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EIR Economics

Oil collapse signals next phase of global depression

by William Engdahl

On Dec. 16, when the United States and Great Britain announced their decision to bomb Iraq, the price of oil traded on the London and New York markets rose a mere 77¢, before falling back down hours later. By contrast, in late 1990, when the Bush administration was carrying out Operation Desert Shield against Iraq, oil prices soared from $16 per barrel to more than $36 per barrel in a matter of weeks. The stark difference between today's mute reaction and that of eight years ago, points to one of the most ominous indicators of the condition of the world economy today. The price of crude oil, the major energy source in the world economy, is undergoing its sharpest fall since 1986, with prices for North Sea Brent, the benchmark for world crude oil prices, briefly dropping to as low as $9.17 a barrel during the week of Dec. 14.

Not everyone is alarmed by the falling price for the world's most important commodity. Financial markets and governments in the European Union and United States have hailed the low levels of commodity price inflation as a tribute to the correctness of central bank "anti-inflation" policies. A closer look at the background for the oil price collapse gives anything but grounds for euphoria.

The price per barrel of world oil in recent days has touched low levels not seen since 1976, with the 1998 average crude price likely to be near $13 per barrel. By comparison, the price for North Sea Brent, the world benchmark crude, was some $22 per barrel in September 1997; it is now just above $9 per barrel, a drop of some 60%, with no bottom in sight.

OPEC is in fiscal crisis

The effect of the collapse on members of the Organization of Petroleum Exporting Countries (OPEC) has been devastating. Various OPEC Persian Gulf countries are only able to sell their oil today at anywhere from $5-10 per barrel, depending on the quality. OPEC oil revenues for 1998 will be down by more than $50 billion. This has a direct impact on new orders in Europe, Japan, and North America for capital goods such as machine tools and industrial equipment which had been imported by OPEC. The Federal Association of German Machine Builders (VDMA) reports that export orders for the past three months are down, year-to-year, by 21%, and that exports to Middle East oil countries are among the hardest hit.

On Dec. 17, only hours after the initial bombings of Iraq, an emergency meeting of the oil ministers of Saudi Arabia, Venezuela, and non-OPEC producer Mexico took place in Madrid. The meeting, the third such emergency summit among the Big Three producers since March, reportedly was divided on what steps to take to deal with the growing crisis. Despite an unprecedented voluntary production cutback by OPEC and several non-OPEC countries of some 2.3 million barrels per day this year to date, the International Energy Agency estimates that world demand for oil dropped another 650,000 barrels per day in the fourth quarter of this year.

"If 1998 has been the bad year for Asia," remarked Walid Khadduri, editor of the *Middle East Economic Survey,* which monitors Middle East oil, "then 1999 will be remembered as the bad year for OPEC. I see no end to the crisis in sight. Take the imponderables for 1999 which will determine world oil price: Will Asian demand begin to recover next year? Will the U.S. and European economies go into recession? Will the abnormally mild winter weather in North America and Europe keep oil demand low? All Gulf oil producers except the U.A.E. [United Arab Emirates] now face fiscal emergency." Oil exports make up 50-90% of Persian Gulf countries' total state revenues. Iran earlier in December was forced

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to ask foreign creditor banks to restructure some of their foreign loans.

Perhaps most alarming, is the potential impact of the current oil collapse on the world's largest producer, Saudi Arabia. While more attention has been focussed on oil export earnings collapse in Mexico, Venezuela, and Russia in recent months, the situation in the Saudi Kingdom has become worrisome to oil insiders and knowledgeable financial market institutions, especially in the City of London.

According to the London Centre for Global Energy Studies, Saudi Arabia's national debt is now at 100% of its Gross Domestic Product, or more than $160 billion. The center estimates that the annual Saudi budget deficit will top 11% of GDP, or almost $15 billion this year, three times worse than that forecast last January. A recent report in a London paper, that Saudi Arabia's government had asked to borrow $5 billion from its wealthy neighbor Abu Dhabi, to finance its soaring revenue deficit, was hotly denied by the government, but the grim reality that a fiscal time bomb exists in the finances of the world's largest oil producer is undeniable.

