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OIL AT \$40 A BARREL: A THREAT AND A SIGNAL

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The recent rapid rise of oil prices reflects an increase in demand against a background of fairly tight supply. Demand has risen because the US economy is buoyant, the Chinese economy is growing rapidly and Japan is making a long-awaited recovery. Between 2000 and 2003, world oil demand rose by 3.1%. In North America, the largest consuming region, it increased by 2%. In China, the fastest growing country, it increased by 20%, and in 2004 Chinese demand is forecast to grow by almost 13%! These strong regional demand factors are operating simultaneously, which is unusual.

Between 2000 and 2003, total oil supply rose by 3.5% and international stocks also increased. This seemingly validates OPEC's claim that there was adequate supply. In fact, the increase in supply came from outside OPEC (+6.3%), while OPEC supply fell by 0.7%. In 2003, over 60% of supply came from non-OPEC countries. Why is it that OPEC -- for years the smaller producer -- is at the center of international attention? The first reason is that it is an organized cartel that explicitly aims to regulate prices and the quantities of oil supplied to international markets. Second, it controls the majority of world oil reserves. Finally, oil production costs in the Gulf are the lowest in the world.

Between 2001 and 2003, the OPEC basket price (an index of prices of different OPEC crudes) rose by 21.5%. In the first quarter of 2004, it was 8.5% above the average 2003 level, and in May it was an estimated 45% above 2003 levels. (See Table 1)

Table 1: OPEC Basket Price (\$/barrel)

2000	27.60
2001	23.12
2002	24.36
2003	28.10
2004 January	29.82
February	29.56
March	32.05
April	32.35
May (estimate)	40-41.50

OPEC has regained some of its strength and much of its will. In April 2004, it decided to reduce its output quota for the ten members, excluding Iraq, by one million barrels a day, a 4% reduction. OPEC production had been running above quota in recent months. The decision to reduce output was taken despite the fact that oil prices were well above the \$22-28/barrel price band that OPEC claimed it was aiming at. OPEC stated that the market was well

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supplied and it blamed the high price on speculators and anxieties about geopolitical factors: code words for Iraq.

The International Energy Agency (IEA) has estimated that a rise in the oil price of \$10/barrel has reduced world GDP by 0.5%, equal to \$255 billion. It also worsened the balance of payments (by transferring \$150 billion from oil importers to oil exporters) and the government budgets of consuming countries. As a result of higher oil prices, some 400,000 jobs have been lost in the main industrialized economies. In sub-Saharan Africa, the GDP loss came to 3%.

But oil prices in May 2004 were nearly \$17/barrel higher than in 2001, so the effects on the world economy have been much greater than those calculated by the IEA. If oil prices remain high, the effect will be extended and the damage to the world economy will cumulate.

In April-May 2004, oil prices rose largely because of worries about supply. This is what OPEC meant when it said that speculators were responsible. Without endorsing the role of speculators in any way, it must be said that they responded to real worries. On 26 April 2004, the oil export facility near Basra in southern Iraq was attacked by terrorists. On 1 May 2004, an even more worrying attack took place: a number of foreign workers as well as some Saudis were killed at Yanbu, on the west coast of Saudi Arabia. This was followed on May 29 by another attack in Khobar in eastern Saudi Arabia that also targeted foreign workers. As a result, a number of foreign companies working in the oil sector announced that they would withdraw their foreign personnel from Saudi Arabia, as others had done in Iraq. Middle East oil supplies looked much less reliable after these events and this was reflected in the price. Other worries in the market had been around for longer: political instability in Nigeria and Venezuela threatened two of the major non-Middle East OPEC producers.

What lessons should be drawn from recent events? The first is that terrorism in the Middle

East has increased prices on international markets, by \$5-10/barrel. This is a serious threat to the world economy, especially to poorer countries that cannot afford higher oil prices. The second is that although OPEC, and specifically Middle East-OPEC countries, are smaller suppliers than are non-OPEC countries, they are more problematic in terms of political risk. This is why, despite their lower costs, they supply less. It is going to be very difficult to significantly reduce their share of total supply, either by reducing the volume they supply or by increasing non-OPEC's output.

The solution to current instability is therefore a reduction in demand. This does not have to be immediate: oil markets operate in such a way that expectations about the future are built into prices. A program to reduce demand for oil, or at least slow its growth, by economizing on its use and/or encouraging greater use of other fuels would change expectations and thus increase stability in the market.

This has to come, among others, from the world's largest consumer: the United States. The US accounts for nearly 30% of world demand although it has less than 5% of the world's population. Oil use is buoyant because the economy is strong but also because there is waste, encouraged by what were, until recently, low prices for gasoline. There is evidence that many US consumers are buying larger, less fuel-efficient automobiles. Because its economy is the most developed, its ability to reduce demand is much greater than in many other countries.

The alternative favored by the Bush administration is to increase supply. There is, however, no supply source that can substitute for OPEC/Middle East output in the long run. The main forecasting organizations suggest that, over the next twenty years, reliance on Middle East oil will increase. Given what has happened in recent months, increased reliance on oil will pose an increasing threat to the international economy. Oil at \$40+/barrel is the signal of what should be done.