OIL, THE LONG TERM VIEW: WHAT GOES UP MUST COME DOWN AND WITH IT EVERYTHING ELSE

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Summary: Concerns for the volatility of the price of oil on the energy markets, and its direct bearing on the economy, are nothing new. What has been seriously missing from the analysis, however, and which should be the real object of close and immediate examination for economists, financial advisers, political pundits, and of course geopolitical strategists, is the looming crisis of the next few decades, which will be caused by the continuing fall of oil prices in the medium to long term. This is more than a hypothesis. The micro- and macro-level technological, economic and political causes of this medium- to long-term downward trend in oil prices must be clarified. Then, the imminent and menacing socioeconomic and political consequences of such a trend — more somber even than that being witnessed now in countries such as Venezuela — can be examined.

The Price Spiral and the Main Culprits: Technology and the Economy — The Current Short-Term Perspective

The controversial oil fracking technology was the start of a major step toward lower oil prices, along with other cost-cutting technological and managerial / outsourcing innovations within the oil industry. The economics of oil fracking were well explained and analyzed in the *Economist* article, “Sheikhs v shale: The economics of oil has changed. Some businesses will go bust, but the market will be healthier,” December 6, 2014.[1] However, an important element missing from that article — because it had not yet occurred — was the US-Iranian nuclear deal, which lifted all sanctions imposed upon Iran, allowing it to increase its production, regain its lost market share, and in the process add to the worsening overproduction situation. The producer market is now extremely crowded, and for all practical purposes OPEC (Organization of the Petroleum Exporting Countries — namely Algeria, Angola, Ecuador, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, United Arab Emirates, and of course Venezuela) exists only in name, as all producing countries, including the non-members that used to have a tacit understanding of the market production with OPEC, have been forced to increase their production as a matter of basic economic survivability. Overproduction increased gradually, but has now moved into a higher gear as producers aggressively eye new markets, even stepping into rivals’ territories. But, at the end of the day, this cutthroat strategy is a losing proposition for everyone. Moreover, Saudi Arabia no longer possesses the political or production leverage — and consequently the respect as the swing producer — to control the production quota, and thus price; additionally it has to deal with all of the same global economic issues and falling revenues that face the other oil producers.

The biggest challenge in curbing the fall in oil prices in the short term is, of course, the official re-entry of Iran into the already-saturated market. This is a seemingly impossible task, for both political and economic reasons. Iran’s response to the political challenges of Saudi Arabia — a political rivalry and schism which echoes the fight for religious and, consequently, political dominance in the region between Shia and Sunni Islam — has widened the gap between the two countries beyond the point of no return. Iran also has no choice now but to continue increasing its oil production because of economic hardship. Two important points should be kept in mind with regard to Iran's oil calculus. First, it has the largest oil and gas reserves in the world — surpassing those of Saudi Arabia and Russia.[2] Second, it can, and probably will, increase its production within the next two years to between 4 and 5 million barrels a day, if not more. It is pertinent to recall that prior to the domestic turmoil of 1978/1979 and the fall of the Shah, Iran produced 6 million barrels a day. The subsequent halting of production caused another oil shock, which resulted in a devastating economic crisis, as prices jumped to a historic record. The point to be retained here is that, with these facts in mind, and without an unanticipated miracle, oil prices are in a downward spiral with no end in sight.

As for the general economic outlook, the entire global economy — and certainly in the major economic centers — is at best very soft, and does not look to be anywhere close to a robust recovery. The US, Europe, and the BRICs (Brazil, Russia, India and China) — the once-promising newcomers on the world economic scene, along with South East Asia — have stalled, which forecasts a lower demand for oil in the short term. But the medium- and long-term prospects for oil prices are not much brighter.

