

Obama's "realist" roots are stronger than his sincere concern for third-worlders struggling for freedom. (If President Obama wanted to bury Iranian president Mahmoud Ahmadinejad's dream of being the hero of the Arab world, he'd immediately order U.S. fighter aircraft into the skies of Libya to destroy all airplanes, helicopters, and armored columns attacking the citizenry.)

The administration may well play an inconsistent game, trying to support democracy seriously in Egypt but less seriously elsewhere. This will be a big mistake, inviting the contempt of Arabs and the collapse of U.S. democracy promotion everywhere. We need a consistent rule: *The United States endorses one form of government—the one it chooses for itself, representative government—and it applauds this everywhere.* The Khalifa family in Bahrain and the Hashemite monarchy in Jordan should be under no illusions about where America's heart and wallet are. We most certainly are in favor of orderly change, which is why the Khalifas and Hashemites should start now to transfer political power gradually to the Shia in Bahrain and the Palestinians in Jordan. They may possibly save their monarchies by doing so (and save us a fairly good friend on the East Bank of the Jordan River and the anchorage of the Fifth Fleet in the Persian Gulf). We really don't want to see the Saudi armed forces rolling across the Gulf causeway to crush democratic protests in Bahrain. If we wanted to create a situation that Iran could exploit, that would be it. If we wanted to ignite sectarian strife throughout the region, that would be how to do it.

The United States has an enormous role to play midwifing democracy throughout the Middle East. And President Obama, if he could realize this despite his profound unease at becoming the successor to the freedom-promoting George W. Bush, might go down in history as America's great third world president—the man who permanently buried our dependency on despots throughout the Middle East. ♦

# A Libyan Oil Shock?

A new risk to the recovery.

BY IRWIN M. STELZER

While political analysts are engaged in the morally elevated task of appraising the effects of events in Libya on the possible spread of democracy in the Arab world, economists are engaged in the grubbier task of figuring out what the effects will be on the economies of their countries. In America, this means taking a guess at the impact of higher oil prices on the nascent recovery.

This is no easy chore. For one thing, it is difficult to determine just now how much of Libya's 1.6-1.7 million barrels of daily production, some 2 percent of the world total, has become unavailable. The International Energy Agency puts the figure at 500,000-750,000 barrels, analysts at Barclay's Capital are guessing that 1 million barrels of production are now shut in, and Eni, the Italian firm active in Libya, puts the figure at 1.2 million barrels. Saudi Arabia has about 3.8 million barrels per day of excess capacity, has historically been willing to increase production to offset supply interruptions, and, after a bit of time, could do so again. Saudi oil minister Ali al-Naimi says his country will again "meet any shortage."

So were it not for other factors, the loss of Libyan production would not be a serious matter, especially since the loss might well prove short-lived: Libyan crude comes primarily from Cyrenaica, an area of Libya in which the tribes now in control are hostile to Colonel Qaddafi and eager to increase their oil revenues. Nor would a per-

manent loss of Libya's reserves create major supply problems. The oil under the Libyan desert accounts for only 3.3 percent of the world's proved reserves, a portion likely to decline if the recent failure of exploration activity there to discover much by way of new reserves is any portent, and if forecasts of reserves to be found in Brazil and elsewhere prove correct.

But there is oil and there is oil, just as there is coal and there are diamonds, almost chemically identical but somewhat different in value. Libyan crude, known as Es Sider, is sweet—low sulfur, light oil easily refined into high-end products such as gasoline and diesel, while Saudi crude is sour—heavy and high in the sulfur content that environmental regulators increasingly frown upon. Refineries in Spain, Italy, and Germany rely on high-quality Libyan oil and are scrambling to find substitute supplies, mostly from Algeria, Nigeria, and the Caspian region or the North Sea. Which is only one reason prices have spiked. Another is the decision of the Department of Energy to sell 2 million barrels of high-sulfur heating oil from the Northeast Home Heating Oil Reserve and to shop for an equivalent amount of low-sulfur heating oil to replace it.

Even though it is somewhere between difficult and impossible to get a fix on the supply consequences of the Libyan trauma, it is possible to imagine a best, a bad, and a worst case. In the best case, whatever government emerges from the Libyan chaos will need the revenues from resumed production and will promptly open the valves, in which case the price spike will prove no more than that—a temporary increase. In the bad case, the

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trouble spreads to Algeria, removing almost 2 million barrels per day from the market, thinning excess capacity to levels not seen since the Gulf war. Then, say the economists at Nomura, we will have to adjust to oil at above \$220 per barrel.

