Chapter 10

Strategic Implications of the Global Oil Market

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Basic Economic Data

The world's proven oil reserves are currently estimated at about 1.2 trillion barrels of oil. As the world's oil consumption is approximately 30 billion barrels a year, reserves will be sufficient for about the next 40 years, based on current production rates. This does not mean that oil will run out within a given period, as there are other reserves ("expected reserves") estimated at more than half of the proven reserves, and more proven reserves are discovered every year. Over the last two decades there has been no significant change in the ratio between proven reserves and the level of global consumption.

Sixty-two percent of the world's proven oil reserves are in the Persian Gulf region, with Saudi Arabia owning the largest reserves (table 1). The remaining 38 percent are located in the former Soviet Union (with about 11 percent of proven reserves), Venezuela, Libya, Nigeria, the US, China, Mexico, Algeria, Angola, and Norway. The oil producers in the Persian Gulf belong to OPEC (Organization of the Petroleum Exporting Countries), which possesses around 75 percent of the world's oil reserves. The proven oil reserves largely determine the status of all the oil producers in the global oil market.

Table 1. Proven Oil Reserves in the Persian Gulf

Country	**Billions of barrels**	**% of world reserves**
Saudi Arabia	264.3	22.1
Iran	138.4	11.6
Iraq	115.0	9.6
Kuwait	101.5	8.5
United Arab Emirates	97.8	8.2
Oman	5.6	0.5
Qatar	15.2	1.3
Syria	3.0	0.3
Gulf total	740.7	62.0
World total	1195	100.0

Source: Annual Statistical Bulletin 2006, OPEC

In 2008, world oil consumption was estimated at about 87 billion barrels of oil a day. The US is the world's largest oil consumer, and if it maintains its current oil production level its reserves could run out in the next decade. More likely, however, oil production in the US will decrease and imports will rise. Elsewhere, the most significant development in recent years has been the sharp rise in demand in Asia and the Pacific. Today this region consumes more oil than North America. Between 1996 and 2006, demand for oil in the region rose about 29 percent, compared with an increase of 14 percent in consumption in North America. Particularly noteworthy is a rise of 30 percent in oil consumption in China between 2003 and 2006.

Table 2. Breakdown of World Oil Consumption (2006)

Country	%
1. North America	28.9
of this: US	24.1
2. Europe	24.9
3. Latin America	6.1
4. Middle East	7.2
5. Asia and Pacific Rim	29.5
of this: China	9
6. World total	100

Source: BP Statistical Review of World Energy 2007

OPEC supplies most of the world's oil demand and about 43 percent of global oil consumption (some of the countries provide for their own consumption, partially or fully). Given the large oil reserves in the Gulf, the surplus in the oil balance (production minus local consumption) of the Gulf oil producers, and the increase in oil demand in the world, a continued rise in oil imports from this region is expected.

Oil Prices Rally

Oil prices rose significantly in 2007, and in April 2008, prices exceeded \$119 a barrel, a record price in real terms (in 1980, following the Islamic Revolution, prices reached \$41 a barrel, the equivalent of about \$100 in today's prices). This rise is a continuation of the trend that started after the 2003 Iraq War. Prices were actually expected to drop after the US victory, but the United States could not stabilize the situation in Iraq (Iraqi oil production still lags behind its level before the invasion of Kuwait) and world demand for oil has increased continually.

