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Oil: The Missing Story of the West's Economic and Geopolitical Crises.

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Introduction

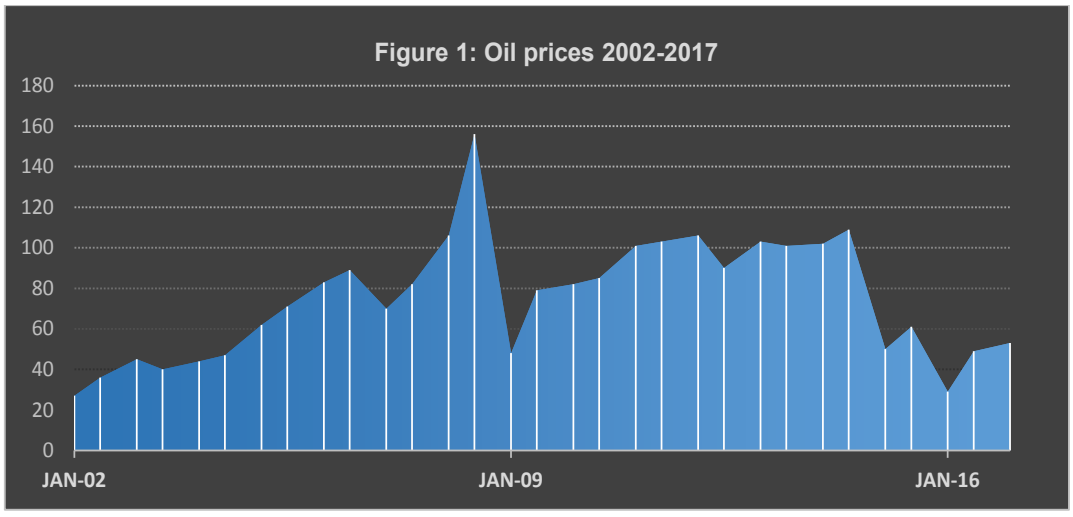
Oil has been the material stuff of modern economies and geo-politics since the early years of the 20th century. Although some have hoped that we are moving towards a world in which oil becomes significantly less important, the present economic and political world has in good part been shaped by oil.

All but one of the recessions in the US since the Second World war were preceded by a sharp rise in the price of oil. Meanwhile, the decline of US oil production in the 1970s and the concurrent emergence of the Middle East as the single largest source of oil at the time of the collapse of Bretton Woods reshaped the post-war international order.

The economic and political world that was created by that shift in the 1970s is now being transformed again by profound changes in oil markets that have taken place since the turn of the century. Oil is the missing story behind the economic and geopolitical crises that face the West. Without understanding this story, we cannot understand the present economic and geopolitical landscape.

