The Moscow Times
30 YEARS
INDEPENDENT NEWS FROM RUSSIA

The Downside of High Oil Prices

By Matthew Hulbert

February 01, 2011

If further evidence was needed to prove that we are back in a bull oil market, then Egypt has done the trick. Benchmark prices breached $100 a barrel directly on the back of political turmoil in Cairo. This is not because Egypt sits on much oil, but because it's a crucial transit route for Middle Eastern oil to global markets via the Suez Canal and home to the Sumed pipeline linking the Red Sea to the Mediterranean. Take out either of these routes, and you're looking at tankers being diverted 9,600 kilometers around the southern tip of Africa — not to mention 2 million barrels per day of oil slipping offline.

Is this a classic case of price movements linked to fundamentals? Perhaps, but when we consider that excess supplies still top 5 million bpd from OPEC ranks alone, the record becomes more circumspect. We all know that speculation plays a hand in oil, but the critical point is that geopolitics is back with a vengeance in a world marked by oil prices exceeding $100 per barrel.

We've been here before, of course. Remember July 2008, when oil prices peaked at $147 per barrel. We are heading toward this level again. No sooner had the barricades been broken in Cairo than talk of political contagion in the Middle East broke out across the trading floors of

London and New York. Events in Tunisia obviously provide a handy straight-line narrative. Tunisian President Zine El Abidine Ben Ali has fallen, Egyptian President Hosni Mubarak is on borrowed time, Iran is simmering from last year's attempt to pull off a Green Revolution — any one of the decrepit monarchical Gulf States could be next. Saudi Arabia, Kuwait, the United Arab Emirates and Qatar are all on the list, as are Algeria, Libya and Morocco in the Maghreb.

But if the markets are jittery about Tunisia and Egypt, it begs the bigger question of where it will head if Iraq takes a turn for the worse, or if Venezuela and Bolivia enact snap expropriations? Further unrest in Central Asia, West Africa and Latin America could be problematic. More dramatically, Yemen could go beyond the point of no return: The implications for the Bab el-Mandeb waterway would be grim. Iran is an even bigger challenge. Tehran will keep nudging toward nuclear capabilities for political gains. Whether it actually goes nuclear is a different question, but one that few in Washington stop to consider. Close the Strait of Hormuz, and you've just wiped out about 20 percent of global supplies.

This cuts to the crux of the problem. The misperception of political risk can be just as potent as the actual risks themselves for the market. If the Egyptian crisis is anything to go by, then geopolitical factors have not been properly priced in. The initial $6 price increase from the chaos in Cairo over the past few days will look like pocket change compared with where oil prices could go if the geopolitical situation in the Middle East explodes.

High prices might sound like good news for producers like Russia that want to replenish state coffers and boost political egos, but they carry two major risks. The first is potential demand destruction. The assumption in 2008 that demand was inelastic was a grave miscalculation. Most leading oil producers were lucky to survive. Whether $100 per barrel will break the bank again remains to be seen, but with anemic growth in the West and inflationary pressures in the East, it would be foolhardy to assume that anything higher than $100 per barrel would be positive for the global economy.

The second risk is that producers will rapidly lose control of the market if geopolitics starts dictating benchmark prices beyond fundamentals. Price hawks such as Iran, Algeria, Nigeria and Venezuela probably have no problem with that since they don't have excess supply to put on the market anyway. But that's not what Russia wants or needs right now. Market stability to increase upstream investment and arrest depletion rates should be the priority of the day, not adding more oil, so to speak, to the geopolitical fire.

It remains to be seen whether Saudi Arabia will agree to put more oil on the market or continue to appease price hawks by maximizing receipts. Price signals have been deafeningly silent so far — blaming speculation over fundamentals is the line coming out of Riyadh. No doubt that's partially true, but that's the point. Speculators like nothing more than the risk of geopolitical calamity to make a killing. Egypt has sent a clear signal to producers — quell the market now, or it will politically emasculate you later.

The last thing Moscow needs is heightened market volatility. The priority should be to stabilize the market, attract consistent upstream investment and arrest depletion to keep production above 10 million bpd. Russia should take note: Take the politics out of oil, or it will surely take its vengeance out on you.

Matthew Hulbert is senior fellow at the Center for Security Studies in Zurich.

The views expressed in opinion pieces do not necessarily reflect the position of The Moscow Times.