

U.S. economy's fate in Saudi hands

Forget the Fed and Washington, D.C. Because of its swing position in the world's oil market, Saudi Arabia wields the real power over our economic future.

By Jim Jubak

Saudi Arabia is running the U.S. economy.

I'm not sure the Saudis want the task, but they've got it. Because the United States still doesn't have a national energy policy, we've thrown decisions about how fast our economy grows and whether our standard of living rises or falls into the hands of Saudi Arabia's oil ministry.

That's risky, since the economic self-interest of Saudi Arabia and the United States aren't always aligned, and because keeping the fractious and often dysfunctional governments of the world's oil producers on the same economic course is a whole lot harder than building consensus among the governors of the Federal Reserve.

Fed ain't what it used to be

Remember the good ol' days? Back when the U.S. Federal Reserve and its chairman were in charge of our economy? The Fed would try to find a delicate balance in setting interest rates: High enough to control inflation and low enough to encourage economic growth. Once upon a time, those policy changes were actually the most important decisions anyone made about the U.S. economy. By the Fed's own admission, the growth of global liquidity has reduced the U.S. central bank's ability to control interest rates -- and thus the economy -- in the United States. Think about this: The Fed raises short-term interest rates relentlessly from their 1% low in June 2003, and yet long-term rates sink as global cash flows overwhelm the Fed's domestic policy shifts.

Still, the U.S. stock and bond markets hang on the Federal Reserve's every word. Just last week the stock market rallied on the release of minutes from the Fed's rate-setting body, the Open Market Committee.

How quaint. Investors would be better off parsing the comments of Saudi oil minister Ali Naimi.

Saudi have the clout

It's now Saudi Arabia that's trying to find a delicate balance. In the Organization of Petroleum Exporting Countries (OPEC), the Saudis are the swing producer -- the only major oil producer with enough extra production capacity to increase supply when the price of a barrel of crude soars, and the only major oil producer with the political will and foresight to cut supply when prices fall too low. Right now, the Saudis are producing at 8.5 million barrels a day. Depending on whose figures you believe, their production capacity is anywhere from 9 million to 11 million barrels a day.

If the Saudis allow oil prices to climb too high, then consumers will cut back on use, and energy alternatives will become sufficiently attractive to investors to cut into oil's share of the global energy market. Worst case: Oil prices will climb so high that they cause a global recession that will certainly cut demand.



If the Saudis allow oil prices to fall too much, they will reduce the revenue they get for oil and reduce their clout among those oil-producing countries that are only willing to follow the Saudi lead as long as it lines their pockets. Worst case: Revenue falls so far that the Saudis and other oil-producing countries don't have the cash to support their own plans for growing their economies and providing the jobs and subsidies that keep many oil-country governments in power.

An oil-thirsty world

One source of Saudi Arabia's economic clout lies in the galloping global -- and U.S. -- demand for oil. The U.S. Energy Information Administration forecasts that total world demand for petroleum will reach 118 million barrels a day in 2030, up from 83 million barrels a day in 2004.

It wouldn't matter if the world was awash in oil right now or if finding new reserves of oil hadn't become so difficult and expensive. Oil supply right now is at 83 million barrels a day, the Energy Information Administration calculates, about even with demand. To meet projected demand, oil supply will have to grow by about 33% from 2004 to 2030. That's a huge increase since, according to the agency, oil production in non-OPEC countries will be flat in the period and falling in such current big suppliers as Mexico and Venezuela.

Only if OPEC increases its production by 14 million barrels a day by 2030 will global supply match global demand. And the biggest chunk of that extra production will have to come from Saudi Arabia, where the Energy Information Administration is projecting an increase in production to 16.4 million barrels a day in 2030 from 11 million barrels a day now. That's roughly a 50% increase.

Demand, prices both rise

The other source of Saudi economic clout derives from the fact that the world is so hooked on oil -- so crucial to development in emerging economies -- that demand for oil goes up even as oil prices rise. In 2006, oil industry analysts calculate, global oil demand grew at a rate of 800,000 barrels a day. When oil is less expensive, as it looks likely to be in 2007 when the average price per barrel is forecast at closer to \$62 than to 2006's average of \$66, demand grows even faster. In 2007, growth in global demand is forecast at 1.3 million barrels a day.

