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Plummeting Petroleum Prices: Why has Riyadh deployed a crude (oil) weapon?

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"*A beleaguered House of Saud believes it may force Moscow to abandon its support of Damascus, and Washington to scotch a deal with Tehran.*"
—Journalist Pepe Escobar[1]

The recent downward trend in oil prices due to increased production by Saudi Arabia has led to speculation that perhaps Washington and Riyadh are using crude oil price as a weapon to put pressure on Russia and Iran. While sustained low oil prices will impact the Iranian and Russian economies, the repercussions in the United States may be even greater.[2] So is Saudi Arabia merely seeking to increase market share or are there other issues lurking in the background?

The world anxiously awaits the next scheduled OPEC meeting on November 27, which just happens to fall three days after the latest deadline for a U.S.-Iran nuclear agreement, to see if Saudi Arabia will keep markets flooded with crude oil or reduce output to raise prices.[3] If Riyadh continues its oil surge, China and India, the second and third largest oil importers worldwide,[4] stand to benefit significantly, as would Thailand, Indonesia, Singapore and the Philippines. Conversely, OPEC members Iran, Iraq, Algeria, Libya, Nigeria, Ecuador and Venezuela, all with break-even points around $120 a barrel, will be adversely affected.[5]

As the world learned in 1986 when oil prices plunged over 50 percent, if Saudi Arabia wants to start a price war to affirm its ascendency, it has both the resources and infrastructure to do just that. The 1986 oil price freefall engineered by the Saudis was simply to increase their share of the market,[6] but this time, Riyadh's price war could make fracking and deepwater drilling as well as alternative energy sources such as solar and wind power economically unfeasible in America. But does Riyadh really intend to strike a blow at the U.S. economy?

Saudi Arabia has the fiscal reserves to tolerate oil prices as low as $70 a barrel for two years without undue hardship.[7] With reserves of almost $750 billion—double the amount held five years ago—Riyadh is clearly in a position to test the resolve of the world's largest importer of oil, the United States, in maintaining its shale oil production at the current levels despite prices well below the $100 a barrel profit benchmark.[8] And if the Saudis hold oil prices below $90 a barrel, shale oil extraction in the U.S. will be rendered unprofitable,[9] which would lead to production cutbacks and greater reliance on imported oil.[10]

It is no secret that Washington and Riyadh have been at odds over a number of issues recently, among them the Saudi perception of a lack of political will in the U.S. administration to topple the Assad government, exasperation due to the U.S. refusal to either strike Iran directly or back an Israeli assault, and utter dismay over the Obama administration's efforts to reach an agreement on Iran's peaceful nuclear program. Indeed, the Saudis may claim to be supporting the U.S.-led campaign against ISIL, but the falling oil prices suggest otherwise.[11]

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An obvious strategic benefit accruing to both the U.S. and Saudi Arabia from low oil prices is the additional economic burden placed upon their mutual adversaries, Russia and Iran. Russia sells most of its daily output of 10 million barrels of oil on the domestic market and needs a price of $100 per barrel to maintain a stable economy. Iran produces 4.2 million barrels per day, and needs the price of oil to be around $130 a barrel to balance its budget.[12] However, there is a sharp negative side to the oil price slide for the U.S., since every $20 drop per barrel roughly translates to a 20 percent reduction in profits for American producers.[13]

While the U.S. has become the world's largest oil producer with an output of 11 million barrels a day surpassing even Saudi Arabia,[14] it remains the world's largest oil importer,[15] so its production, like Russia's, mainly supplies the domestic market. And despite years of rhetoric from successive Washington administrations about achieving energy independence,[16] America's domestic energy output has failed to supply all the country's needs since the late 1950s. Consequently, with U.S. output 15 percent short of satisfying the gluttonous appetite of the world's largest energy consumer,[17] the current Saudi oil war has the potential to damage the U.S. economy by making shale oil extraction unprofitable.[18]

The U.S. gained the lead in world oil and gas production using costly methods of extracting oil and gas from rock strata by hydraulic fracturing, also known as "fracking," which is profitable as long as oil prices remain above $100 a barrel, but below this price level, fracking becomes marginal at best.[19] While some U.S. energy firms could break even at oil prices of $80 a barrel, others are unprofitable below $90, but if weak oil prices continue, "There could be an immense amount of pain," according to energy economist Phil Verleger.[20] In short, what Harvard economist Joseph Nye has called America's "shale gale"[21] may turn out to be just a whirlwind in the Arabian Desert.

Unlike 1986, the U.S. economy is in no shape to weather a protracted global downturn. At that time, with the prime rate hovering around 9 percent, the focus of the Federal Reserve was on curbing inflationary pressures,[22] but today, the Fed is far more worried about deflation than inflation.[23] Despite an "official" prime rate of 3.25 percent since December 2008[24] and a Federal funds rate at 0 to 0.25 percent, the Fed has failed to attain its goal of a 2 percent inflation rate.

Since November 2008 with the intent to keep interest rates low and thereby stimulate the economy, the Fed has purchased $85 billion of U.S. Treasury securities each month, only decreasing that amount by increments of $10 billion at each Federal Open Market Committee meeting since January 2014. But after three rounds of so-called quantitative easing that bloated its balance sheet to nearly $4.5 trillion, the Fed has officially given up on the program, [25] due no doubt to the inflationary effect of falling crude oil prices.

U.S. corporations have even bought back $1.09 trillion of their own stock to maintain the level of the Standard and Poor's 500 stock index. As one analyst put it, "When one can't even give a business away that includes thousands of patents, IBM engineers and two operating factories, times are tough."[26] But despite these massive efforts to jump start the U.S. economy, the labor force has a participation rate of only about 63 percent, meaning that the real U.S. unemployment rate remains around 37 percent,[27] refuting the Fed's latest claim of "solid job gains and a lower unemployment rate."[28]

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With the top 10 percent in the U.S. amassing over 50 percent of the income, the anemic American economy threatens the world with a deflationary spiral on the order of the Great Depression in the 1930s, which would drag down the rich along with everyone else.[29] And until the Saudis torpedoed the markets, crude oil price has been a key factor that has allowed both the Fed and the U.S. Congress to avoid addressing deflation. So it may be that the Saudis have deployed their "oil weapon" in a magnanimous move to aid the international banking cartel in their losing battle against global deflation.[30] However, this seems improbable considering the ongoing Washington-Riyadh tensions.[31]

More likely, Riyadh launched its "oil weapon" simply to pressure the United States to back away from a nuclear deal with Tehran, and force Russia to give up its support of Damascus. Certainly, as was the case in 1986, there is an aspect of increasing market share in this, but that the Saudis also hoped to save the world from mass economic destruction seems highly doubtful.

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