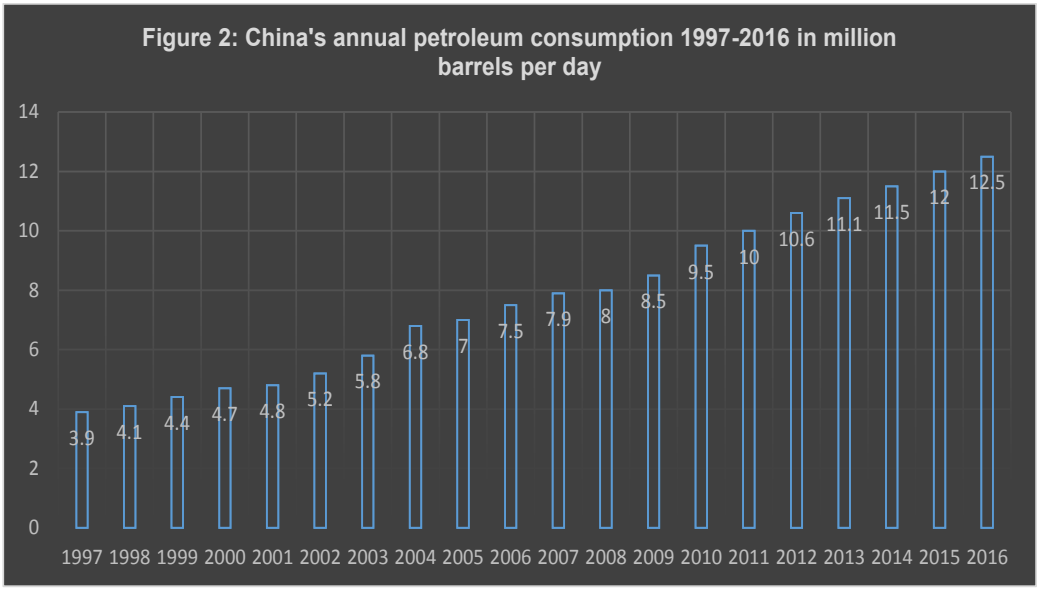
Background

- Oil prices since 2002 have moved dramatically, reaching a peak in July 2008, two months before the global financial crash, and falling back in January 2016 to around the level where they started.



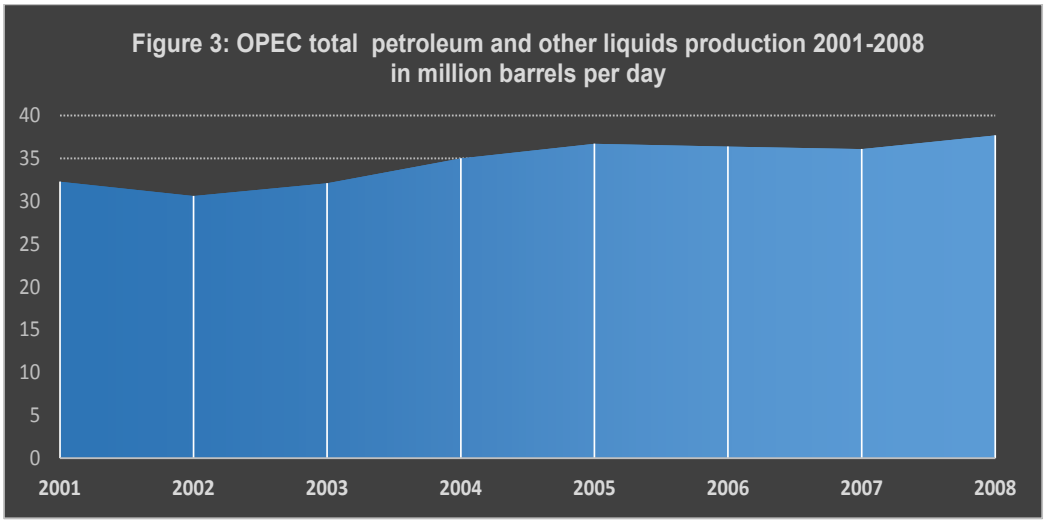
Source: Macro Trends. Prices are for West Texas intermediate and inflation adjusted to May 2017.

- These price changes have been driven by both demand and supply factors.
- On the demand side, non-Western consumption of oil has grown sharply, nowhere more so in the last 20 years than in China.



Source: US Energy Information Administration, international energy statistics.

- On the supply side, the OPEC states were unable to respond in the first years of the twenty-first century with a substantial increase in supply, and prices increased sharply, as shown in Figure 1.