Oil Prices: Medium- to Long-Term Outlook, 2030–2050

Oil and gas are not used simply for energy. In fact, these two precious resources are used in approximately 400 areas, including the manufacture of food, cosmetics, plastics and other very important commercial organic chemicals, numerous household products and byproducts of the petrochemical industry. However, at least until the past decade or so, when the development of alternative energy was put into high gear by the consumer countries and the demand side of the equation, the use of oil and gas to generate electricity and fuel for transportation took an incredible proportion of the market share. To put this into perspective, in the US — the biggest consumer of hydrocarbons — roughly 75 percent is currently used for gasoline, diesel fuel, jet fuel and heating oil. Inevitably, therefore, the technological and economic factors that led to low oil prices will continue to apply during the next two-and-a-half decades. These factors should be used as indicators of the direction that oil and gas prices will take in the medium and long term.

It is difficult to make predictions, especially about the future

— Danish politician Karl Kristian Steincke

10 = 100 Phenomenon And The Butterfly Effect [3]

The twentieth century was the stage for much fundamental scientific advancement, which was subsequently applied to create significant practical, social and economic benefits. However, many analysts have overlooked the unprecedented speed of current technological and scientific development. A decade of research and innovation can now achieve what used to take a century. The rate of change to the economic landscape is now exponential.

The advent of cleaner and more cost-effective forms of renewable energy to replace oil is already a reality, and one that continues to propel enormous changes in the field by the day. Three such areas — among many more — affecting the oil industry, which should be noteworthy for all energy analysts, are:

- The evolution of cheaper and more efficient solar energy technology, which continues to increase its viability, with spillover effects on the entire energy industry.
- Production of next-generation electric and hybrid vehicles, including trucks already on the market, pushed forward at an exceedingly fast pace by all auto industry companies.
- Development of more powerful and cost-effective batteries for homes, cars, industry, and general urban utilities, such as windows that can generate electricity. Furthermore, hybrid — and eventually fully-electric — airplanes will be on the horizon within the next two decades.

Thus, from 2030 onward, if not sooner, oil will lose its position as the main source of energy as Star Wars, Star Trek and other futuristic science fiction scripts will be closer to the matching reality. Demand in the United States alone will fall by up to 50 percent, with serious global consequences. The result will be an immense economic, sociopolitical and consequently power shift.

Economically, this will be a double-edged sword. Cheaper sources of energy that are stable in the long term will help the general prosperity of all economies, and particularly those of underdeveloped countries, where the lack of sufficient cheap energy has been a root cause of stagnant economic growth — an issue mostly ignored or misunderstood by students of development. At the same time, the experience of economies dependent upon oil exports will be very painful. Recently, Venezuela has suffered significant social upheaval because of falling oil revenues, but in fact all oil-producing countries — both members of OPEC, and non-members such as Russia and Norway — are facing huge budget deficits caused by falling oil prices. Oil revenue in OPEC producing countries has been roughly halved, and continues in free-fall. This forced a major bond sale to raise cash of over 30 billion US dollars during 2016 alone by the Persian Gulf countries that included Abu Dhabi, Qatar, and Saudi Arabia, with a very generous offer of 120 to 210 basis point over the US Treasury in order to attract investors. However, all these Persian

Gulf countries still exhibit denial of the reality of sinking oil prices; Qatar's spending of over 200 billion US dollars for example in preparation and construction to host the 2022 FIFA World Cup -- along with the bribery scandal to assure itself the hosting of the games -- has been a mien of pure *folie de grandeur*. So, what are the medium- to long-term consequences?

First, the major oil-producing countries have to start breaking open their piggy banks. In the past, these countries created what became known as Sovereign Wealth Funds (SWFs), which held assets, bonds and equities in the market, as they began to accumulate petrodollar wealth — along with their foreign reserve funds. However, in the current budgetary bind, these funds must be utilised, along with the issuing of bonds. But both have been tried, to little effect. Norway, which holds the biggest SWF — reportedly one percent of all globally-issued equity — has started selling to raise cash. After depleting its foreign reserve fund of approximately US$600 billion by about 20 percent, Saudi Arabia has opted for the sale of its SWF, as well as issuing bonds, and has also created an ongoing hype with the idea of an IPO (Initial Public Offering) of its family jewel, the state-owned oil company Aramco, in 2017. Russia, too, has played around with the idea of selling almost one fifth of Rosneft, the state-owned oil giant, to China and India.

