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The Consequences of $100 Oil

By Simon Henderson
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Over the next few days, oil is likely to break the $100 per barrel mark -- a price that will further raise U.S. consumer costs and conflict with economic measures such as the October 31 interest rate cut. Ironically, good news, such as predictions of greater economic growth, is just as likely to push oil prices above $100 as bad news. In either case, the price spike means both continuing danger and new opportunities for U.S. policy in the Middle East.

Global Effects on Price

The reliable flow of oil to the world economy is a vital interest of the United States. The Persian Gulf countries Saudi Arabia, Kuwait, the United Arab Emirates (UAE), Qatar, Iraq, and Iran have huge oil and natural gas reserves, accounting for two-thirds of the world's oil. Around 40 percent of internationally traded oil is shipped through the Strait of Hormuz, a route that is vulnerable to Iranian interference -- as recently as last year, for example, Iranian Supreme Leader Ali Khamenei warned that energy flows could be endangered.

The United States does not depend solely on Middle Eastern oil, as it imports much of its energy needs from countries such as Canada, Mexico, Venezuela, and Nigeria. Saudi Arabia is the only significant regional oil exporter to the United States, and achieves this role by effectively subsidizing high shipping costs in order to supply its refineries in the United States, as well as to underpin its diplomatic voice in Washington.

Over the past three decades, peaks in oil price have been linked to bad news in the Middle East: the 1973 Yom Kippur War, the 1979 Islamic Revolution in Iran, the 1990 Iraqi invasion of Kuwait, and the 2003 U.S. invasion of Iraq. More recently, renewed concern about Iran's nuclear ambitions, as well as Turkish military action in the key oil region of northern Iraq, helped push prices past $90 per barrel. But other important upward pressures on price have come from outside the Middle East, and have even reflected good news. For example, recent spikes reflect the positive economic news from China and India, as well as concerns about falling oil production levels in countries such as Nigeria and Venezuela in the wake of domestic unrest and bureaucratic incompetence.

Danger to U.S. Regional Interests

The current oil situation has negatively affected several of Washington's policy interests in the region. In Iran, high prices provide a cushion against U.S.-led sanctions, leaving Tehran free to pursue its nuclear ambitions and subsidize gasoline for the citizenry. The most effective pressure on President Mahmoud Ahmadinezhad arguably comes from his own electorate, but high oil prices have temporarily propped up the poorly administered economy. The tight oil market has also enabled Iran to find alternative customers for its resources.

Concern about oil supply is likely one of the main reasons why China, for example, is less than supportive of proposed UN Security Council measures against Iran. Beijing is seeking to develop supply relationships and production concessions across the Middle East, but sanctions, real or threatened, disrupt these plans. High oil

prices make such relationships even more valuable -- and cause Beijing to be even less sympathetic to U.S. concerns.

Beyond Iran, high prices may lead other members of the Organization of the Petroleum Exporting Countries (OPEC) cartel to reduce supply. Under such a scenario, they would still be able to maintain revenue flow and balance government budgets without diminishing their valuable natural resource.

High prices also give some Middle Eastern oil producers the economic means and justification to develop civil nuclear power, which inevitably raises fears of military applications and regional proliferation. Recently announced nuclear development plans by several regional countries -- including Egypt this week -- may be a diplomatic warning that they intend to match Iran's suspected military nuclear program. A rash of regional nuclear weapons programs prompted by Iran's efforts would be seen as the demise of the Nuclear Non-Proliferation Treaty and a breakdown in the global system that has provided diplomatic stability for the past fifty years.

Finally, greater oil wealth often results in greater charitable giving. Although most such charity is praiseworthy, there is concern that some money will flow to front organizations used by radical Islamist groups, countering the effect of government restrictions enacted in many countries under post-September 11 U.S. pressure.

Potential Benefits

The price spike is also fueling regional trends that could benefit U.S. interests. For example, although Iraqi oil production remains lower than during Saddam Hussein's reign, oil revenues are much higher, giving Iraq's central bank more than $25 billion in reserves. Currently, bureaucratic inefficiencies have rendered the new Iraqi government unable to spend all this revenue. Yet, if Iraq can capitalize on its oil potential -- arguably the greatest in the world after Saudi Arabia -- its economic fortunes would greatly improve.

Higher revenues also provide investment money that could be used to expand production capacity, particularly in conservative Arab states such as Saudi Arabia, Kuwait, and the UAE. This long-delayed development would be most welcome, given the high risks accompanying the currently thin margin of surplus capacity. Yet, despite seeing their oil exports nearly double in value between 2003 and 2006, the six Gulf Cooperation Council (GCC) states -- Saudi Arabia, Kuwait, Bahrain, Qatar, the UAE, and Oman -- have used most of their revenue conservatively, to repay government debt and finance badly needed infrastructure. In addition, Iran's challenge to Gulf security has led to more than $40 billion in arms deals in the past year alone. At the same time, GCC states have provided little additional funding for foreign aid -- not even for Palestinians.

Unfortunately, these countries have only modest plans regarding production capacity, and they continue to harbor nationalistic sentiments that make them loath to accept foreign oil investment. Sound energy security policy calls for a variety of measures among both producers and consumers, however, and expanding capacity is a particularly important and early priority.

Domestic Implications

Theoretically, high oil prices should provide an economic incentive for increased research into alternative fuels, particularly for use in transport. The link, however, is not straightforward; in the same way that a quadrupling in the international oil price since 2001 has had no great deleterious effect on world economic growth, a threefold increase in the price of gasoline has not significantly changed the driving habits of the average American family. In addition to investments in technological alternatives such as bio-fuels and electric and hydrogen cars, price spikes also make increased oil development economically feasible, including in North America's tar sands and oil shale.

Oil at $100 per barrel will certainly capture the attention of the presidential campaigns, but its precise impact

on electioneering is difficult to predict. The notion of reducing dependence on foreign oil is bipartisan, although recommendations on how to achieve it diverge widely. For some years to come, ground transport will rely on gasoline and diesel fuels. Moreover, given that oil is easily transported across long distances -- and that the United States is increasingly dependent on imports -- the country will not be able to make itself immune from the consequences of price fluctuations.

Oil prices could fall significantly in the near term if there is a recession in the United States. But Washington is not at the complete mercy of economic forces. As prices have risen, many have wondered why the United States has not used its diplomatic muscle to convince OPEC leader Saudi Arabia to open its spare capacity and increase supply. Although Washington has not even publicly hinted at such a tactic, there is still time to apply it.

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