Libyan Turmoil, Oil Prices, and the Global Economy

Mohsin S. Khan sees a continuing economic threat posed by instability in Libya and other oil producing states.

Edited transcript, recorded March 3, 2011.

Steve Weisman: The instability and demands for democracy in the Middle East have spread. This is Steve Weisman at the Peterson Institute for International Economics with Mohsin Khan, senior fellow here who was assessing the situation at the height of the Egyptian crisis a few weeks ago. But now that it has spread. Mohsin welcome back to give us an update.

Mohsin Khan: Thanks a lot, Steve.

Steve Weisman: You were a little sanguine when we last talked a few weeks ago about the repercussions of the Egyptian crisis. Now Egypt has stabilized some but the turmoil has spread to other countries, including Libya (which is a major oil producer). What concerns do you have?

Mohsin Khan: I think that perhaps I should start off by saying that I did say when we last spoke that the serious danger was that this would spread to other countries. And that is what most analysts are worrying about. I think that my initial thought was that it would spread to North Africa, and to countries like Jordan. Sure enough, it has spread to North Africa. You have problems in Algeria, now in Libya. There is some renewed tension in Tunisia. There are some troubles as well in Morocco. So yes this political turmoil and the potential economic effects of this turmoil are spreading all over North Africa. There are now problems in Bahrain, Oman. There were already problems in Yemen, so it is getting into the Gulf. There are some rising tensions even in Iran. So this is becoming a Middle East phenomenon not just an Egyptian phenomenon.

Steve Weisman: What has been the impact on oil prices?

Mohsin Khan: If you recall, I said that that is where the big issue is. If oil prices begin to react to the crisis and to rise, that is something the world should worry about. I think the world should worry about the political developments too, but from an economic standpoint the way the Middle East would affect the world economy would be through oil. And when we last spoke we were in the early days of the Egyptian crisis. Oil had risen to about $100 a barrel. That was more based on fears of the closure of the Suez Canal and some expectations that the crisis would spread. Since the 24th of January, oil prices have risen 15 percent, primarily because of Libya. Oil disruptions have been taking place there.

Steve Weisman: Specifically?

Mohsin Khan: There is some talk that Libyan oil production has been cut in half. That is disputed. It is interesting that where the so called rebels or the protestors claim [to be in control], oil is flowing freely. And it was interesting to me that the Chairman of the National Oil Company in Libya (obviously closely related and associated with the Gaddafi regime) says that oil production has been cut in half as a result of these effects.

Remember, Libya produces approximately 2 million barrels a day of oil. And it exports something like 1.6 million barrels a day and it exports primarily to Europe, Italy and the rest of Europe, and of course some to neighboring countries, but mainly to Europe. And it is a particular kind of oil. This has important implications. It is what they call a light sweet crude. That means it has low sulfur content and is much easier to refine than the heavier crudes.

Now Saudi Arabia has stepped in and said, we will cover the shortage of oil caused by the disruptions in Libya. But Saudi Arabia's excess capacity lies primarily in heavier crudes. And these are more expensive and more difficult to refine. That is not to say that it cannot be refined, but it is more difficult to refine. It is not quite clear whether in fact Saudi Arabia saying that it's ready to be the supplier of last resort and keep stability in the oil market will work. The Europeans require a certain type of oil, and Saudi Arabia does not produce or at the moment does not have the capacity to produce that particular kind of oil.

Steve Weisman: Where is the oil refined? In Libya or in Europe?

Mohsin Khan: It is refined in both. Shipping of refined products is an expensive business so primarily the refineries in Libya are geared to Libyan demand.

Steve Weisman: There have been mixed reports about whether those refineries are operating, or they have been bombed?

Mohsin Khan: It is difficult to say. Right now there anecdotal evidence that tankers are being loaded still. One of the things to remember is that it is not just the production of oil that matters as far as the world is concerned, but it is the shipping. So if tankers are unable to come into the ports because of the chaotic situation in the ports, that means there is an oil disruption. Even though the oil may be flowing, it is just flowing into holding tanks.

Steve Weisman: Explain the connection between the spiking of these spot prices for oil and what we see at the pump. Gas prices seem to have risen.

Mohsin Khan: The connection is how much of a pass-through is there between the spot price of crude oil and the price at the pump. In the United States, the pass-through is very quick. Oil prices move a blip, and domestic gasoline prices move very fast. Remember who is actually selling the gasoline to your gas station. It is the oil companies. So if the oil companies are in fact at the one end of the production stream finding oil prices rising, they will very quickly pass on the increase into the prices at the pump.

Steve Weisman: Libya is the main oil producing company that is in turmoil, but the other countries are also oil producers or oil transmitters.

Mohsin Khan: In North Africa for example, Algeria is another oil producer. And it produces about half of what Libya produces but it is a major gas producer. And it sells an awful lot of gas to Europe. So I see the Libyan crisis impacting Algeria, it already has to some extent. And in fact the Algerian demonstrations predate Libya. But that is the next country. In the Gulf itself, Bahrain is not a major oil producer. In fact Bahrain is sometimes considered not to be an oil producer. It does produce oil, but the oil that it produces is from wells that have a field that the Saudi government has given Bahrain to be able to use and pump and utilize their revenues. So it is in a sense a subsidy, if you like, that Saudi Arabia provides Bahrain.

Oman is an oil producer, but it is small oil producer and it is running out of reserves. And now it has a problem. I mean, it is having demonstrations and people are getting killed. So in a sense you are getting now very close to the really big producers of oil, big exporters of oil. And the king of oil producers is Saudi Arabia, United Arab Emirates, Abu Dhabi in particular, the Emirate of Abu Dhabi and Kuwait.