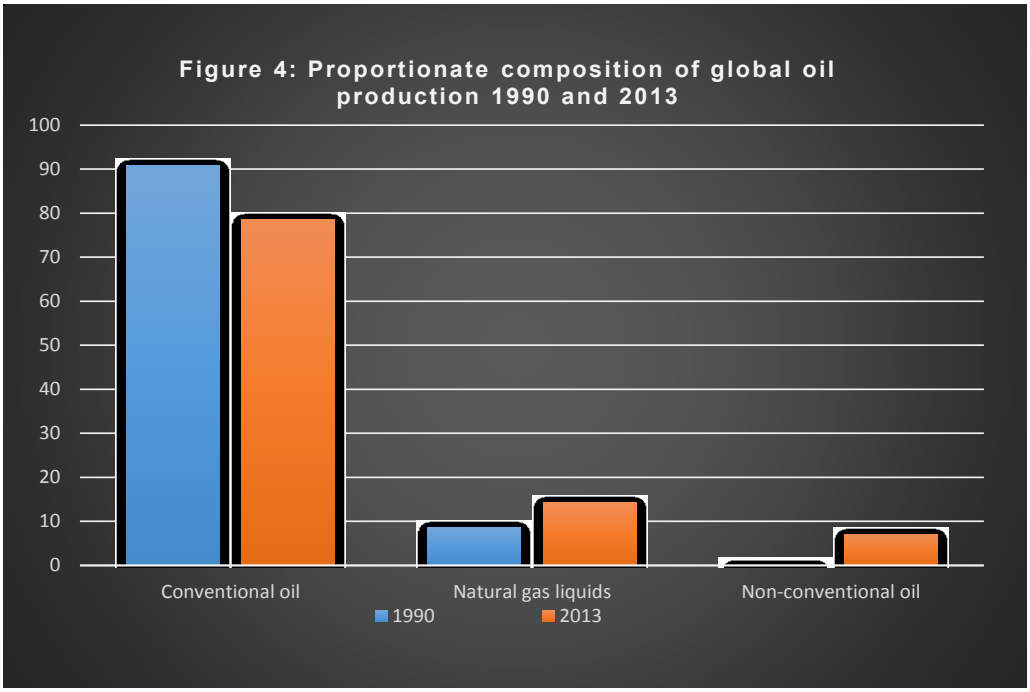


Source: US Energy Information Administration, international energy statistics.

- The stagnation of OPEC supply as demand increased reflected the growing long-term weakness of conventional oil production – namely oil that can be extracted by traditional drilling and pumping.

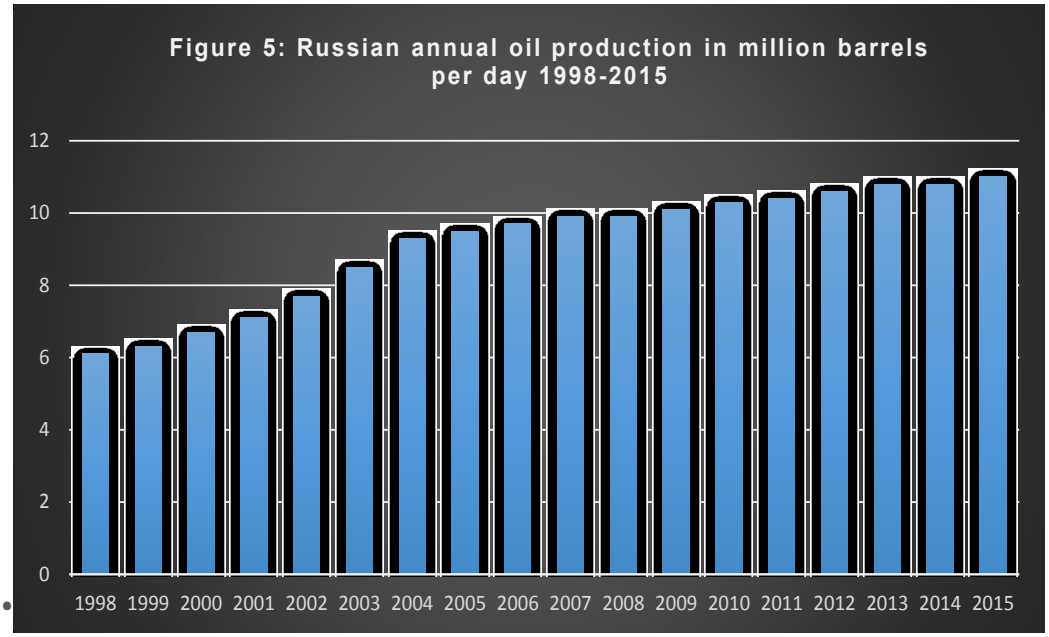
- Discoveries of conventional oil have been falling since 1972 and in 2015 new finds reached their lowest level since 1947.

- The present composition of oil production is significantly different than it was at the beginning of the 1990s, leaving supply now dependent on natural gas liquids and non-conventional oil – oil that is extracted through specialised techniques such as hydraulic fracturing (shale oil) and steam-assisted gravity drainage (tar sands).



