

## THE FINANCIAL PAGE TROUBLED WATERS OVER OIL

The past few months haven't been easy for Iran's President, Mahmoud Ahmadinejad. His refusal to halt Iran's uranium-enrichment program led the United Nations to impose sanctions in December. Inflation in Iran has exploded, with the price of commodities like bread and meat rising as much as twenty-five per cent. In the country's recent municipal elections, Ahmadinejad's political allies were crushed, and clerics and lawmakers have begun criticizing him in public. Worse still, through the second half of 2006 the price of oil tumbled almost thirty per cent, a disaster for an economy as dependent on oil revenue as Iran's. (The country pumps almost four million barrels of oil a day and ultimately exports more than half of it.) And then the Bush Administration said that it had authorized U.S. troops to detain or kill any Iranians found to be working with the Iraqi insurgency, and dispatched a second aircraft-carrier group to the Persian Gulf, sparking rumors that a military strike against Iran was in the works.

This latest confrontation with the U.S. should have been the capper to a bad winter for Ahmadinejad. Strangely, though, it may instead have brought about an upturn in his fortunes. Soon, oil prices started to rise, jumping twenty per cent in just two weeks. As a result, the Iranian regime suddenly has an extra twenty million dollars or so to spend every day, a windfall that will help Ahmadinejad to placate his critics and solve some of his country's more pressing economic problems.

The jump in oil prices wasn't entirely a geopolitical phenomenon—the cold snap in the U.S. was also a big factor—but it was driven in part by an increase in what oil traders call the “risk premium.” When buying and selling oil, traders don't just look at today's supply and demand. They also try to forecast the future. And if buyers think there's a chance that supply is going to be lower down the line—because, say, Iranian oil fields will be shut down—they will be willing to pay a higher price today in order to guarantee that they will have the oil they need.

That's why, in the run-up to the Iraq war, oil prices jumped more than fifty per cent. In the current confrontation between the U.S. and Iran, these same concerns create a perverse set of incentives: whenever the U.S. says things that make a military conflict with Iran seem more likely, the price of oil rises, strengthening Iran's regime rather than weakening it. The more we talk about curbing Iranian power, the more difficult it gets.

It's hard to measure the risk premium exactly, but most estimates suggest that in the past couple of years, thanks largely to the turmoil in the Middle East, it has accounted for somewhere between ten and twenty dollars on each barrel of oil. (Last year, Qatar's oil minister said, “If



you can stop the politicians from making negative statements, I am sure you will see almost fifteen dollars disappear from the price.”) And, because Iran has the world's second-largest reserves and pumps so much oil, trouble with Tehran sends the premium soaring. Ten months ago, for instance, when Iranian leaders were talking about their progress in enriching uranium, and were threatening to attack Israel in response to any U.S. attack, the price of oil rose to more than seventy-five dollars a barrel. The economic consequences of this are not trivial; in the past few years, the inflated risk premium has given Iran tens of billions of dollars that it would otherwise not have had.

This helps Ahmadinejad enormously, because Iran has made huge commit-

ments to government spending that can be kept only by relying on oil revenue. Last year, Iran spent more than forty billion dollars on things like subsidies for gasoline, bread, and heating fuel, and to keep money-losing enterprises in business. High oil prices also help protect Iran against the woeful state of its oil infrastructure. Getting a barrel of oil out of the ground can cost Iran three or four times what it costs Saudi Arabia, and a recent paper by Roger Stern, an economic geographer at Johns Hopkins University, argues that Iran's lack of investment in its oil fields has reached a point where the country may be unable to export oil within the decade. Iran, in short, may well be running itself into the ground. But higher oil prices defer the day of reckoning.

The persistence of the risk premium means that Ahmadinejad, whatever his religious or nationalist inspiration, has an economic incentive to say confrontational things that spook the oil market. But the effect of his pronouncements is limited, because traders know that self-interest is likely to keep Iran from doing anything that would cut off the supply of oil. What really keeps the risk premium high is the American penchant for public responses to Iran's provocations. So cooling down the martial rhetoric—even if we plan to take military action eventually—would likely bring oil prices down for a time, making Iran weaker. History shows that regimes that inflate their promises to their citizens during periods of high oil prices often have a hard time when prices fall. (The collapse of the Soviet Union, which, in the nineteen-seventies, had used oil wealth to make modest improvements in the standard of living of its people, was likely accelerated by the collapse of oil prices in the mid-eighties.) Lower oil prices won't, by themselves, topple the mullahs in Iran. But it's significant that, historically, when oil prices have been low, Iranian reformers have been ascendant and radicals relatively subdued, and vice versa when prices have been high. Talking tough may look like a good way of demonstrating U.S. resolve, but when tough talk makes our opponent richer and stronger we may accomplish more by saying less.

—James Surowiecki