THE GLOBE AND MAIL

December 19, 2014

Secret Saudi oil game pushing OPEC members toward fiscal cliff

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The kingdom's move to leave the oil taps open are putting members such as Venezuela and Nigeria in a precarious position

The cartel that pumps about 30 per cent of the world's oil, OPEC, is going through an existential crisis. Roughly a million pundits, analysts and commentators have concluded that the Organization of Petroleum Exporting Countries has lost control of the oil market and is pretty much finished. The death blow was delivered by the United States, whose surging shale oil production has tilted the balance of power away from OPEC, led by Saudi Arabia.

The argument is simplistic. If OPEC has really lost control of the market, how was it able to engineer the fall that has taken prices down by 45 per cent since the early summer? The fall was no accident. OPEC, that is, Saudi Arabia, decided it would not support the price by reducing its own output. Its goal was to buy market share by choking off expensive, non-OPEC production in the United States, Canada, Russia, offshore Brazil and elsewhere. The strategy may work, since the best cure for low prices is low prices just as the high prices in 2007 and 2008 were unsustainable. How long it will take is an open question.

The problem with the Saudis' low-price strategy is that it hurts OPEC, too. Its 12 member states are not created equal. The ones in the Gulf – Saudi Arabia, Kuwait, Qatar and the United Arab Emirates – probably have the financial muscle to endure low prices for some time, perhaps a few years. Not so the weak OPEC members – Venezuela, Nigeria, Libya and perhaps Iran. The world of $60-(U.S.)-a-barrel oil is pushing them toward the fiscal cliff. If OPEC falls apart, it won't be because it has lost control of a market swimming in American oil; it will be because the low-price policy is sabotaging the economy and finances of a few of its own members. OPEC is becoming a cannibal family, one that eats its own.

OPEC was formed in Baghdad in 1960s and has its headquarters in Vienna, where it hosted the Nov. 27 meeting that left the overall production target intact at 30 million barrels a day, triggering the latest price plunge. Over the decades, it has used its once-commanding market share to try to find a Goldilocks price – neither too hot nor too cold.

The strategy did not always work. In 1986, for instance, OPEC reacted too slowly to the North Sea oil gusher. To defend the price, the Saudis shut down as much as seven million barrels a day of their own production, a decision that pushed Saudi Arabia into a rare budget deficit. Still, the price fell and the Saudis eventually gave up trying to prop it up. OPEC again moved too slowly in the two years before the 2008 financial crisis, when the price shot up to a record $147 before collapsing. In retrospect, OPEC should have used every ounce of its spare capacity to prevent prices from reaching that price-gouging level. The trick is to find a level that ensures adequate income for OPEC without destroying demand.

In some ways, the current strategy is a repeat of the 1986 episode. Today, oil is declining and OPEC is not defending a price – it's letting the market take over. The problem is that OPEC's weaklings are already in trouble, to the point they face social chaos. The Saudis' decision to let prices drop is hurting some of the OPEC countries much more than the non-OPEC ones.

The immediate worry spots are Venezuela and Nigeria. Venezuela, like Saudi Arabia, has vast reserves and is a one-trick pony – its economy is utterly dependent on oil. Unlike Saudi Arabia, Venezuela is a fiscal disaster area with wholly inadequate foreign reserves. It has the world's highest inflation rate, at a staggering 60 per cent, and its sovereign bonds are trading at default levels. Public spending as a percentage of gross domestic product is more than 50 per cent, the highest in Latin America (Brazil's is 22 per cent). Anti-government protests have crippled its cities at times, and some basic consumer items, such as toothpaste, are scarce. When oil was $100 or higher, Venezuela could – barely – keep the charade going. At $60 oil, it's game over.

A bailout of Venezuela is not out of the question if oil prices remain low. But who would do the bailing?

Nigeria, the third-biggest oil exporter, after Saudi Arabia and Russia (which is not an OPEC member), has also entered the house of pain. A new report by Royal Bank of Canada's investment arm says: "The OPEC country at most immediate risk for civil unrest in this price environment is probably Nigeria.... Nigeria has experienced coups in previous low-price environments due in part to drying up patronage funds." Buying off politicians and military generals is harder when the government's crude-oil bank accounts are running dry.

Libya, which is in the middle of a civil war, and Iran which needs about $130 a barrel to balance its budget, are also suffering greatly as the oil price sinks.

Venezuela could collapse and Nigeria could descend into social chaos. Both countries have urged the Saudis to support the oil price by tightening up production, to no avail. The Saudis must be aware of the damage inflicted on Venezuela and Nigeria and they must also know that financial and social chaos would prevent those two countries from keeping oil production intact. If that's the secret Saudi game, it's a brutal one, because the Saudis are allegedly going after non-OPEC countries. To be sure, the low-price strategy will eventually trim global production. But it could wreck OPEC at the same time. In soccer, this is called an own goal.