

## **WORLD OIL PRICES: WILL THEY FALL?**

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Crude oil prices have risen sharply this year, with spot prices reaching almost \$50 per barrel recently. Gasoline and home heating oil prices followed suit. The sustained and dramatic price increase prompted experts to predict a continuation of this trend, as did economist Paul Krugman in the *New York Times*. However, this ignores several political, economic, and historic factors that influence the world oil market.

For two decades, a reciprocal arrangement between Persian Gulf governments and the U.S. and Europe has determined world oil prices. Simply put, Western governments provided military security, and Persian Gulf governments supplied stable and growing oil exports. This arrangement (military security for stable oil exports and prices) has been 100 years in the making.

For the first three quarters of the 20<sup>th</sup> century, British Petroleum and then American oil companies such as Aramco, CFP, and Texaco, established the market price for crude oil. In 1973, the Arab-Israeli war created a surge of antagonism in the Arab world against U.S. and Europe. OPEC nations, led by Saudi Arabia, seized control of oil production within their countries. Their efforts to raise oil prices were initially successful – oil prices reached \$40 per barrel – but had collapsed by 1986 with crude prices at \$10 per barrel.

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In 1986 then-Vice President George H. Bush worked with the Saudi King and government to stabilize oil prices at a higher level. From 1986 to 1997 OPEC maintained prices within the target range of \$15-20 per barrel (the only exception was the 1990 price when Iraq invaded Kuwait). This price range collapsed in 1998 due to the combined influences of the economic recession in Asia in that year, the 300% increase in Iraq's oil output between 1996 and 1998, and the inflation-reduced value of oil revenues. A new price range of \$23-\$30 was established in 2000 (equivalent, coincidentally, to the old range adjusted for inflation). In each of the last four years, oil prices have remained within this new range.

Persian Gulf countries have more than half of the world's remaining crude oil. At the same time, extraction costs in that region are less than \$5 per barrel. Why then don't these countries follow a low-price policy that would increase their sales, market share, and possibly revenues? Conversely, why don't they attempt to charge monopoly prices? The answer lies in the joint pay-offs to Persian Gulf producers and their key Western importers under the price band arrangement.

Production costs in the lower 48 states of the U.S. are around \$15 per barrel, and about \$25 per barrel in the Arctic National Wildlife Refuge. When world oil prices are below \$15, high-cost facilities are shut down and drilling plummets in the U.S. American oil producers' revenues are affected twice: first by reduced production, and second by a lower price. Therefore, at very low oil prices, U.S. petroleum companies influence American policy to raise prices, as in 1986 and 1998. In contrast, with very high oil prices, American consumers and oil-using businesses dominate American policy.

Congressmen from states without oil production call for termination or reduction of military support for Persian Gulf governments.

For the Persian Gulf producers, a long-term perspective is essential. Since their economies are critically dependent on oil revenues, they prefer to maintain a price range that ensures a healthy production rate. If prices are too low, Persian Gulf producers face domestic economic problems due to the lower revenues, even though world demand rises. On the other hand, high prices slow down the economies of the U. S. and other key importers, and they have an incentive to reduce oil consumption as well.

Persian Gulf oil is worth several tens of *trillion* dollars. This enormous wealth is a serious problem as it encourages military action such as the Iraqi invasions of Iran and Kuwait. Military support for the Kuwaiti monarchy from U.S. and European allies was crucial in turning back Iraq's 1990 invasion. We believe that this military support is a major incentive for the southern Persian Gulf countries to maintain oil prices within the target range.

Has the current Iraq war destroyed the target price arrangement? In the short term, yes. Increased hostility to American interests has led to more frequent and dangerous attacks against oil facilities and personnel in Saudi Arabia and Iraq. World oil markets are now experiencing a "risk premium" of \$15 per barrel. However, for the long term, the economic logic underlying the current framework remains intact, though it relies on the premise of a broad based civil authority capable of protecting oil facilities. With the war being fought on Iraqi soil and the concomitant breakdown of civil authority, the oil infrastructure is an obvious target for terrorist and insurgent groups trying to fight a super-powerful enemy. We believe that an era of stable oil prices will ensue if we can

ensure (a) political or military institutions that deter appropriation of the oil wealth in the Persian Gulf, (b) national governments in this region that are supported by their citizens, and (c) acceptable oil revenues to the governments of this region. We think this is an international responsibility and cannot be accomplished by America acting alone.