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Oil Prices and Democracy

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Many consumers think that current oil prices are too high, and governments of industrialized nations use every chance they can to push moderate prices through OPEC. While the current price of US$50 per barrel is equivalent to oil prices in the 1950s, it falls to US$6.5 per barrel when adjusted for inflation. This is especially remarkable considering the fact that, since the creation of the international oil market in the 1930's, worldwide demand for oil has risen by 2000% while oil resources have become scarcer. Why, then, hasn't the price of oil risen accordingly? In my opinion, the lack of democracy in the Golf States, which own the largest oil reserves, is the most important reason for this apparent mystery. More democracy – wanted by all – causes oil prices to rise – which, however, very few desire. This is a surprising theory for many, but recently it has become an explosive issue due to the *Greater Middle East Democracy Initiative* (insofar as this is meant sincerely).

Price mechanisms for non-renewable resources

Presuming the presence of functioning markets, it is important to note that current oil prices are regulated not by the cheapest, but rather by the most expensive type of oil; in other words, current oil prices are regulated by the cost and revenue expectations of the marginal supplier (marginal or opportunity costs).

This market mechanism also explains the high bond revenues in the Persian Golf oil states, who reap the benefits of unusually low production costs. In addition to the increasing scarcity of supply, a second mechanism would have also substantially contributed to rising oil prices – namely, the interest rates in the financial markets.

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The lower the interest rates on oil sale revenues, the bigger the motivation for oil producers to delay collecting raw materials out of the ground – in the hope of either rising prices or rising interest rates. This is because oil is considered investment capital before they have been extracted from the ground. With high interest rates in the financial markets, owners want to sell the black gold quickly and in large amounts, in order to invest this money in the global financial markets. When low interest rates dominate, owners prefer to dampen production levels in order to raise them again once market prices rise, thus increasing their income accordingly. Assuming a functioning market, this plausible "optimizing conduct" forces the producers of non-renewable resources such as oil to restrain production levels. This connection led the US economist *Harold Hotelling* to declare in 1931 that the market price for non-renewable resources would increase exponentially in the long-term, and that this increase would minimally encompass the rising value of capital investments according to the law of interest rates.

The price of land for development has indeed risen in the long-term in accordance with *Hotelling's rule.* Oil prices as well as those of raw material with a high market share of developing countries, however, remain far behind the development path predicted by this theory. How can this phenomenon be explained? The neoclassical mainstream sees falling prices for oil and raw material as proof positive *that Hotelling's rule* is fundamentally flawed. The Nobel Prize-winner *Robert Solow* even declared in 1974 that the oil supply was not scare at all; rather, that there was an oversupply of oil available. Solow's assumption has since been proven drastically miscalculated, and therefore, there must be a different cause for the aberrant development of oil prices.

Oil is the most important lubricant of economic growth; rising oil prices therefore hinder growth and burden the consumer. The IEA calculated that growth in OECD countries slows by 0.4% when oil prices rise by US$10 per barrel. However, rising oil prices bring higher rent revenues to oil supplying states. In this way, oil prices maintain a double function: on the one hand, they stimulate and/or repress economic growth; on the other hand they act as the deciding lever for the global distribution of oil rents. Hence, the OECD states, as primary consumers, have had a fundamental interest in maintaining the lowest possible oil prices, supported by an international oil

market with great flexibility of supply and stable prices at a low level. Through this construction it has been possible to achieve higher economic growth rates while also securing a steady and long-lasting redistribution of rent revenues from the supply to the demand side – a redistribution involving astronomical sums of several hundreds of billions of US dollars per year. Indeed, low oil prices in OECD countries have developed into an effective instrument of domestic consensus building and stability in "affluent democracies." The structural overproduction of oil and all other fossil energies that has dominated the international oil market for the last 70 years – despite increasing depletion of oil reserves – aligns completely with the interests of the OECD states, even though this phenomenon was a novelty in the history of capitalism and contradicted all market logic. Normally, suppliers in the economy react to overproduction and falling prices with a decrease in production levels. Paradoxically, however, this did not happen in the oil sector; this is especially surprising considering the oil sector is exactly the type of market that demands a reduction in supply in times of relative scarcity – not overproduction.

