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# EIR Economics

# Will 'Paper Oil' Blow Up the Global Economy?

by William Engdahl

With a speed that has stunned all but the most observant industry insiders, oil has exploded onto the world political and economic arena in a crisis not seen since 1973, when Henry Kissinger rigged the "Great Oil Hoax" (blamed on the Organization of Petroleum Exporting Countries [OPEC] oil boycott) and thereby triggered the first "oil shock" of 400% price increases which plunged Europe and much of the world into deep recession or worse.

All of the storm and fury, however, is largely a circus sideshow diverting from the fundamental problem now unfolding. The world is swimming in surplus oil. OPEC has raised its output quota four times since April 1999 (see **Figure 1**), the latest on Sept. 10, when its members agreed to pump another 800,000 barrels per day beginning on Oct. 1. The market reacted to the news with a steep price rise!

Once again, the currencies of the recently ravaged East Asian economies—Thailand, the Philippines, South Korea—are in sharp fall. This time the culprit is not global speculator George Soros and leveraged hedge funds. It is the staggering rise in the price of imported oil. Oil, sold in dollars, is putting a foreign currency drain on emerging countries similar to that of 1973-79.

Most attention, though, has been on the situation in the Group of Seven (G-7) economies, most especially the United States and the European Union (EU). In continental Europe and Britain, huge convoys of angry truckers have been blockading oil refineries across the continent, bringing economies to a halt, to protest soaring diesel prices.

The impact on European economies of the oil price is far more dramatic even than in the United States, owing to the fact that oil is sold in dollars and imported into the EU, where the euro currency has lost 27% against the dollar. This gives European industry and consumers a double whammy, comparable to the devastation of the 1973 oil shock.

Reflecting a growing climate of political panic, on Sept. 20 French Finance Minister Laurent Fabius called for an emergency G-7 meeting with leading oil-producing countries during the Sept. 22-24 Prague International Monetary Fund annual meeting. Saudi Arabia has signalled its willingness to join such talks.

On the same day that Fabius issued his call, the French convened an emergency meeting of EU transport ministers to deal with the spreading crisis, as crude oil futures prices soared $4 per barrel over the past days to $37 per barrel. The meeting ended in chaotic disarray, as no consensus emerged. France called for others to follow its lead, and cut Europe's staggering fuel taxes, on average some 60-76% of the price of an EU gallon of gasoline at the pump. But the EU Commission is threatening to impose stiff sanctions on France and other countries that follow this example, further adding to the political chaos.

## Richardson: 'Dangerously High' Prices

U.S. Energy Secretary Bill Richardson is calling energy prices "dangerously high," promising to use "all options" to control the situation. He neglected to elaborate what he has in mind. President Clinton told reporters that he is considering a scheme to take 2 million barrels from the government's Strategic Petroleum Reserve, to be converted into heating oil for the coming winter to prevent shortages. That, however,



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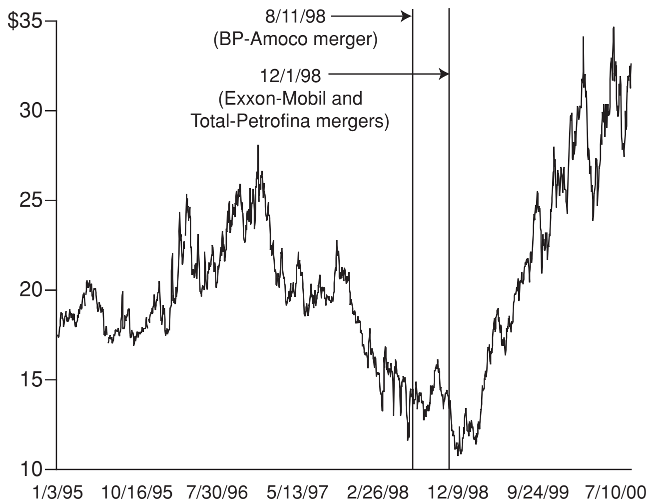
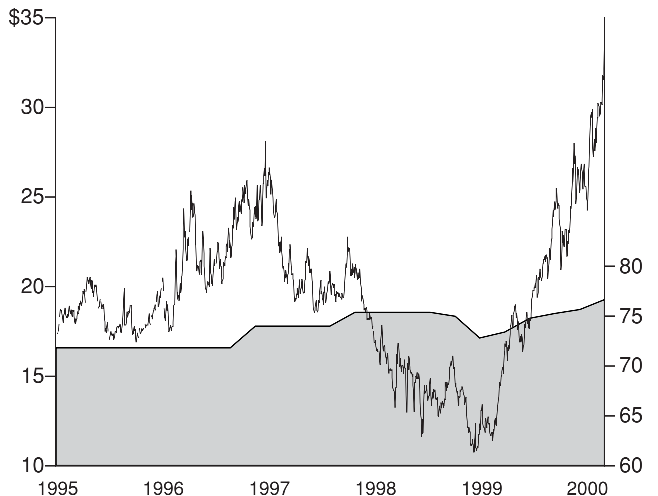
FIGURE 1
### Oil Price Skyrocketted in Wake of Big Mergers
Oil price, West Texas crude
($ per Barrel)