In the worst case, the Saudi regime is the next domino to fall. King Abdullah's decision last week to allow a \$37 billion "royal gift" of the kingdom's riches to trickle down to civil servants, students, the unemployed, and to new infrastructure fails to appease the dissidents. And the country's brutally repressive secret and religious police forces prove no match for demonstrators intent on overthrowing the House of Saud. If that happens . . . well, maybe it won't.

One thing seems certain: The U.S. recovery is under threat. James Hamilton, a member of the economics department of the University of California, San Diego, has studied the effect of oil shocks from 1859 through 2010. He finds, "All but one of the 11 postwar recessions were associated with an increase in the price of oil. . . . The correlation between oil shocks and economic recessions appears to be too strong to be just a coincidence."

Many economists argue that past oil shocks have had such a jolting effect on the economy because policymakers reacted irrationally—they rationed supplies instead of letting prices rise, they tightened monetary policy to avoid inflation when they should have loosened it to offset the growth-dampening effect of higher oil prices. Unfortunately, this hard-won wisdom might not be applicable in current circumstances. Higher oil prices are hitting the economy at a time when monetary policy is already loose and, combined with eye-watering fiscal deficits, threatening to unleash an inflationary wave. With the printing presses already running at top speed, and a flood of red ink pouring over the national ledgers, policymakers, even those wise enough to avoid past errors, have little room for maneuver should oil prices stay at anything like current levels.

The best attempt at a back-of-the-envelope calculation of the effect of

higher oil prices on the current recovery comes from Marc Sumerlin of the Lindsey Group consultancy. Every \$10 per barrel increase in the price of oil costs the American economy \$46 billion in real income per year. That would offset about 38 percent of the stimulus effect of the \$120 billion payroll tax cut agreed to by President Obama and the outgoing Congress at the end of last year, and knock about 0.3-0.4 percent off the growth rate.



A service station in Easthampton, Mass.

Since most forecasters are guessing that the economy will grow this year at somewhere between 3.5 percent and 4 percent, the recovery would continue, but at a somewhat reduced rate. A serious and sustained oil price shock (think unrest in Saudi Arabia should King Abdullah die) would roil financial markets and markedly increase the negative drag on the recovery.

The threat from oil markets is magnified by the fact that inflationary pressures are mounting. Even cut-price retailer Walmart is estimating that the price of its mix of goods will increase by 4 percent this year. If you don't eat, drive, wear clothes, or take any medications, you will believe the Fed's assertion that inflation is currently tame.

Otherwise, you won't. Andrew Clare of London's Cass Business School reckons that the move from \$90 to \$100 per barrel could drive the headline inflation rate up by about half a percentage point, "creating a particular problem for the Fed."

If inflation forces the Fed to stop buying Treasury IOUs; if Republicans and Democrats frighten investors by failing to agree on a deficit-reduction package, which in the absence of leadership from the president is likely; if rising commodity costs cut into profits and cause share prices to drop; if inflationary expectations increase in response to what consumers are experiencing at the supermarket; and if oil prices do stay high and the prices of other commodities continue their upward trend, interest rates will rise. That would have a calamitous effect on the federal budget, driving interest costs on the national debt to recession-inducing levels. And it would add to the pressures consumers feel from higher gasoline prices, which because of the repetitive nature of tank-filling expeditions to the gas station, have a disproportionately large effect on inflationary expectations. Recovery, R.I.P.

But these "ifs" must be weighed against a contrary set. If Libyan production is quickly restored; if the Saudis ramp up production; if refineries adjust to the kingdom's heavy crude; if the Fed's economists are right to believe that inflation is minimal, or that they will be wise enough to see it coming and immediately turn off the printing presses; if the International Energy Agency is right that "both consumers and producers have tools at hand to deliver adequate oil to the market," then, a semblance of calm will be restored.

The important question will remain: Has the uproar in oil markets persuaded the Obama administration to lift its several obstructions to the development of domestic sources of oil? My guess is that the ideology that supports uneconomic subsidies for wind and solar, which have nothing to do with the transportation needs of America, will trump the reality of the nation's continuing need for oil. ♦