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# The Drop in Oil Prices: Economic and Strategic Implications

If oil prices continue to spiral downward, what will be the economic and strategic results? Not too bad, says Gawdat Bahgat. Consumers will benefit at the expense of producers and, perhaps more controversially, the 'oil for security' bargain crafted between Western powers and Middle Eastern suppliers will remain intact.

By Gawdat Bahgat for ISN

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Shortly after the 1973 Arab-Israeli war Arab oil producing countries cut production and imposed an oil embargo on the United States and a few other countries in retaliation for their support of Israel. This led to a rapid surge in oil prices that came to be known as the first 'oil shock.' Since then, oil prices have fluctuated in response to changes in supply and demand as well as political developments. In 2008 oil prices reached their peak, around \$147 per barrel and stayed above \$100 per barrel in subsequent years. The last few months, however, have witnessed a steady decline in oil prices. In early November, a barrel of oil sold for a little more than \$80 per barrel.

The forces that have led to the recent decline in prices (more production and less consumption) seem to differ from those that led to previous declines. This time, it is likely that prices will remain low for a prolonged period of time. Major producers and consumers will have to re-adjust their economic policies and strategies to respond to these key changes in the global energy landscape. Although oil consumers are likely to benefit at the expense of producers, economic and strategic cooperation between Western powers and Middle Eastern countries is likely to continue.

## Reasons for declining oil prices

Oil prices, like the prices of any other commodity, reflect and respond to changes in supply and demand. For decades major consuming countries, led by the United States, have felt vulnerable to economic and political upheavals in producing countries. Since the Nixon administration in the early 1970s U.S. officials have talked about reducing dependency on the Middle East and ending the nation's 'addiction' to oil. In pursuing these objectives, consuming countries have adopted a three-fold strategy: increase oil and gas production, diversify the energy mix, and reduce consumption.

*Increase oil and gas production* : Oil companies have invested heavily in new exploration techniques. In recent years drilling in deep water has substantially contributed to increases in both production and reserves. Equally impressive, the so-called shale revolution (a combination of horizontal drilling

and hydraulic fracturing or 'fracking') has added millions of barrels in US production (and billions of cubic meters of gas). This technology has transformed the U.S. from a major importer to a rising exporter. The United States has taken the lead in producing shale gas and shale/tight oil, but proven reserves have been reported in many other countries in Europe, Russia, China and others. In other words, the promise of the shale revolution is not limited to the United States. Finally, the technology is not static. Oil companies are investing in improving the technology and overcoming environmental challenges.

*Diversification* : In addition to the rise in oil and gas production consuming countries have sought to diversify their energy mix - i.e., reduce the share of fossil fuels and increase the share of alternative energy, particularly renewable sources. These efforts are driven mainly by concerns over energy security and climate change. Renewable energy is any form of energy that is replenished by natural processes at a rate that equals or exceeds its rate of use. Renewable energy is obtained from the continuing or repetitive flow of energy occurring in the natural environment and includes resources such as biomass, solar energy, geothermal heat, hydropower, the tides and waves, ocean thermal energy, and wind energy. Some renewable energy resources such as hydropower are technically mature and have been deployed at a significant scale. Others, such as wind, solar, and geothermal, are in a nascent phase of technical maturity and commercial production and deployment. Unlike fossil fuels, almost all countries have access to some form of renewable energy. For example, solar and ocean energy are widely distributed. Still, the contribution of renewable energy to the overall energy mix varies substantially from one country to another. In recent years renewable energy has been expanding rapidly. The International Energy Agency (IEA) projects that renewable energy will account for nearly half of the increase in global power generation to 2035, with wind and solar making up 45% of the expansion.

*Energy efficiency* : The energy equation has two sides - supply and demand. The increase in oil supplies has been accompanied by aggressive efforts to reduce consumption. The IEA estimates that investment in energy efficiency markets worldwide in 2012 was between \$310 billion and \$360 billion. The Agency estimates that final consumption in the IEA countries is 60% lower today because of energy efficiency improvements over the past four decades. European countries and the United States are taking the lead in global energy efficiency. The European Union (EU) has set itself ambitious energy and climate goals. By 2020, Europe should achieve a 20% decrease in energy consumption, and a 20% share of renewables in the EU energy mix. In its Energy Efficiency Communication, released in late July this year the EU proposed a new energy efficiency target of 30% for 2030. Indeed, most of the increase in consumption in the coming decades will come from South Asia and the Middle East.