Source: *Wall Street Journal.*

FIGURE 2
### Oil Price Soars, Regardless of Production Level
Oil price, West Texas crude
($ per barrel)
World Oil Production
Millions of Barrels Per Day*




*Yearly average, 1995-1998; quarterly average, 1999-2000 Q3.
Source: U.S. Department of Energy; International Energy Agency

would only rob 2 million barrels from the private production of refineries. The government has no refineries, and therein lies the bottleneck.

Vice President Al Gore, earlier in the Summer, blamed OPEC for not pumping enough crude. This was election fraud: Presently, the world is producing some 1-2 million barrels per day more than it consumes.

The exploding price inflation, which today for specific reasons is concentrated on the world's largest traded commodity, oil, reflects the beginning phase of a sea-change shift of assets of global financial interests. This shift, is a move out of bloated stock and other financial assets, into hard commodity assets. As U.S. economist Lyndon LaRouche has repeatedly warned in recent months, this is the opening shot of the kind of hyperinflation that struck Germany's Weimar Republic in 1923.

In remarks on Sept. 20, LaRouche (see accompanying article) insisted that only government-to-government emergency measures, to take back control of oil supplies from financial speculators and giant oil cartel groups, can address what is becoming a colossal national security problem, not only for the United States, but also for most nations dependent on energy imports.

## 'Paper Oil Is Speculators' Paradise'

As OPEC has repeatedly charged, oil prices are rising, not because there is too little oil, but because there is too little refining capacity in key markets, combined with out-of-control derivatives speculators manipulating the market.

The politically opportune finger-pointing at OPEC as the cause, by U.S. and EU politicians, is irrelevant to the point of absurdity. More alarming, even were OPEC to pump more oil, is the energy price and the crisis of refined product supply crisis are set to escalate dramatically in coming weeks and months, barring the kind of emergency actions indicated by LaRouche, by the United States and other nations.

That action, however, would require the U.S. President to admit the true scale of the unfolding emergency, something which could have severe political repercussions on his Vice President's Presidential ambitions, but, just as readily, if he did something sensible, would improve the Administration's political standing. As well, it would require EU governments to rescind key provisions of the Maastricht Treaty which severely limit budget deficits, in order for them to cut energy taxes, and provide emergency relief to the economy. Neither looks terribly likely at present.

Several aspects of the crisis, must be comprehended. The structure of the world oil market, the process by which a barrel of oil produced in, say, the Persian Gulf, gets to a refiner in, say, Philadelphia, where it is converted into gasoline, diesel, or heating oil for market, has fundamentally changed since the fall of the Shah of Iran in 1979.

In the relatively stable days of the 1960s up to the October

TABLE 1
**Most of Gasoline Price Doesn't Come From Crude Oil**

| | Three Parts of the Price of Gasoline | | |
|---|---|---|---|
| | Crude Oil | Taxes | Refining, Transport, and Distribution |
| United States | 38% | 33% | 30% |
| France | 15% | 71% | 14% |
| Italy | 16% | 70% | 14% |
| Germany | 18% | 64% | 18% |
| Britain-U.K. | 12% | 68% | 20% |
| Canada | 30% | 38% | 32% |
| Japan | 19% | 41% | 40% |

Source: Venezuelan press, week of 9-11-2000.

