

The Oil Crunch

Before the start of the Iraq war his media empire did so much to promote, Rupert Murdoch explained the payoff: "The greatest thing to come out of this for the world economy, if you could put it that way, would be \$20 a barrel for oil." Crude oil prices in New York rose to almost \$40 a barrel yesterday, a 13-year high.

Those who expected big economic benefits from the war were, of course, utterly wrong about how things would go in Iraq. But the disastrous occupation is only part of the reason that oil is getting more expensive; the other, which will last even if we somehow find a way out of the quagmire, is the intensifying competition for a limited world oil supply.

Thanks to the mess in Iraq — including a continuing campaign of sabotage against oil pipelines — oil exports have yet to recover to their prewar level, let alone supply the millions of extra barrels each day the optimists imagined. And the fallout from the war has spooked the markets, which now fear terrorist attacks on oil installations in Saudi Arabia, and are starting to worry about radicalization throughout the Middle East. (It has been interesting to watch people who lauded George Bush's leadership in the war on terror come to the belated realization that Mr. Bush has given Osama bin Laden exactly what he wanted.)

Even if things had gone well, however, Iraq couldn't have given us cheap oil for more than a couple of years at most, because the United States and other advanced countries are now competing for oil with the surging economies of Asia.

Oil is a resource in finite supply; no major oil fields have been found since 1976, and experts suspect that there are no more to find. Some analysts argue that world production is already at or near its peak, although most say that technological progress, which allows the further exploitation of known sources like the Canadian tar sands, will allow output to rise for another decade or two. But the date of the physical peak in production isn't the really crucial question. The question, instead, is when the trend in oil prices will turn decisively upward. That upward turn is inevitable as a growing world economy confronts a resource in limited supply. But when will it happen? Maybe it already has.

I know, of course, that such predictions have been made before, during the energy crisis of the 1970's. But the end of that crisis has been widely misunderstood: prices went down not because the world found new sources of oil, but because it found ways to make do with less. During the 1980's, oil consumption dropped around the world as the delayed effects of the energy crisis led to the use of more fuel-efficient cars, better insulation in homes and so on. Although economic growth led to a gradual recovery, as late as 1993 world oil consumption was only slightly higher than it had been in 1979. In the United States, oil consumption didn't regain its 1979 level until 1997.

Since then, however, world demand has grown rapidly: the daily world consumption of oil is 12 million barrels higher than it was a decade ago, roughly equal to the combined production of Saudi Arabia and Iran. It turns out that America's love affair with gas guzzlers, short-sighted as it is, is not the main culprit: the big increases in demand have come from booming developing countries. China, in particular, still consumes only 8 percent of the world's oil — but it accounted for 37 percent of the growth in world oil consumption over the last four years. The collision between rapidly growing world demand and a limited world supply is the reason why the oil market is so vulnerable to jitters. Maybe we'll get through this bad patch, and oil will fall back toward \$30 a barrel. But if that happens, it will be only a temporary respite.

In a way it's ironic. Lately we've been hearing a lot about competition from Chinese manufacturing and Indian call centers. But a different kind of competition — the scramble for oil and other resources — poses a much bigger threat to our prosperity.

So what should we be doing? Here's a hint: We can neither drill nor conquer our way out of the problem. Whatever we do, oil prices are going up. What we have to do is adapt.

PAUL KRUGMAN
May 7, 2004 - New York Times