Market laws are only valid, however, when all market players are in the position to act sovereignly on their individual optimization criteria and preferences. This is the implicit fundamental assumption of all neoclassical market, price and balance theories. The sovereignty of market players is, however, unimaginable without freedom of choice, self-determined optimization criteria and competition for the optimization of interests. In other words, sovereignty is inextricably linked with democracy, and this linkage applies to both domestic and global trade between nations. A lack of democracy in the oil states is the primary cause of steadily decreasing oil prices that defy market mechanisms for non-renewable goods. In order to precisely elucidate this theory, two historical periods must be defined: The first period runs until the beginning of the 1970's and is defined by the self-interested use of the Golf region oil supply by large oil groups. The second period begins in the early 1970's, with the area-wide wave of nationalization of the oil sector in all OPEC states.

Until the beginning of the 1970s, oil owning states in the south literally gave their sovereignty as market players to a handful of multinational oil groups for a negligible 10 – 20% of the profits. Out of fear that these unfair contracts could collapse at any

moment, the multinational oil groups pulled as much oil from the ground as they could over almost four decades, investing the revenue in the international finance markets. The keen competition to turn cheaply-produced oil into currency turned the multinational oil groups into the most financially powerful concerns in the world. However, this competition also caused a latent overproduction with prices of US$1 to US$2 per barrel. While the flood of oil from the reserves of the Middle East became the cornerstone of mass consumption and the Fordist growth model in the USA and Europe, the peoples in the Middle East irreversibly lost a portion of their natural wealth. The elite of oil states signed slave-like contracts with oil concerns for the unrestrained exploitation of their oil reserves because they were motivated purely by their own interests and did not act in the interest of their people or future generations. Democratically legitimated elite, on the other hand, would most likely not have entered into such contracts.

In 1951 the nationalization of the oil industry became the primary goal of the first – and currently only – democratically elected government in Iran and in the whole Middle East. This government was tied closely to the name Mossadegh and can be cited as the first sovereign Middle Eastern actor in the international oil market. This government would have motivated other people to emulate its examples, and perhaps even started a wave of democratization in the entire region, had it not been toppled in 1953 through operations of the American secret service, the CIA, and replaced with the dictatorial government of the Shah. Eisenhower, however, already recognized the danger of a democratized Middle East for economic growth and the American consumer model, and used the pretense of “communist danger” to give the CIA the green light to overthrow Mossadegh. Is this example not historical proof that the oil-dependent West wanted to eliminate sovereign market actors and thus render the market logic in the international oil markets null and void? It was always about the maintenance of low oil prices as the motor of economic growth in the West, and just as importantly, as an instrument for the redistribution of substantial oil income from the supply to the demand side.

The multinational oil concerns were right in the end, and the slave-like contracts did not last. Under growing legitimacy pressure from their own peoples, even dictators were forced to nationalize the oil industry in the early 1970’s (for instance, the

retrieved Shah Reza Pahlewi in Iran). In doing so, these dictators were able to win back a portion of their market sovereignty. As a result, there were two oil price surges – catalyzed by the Yom Kippur War of 1974 and later the Iranian Revolution in 1979. The first surge saw prices rising from US$2 to US$10 per barrel, while the second surge brought prices to US$40 per barrel (US$80 per barrel when adjusted for inflation). These shocking price surges pointed to the enormous gap between market demand and low oil prices. In fact, whenever there has been an opportunity for oil suppliers to consciously and confidently intervene in market events, this ever-accumulating gap unloads in the form of drastic price surges.

