Keep oil prices down or risk another disaster

Two things can be done: the Saudis must be pressed into supplying more barrels and investors must stop hoarding

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Since the first Arab embargo of 1973, there have been five global oil shocks, in which oil prices have doubled in the space of a few months. All these shocks — in 1973, 1979, 1990, 1999 and 2008 — have been followed by global recessions. After this experience, it is hard to avoid a frightening conclusion. If the recent escalation of oil prices continues much longer, then the world will soon face another financial catastrophe even worse than the one of 2008, since governments and banks are much more vulnerable today than they were three years ago.

What can be done to avert this disaster? Conventional wisdom suggests that all we can do is pray for a quick transfer of power in Tunisia, Egypt, Libya and perhaps Algeria, followed by a loss of interest in democracy in other Arab states. Until the wind of change dies down, the price of oil can only go up.

Luckily, however, the non-Arab world is not quite as powerless to protect itself from the consequences of Middle Eastern upheaval as this conventional wisdom implies. There are, in fact, two broad strategies for America, Europe and Asia to protect their economic interests.

The first is to force the Saudi regime, as long as it survives, to push down prices by supplying the market with every barrel of oil that it can produce. The second is to act much more boldly against the demand for oil, not just in the long term but in the here and now.

Starting with supply, Saudi Arabia has 3 to 3.5 million barrels a day of spare capacity. There is another 0.5 million barrels available in the neighbouring sheikhdom of Abu Dhabi. Their combined spare capacity of 3.5 million to 4 million barrels would be enough to replace the entire output of Libya (1.6 million), Algeria (1.3 million) and Oman (0.8 million), even

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in the unlikely event that all three of these countries completely stopped pumping oil at the same time.

Since such a total cessation of oil output has never happened, not even during the Iraq war or the Iranian revolution, there is no reason for global oil supplies to be reduced by the recent upheavals in North Africa.

There is even less reason to worry about oil supplies in the long term, since a democratic Libya that attempts to meet the aspirations of its people will try even harder to sell every barrel of oil than the kleptocracy catering to the whims of a single family, however extravagant and greedy.

Why, then, are oil prices so high? On the supply side, Saudi Arabia, far from stabilising the market, as it has loudly and frequently promised, has been careful to sell less oil than was needed to compensate for the losses from Libya, Algeria and Oman. Why have the Saudis behaved in this unhelpful way? Perhaps it was simple greed. More likely, the Royal Family hoped to signal the economic disaster that would unfold if democracy ever touched Saudi shores.

Whatever the Saudis' motivation, the West can now call their bluff, for we have something the princes need even more than we need their oil. That is protection for their personal wealth and safety. With the rest of the Muslim world now polarising into democracies and terrorist theocracies that hate the Saudis almost as much as they hate America, the princes can no longer rely on comfortable exile among their neighbouring dictators and despots. If they have to flee their country, they will rely entirely on the goodwill of Western nations.

That goodwill should depend on how co-operatively the Saudi rulers behave. If the Saudi princes treat their own citizens humanely and co-operate to stabilise the world economy, they can hope for a comfortable exile if they are eventually overthrown. On the other hand, if they defy global political norms and economic interests, they should expect treatment similar to Mubarak or Gaddafi. If they are deposed, their homes, shares and financial assets in America and Europe should all be subject to confiscation as property of the post-monarchical Saudi state. Such arguments should be sufficient to persuade the Saudis that their interests now lie in relieving the oil shock rather than making it worse.

Just as important as increasing the supply of Saudi oil is action to reduce demand. It should now be clear that long-term demand reduction is needed, not only for environmental

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and geopolitical reasons but also because of the economic instability created by oil. Ratcheting up oil taxes and using part of the revenue to subsidise other energy sources is the best way to achieve this. The right objective is not a "level playing field" between oil and other technologies, as in today's British energy policy. Instead, nuclear power and alternative energy should be heavily subsidised.

An even higher priority is demand reduction in the short term — and the key is to prevent financial institutions from hoarding oil. Numerous academic studies, mostly funded by banks, have claimed that financial speculation has no effect on demand for oil. For every buyer in the futures markets, there has to be seller, they argue. But this specious argument deflects attention to the wrong issue.

The financial activity pushing up oil demand is not short-term speculation in futures markets, but long-term investment by pension funds and other permanent hoarders, not only of oil but also of gold, copper and even agricultural commodities.

In addition to the warehouses and tankers in Rotterdam, Singapore and elsewhere that are stuffed with potentially productive commodities taken off world markets by financial investors, enormous paper bets have been placed by these institutions with investment banks. The banks in turn have hedged these bets in futures markets by buying continuously and regardless of price, in a process closely analogous to the sub-prime mortgage boom. And just as rising house prices pulled more money into mortgages, driving up prices still further, the recent increase in oil prices, instead of reducing demand, has encouraged more financial hoarding, pushing up both prices and demand.

If pension funds want to bet on higher commodity prices, they should do this by buying shares in productive businesses such as oil companies, agricultural businesses or mines. If instead they choose to hoard commodities, they should, at a minimum, lose their tax privileges and ultimately face outright bans.

Ideologues will object that such intrusive measures interfere with free-market forces. But the world has learnt by now that markets can sometimes be dangerously dysfunctional. Today's oil market is a frightening case in point.