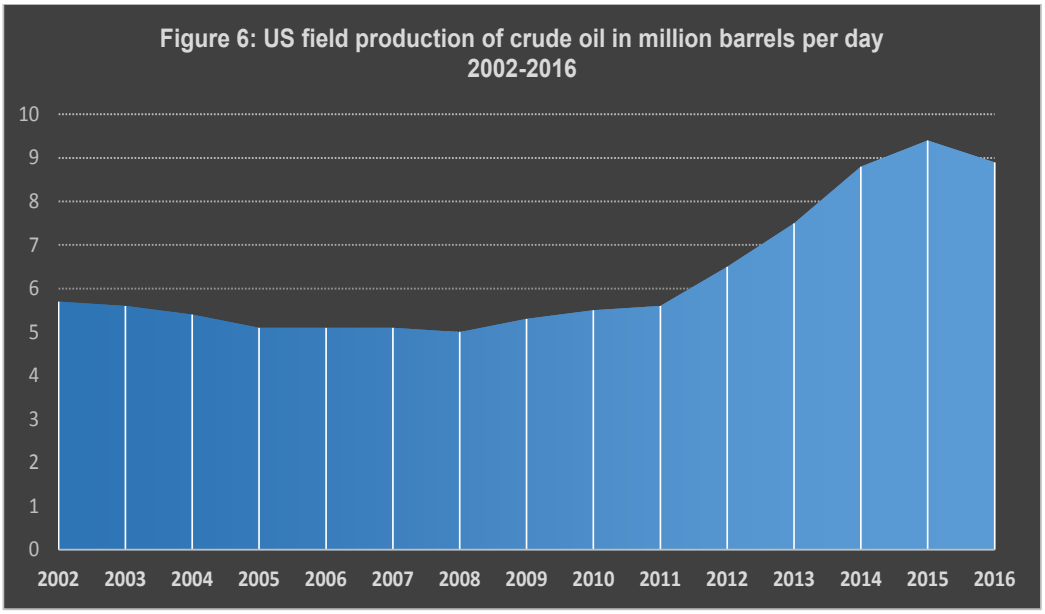
Source: World Energy Outlook 2014.

- The one large-scale conventional oil producer that is producing significantly more oil than it was in the late 1990s is Russia.



Source: US Energy Information Administration, international energy statistics.

- The rise of non-conventional oil production from 2011 has been driven primarily by shale oil production in the United States. Shale oil production led to a reverse in the long-term decline of US crude oil production, which had previously peaked at 9.6 million barrels per day in 1970, rising to 9.4 million in 2015.



Source: US Energy Information Administration, petroleum and other liquid.

Analysis

- The changes that have taken place in the global oil market in the twenty-first century have had profound consequences economically and geopolitically.

Economic consequences

- The sharp rise in prices from 2002 to mid-2008, and from 2007 to mid-2008 in particular, played a crucial part in the recessions around 2008.
- Although these recessions are frequently attributed to the financial crash that began in September 2008 after the bankruptcy of Lehman Brothers, the recession in the US began in Q4 of 2007 and in Britain and the euro zone in Q2 of 2008, a period during which oil prices rose in inflation-adjusted terms from $87 in August 2007 to $156 in June 2008.
- In the case of the US, oil consumption fell in 2007-8 for four quarters in a row for the first time since 1973, the year of the first oil price shock.
- From 2004 rising inflation generated by the increase in oil prices caused significant problems for monetary policy-makers. Mervyn King, the then Governor of the Bank of England, pronounced in September 2005 that rising oil prices had ended what he termed NICE (Non-inflationary consistently expansionary growth). For its part, the European Central Bank (ECB) raised interest rates in July 2008 in reaction to the sharp rise in oil prices during the first two quarters of the year, not realising that the euro zone economy had entered recession, high prices also having depressed consumer demand.

- The policy response to the recessions in Western economies from 2007 to 2008 and the financial sector crash of September 2008 was primarily monetary. Central banks shifted to a zero-interest rate policy (ZIRP) and in the case of the US Federal Reserve Board and the Bank of England quantitative easing (QE).
- ZIRP and QE made the US shale oil boom possible. Shale output is credit-dependent. It requires intensive capital investment and a cash flow to finance ongoing extraction when prices fall.
- ZIRP allowed oil companies to borrow from banks at extremely low interest rates. The worth of syndicated loans to the oil and gas sectors in the US rose more than 160 per cent from 2006 to 2014.
- QE produced a resurgence of high-yield (junk) bond markets. Issuance by US energy companies in the high-yield bond markets rose three-fold from 2005 to 2015.
- Shale oil production also requires higher prices because of its heavy extraction costs. The quick return to escalating oil prices from 2009 and a subsequent three-year period in which they consistently averaged over $100 a barrel was a necessary condition of the rise of non-conventional production.
- Given the weak recoveries after 2009, the return of high oil prices created renewed monetary problems for Western central banks. Whilst the Federal Reserve Board and the Bank of England accommodated rising inflation, the ECB twice raised interest rates in 2011 in response to oil prices. In part as a consequence, the euro zone suffered another recession from the fourth quarter of 2011 to the first quarter of 2013.
- The fall in oil prices from mid-2014 through to January 2016 created a different kind of problem for monetary policy-makers. The Federal Reserve Board's attempts to begin to return to monetary normalcy by raising interest rates were made much more difficult by the extremely low headline inflation produced by falling oil prices. The ECB, for its part, turned to QE and negative interest rates in 2015 in the face of such low inflation, exacerbating tensions within the euro zone between the economies where recovery had taken place and those Mediterranean states where it had not.