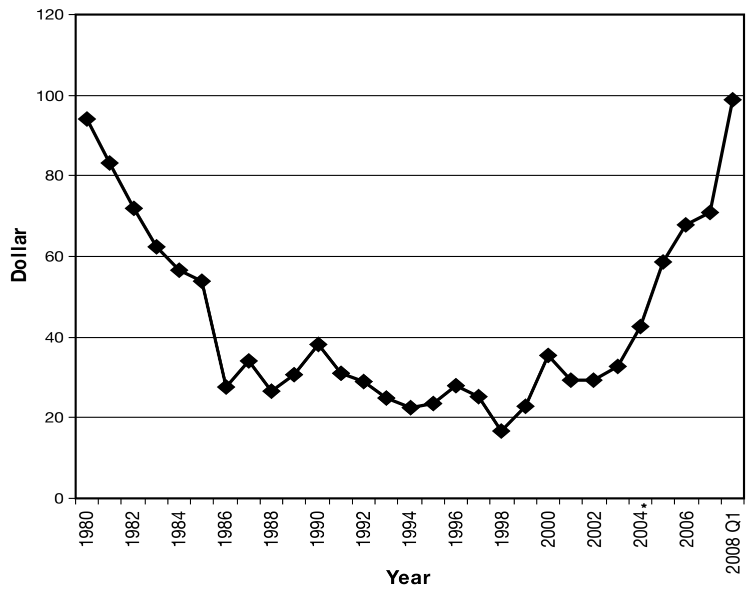

Figure 1. Real Changes in Oil Prices
(annual average cost of a barrel of oil in dollars, in fixed 2007 prices)

Source: BP Statistical Review of World Energy 2007 (through 2006); 2007 and 2008 – author estimates

The fundamental reason for the price rise is the increase in world oil demand, particularly due to marked growth in the developing countries. The level of oil prices in the world is dependent on continued growth of the global market: rapid growth will support the high price level, while a substantial slowdown in global growth will generate a drop in prices. Oil prices are currently in a state of flux, and despite the steady rise, concerns over a possible global recession prompted a slight drop in March 2008. There are different assessments of oil prices for the coming years: from \$200 a barrel, in the case of rapid growth, to \$60 per barrel if the world enters into a recession.

In addition, OPEC regulates the production level of the member countries. Led by Iran, Venezuela, and Algeria, the cartel has supported high price levels. These countries have relatively large populations, have experienced economic difficulties over the past decade, and do not see any reason to consider the needs of oil consumers. Their policy is to maximize revenues from oil and gas exports by maintaining high prices. Iranian President Mahmoud Ahmadinejad, prior to the OPEC summit in Saudi Arabia on November 17, 2007 (when oil prices were close to $100 a barrel), declared that oil prices should rise, as OPEC countries were subject to unjustified "heavy political and economic pressures." Venezuelan President Hugo Chavez added that $100 for a barrel of oil was a fair price, as it was the equivalent of $30 a barrel in 1970s prices.

In contrast to the radical camp, it appears that Saudi Arabia and the United Arab Emirates, which possess about 40 percent of the oil reserves and have relatively small populations, fear that a sharp rise in prices will encourage the development of alternate energy technologies and the search for extra-OPEC energy sources and will accelerate a policy of energy savings. Nonetheless, these states have done nothing to block the dominance of the radical bloc.

The sensitivity of the oil supply likewise affects prices. Surplus production capacity (the ability to increase production in the short term) is very low, and as such, any disruption in oil production – be it from security tension in the Gulf, adverse weather conditions in the production areas, internal tension in oil producing countries (Iraq, Nigeria), strikes at oilfields, disputes between an oil company and a country with oilfields (Venezuela), changes in strategic stocks (Western countries) – generates a price rise.

Saudi Arabia is the only country with a surplus production capacity to speak of. As of mid-2007 Saudi Arabia produced 8.6 million barrels a day and its full production capacity is 10.5-11.0 million barrels a day. Yet this is a relatively small amount (about 2.3 percent) compared with world oil consumption, and it cannot compensate for the shortage if any major event (e.g., a military confrontation between the US and Iran) leads to a substantial drop in the supply of oil from the Gulf. In addition, there is speculative activity by financial entities that have gambled on oil prices or sought shelter from the drop in the value of the dollar. All these have contributed to the hike in the price of oil.

The higher cost of oil creates difficulties for consumers. In the United States in 2007, for example, there was a rise of 4.1 percent in the consumer price index (CPI), compared with 2.5 percent in 2006. Most of the difference is attributed to the rise in energy prices, which was 17.4 percent in 2007. In the fourth quarter of 2007, when there was a particularly sharp rise in energy prices, the CPI rose 5.6 percent in annual terms. This was the highest rate of inflation in the United States since 1990. At the same time, there are expectations of a decline in American product growth in 2008.