### **Economic and strategic implications**

The rise in oil and gas production, the diversification of the energy mix, and the decline in consumption have fundamentally altered the global energy landscape. Almost all countries in the world have contributed to these new dynamics, albeit to different degrees. The potentially prolonged period of low oil and gas prices is likely to have significant and wide-spread implications.

*Environmental impact*: Since the early 2000s, global natural gas production has substantially increased. In addition to well-established players such as Russia, Iran, and Qatar, several new producers have emerged as well-established exporters. These include Turkmenistan, Australia, and the United States. Cheap gas has replaced coal in generating electricity in many countries. Given that coal is more polluting than gas, this replacement is considered a positive development in the efforts to contain pollution. However, cheap gas has also reduced incentives to invest in renewable energy, which is less polluting than gas. In other words, cheap gas is considered a mixed blessing with regard to environmental protection and climate change.

*Economic impact* : Consuming countries will benefit from cheap oil and gas while producing countries are likely to lose out (at least in the short term). Lower prices mean that the billions of dollars the United States and Europe would have transferred to producing countries will, instead, be spent and/or invested in their domestic economies. These 'saved funds' can be used to stimulate the economy and generate jobs. On the other hand, low prices might negatively impact (slow or even undermine) the shale revolution. Shale/tight oil and production from the North Sea are expensive.

Production costs in the Middle East are the cheapest. Middle Eastern producers can make profits even at \$70 per barrel. However, such a low price would not be enough to allow them to balance their budgets. In the last few decades most Middle Eastern producers have achieved very modest success in their efforts to reduce their heavy dependency on oil and gas revenues. They need high prices to maintain and support the high standard of living they enjoy. Several Middle Eastern producers have created sovereign wealth funds (oil funds) to invest their oil revenues. These funds (such as the United Arab Emirates' Mubadala, Qatar Investment Authority and Kuwait Fund are among the richest in the world. Their massive financial assets can help to overcome the declining oil revenues. Less wealthy oil producers such as Iran will have to be more aggressive in reforming their economies and creating other sources of revenue.

*Strategic impact*: Oil is not only an economic commodity, it is a strategic one as well. The key changes in oil markets are likely to have a significant impact on the political and security relations between producers and consumers. In its Energy Outlook, British Petroleum concludes that the United States is on a path to achieve energy self-sufficiency, while import-dependence in Europe, China and India will increase. Asia will become the dominant energy importing region. Russia will remain the leading energy exporter, and Africa will become an increasingly important supplier. While it will remain a key energy player, the Middle East is likely to see relatively static exports. These projections are likely to shape geopolitical relations between producers and consumers.

Since the 1940s many analysts have argued that Western, particularly American, relations with the Middle East were largely driven by the 'oil for security' bargain. In other words, Middle Eastern producers, led by Saudi Arabia, would provide un-interrupted oil supplies to Europe and the United States at 'reasonable' prices and, in return, Western powers would guarantee their security. In recent years the fundamentals of this bargain have changed. The United States is becoming less dependent on foreign supplies from the Middle East and elsewhere. Currently the bulk of US imports come from the Western Hemisphere. Meanwhile, large Asian economies (i.e. China, India, Japan and South Korea) are growing more dependent on Middle Eastern oil. In the last two decades the broader economic and trade ties between the Middle East and South Asia have grown much faster and become deeper than those between the former and Western powers. These expanding volumes of trade and investment suggest that sooner or later Asian powers (particularly China) are likely to assume responsibility for protecting sea lanes and oil shipments from the Gulf to South Asia.

Middle Eastern producers have reacted to the sharp decline in oil prices in multiple ways. Instead of cutting production, Saudi Arabia, the United Arab Emirates, and Iran (among others) have reduced the price. The UAE has recently allowed the expiration of some longstanding concessions to major Western oil companies and is considering replacing some of them with partners from Asia. The Qatar Investment Authority announced plans to invest \$15 billion across Asia in partnership with China's Citic Group.

These recent reactions by oil producers, however, should not be over-estimated. Oil funds will not turn their backs on Europe. The continent remains the major destination of investments from the Persian Gulf and elsewhere. Western oil companies have the most advanced technology in oil exploration and development and will continue to play a major role in the energy sector in the Middle East. The bottom line is that the oil market is a global one where disruption anywhere

impacts prices everywhere. The long-standing close economic and strategic cooperation between Western powers and Middle Eastern producers is likely to survive the recent drop in oil prices.

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