

## Zakaria: Why oil prices will stay high

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The next time you pay \$3.50 dollars for a gallon of gas, stop and think about a basic rule of economics. When demand is low and supply is strong, prices should fall. Right?

Now apply that to oil. People drive less in the winter. The American economy is slow. The Euro Zone has stalled. China and India are slowing down. So demand for oil worldwide is low. So why is oil trading high at \$113 a barrel, more than twice the price it was trading at five years ago when the global economy was booming? What in the world is going on?

There's a school of thought that suggests the global economy is doing better than we think. China and the U.S. are proving resilient to Europe's problems and so traders are expecting renewed demand in the world's two top economies. But another school of thought argues we're in the midst of a bubble. Speculators have been driving up the price of oil and eventually it will crash.

Now I think that the economic fundamentals really can't justify oil prices at their current levels. The real driver of high oil is not the stuff you find in the business section of the newspaper - the demand for oil in India and China. It's on the front page: Global politics.

You see, traders worry about risk. And the biggest risk to oil supplies is the threat of war in the Persian Gulf. Meanwhile, in Nigeria mass protests are raising worries about the supply of fuel from there. Venezuela is in a slow-motion collapse because of Hugo Chavez's mismanagement. There have also been protests in Russia, the world's top oil producer. And remember the fallout of the Arab Spring - Libya's oil production in 2011 was severely curtailed. Iraq continues to disappoint with its oil output and its recent political tensions certainly haven't made things any better.

So a mix of war rhetoric and local troubles in key oil states are factors driving up the price of crude. And that translates to higher prices at the pump. Now that logic suggests that prices will fall when the news calms down.

But perhaps not. Perhaps oil producers want these sky high prices. Usually the major oil producers understand that keeping prices too high in the short term means people start finding alternatives to oil. They start driving more efficiently; they start looking for alternate energies. But this time, oil states face crucial challenges. Look closer at the Arab Spring. The only oil rich country that has been forced into regime change is Libya. Why? The Gulf states lavish subsidies and salary increases on their citizens. They've upped spending to record levels to suppress any popular discontent.

I saw some striking numbers this week: Look at the "break-even" costs for the world's top oil producers. That is the minimum price at which these countries need to sell oil so that they can balance their budgets.

Russia now needs oil at \$110 a barrel to manage its finances. For Iraq, the number is \$100. Even

Saudi Arabia now needs oil to trade around \$80 a barrel just to balance its budgets. The numbers are also high for Algeria, Qatar, and Oman. Only a decade ago Saudi Arabia was able to balance its budget with oil prices averaging around \$25 a barrel.

So now it is in these countries' interest to keep oil prices high, which they do by curtailing supply in one way or the other. This is perhaps the most lasting impact of the year of global protest: High oil prices.

So, the bottom line is an oil crash seems unlikely. Even though the engines of global growth are sputtering, be prepared for a period of expensive commutes. Maybe it's time to trade in your Escalade for a Prius.

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