1973 Arab-Israeli War, oil was one of the most predictable commodities in the world. It was produced mostly by OPEC members, usually by government-owned companies such as NIOC in Iran, or Aramco in Saudi Arabia. Those OPEC government companies then made long-term supply contracts with the "Seven Sisters" oil multinationals or other larger independent oil companies. The big oil companies such as Exxon or Shell all owned their own tanker fleets which transported the contracted oil to their own refineries, whether in Aruba, Philadelphia, Houston, Rotterdam, or Hamburg.

Contracts were typically either state-to-state, say Saudi Arabia to Brazil, or, more often, they were state to private company, say Saudi Arabia to Mobil or Exxon. They were years-long, fixed supply and price agreements. Thus, if oil prices fluctuated even a few pennies per barrel, it was news. The third way to buy oil in the pre-1973 period was a tiny market, dubbed the "Rotterdam Spot Market," for the largest oil port in Europe. Here, on average, less than 3% of world daily oil output traded hands in small cargoes, often when another contracted supplier could not take delivery and it was free to be sold.

"The oil market today has totally changed from 20 years ago," commented a senior oil tanker industry source from Fearnley's Research in Norway, in a discussion with *EIR*. "Today, between the day a given tanker is loaded with oil in, say, Dubai, and the time it is finally offloaded at, say, a U.S. or Rotterdam refinery, that oil cargo could be sold 15-20 times or more."

"Derivatives have made this possible," he stressed. "The price you read for Brent or WTI [West Texas Intermediate] crude in the daily papers today is no physical, actual price of oil on that day. It's the futures or derivatives contract price one or two months away, on either the London International Petroleum Exchange where Brent contracts for North Sea oil are sold, or on the Nymex in New York, where WTI contracts are traded. It is all derivatives or futures prices we speak about, and that can swing wildly depending on any credible rumor, especially in a tight market like today."

## Speculative Rumors and Swindles

Oil prices shot up $2 in one day in mid-September, on reports that Iraq had charged Kuwait with illegally stealing its oil from the Neutral Zone area, the same issue that triggered the 1990 Iraq invasion of Kuwait. Since the price is actually the futures contract price, and a tanker of oil loaded in the Persian Gulf takes on average 60 days to offload on the U.S. East Coast, rumor and "perception" can play a huge role in speculative buying or selling of oil futures. It is a speculator's dream.

Fearnley's analyst elaborated, "You only saw the first oil trader come in 1974 or so with Phibro Co. There were virtually no traders then. In the end of the 1970s and the 1980s, the

# LaRouche: Bring Oil Price Inflation Under Control

*The following memorandum was issued by Lyndon H. LaRouche, Jr. on Sept. 19.*

1. The following statement constitutes a preliminary statement of policy "On the Subject of Emergency Action by Governments to Bring the Present Petroleum-Price Inflation Under Control."

2. Broadly, the current global inflation in petroleum prices threatens to be the detonator of a chaotic breakdown in many, if not all of the economies of the world. The actions proposed here to deal with that emergency situation will not solve the more general problem of the world's financial and monetary systems at large, but will contribute an important, and perhaps decisive step in that direction.

3. The underlying cause of the crisis, of which the petroleum-price crisis is but the presently leading political-economic consequence, is a general hyperinflation in financial asset-prices, which is now being expressed, at increasing rates, as a hyperinflation in commodity prices now following a trend similar to that suffered by Weimar Germany during the interval March-November 1923.

4. For sundry, converging, and relatively obvious reasons, the most brutal effect of that upward spiral of financial hyperinflation is being expressed in devastating rates and magnitudes of rises in the costs of petroleum. The increasingly desperate effort to secure inflows of financial assets into the U.S. dollar sector, has seized upon several

market changed dramatically. Oil multis got out of the tanker business, especially after the *Exxon Valdez* debacle. State-to-company contracts vanished. Today the market is dominated almost entirely by traders. This has made things far more volatile, because that's where traders make profit."

In a $10 million lawsuit filed in U.S. Federal Court in the Southern District of New York on Sept. 13, the large U.S. oil refiner Tosco Corp. charged that a group of oil speculators in London, led by Arcadia Petroleum, a subsidiary of the Japanese Mitsui Trading Group, and Glencore, of Zug, Switzerland, created a deliberate market "squeeze," using derivatives or oil futures contracts, traded on the London International Petroleum Exchange. Tosco alleges that Arcadia Petroleum effectively took control of the Brent North Sea oil market for the two weeks between Aug. 21 and Sept. 5, just four days before the OPEC meeting. It did so by buying more futures contracts (i.e., agreements to buy at a future date) than the entire Brent North Sea market supplied in the month of September.