However, despite demands for formal sovereignty over oil reserves, the normalization of market forces in the oil sector was short-lived. This was due to the fact that true democratization – including open competition for path of optimal national utility of the oil business – did not take place after the nationalization of the oil fields. In addition, the ruling petrodollar monarchies were inclined to engage in horse-trading with the USA, the biggest oil consumer: *the safeguarding of their own authority in exchange for a moderate policy on oil prices.* A lack of legitimacy and control through their own people thus kept the governments of oil states open to manipulation.

This was especially true for the three petrodollar oligarchies of Saudi Arabia, Kuwait and the Arab Emirates, who together account for just under 20% of the world oil market. The oligarchies in these countries increased production capacity and continued to generate a latent overproduction of oil in the 1980's and 1990's. As a result of the substantial overcapacity in OPEC and the expansion of more costly oil and energy sources outside of OPEC, there arose henceforth a literal downward spiral of oil prices from US$40 to US$10 per barrel in the late 1990's. Even the sudden halt of Kuwaiti and Iraqi oil supplies during the Kuwait Crisis failed to incite dramatic and long-lasting oil price increases (see accompanying graph). Considering Kuwait and Iraq together supplied 20% of OPEC oil, a dramatic rise in oil prices should have been expected. The Saudis, however, quickly moved to utilize extant excess capacity, successfully filling the market hole left by the sudden halt of Kuwaiti and Iraqi supply.

Through doubtful contracts and later through systematic and purposeful cooperation with half-sovereign, illegitimate oil supplier governments in the Middle East, industrialized nations managed to render market laws in the oil sector void for nearly seven decades. Despite ever-increasing demand and the gradual depletion of resources, the oil market has yet to come face to face with scarcity. Rather, the oil market has been – and continues to be – characterized by low prices maintained through a structural overproduction of oil supported by political motivations. A lack of democracy in the oil states was and is the critical cause for overproduction and low oil prices.

Rising oil prices due to shortages and the democratization of the oil supplying states

Based on the above oil price theory and a political-economic analysis of the international oil market, it is to be expected that in the course of democratization the oil states will commit themselves to long-term national interests more than ever before, and will begin striving towards the goal of optimizing collective marginal utility – as neoclassical economist would put it. This, however, would entail the full expansion of market powers to replace politically motivated dictations from the demand side and the resulting increasing oil prices. Truly free and independent parties in democratized oil states would hardly be able to free themselves from societal discourse around sovereignty and national interests. Thus, in order to win a majority, they would be forced to campaign on the issues of new oil quantity and oil price strategies, and provide a solution to lessen their own dependency on oil income. In the end, this would produce oil scarcity instead of overproduction. Additionally, rapidly increasing oil demand in China and India is causing a dramatic trend towards depletion, adding optimization pressure to the mix. Now thus definitely shattering the illusion of an eternal oil supply.

The expansion of alternative energy technologies whose cost-effectiveness would rise with oil prices is the only way to set boundaries on oil price increases that are based on the optimal utility strategies of the oil suppliers. This approach cannot be objected to out of economical reasons in the context of free formation of global market prices, nor out of moral, and certainly not out of climate protection policy

reasons. A moderate evolution from the fossil energy path to the age of solar power should definitely take place within a corridor of oil prices well above US$30 per barrel will most likely range above US$50 per barrel. In this way, the controlling mechanisms of the oil market would morph into the most effective instruments against the wasteful energy policies that have dominated until now. As long as the market mechanisms are subordinate to the common good of the affected peoples, they will no longer stand in opposition to the concept of sustainable development. Democratization in the oil states would thus become a complementary cornerstone to a strategy of global sustainable energy supply and of climate protection.

According to this analysis, the US neoconservatives' new democratization project *Greater Middle East* would contradict both the hegemony and current climate protection policy of the United States. This is because democratization and sovereign states in the Middle East would render costly military protection of the energy supply superfluous. Fair trade would adequately provide this protection, just as trade between industrialized nations currently does. In addition, increasing oil prices strain the wealth of the USA, which is largely dependant on energy. Do the neoconservatives really want this, or do they believe the USA can continue to control the energy sources of the Middle East and the global oil market through other means: the export of democracy as the new vestment of hegemonic politics.