



JAMES A. BAKER III INSTITUTE FOR PUBLIC POLICY
RICE UNIVERSITY

THE INCREASING ROLE OF
GEOPOLITICAL RISK IN ENERGY MARKETS

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The phrase “May you live in interesting times” entered the English lexicon, as a purported Chinese curse, some 70 years ago, during the turbulent years between the two world wars. A decade later, after the conclusion of World War II, the world embarked on a remarkable, albeit checkered, journey of unprecedented economic growth and international cooperation. Today, we stand at another historical crossroads, with the international financial system — and the age of trade, economic and political globalization that it has supported — hanging in the balance.

My colleagues at the Baker Institute will summarize some of the results of our research and policy analysis in their presentations today, and we will hear from other important organizations like Accenture, Baker Botts, BP, Nezavisimaya Gazeta, and The Brookings Institution. I would like to preface these presentations with a brief overview of their three interwoven themes on energy markets, geopolitical trends and the international financial system.

When we think about the oil crises of the 1970s, we remember wars, embargoes and revolutions. By the early 1980s, the world faced very similar problems after those events. The United States was running substantial trade and fiscal deficits, triggered initially by the Vietnam War, but also in the context of feverish Asian economic growth (led by Japan) and historical escalation of energy prices, unseen since the late nineteenth century. Then, as now, we wondered if the international system that emerged following World War II was sustainable. I do not need to remind you of then-Secretary of the Treasury James A. Baker, III’s role during the 1980s, which included the masterful orchestration of the Louvre and Plaza Accords, to bring Asian, European and American policymakers together. Those efforts allowed the world to weather the brewing financial storm and to embark on many more years of substantial economic integration and growth.

A few years ago, the United States was again accumulating substantial debts through twin fiscal and trade deficits, again aggravated by two wars (in Iraq and Afghanistan) and rising energy prices. Asian and other creditor countries seemed satisfied with an export-oriented economic-growth model through which their savings were used to finance U.S. debts, both public and private, at historically low interest rates. In return, American firms were able to earn significantly higher rates of return on their investments in Asian countries with significantly cheaper and more

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abundant labor supplies. This symbiotic relationship was dubbed by some economists “Bretton-Woods II” because of the continued centrality of the U.S. dollar and the maintained role of the United States as the de facto world banker, borrowing cheaply short term and investing profitably long term.

The feverish pace of growth in Asia, most notably in China and India, resulted in significant growth of demand for energy, and has been credited with what is often referred to as a remarkable “demand driven” rally in oil prices. No doubt rapid demand growth was a catalyst, but supply was also extremely slow to respond — in part because of underinvestment in productive capacity during the 1990s, and in part due to geopolitical turmoil in various oil-rich regions, and in part because of national and corporate strategies that failed to recognize the magnitude of the consequences for a tepid response. As a result, the world has witnessed a surge in petrodollar flows that rivals what we had seen two decades earlier. Those petrodollars added to the Asian-based “savings glut” that allowed interest rates to remain excessively low in the United States, even as bankers were seeking exceedingly higher levels of credit risk. We all know how this chapter of the story is ending: Credit markets have collapsed in the United States and around the world. The question that remains in the balance is whether the citizens of petro-states will benefit more this time around than in the 1970s. As Dr. El-Gamal will discuss later in the day, trickle-down effects may be less sustainable if sound policies are not put in place.

There is some room for hope. The banking crisis that has ensued could be a blessing in disguise if managed properly. There is no doubt that financial and real sectors of our economies are suffering as a consequence of this negative financial cycle. However, there is a significant silver lining to this dark cloud: The banking crisis does not appear to be, as some of our economists had feared, accompanied by a currency (i.e. dollar) crisis. There have been many financial crises since the Bretton-Woods system ended in 1973, most of which took place in emerging-market economies.

We are fortunate that central bankers and other authorities around the world have collaborated promptly to infuse liquidity and simultaneously to protect the dollar, which continues to lie at the center of our international financial system. Many had feared that the level of cooperation that

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we witnessed in the 1980s and early 1990s — cooperation for which Japan, Kuwait, Saudi Arabia and other countries willingly paid a hefty price — would not be possible today. We are very fortunate indeed that political and economic leaders around the world have recognized the severity of the problem and have rallied to address the current banking crisis. But there is still more hard work to do, both in energy markets and in financial markets and the long-term fate of how nations handle their currency issues. Participation and coordination in global monetary policy remains a huge challenge, given the realities of globalization and market contagion that is ravaging economies as diverse as Iceland and sub-Saharan Africa.

There is reason to believe that the adverse effects of the banking crisis will be contained because of this level of international cooperation, at least in the short term. The danger remains, however, that we may fail to follow through after the short-term crisis is over to address fundamental structural weaknesses in the global system. The Middle East could also be adversely affected, despite its current surpluses, as it was in the mid-1980s by the sudden downturn in petrodollar inflows that resulted from falling energy demand across the globe.