The effect of a rise in oil prices on the Israeli economy has to date been limited compared with previous rises in the oil market, in part because the relative share of oil in generating economic activity is far less than in the past. A major part of Israeli product comes from technology industries that do not use large amounts of energy. Another reason is the strengthening of the Israeli shekel in relation to the currency basket, which led to a considerable drop in the price of imports into Israel and of dollar-calculated services. Thus, a large part of the rise in the energy prices in the CPI was offset.

The rise in oil prices in recent years contributed hundreds of billions of dollars to oil exporting countries. For example, Saudi Arabia's revenue from exports in 2007 is estimated to be $218 billion, in real terms triple the revenue in 1996 and almost seven times the 1986 revenue. As a result of the increase in the price of oil, there was already a current account surplus of $95 billion in the Saudi balance of payments in 2006 (even before the sharp rise in prices at the end of 2007), about $50 billion in the Kuwaiti account, and about $14 billion in Iran's account.

The rise in revenues among Arab oil states trickles down to countries that do not produce oil (such as Jordan and Lebanon), and to smaller oil exporting countries (Egypt and Syria). Oil revenues reach these countries through remittances of workers (Egyptian, Jordanian, Syrian, Lebanese, Palestinian) in Gulf states to their families in their

Table 3. Oil-Related Revenues of Arab Oil Producing Countries and Iran
(In billions of dollars, in fixed 2008 prices*)

	1966	1976	1980	1986	1996	2006	2007*	2008**
Saudi Arabia	8.74	147	269	36	76	210	227	338
UAE	1.34	32	58	14	21	76	82	122
Kuwait	8.74	35	50	13	20	59	64	96
Qatar	1.34	8	14	3	5	26	28	42
Iran	7.40	88	31	12	27	64	69	102
Iraq	4.71	35	69	14	1	31	34	51
Libya	6.72	37	58	15	13	40	44	65
Algeria	3.36	18	34	10	12	41	45	67
Total OPEC***	61	493	736	153	239	701	758	1129

Source: 1976-2006 figures from the OPEC Annual Statistical Bulletin. The figures include crude oil, oil products, and thickened and liquid gas, without offsetting imports of oil products.

* Estimate
** Forecast - based on average OPEC price of $110 per barrel
*** including OPEC states not listed in this table

home countries, trade between countries, and funding of projects by oil producing countries in other countries. In non-oil producing countries such as Jordan, some of the impact of the oil monies is offset by increased energy costs. The oil revenue has a positive effect on the economies and internal stability of Arab countries that lack oil or are small oil producers. Nonetheless, the growing gap in wealth increases the potential of estrangement between the large oil-producing countries, which continue to amass wealth, and other Arab states. Saudi Arabia and the UAE possess around 75 percent of the oil reserves of the Arab world (about 4 percent of the world's proven reserves), while Egypt – the most powerful country in the Arab world – has dwindling reserves and will soon become an oil importer.

Political and Security Aspects

The United States' anxiety over the specter of Iran emerging as a hostile regional power with nuclear weapons that could dictate global oil supply policy is a function of oil's political and economic power. The struggle against Iran, like that against Iraq under Saddam Hussein, combines two main challenges: preventing a nuclear capacity and controlling energy sources. The Arab-Israeli political process is also perceived in part as one of the main components for achieving regional stability and ensuring the uninterrupted flow of oil from the Gulf to the West. It is not by chance that steps to bolster stability in the Gulf, contain Iraq, and advance the political process between Israel and the Arabs were packaged together by then-Secretary of State James Baker after the 1991 Gulf War.

The importance of the Persian Gulf as the world's primary energy source will make it hard for the US to withdraw from Iraq without a guarantee of regional stability. Nevertheless, the higher the oil prices, the more the US will find it difficult to intensify economic sanctions on Iran.

Al-Qaeda uses the oil lever with the claim that the US exploits the Muslims' natural resources through secular Arab regimes that kowtow to it. For example, in an interview published in December 2005, deputy al-Qaeda head Ayman Zawahiri said, "I call to concentrate efforts on the stolen oil of Muslims, whose main profit goes to the enemies of Islam, while the remainder is stolen by the thieves that control those countries." Comparable anti-American expressions were voiced by the presidents of Iran and Venezuela. In other words, some portray the struggle over oil as a clash of cultures.