Brent is the "benchmark" crude which sets the price for all the major oil-producing Atlantic countries, from Nigeria to Angola to Libya to the entire North Sea. It is a small market and, given the huge volume of derivatives traders in the London Brent futures market at the IPE, Tosco claims that Arcadia artificially pushed prices $3.33 higher in two weeks.

"The paper oil market today allows the kind of thing Arcadia did," remarked a senior oil trader at a large London bank. "The Brent market was set up years ago. If a trader focusses his positions into a one- or two-week period, like Arcadia, taking futures positions on tens of millions of barrels, you gain huge profits if spot or so-called dated Brent prices rise versus the futures price. Arcadia ensured that, by

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combined factors, as the opportunity to increase asset-price accumulations from hyperinflationary trends in the delivery prices of petroleum products.

These factors include: recently increased concentration of ownership of major oil companies through mergers and acquisitions, the increased role of the spot market in petroleum deliveries, the significance of denomination of deliveries in U.S. dollars, and an intensity of speculative activity, especially in the form of financial derivatives, in this area which threatens to bring the per-barrel price of petroleum to between $40 and $50 per barrel, soon, and not much later, much higher.

5. No ordinary means could bring this problem under control during even the short term. Only drastic measures taken in concert between and among sovereign national governments, could bring the petroleum-price crisis itself under control. Any other proposal would be a childish delusion. For the immediate future, either such governmental action will be taken, or the eruption of international chaos within the weeks ahead were the likely result.

6. The appropriate action, which must be led by the U.S. government, must aim at immediate emergency cooperation among the governments of principal petroleum-exporting and principle petroleum-consuming nations.

7. These governments must: a) Declare a general strategic emergency in the matter of stability of flows and prices of essential energy-supplies of national economies; b) Establish contracts, directly between and among governments, of not less than twelve months government-scheduled deliveries of petroleum from exporting to consuming nations; c) Define reasonable prices for these contracts; d) On the grounds of a global strategy emergency in petroleum prices and supplies, these governments must set priority on processing of such contracted petroleum flows through relevant refiners to priority categories of consumers in each nation, causing other stocks to be shunted to one side in the degree that these priority deliveries must be processed first.

8. Such action will, obviously, collapse much of the current hyperinflationary trends in petroleum. That will have a significant political effect, in the form of reactions from the speculators currently gorging themselves on the suffering of national economies suffering zooming speculative prices of petroleum. We can not permit the cupidity of a powerful few speculators to destroy enterprises essential to the national interests of nations, and to the relations among those national economies. That opposition to urgently needed measures must be resisted on grounds of overriding national strategic interests.

9. This proposed action will not cure the more general hyperinflationary trend in progress. It will only bring a most critical segment of this speculative inflation under control; but it will set standards of cooperation now urgently needed, for dealing with the general international banking and related crises about to strike the world as a whole during the weeks and months immediately ahead.

10. There are many details of the current speculative marketing of petroleum contracts which require closer scrutiny and related assessment. That investigation should proceed; it is urgent. However, those representatives of governments who understand the politics of oil, must play a leading role in implementing the general measures I have indicated, now, without delay. After a thirty- to ninety-day initial period of operation of the proposed agreements, secondary and tertiary features of the problem will be clearer, and, most important, governments and others will have developed the mechanisms needed for further courses of action.

paying a huge cash premium for 5 of the 22 cargoes produced that period for Brent. It lost money on that part, but that forced panic buying by exposed speculators, which gave Arcadia huge profits on the other 17 cargoes it had in futures."

He continued, "Tosco sees the price it has to pay jump from $32 per barrel to $36 in days, for no reason. The problem is, this is derivatives; this is an unregulated market. Arcadia, so far as I can tell, broke no laws; there are none—it's the free market. This is the largest commodity market in the world, and there are huge profits to be made if you don't care about the effects."