Geopolitical consequences

- Geopolitically, oil has been a destabilising force since the end of the 1990s.
- US policy in the Middle East during the administration of George W. Bush occurred in the context of stagnating conventional oil production. At the beginning of the Bush presidency in 2001, three major oil producers – Iran, Iraq and Libya – were under sanction regimes that restricted their output. The Cheney Report in 2001 committed the Bush administration to action to increase oil production in the region by policy changes that would allow sanctions to be eased. By the end of Bush's presidency only Iran remained under a sanctions regime.
- Rising oil prices allowed President Putin to reassert Russian power, and Putin came to power in December 1999 determined to use Russia's energy resources to achieve geopolitical change.

- The rise of US shale production from 2011 made possible the confrontational policy the Barack Obama administration pursued towards Iran over its nuclear programme. For the first time Iran was subject to significant oil sanctions. After previous resistance the EU agreed to accept sanctions as the shortfall of Iranian supply could be compensated by American production without an increase in prices.
- US shale production eventually created a counter-reaction from Saudi Arabia that led to the sharp fall in prices from the second half of 2014.
- Initially, the Obama administration perhaps tacitly encouraged the price fall because of the damage it would also inflict on Russia. But a period of sustained low prices driven by OPEC production levels led to a fall in shale production and significant bankruptcies in the sector.
- Although Saudi Arabia inflicted significant damage on the shale sector, not least financially, it has not been able to win the war. There is now an impasse between conventional and non-conventional oil producers in which there is no price that can accommodate the interests of each.
- Similarly, there is no price range that can satisfy the interests of net oil-producing and net-oil consuming states. For example, Low oil prices have left Venezuela, which is dependent on oil for around 96 per cent of its export revenues and 50 per cent of its fiscal revenue, mired in a deep economic, political and humanitarian crisis.
- In the wake of the shale war US-Saudi relations deteriorated during the latter part of Obama's administration, throwing into question the US-Saudi axis on which Western oil interests and the primacy of the dollar as a reserve currency have rested since the mid-1970s.
- Although non-conventional oil production reduced the supply pressure once Western economies began to grow again after the 2007-9 recessions, the supply from shale in particular will tail off over the next two decades.

Conclusion

There are striking similarities between aspects of the West's current predicaments around oil and the problems Western governments faced in the 1970s. As world conventional oil production stagnated in the mid-2000s, so American production began to decline in 1970. In both cases rising oil costs became part of a growth crisis and triggered the production of more expensive supply. Geopolitically, the energy crisis of the 1970s increased the significance of the Middle East, as did the constraints on conventional oil production in the first half of the 2000s. As the US failed to maintain its alliance with Iran in the 1970s, so the US has now failed to establish stable pro-Western regimes in Iraq and Libya.

The present version of these problems is worse than those that were manifest in the 1970s because the paths that were taken out of the 1970s are now exhausted. There is no more inexpensive oil to be extracted in the West. The largest source of cheap oil remains in the Middle East, where American influence is waning and Russia's rising. As the geopolitical plates shift, there are strong incentives for Russia

and China to form an energy alliance. Credit-wise, the international economy can now only sustain debt by ZIRP and QE, which have created extreme monetary and financial dysfunctionalities that oil only deepens. Even if oil consumption were significantly to fall in the future, there is no way of solving these problems, leaving only the option of living with the predicaments generated by a century of oil-based economies and the geographical distribution of hydrocarbons formed hundreds of millions of years ago.

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