On the financial front, increasing numbers of economists have begun to agree that escalating twin (fiscal and trade) deficits of the United States are unsustainable. The dollar must depreciate substantially against the managed (especially Asian) currencies before the current pattern of trade imbalances is corrected. European Central Banks and Middle-East sovereign wealth funds need simultaneously to support the dollar in order to avoid what Nobel Laureate Paul Krugman has called a Wile E. Coyote moment, where all holders of dollar-denominated assets collectively observe the values of their portfolios plummet. The new U.S. administration will have to create an environment that will welcome foreign investment to U.S shores in a manner that repairs damage done by incidents such as the Dubai Ports scandal. Once the panic settles, I expect there will be some good “buys” in the U.S. economy for sovereign wealth funds.

India’s central bank unexpectedly cut its interest rates in an effort to stave off what it feared could be substantial economic declines; and analysts are predicting that the severe slowdown in China’s private sector, with 70,000 private businesses closing their doors in recent months, can only be reversed by a massive Chinese government fiscal spending program. News out of Europe

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has been equally dismal, prompting the United States and France to call for a global summit, which will be held in Washington on Nov. 15.

On the energy front, oil-rich countries need to continue and accelerate investment in productive capacity, even as energy prices decline during the inevitable global recession. The lesson of the previous two petrodollar-flow cycles is unmistakable: Amplification of the oil-price fluctuations is dangerous, because severe upswings create distortionary financial bubbles and severe downswings create budgetary and geopolitical problems.

The lessons of the early 1900s is that if nations respond to the current crisis with protectionist national policies in the name of protecting local workers, the consequences could be dire. And we must be careful that such protectionism isn't propelled by populism both inside the United States and around the world, as political leaders meet to respond to global challenges but also worrying about facing the media and the public in their own home constituencies. Such populism has tempted certain energy producers towards energy mercantilism that has proven ill-fated both for their own countrymen and for global consumers everywhere. Let us hope that the United States, under new leadership, and other powers will resist such temptations and that we will restore a global order where vital and highly symbiotic trade is never used as a political tool — not energy, not food, not financial and other commodities. By the same token, we will also have to be doubly vigilant that trade protectionism does not rear its head in a veiled manner, disguised as global climate policy that is blocking imports by claiming that we are aiming to guard against “high carbon content” if other protectionist motivations are the real drivers. Let me make clear that we should pursue legitimate global climate change policies on their own merits.

In May, the Baker Institute Energy Forum released a new study called “The Global Energy Market: Comprehensive Strategies to Meet Geopolitical and Financial Risks.” We will be presenting the relevant findings from that study in today's session, as well as hearing from other experts about the future of the energy market, the energy industry and the global economy. That study warned that sharp changes in energy prices were having “dramatic effects on the stability of the global economy” and added that “to prevent a breakdown of the smooth functioning of markets will require thoughtful and sound policies on both economic issues and energy issues.”

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The study considered the pronounced problems of market contagion, speculation and geopolitical risk and discussed a new definition of energy security in the context of a world where fears were rising that energy would be used as a political lever. But the study concluded that many of the risks that had been driving the so-called “terror premium” for oil had been easing over the spring of 2008 and argued that these risk factors “may be less catastrophic than they seem at first glance.”

My recently published book, “Danger and Opportunity: An American Ambassador’s Journey through the Middle East” contains my analysis and policy recommendations on U.S. policy towards the broader Middle East and the Muslim world and starts out with a letter to the incoming president of the United States.

The costs of the United States not talking to its adversaries are very clear. This lack of official and sustained communications between the United States and its so-called “nations of concern” has not only led to misperceptions on all sides, but has been an impediment to effective U.S. foreign policy and global conflict resolution. It is my view that we must focus on Afghanistan and Pakistan in combating terrorism. The larger struggle in the broader Middle East and the Muslim world is the struggle of ideas between the Islamic radicals and Muslim moderates. Our policies should be aimed at using all the “soft and hard power” tools available to us to marginalize the terrorists and extremists and reinforce the moderates. Also, we must move from conflict management to conflict resolution in the broader Middle East and South Asia, including resolving the Arab-Israeli conflict and the Kashmir issue.

Barring unforeseen circumstances, I believe we will see an organized and phased withdrawal of U.S. troops from Iraq within the time frame of 2011. Specific timelines for U.S. military contingents will likely be established, but with flexibility to respond to facts on the ground to provide a condition-based withdrawal. I am confident that no matter who wins the presidency in the United States next week, we will be committed to a course of active dialogue and diplomacy, with the current crisis demonstrating to all how intertwined our fates will be.

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I am pleased to begin this roundtable discussion with a presentation by a truly global thinker, Dr. Atul Arya, head of policy and long-term strategy development for BP. Dr. Arya has an interesting vantage point with which to discuss the long-term challenges and strategic issues facing the energy industry today. He is not only a distinguished petroleum engineer (well educated, I might add, in Texas). He has served as a leader in BP's solar and renewable energy business. We look forward to discussing with him the state of the industry and its future.

Dr. Arya....