"The Gulf producing countries, starting with Saudi Arabia, need to implement thorough structural reform, or they're facing real trouble," said the *Middle East Economic Survey*'s Khadduri. "The Saudi economy is a total welfare state with the entire economy dependent on state subsidies, from agriculture to industry. This system must be ended, but the political stability of the House of Saud is built on the system of subsidies, and change therefore comes very slowly."

Already several major oil-producing nations have been forced to turn to the International Monetary Fund (IMF) for emergency financial support, including Algeria, Venezuela, and Indonesia. Nigeria is believed the next likely candidate for the IMF's bad medicine, and probably not too much later, the Persian Gulf states.

Harbinger of global depression

More than any other single economic indicator, the deflation of oil prices since the onset of the Asia crisis in summer 1997, serves as a harbinger of the collapse of global economic growth. Asia, including China, had been the largest growth market for oil consumption for most of the 1990s, until the Asian financial collapse brought the demand to a halt.

The oil crisis is made worse because of the buildup of oil inventory around the world as cargoes go unsold. Inventory stands near record levels and many parts of Europe and North America report no further available space for oil storage. The unusually warm November-December weather in North America caused severe problems for heating oil demand, depressing prices more. As well, the United Nations in November approved an increase of Iraqi oil exports in the food-for-oil agreement to a level of 1.8 million barrels per day. That is unlikely to be affected by the ongoing attack on Iraqi targets. Oil analysts estimate that even under ideal conditions of a miracle recovery of Asian economic growth, it would take more than one full year to draw down the high inventory.

The U.S. Department of Energy's Energy Information Administration just issued a report projecting a gloomy oil price outlook. "World oil prices are expected to be affected well into the next decade by the recent economic crisis in East Asian countries, with prices for 2000 forecast to be as much as $5 per barrel lower than projected one year ago," the report states. The EIA does not expect world oil prices to recover until 2007 under current trends.

City of London worries

Very soon, as the crisis in oil revenues worsens, the attention will shift from what is now seen by the Group of Seven (G-7) central bankers as a contained "OPEC crisis," to alarm at a likely trigger for the next explosion of the global financial crisis.

As the oil price continues to fall, concern is growing in leading financial centers, above all in the City of London, that wealthy OPEC states could be forced to begin liquidating their vast overseas investments. Gulf states today still hold $800 billion of liquid investment outside the Persian Gulf, most in stocks and bonds of the G-7 economies, according to the estimate of the Saudi Federation of Gulf Cooperation Council Chambers of Commerce. Saudi Arabia alone holds some $500 billion of that. Much of the Arab OPEC funds, private as well as government, are invested through City of London financial channels.

Already back in July, when the condition of the world economy appeared far less alarming than today, the Bank of England and the British Foreign Office and Treasury were so alarmed at the pressures on Middle East oil countries because of the falling oil price, that they convened a top-level closed-door meeting at St. James Palace in London. Bank of England governor Eddie George and former Foreign Minister Sir Douglas Hurd presided over a discussion among the hand-picked finance ministers and diplomats of the Arab OPEC states. The title of the talks was indicative: "London: The World's Financial Centre: Partner of the Middle East."

According to first-hand Arab reports, the leading financial institutions of the City of London privately are terrified that the oil crisis will cause a wholesale liquidation of OPEC Arab investments in City of London banks and financial securities. That, in turn, would lead to a meltdown in United Kingdom government bond markets and stocks, and would likely spread to U.S., Swiss, and other preferred Arab investment havens.

As the oil crisis continues to worsen in parallel with the deepening depression over the coming months, the likelihood is that the huge OPEC investments in G-7 markets will begin to be sold off. At that point, the impact of the "low inflation" oil price will indeed trigger a new round of global financial meltdown. That is the point at which the benefits of price deflation for financial markets will turn into a Frankenstein monster.