Underscoring the speculative factor, on Sept. 20 OPEC President Ali Rodríguez of Venezuela released a report charging that $8 of the price of every barrel of oil today is the result of such speculative futures manipulation by oil traders. OPEC charges that "bottlenecks in the refining industry, speculation in the futures market, [and] manipulation of the Brent market due to dwindling volumes of crude," are the real cause of the exploding oil prices over the past 15 months.

According to industry sources, today the world's leading oil traders are owned by some of the world's largest banks and financial houses, the same speculative forces of global finance which brought the world to the brink of financial collapse in September 1998 with the failure of Long Term Capital Management, heavily involved in derivatives. The top oil traders, who control gasoline and heating oil prices, include the Wall Street firms: Morgan Stanley; Goldman Sachs's J. Aron & Co.; Citigroup-Travelers' Phibro; Glencore of Zug, Switzerland; Mitsui's Arcadia; the Dutch-Swiss Vitol; Elf-Total-Fina of France; and Deutsche Bank, through the derivatives operations of its Bankers Trust.

These financial traders, and not the major oil companies, are the prime buyers of oil from OPEC, North Sea, or other major oil producers. Their interest is in maximizing speculative paper profits on their derivatives trades in oil, not in maintaining reliable energy prices for the world economy.

## An Un-Refined Emergency

A second factor which oil speculators such as Arcadia or Phibro are using to send prices of gasoline and heating oil through the roof, are, as OPEC points out, the "bottlenecks in the refining industry." The worst refining bottleneck is in the largest market for oil consumption, the United States. Here, the crisis is set to detonate into its most severe phase, just as Americans go to the polls to elect a new Congress and President, in early November.

One consequence of the huge oil company mergers of the past several years has been the hiving off of oil refining from the direct ownership of the oil giants. Today, four super-giant firms virtually monopolize the world oil and gas market. One is American—Exxon-Mobil of Plano, Texas; two are British—Royal Dutch Shell and BP-Amoco-Arco; one is French—Elf-Total-Fina.

When the Clinton Administration foolishly gave the green light to the unprecedented concentration of economic power in so few private hands, it made a few colossal blunders, which have been largely responsible for aggravating the present crisis to the breaking point. A lollapalooza was the demand by the Federal Trade Commission, as a condition to approve the mega-mergers, that the new companies divest their refining capacity to other companies. One of the benefactors was Tosco, which became one of the nation's largest refineries, by acquiring the facilities of Mobil as well as BP-Amoco.

As an example, instead of the large oil company refiners of a decade back, today the U.S. East Coast is dominated by four new companies—Tosco, Valero, Coastal Corp., and Sun.

But the fact that the refiners do not have their own oil any more, as when they were part of Shell or Exxon, is only part of the problem. A far bigger problem is the critical lack of U.S. refining capacity, amid soaring energy demand of recent years.

In 1981, according to a study in the Sept. 21 *Oil & Gas Journal,* the United States had a total of 300 refineries. Today, it has only 150. Total refining capacity is 15% less than in 1981, yet demand is not. Moreover, in October, refineries have announced, they must close some 10% of total refining capacity, in order to conduct necessary repairs and maintenance, since no refiner wants to risk fire or explosion from faulty maintenance. That shutdown will hit, just as the peak season for U.S. heating oil consumption begins. In recent weeks heating oil prices in the U.S. East Coast market have gone up by over 30% from a year earlier, as consumers prebuy at near-panic pace, to prepare for Winter amid press reports of looming shortages.

U.S. inventory stocks of high-sulfur distillate, used for heating oil, were 20% lower in August 2000 than in August 1999, which itself was a dangerously low stock level. In a frantic bid to avert a heating oil shortage, U.S. refineries since August have been running at full-throttle, between 95% and 98% of capacity.

An industry rule-of-thumb, is that a company decides to add new refinery capacity when the utilization level reaches 75%. Because of cartelization, hiving refining off to smaller companies, and the general energy deregulation of recent years, the state of U.S. refining capacity today is approaching national emergency status. Were the dimension of this national infrastructure gap to become widely known, it would reveal a critical lack of policy attention by the Clinton-Gore Administration, to a problem which could be seen several years back.

In this situation, all the oil in the fields of Saudi Arabia, even if enough tanker capacity existed (another critical infrastructure shortage), could not prevent the next explosion of fuel prices in the United States, Europe, and other parts of the world economy this Winter. A wonderful thing, the unregulated free markets. Or are they?