The U.S. economy is no exception. Total oil imports into the United States jumped by 14% in March from February to hit record levels. And even as gasoline prices soar in the United States, consumption growth continues. U.S. gasoline demand in May was up about 1% from May 2006. How much clout does that give the Saudis over the U.S. economy? The United States imports about two-thirds of its oil at a cost of about \$300 billion a year. According to a study by the Rand Corp., each \$10 increase in the cost of a barrel costs the average American household \$700 a year.

Oil up, GDP growth down

In January 2004, the price of oil was \$34.27 a barrel, according to the St. Louis Federal Reserve. It closed at \$65.08 on June 1, 2007. Using Rand's numbers, that's an increase of \$2,156 per household for oil. In that same period -- when the Federal Reserve's short-term interest rate increases pushed the yield on the 10-year Treasury note to 4.95% from 4.30% -- U.S. Gross Domestic Product growth dropped from 3.9% in 2004 to 3.2% in 2005, 3.3% in 2006 and to 0.6% in the first quarter of 2007. I certainly can't tease out the effects of higher oil prices from the effects of higher interest rates, but my suspicion is that the former has had a bigger effect on the U.S. economy in this period than the latter, thanks to the continued availability of cheap money from global sources such as Japan.

Saudi Arabia has no interest in killing the U.S. or the global golden goose. Sending our economy or, worse yet, the global economy into a recession, or even quarter after quarter of growth below 2%, would wreak havoc with Saudi revenues.

Many oil producers use oil revenue for political gains, but Saudi Arabia actually has a relatively reasonable long-term view, says MSN Money's Jim Jubak. That's better than what we see from countries like Iran and Mexico, who manage their oil for short-term gains, he adds.

But it is in Saudi self-interest to charge the most the market will bear; after all, oil is an exhaustible resource. Even though we can debate about when that resource might be so depleted that Saudi Arabia can't produce significant oil, we all know that one day the oil will be gone. So every time a terrorist attack in Nigeria, a flare-up in tension between the United States and Iran or an expropriation by Venezuela's Hugo Chavez spikes the price of oil, you can bet the Saudis are studying the market response. If a price spike doesn't result in a significant decline in consumption, then the inclination of any rational oil producer would be to let prices drift higher (or to push them higher by cutting production).

And it won't end soon

I have bad news for anybody who thinks that this Saudi control over the U.S. and global economies is a brief phase that will end by itself. The decision among oil producers such as Saudi Arabia to shift away from being a mere producer of

crude oil to becoming a producer of value-added products made from oil -- such as gasoline, fertilizer and plastics -- will prolong the economic clout of these countries. Saudi Arabia will go from being the low-cost swing producer of crude oil to being the low-cost dominant producer in gasoline, fertilizer and plastics. The cost advantages that Saudi Arabia brings to the game are huge. Methane and ethane, key feed stocks for petrochemical production, cost about 75 cents per million BTU in Saudi Arabia and \$7.50 per million BTU (for methane) on New York commodity markets. Within five or 10 years, new industries now being built in Saudi Arabia are likely to soak up cheap natural-gas-feed stocks such as these. But even if the country has to switch to refined feed stocks such as naphtha, Saudi Arabia will have a huge cost advantage. Naphtha from a Saudi refinery might cost \$50 per metric ton compared to a market price of 10 times that from a refinery elsewhere in the world.

It's up to the consumer

The only thing that changes this game -- that redresses the balance between supplier economies and consumer economies -- is a change in the price signals that consumer economies send in response to price increases. As long as the response to an increase in the price of oil is an increase in consumption, then oil prices will drift higher at a pace set by the self-interest of oil producers. Those of us who live in the consuming economies will just have to hope that the Saudis and other oil producers efficiently milk consuming countries' cash-cow economies.

On the other hand, if higher prices lead to less consumption because consumers become *permanently* more efficient in the ways they use energy, and because consuming economies adopt *lasting* sources of alternative supply (and don't abandon them at the next dip in oil prices), then consuming countries have a chance to take back some degree of control over their own economies.