The bitter truth is that none of these remedies is a solution, in either the short or long term, to the economic problems that the oil-dependent economies are facing — and particularly those of the Persian Gulf. To some extent, all of the countries in the region — perhaps with the exception of Iran — have failed to use their oil assets in the decades since the oil boom of the 1970s as the Shah of Iran envisaged, to move away from oil dependency. Whatever they contemplate doing now is too little, too late, and comparable to the "lost decade" of the Latin American crisis during the 1970s and '80s.

The short-term repercussions are going to be an interwoven, complex economic and sociopolitical turmoil. As SWFs continue to be unloaded, or their investment strategies are reevaluated in order to protect them from the uncertainties in the financial markets, many fund managers are likely to push the panic button, despite their straight-faced public denial, in order to protect themselves faster than the next guy. As valuations have gone haywire and proved unjustifiable, and outrageous housing, healthcare and food costs continue to feed a creeping inflation in the US, reaction to the unloading of SWFs will only exacerbate the fragile situation, proving to be the *coup de grace* in the collapse of the economy, a process which might easily begin with the bursting of the latest tech start-up bubble. Then, the hollowness of the IT euphoria, which has not been so exposed since the dot-com bubble of 2000, can damage other sectors; or, perhaps, the other way around, since the tech sector has become highly vulnerable to the general domino effect of a stock market fall.

The oil sector in the United States is already hurting badly — in Texas, for example — and might also help to trigger another housing and financial crisis. The fact that the Federal Reserve has not raised rates by even .25 of a percentage point for such a long time, fearing negative consequences, speaks volumes about the fragility of the American economic recovery. In short, the decline in oil prices looks like a worrisome turning point for the entire world economy.

One cannot help but be dismayed at the amnesia of financial, economic and political analysts for past mistakes, which are as a consequence being repeated today. While it is true that America — and humanity in general, to some extent — has never been a good student of history, this is especially true of American financial institutions, and particularly the Federal Reserve. Despite its official recounting of the Latin American debt crisis of the 1980s,[3] it is seemingly and scandalously absent from the current crisis in the oil-producing countries — which, like the Latin American debt crisis, is destined to hit the US and the world in the face again if unchecked. A quick glance at some of the similarities between the two situations is relevant. According to the Federal Reserve's official postscript account:

During the 1970s, two large oil price shocks created current account deficits in many Latin American countries. At the same time, these shocks created current account surpluses among oil-exporting countries. With the encouragement of the US government, large US money-center banks were willing intermediaries between the two groups, providing the exporting countries with a safe, liquid place for their funds and then lending those funds to Latin America.[4]

Latin American borrowing from US commercial banks and other creditors increased dramatically during the 1970s. At the end of 1970, total outstanding debt from all sources totaled only $29 billion, but by the end of 1978, that number had skyrocketed to $159 billion. By 1982, the debt level reached $327 billion.

. . .

Lessons Learned

Despite the many warning signs that the LDCs' debt level was unsustainable and that US banks were overexposed to that debt, market participants did not seem to recognize the problem until it had already erupted. The result was a crisis that required a decade of negotiations and multiple attempts at debt rescheduling to resolve, at considerable cost to the citizens of Latin America and other LDC countries.

In the United States, the chief concern was the soundness and solvency of the financial system. To that end, regulators weakened regulatory standards for large banks exposed to LDC debt to prevent them from becoming insolvent. On one hand, this regulatory forbearance was effective at forestalling a panic. On the other hand, forbearance allowed large banks to avoid the consequences of their prior lending decisions (albeit decisions that were to some extent officially encouraged in the mid-1970s). But allowing those institutions to delay the recognition of losses set a precedent that may have weakened market discipline and encouraged excess risk-taking in subsequent decades.

Fact Check

Then: The Latin American problem began in the 1970s with two large oil price shocks.

Now: The oil-producing countries have the same problem — and prices are falling.

Then: “At the end of 1970 [i.e., at the outset], total outstanding debt from all sources totaled only US$29 billion . . . "

Now: The current bond issues to the Persian Gulf countries amount to US$30 billion.

