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ECONOMIC NEWS UPDATE

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It's tough attending dinner parties these days. Until recently, all an economist had to cope with was a demand for a forecast of house prices -- for each of the neighborhoods represented at the table. Now things are harder. Every guest has his own reason for wanting a forecast of oil and gasoline prices.

Politicians are convinced that the price of gasoline will affect who controls the House of Representatives after the November elections. Republicans profess to see the recent 50-cent-per-gallon drop in prices reflected in an uptick in their polling ratings.

Monetary policy types also want to know about oil prices. The recent decline, they say, provides ammunition to the members of the Federal Reserve Board's monetary policy committee who want to extend the "pause" in interest rate increases as they battle the inflation hawks who are arguing for just one more rate rise.

Oil industry executives are quite naturally eager to peer into the future. They are using the recent drop in oil prices -- down about \$15 per barrel -- to

prove that markets are finally working as they should. And the OPEC cartelists are citing the price plunge to prove three things.

First, prices never really were as high as the industry's critics contended. Even when prices reached \$78 per barrel in July, they were far below the inflation-adjusted almost-\$100 per barrel (inflation-adjusted) that they hit in April 1980. Second, the price drop shows that the markets are retreating from the nervousness created by the "peak oil" crowd that has been arguing that the world is running out of oil. So no need to subsidize oil substitutes.

Third, the drop in prices has allowed the cartel to signal its members that they are free to cut back production as demand for oil dictates. Translation: don't produce so much as to encourage further drops in oil prices. So much for OPEC's now-forgotten pledge to keep prices below \$30 per barrel.

Most important to the cartel, the easing of price pressures eases the political pressures on them. The Saudi regime, after all, still counts on the American military to defend it should bin

Laden or others attempt a coup. Never mind that it is the Saudis who fund the worldwide teaching of the Islamic fundamentalist creed that fuels the anger of the terrorists: what President Bush calls our oil addiction requires us to support the House of Saud much as a drug addict's habit requires him to support his dealer-pusher.

It does seem that forces on both the demand and the supply sides of the market are starting to make themselves felt. On the demand side, thousands of unsold SUVs and pickup trucks dot dealers' lots as consumers shy away from these fuel-intensive vehicles. On the supply side, \$60-70 oil has encouraged Chevron to drill deep under the Gulf of Mexico, and uncover a field that might contain as much as 15 billion barrels of oil, adding 50% to US reserves. Even a loyal Russian KGB apparatchik knows the difference between \$20 oil and \$60 oil: Putin has announced that Russia will spend \$100 billion over the next decade to shore up his nation's ability to get oil to market.

But easing of demand, and increases in supply do not necessarily portend a return to the era of low-priced oil, as a quick review of potential supply sources indicates.

- In America, environmentalist continues to block development of reserves in Alaska, and cite BP's environmental and safety problems as an added reason to leave the caribou undisturbed.
- In Venezuela, production will continue to decline as Hugo Chávez's political appointees prove unable to operate the nation's oil

fields as efficiently as the technicians he fired.

- In Mexico, the government refuses to allow the gringo investment it needs if it is to reverse the declining productivity of its oil fields.
- In Iraq, terrorists continue to blow up oil facilities, preventing that country from achieving its production potential.
- In Iran, the Mullahs and their firebrand president threaten to shut down their fields, and even close the waterway through which most of the world's oil travels if anyone interferes with their drive to obtain nuclear weapons.
- In most of the Middle East, where the great bulk of the yet-to-be-discovered reserves lie under desert sands, Western investment and technology are barred, bringing into question future production capabilities.

Only Canada holds promise for significant trouble-free supplies, if prices remain high enough to warrant continued development of its extensive tar sands deposits.

So we are not dealing with a market of the sort Adam Smith had in mind -- rational, profit-maximizing players interacting with full knowledge of market conditions -- when he described how supply and demand interact to set price. It seems highly unlikely that the risk premium reflected in oil prices will disappear any time soon. So Rodrigo Rato, managing director of the International Monetary Fund, is probably

right when he warns, “Oil is going to continue at high prices in comparison to the last two-three years”.

That will have repercussions far beyond oil markets.

Wealth will continue to be siphoned off from consuming to producing countries, enriching the Saudi fundamentalists and the likes of trouble-making Chávez. Russia will be able to replace its clapped-out military with dollars, euros and yuan as a source of geopolitical power, witness its purchase of an interest in EADS, the European defense firm that manufactures ballistic missiles for the US military. America’s trade balance will continue to suffer from the outflow of dollars needed to pay for the inflow of oil. And its ability to defend the West in its war on terror will hinge on the willingness of Arab and other hostile states to provide the fuel on which its economy depends, and which its military needs for its Humvees, drones and other equipment. Oil addicts do indeed pay a high price to avoid the temporary withdrawal symptoms that a sensible energy policy would produce.



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