer economies. When they fall from that into civil and ethnic war their capacity to supply oil also takes a hit.

Today's New Industrial countries (NICs) include China, India, Pakistan and Brazil. All have either big or immense internal or domestic markets, and large potentials for *military keynesian* spending, that is safeguarding national economic growth through deficit financed and labor intensive modernization and expansion of their military systems. The relative lack of integration of these *behemoth economies* in the world system, particularly India and Pakistan, also provides them with some cover or shelter from the effects of world recession, when or if the OECD countries tilt to all-out recession. Conversely, whenever any increase in world solvent demand for manufactured goods occurs, these countries will rapidly increase output. China is now and without question the world's leading industrial power for medium- and low-value consumer manufactured goods and will soon become the world's single biggest industrial economy. Under almost any hypothesis, therefore, fossil energy demand – particularly oil – will increase in China and India, and in the other large population NICs. Demand growth can only run at rates close to, or above their rate of economic growth.

### **Demand pull, supply pinch and oil price feedback**

According to some analysts we are edging closer to the absolute peak of world production, perhaps no more than 84-87 Mbd on an all liquids base, and very far indeed from US EIA and OECD IEA prognostications of up to "120 Mbd by 2020". Maximum production increases, after replacement of production capacity lost through depletion impacts through the 2003-2010 period may be no more than a net of 1 - 1.25 Mbd annual. Current world demand is on an underlying growth track of about 2.25% annual, or around 1.75 Mbd increase for the next 12 months.

This situation, logically, should entrain very large or nearly unlimited increases of oil prices within a period of no more than 2 – 3 years. Various *military adventures* in Iraq, or elsewhere, will have little real impact on emerging and structural *supply deficit* on world oil markets. The role of, and scope for utilisation of 'strategic' petroleum reserves (SPR) will become ever more symbolic since the constitution of these reserves always *increases total demand*. At the present time not only the US, but also China and India are constituting or increasing their SPR with inevitable, additional impacts on world demand.

Sharp and large oil price increases can likely result in significant falls in OECD demand, within periods extending from 3 – 6 months but this is not at all the case in nonOECD economies. Taking current world regional per capita oil consumption rates, and economic output per barrel or barrel equivalent of commercial energy, the effectively *price elastic* OECD North, and *price inelastic* NICs and LICs present almost totally different 'profiles' under oil shock conditions. The bottom line is that relatively large and rapid falls in oil demand in the OECD North, and sustained demand increase by NICs and LICs can be

expected whenever oil prices break through the current, artificially low range of no more than \$30-\$35/bbl in 2003 dollars. On a composite base, and depending on exactly how far oil prices rise, net world demand can likely *increase* when or if oil prices increase to \$60-per-barrel or below.

## **Conclusions**

For various economic doctrinal and economic mythical 'reasons' Cheap Oil is seen by the decisionmaking elite in the richer nations as the 'passport to economic growth'. This is a pure fantasy.

Cheap oil necessarily reduces the price, and value of real resources relative to services, information and the ritual forms of 'wealth' created and maintained in the old, and aging democracies, whose urban *industrial* lifestyle is now the reference format, the model and framework for economic development and social progress anyplace in the world. The 'globalized' economy is itself a powerful motor for continued and strong demand growth for fossil energy, worldwide. Positive feedback from this economic and policy structure reinforces dependence on fossil fuels.

Physical depletion is either rejected or ignored as a price setting factor for oil and gas. Concerning oil there is mounting evidence that net additional production capacity is decreasing every year, while the ratio of annual new/lost capacity declines on a regular base. In addition the annual ration of discovery/consumption remains at 1/6 or worse. Refusal to accept this evidence makes various 'shocks' (price and supply) both necessary and inevitable. By 2008 the world oil market may enter a situation of structural supply deficit.

In the case of conventional or classic economic growth, this will be enabled and facilitated at the world or 'composite' level by rising oil prices up to and probably above \$75/barrel in today's dollars.

Also because of depletion, but in addition because of environment and terrestrial limits, energy transition away from fossil fuels must and will happen. Price signals, in the existing economic system and framework, are needed if this is to start, and to build from the immediate near term. Existing and developing frameworks provide by the Kyoto Treaty offer some potential for adaptation and direction to the task and goals of energy transition.

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