Then: “[O]n one hand, this regulatory forbearance was effective at forestalling a panic. On the other hand, forbearance allowed large banks to avoid the consequences of their prior lending decisions (albeit decisions that were to some extent officially encouraged in the mid-1970s).”

Now: The magic words from the Feds that apply to the current oil-producing countries are: “forestalling a panic” and “(albeit decisions that were to some extent officially encouraged in the mid-1970s).”

Thus, with oil prices falling, and no realistic rise in sight — or perhaps ever, absent a short-term climatic disaster or political unrest, which even then would likely result in production being fulfilled by other hungry producers — along with the irresponsible fiscal policies of the borrowing countries, and the politics of greed practiced by lenders, with the governments’ permission and encouragement, it won’t be long before everyone finds themselves at the same point of no return. If lending is not conservatively managed right now, this could be the sequel to the Latin American “lost decade,” and we know how that played out. The chances are that the Federal Reserve’s claim of “lessons learned” is an empty one.

Conclusion

The clear message for the oil industry is that this is the end of the road for those who are willing to see the writing on the wall, as the Saudis already have, with their panic driven multi-strategies in every direction from increased production, envisaged Aramco IPO or buying overseas refineries including the US to assure the end sale and vertical monopoly of marketing their oil -- desperately looking for strategic advice from the same gurus that were happy to charge inflated fees but never saw this coming. An analogy with the coal industry is apt: despite the two oil shocks of the 1970s, by the early 1980s its obituary had been written, and this was the main economic reason why in Britain Margaret Thatcher began a major confrontation with the powerful National Union of Mineworkers (NUM), which resulted in a drastic reduction of the country’s coal mining industry. Of course, politically, Thatcher was also set to destroy the NUM in order to move forward with her conservative political agenda through many unfounded accusations and smear campaign against the NUM leaders.It was later revealed that MI5 the domestic Brirish security services had gone as far as tapping the Union leaders phones andauthorizing counter-subversion excersises.Thus,the same is true with the oil industry, as solar and other alternative renewable sources of energy — along with increasingly efficient technology and much political intriguer — continue to challenge its viability. Finally, the *Economist* article about oil fracking concludes by suggesting that:

That should reduce the volatility not just of the oil price but also of the world economy. Oil and finance have proved themselves the only two industries able to tip the world into recession. At least one of them should in future be a bit more stable.

Alas, they are shamelessly leading us again on a journey packed with denial, greed, ignorance, shortsightedness, and of course total indifference to the sociopolitical and economic damage they will be causing. Western public opinion will be vindicated and reinforced by the perception of an ever-more-powerful and untouchable banking industry -- like the recent Wells Fargo scandal of opening illegal and phony accounts -- without the customer's knowledge and approval; while the Middle Eastern mentality will be fortified by the perception and suspicious of yet another Machiavellian Western plan to suppress their countries and encourage their socioeconomic malaise and calamities -- as many countries and regions will rapidly collapse into fatal political turmoil.

But the world as a whole will suffer, as the global village is ever more interconnected, and no part is immune. The news media will again play Monday morning quarterback after it has become too late. Remember the recession of 2007? Fasten your seat belt. The next impact is approaching, but hopefully the world economy can rise like a phoenix in an oil-less world this time — although only finance and banking are guaranteed to be around forever. They will be bailed out again if need be -- without the Taxpayer's consent, until the next round.

[1] http://www.economist.com/news/leaders/21635472-economics-oil-have-changed-some-businesses-will-go-bust-market-will-be

[2] *The Economist*, October 29, 2011, p. 76.

[3] A concept reinforcing the notion of cause and effect by underlining the fact that a very small causality can result in a tremendous effect. This concept was first used in weather prediction. For more detail see: https://en.wikipedia.org/wiki/Butterfly_effect .

[4] For more details see http://www.federalreservehistory.org/Events/DetailView/46

[5] Money-center banks are banks that borrow from and lend to governments, large corporations, and other banks on national and international financial markets.