The tension in the global arena is likewise reflected within OPEC. In recent years, the anti-American camp in OPEC, which includes Iran and Venezuela and Algeria to a degree, has gained in strength. These states control around one fifth of the world's proven oil reserves and about one quarter of OPEC reserves. At the November 2007 OPEC conference, Chavez cautioned the United States over attacking an OPEC member state, and said that the price of a barrel of oil would reach hundreds of dollars if the US attacked Venezuela or Iran. Overall, the West has been hard pressed to influence OPEC to increase production in order to moderate the rise in prices.

The dependence on oil and the increasing wealth of Arab oil countries enhance their political power in the world, particularly in the eyes of oil consumers, including in Asia, whose role in the global power game has increased. Organized political use of the oil and money weapon, as occurred after the 1973 Yom Kippur War, is not expected in the foreseeable future given the fragmentation in the Arab world and relations between the oil countries and the United States. However, there will presumably be companies that prefer not to do business with Israel or invest in Israeli companies so as not to harm their dealings with certain Arab countries and with Iran. The same may be said for economic corporations with large percentages of Arab shareholders. Other significant use of oil revenue might be triggered by a serious crisis in the Middle East.

The cash reserves accumulated by the Arab oil-producing countries led to an increase in their investments in economic corporations around the world, which may also endow them with future political influence. In late 2007, Saudi Arabia announced that it was creating a government investment fund – one of the largest in the world – to invest in companies worldwide. In December 2007, the Abu Dhabi Investment Fund invested $7.5 billion in convertible bonds of Citigroup, which grants it the right to convert the loan to 4.9 percent of the financial giant's share capital. While the deal will not provide Abu Dhabi with control of Citigroup and will not give it a seat on the management board, it provides entry into the corporation and strengthens the presence there of the Arab oil-producing countries (Saudi Prince al-Walid bin Talal is the largest private shareholder in Citigroup, with about 5 percent of the corporation's shares). Underscoring the importance of the large corporations, in January 2008 President Bush called on financial giants Deutsche Bank and

UBS (Switzerland) to limit their loans to Iran, in order to increase pressure on it to freeze its nuclear project.

Within the oil-producing countries it appears that some of the phenomena that characterized the previous rise in oil prices will recur, including an increase in ongoing consumption and the acceleration of large infrastructure projects. Investment in local production capacity will likely increase and contribute to long term growth. The dramatic rise in revenues has also led to an increase in military spending, with the regional security-political climate impacting on the size of this expenditure. Meanwhile, arms manufacturers have courted oil producers, raising the risk that weapons deals may upset the regional balance of power. Iran's ability to fund weapons deals and boost its financial support of Hizbollah and Islamic Palestinian organizations has widened. On the civilian level, an increase in consumption and infrastructure investments is expected in Iran, including in the energy field. Overall, high oil prices are encouraging the development of oil substitutes, including nuclear energy. The cultivation of manpower and infrastructure in the nuclear energy field may influence the potential for developing a military nuclear capacity in certain countries.

An increase in oil revenue potentially has an impact on inter-Arab aid. However, in contrast to the Baghdad aid (1979-88) to support Syria, Jordan, and the Palestinians in their struggle against Israel, there is now a chance that billions of dollars can contribute to regional peace and stability, if they are earmarked for projects such as rehabilitating the refugee camps in Arab countries, constructing a secure passage between Gaza and the West Bank, and desalinating water in the Gaza Strip and transporting it to the West Bank. In other words, today the question is not one of ability but of intent: do the Arab oil producing countries want to help promote a solution to the conflict using their resources? This question is more relevant than before in view of the Saudi initiative regarding the political process.

Conclusion

As long as no alternative is found, oil prices are expected to rise in the long term. On the other hand, history shows that the oil prices do not rise in a linear fashion. The current wave of price rises is unique in that it is not the result of a severe political crisis, as in 1973 or in 1979, but due to the accelerated demand for oil by developing countries such as China and India. Thus, as most of the world's oil reserves are located in unstable regions such as the Persian Gulf, an alternative to the current oil supply is increasingly important, for both economic and political reasons.