Steve Weisman: But these countries don't seem to be facing the turmoil that other countries have been hit by--yet.

Mohsin Khan: I think you know that "yet" is a very good word here. Nobody was predicting that it would spread to Bahrain and Oman either. There was some tension in Bahrain because of the sectarian problem there, where you have a majority Shia population and a minority Sunni ruling family. The worry really is, will it go from Bahrain to Saudi Arabia? And the connection there is another sectarian connection.

Steve Weisman: Saudi Arabia has a very excitable Shiite population that happens to reside in oil producing areas.

Mohsin Khan: The second part of what your statement was right. I'm not sure you could say they are excitable. They have been marginalized to some extent. They feel oppressed. They feel discriminated against. And they are, if you like, unhappy. And yes, the Bahraini Shias and the Saudi Shias [live] in the eastern province, where the oil is, where in fact Saudi Aramco, the biggest oil company in the world possibly the biggest company in the world, is based. So the fear is that, were the Shia to take over Bahrain, the Shias in the eastern province [of Saudi Arabia] would start demanding their rights and their economic opportunities. And that would lead to the same type of protests you saw in Egypt and in Tunisia, etc., where people rise up because they feel they have been economically discriminated against. And the Shia in the eastern province of Saudi Arabia certainly feel that.

Steve Weisman: There is a move to freeze the Libyan assets to pressure and bring about a solution. What economic impact would that have?

Mohsin Khan: At the moment, as I understand it, some $30 billion of Libyan assets have been frozen. Some people say a large chunk of those belong to the Gaddafi family or close associates of the Gaddafi family. That in itself will not have a major impact. And the reason that it won't have an impact is that as long as the Gaddafi family is in a position to control the reserves of the Central Bank, which are approximately $110 billion, there is still a lot of wealth that they have and they can get their hands on. The question is: will the United States do what it has been doing in the case of Iran? Which is not through direct sanctions, not through direct freezing of assets, start directing its banks (the US banks) not to have dealings with the Libyan banks or with the Libyan Central Bank. That is the situation in Iran.

Unfortunately, even in the case of Iran, this didn't have much of an impact. There are always ways around these financial sanctions. And the Iranians have found their way. Since we are on Iran, I should touch on that, since we were talking about it. I think that Iran is going through some protest of its own, but the government of Iran must also be looking, well, should I say, joyfully at what is going on in Bahrain and possibly in the eastern province of Saudi Arabia, to the extent that I think the Saudis and the Bahrainis blame Iran for instigating these problems. I don't buy that. This is a home grown protest.

Steve Weisman: But that hasn't stopped them from blaming them.

Mohsin Khan: Of course not. The last few days Colonel Gaddafi has been blaming a lot of people for what is going on. First he denies that there are any protests at all and then he says that whatever protests there are, the protestors are drugged by Al-Qaeda or whatever.

Steve Weisman: And don't forget the media.

Mohsin Khan: And the media of course, particularly the international media. And he claims that his people still love him and they support him. But blaming outside agitators, it's a standard and knee jerk reaction of any political leader in trouble facing demonstrations. The first thing you do is say it's outside forces, outside agitators. That is none of that.

Steve Weisman: It's always, as the old saying goes, hard to make predictions especially about the future. Should the rebellion in Libya succeed, do we have any sense of Libya's orientation and ability to continue to pump oil?

Mohsin Khan: Let me contrast Libya with Saudi Arabia. Libya lived for a long time under sanctions and it continued to pump oil. Its production facilities deteriorated, its refineries deteriorated, much like Iraq during Saddam Hussein, and the sanctions it faced. The transformation that has taken place over the last two or three years, after the rapprochement with the West, has allowed foreign companies to come in and more importantly foreign engineers to come in. The question is how soon will these people return to Libya and start working in the oil fields?

Steve Weisman: They all have fled.

Mohsin Khan: They all have fled, yes. In my prediction when somebody asked me what is the indicator you look for that the oil supply is in trouble since, you don't have actually real time data on what is being produced. And somewhat half seriously I said "Well, when foreign oil and petroleum engineers start leaving the country fast." That spells trouble. Saudi Aramco and Saudi Arabia are different because they have a very strong professional group of Saudis running the Saudi Aramco, as opposed to Libya, which had a lot of foreigners. BP closed shop and the other companies have closed shop. So it is going to be a while.

Steve Weisman: What are the big companies that went in after the Lockerbie incident was resolved and sanctions were lifted?

Mohsin Khan: The biggest one was BP. ENI from Italy is very big there. So there has been a lot of investment in the infrastructure in the oil industry in recent years. I think the question is, what is going to happen? I think Libyan oil disappearing off the market -- worst case scenario. It still is not going to be enough to cause a serious supply destruction in the world.

Again the world supplies close to 90 million barrels a day. If you take 2 million barrels a day off the market completely, it is going to have an effect but it is not going to have such a dramatic effect. I think what happens. really, is the question of when people start hedging and locking themselves into forward contracts at the current price. That in itself feeds the spot prices and the spot prices begin to rise. My worry is that there is speculation involved or momentum trading, starting to take place. Once that happens, oil prices will spike very sharply, even though there may be no supply disruption. But the fear of supply disruption will force these prices to rise.

Steve Weisman: And to have an impact on the economy so in the United States and Europe.

Mohsin Khan: That is exactly right. And I think the world economic recovery is still fragile. I've heard people say that if oil prices stay at $120 [a barrel] – they were $115 today – and stay there for a while, that is going to shave some of the world growth. I think that certainly true. But I would say that I think they could spike much higher if in fact people really fear that there will be a supply disruption of a serious kind. And then I think, Steve, all bets are off.

Steve Weisman: On that sobering note, thanks, Mohsin.

Mohsin Khan: Thank you very much Steve.