

## ***Economics Group***

### **Special Commentary**

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# **Of Oil, Nuclear Energy and the MENA<sup>1</sup>**

## **From Stability to Instability in the Blink of an Eye**

A good friend of mine always argued with me that the Middle East and North Africa (MENA) was one of the most stable regions of the world. He was right, up until Tunisia, then Egypt, and now Libya blew up in succession with the potential to spread to other countries of the region; it was one of the most stable regions in the world. But now, even Saudi Arabia and China are not immune to the talk of the town: Are they next?

Why are markets putting Saudi Arabia and China in the same bag as Tunisia, Egypt and Libya? The former is one of the wealthiest countries in the region, while the latter is the fastest growing country in the world. The fundamental reason is that all of them have autocracies or authoritarian regimes with various degrees of differentiation. When you have a country's population under the gun for years, decades or even generations, the stability of that country could come to an end very rapidly and many times take unforeseen and violent paths. Why? Because the institutions of autocratic regimes are not capable to adapt to changing conditions and force is the only instrument these regimes have to quench dissent and attempt to remain in power.

Thus, the end of these regimes is not a matter of "if," it's a matter of time, or when. This is especially true in these times of global communications and social media of the likes of Facebook, Twitter, YouTube, e-mail, etc. This means that Saudi Arabia and China are fair play and their leaders know this very well. That is why they have taken very strict measures to try to limit the ability of people to get together, to conglomerate, to communicate and to demonstrate against the regimes.

Every autocracy or authoritarian regime's worst fear is the fear of mass movements. Strangely enough, these regimes fear any group of more than two people. I remember that the Argentine military junta in the 1970s and 1980s considered a group of two or more individuals gathering on a public site a "terrorist act" from a "terrorist group" and the members of the "terrorist group" were liable of being punishable by the junta's antiterrorist laws, which included the forceful disappearance of the offenders.

## **Kissinger Is Right**

At an IHS CERA conference in Houston last week, Henry Kissinger, President Nixon's secretary of state, argued that thinking that the Middle East is heading toward democracy is "wishful thinking," continuing with the phrase that "there's evidence of rejection of the previous model, but no evidence of what the new model will be."<sup>2</sup>

Thus, the road ahead for the MENA region will be long and treacherous, and the end result is, and will remain, anybody's guess. A big part of the result will depend on the ability of different sectors in these countries to find a common goal that will enable them to unite toward a process of nation building. Furthermore, even if they find this unifying goal, they will probably go through a process

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<sup>1</sup> MENA stands for Middle East and North Africa.

<sup>2</sup> "Kissinger throws cold water on Mideast optimism," CNNMoney.com, Steve Hargreaves, March 11, 2011.



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of less than democratic governments, and some of these countries may even disintegrate into smaller countries as happened in the former Yugoslavia and the former USSR.

But, the most important issue here will be the issues of the economic riches, with oil likely determining which way the pendulum will move. Often times, rich regions in already established countries argue why they have to “support” other, poorer parts of their countries. In the United States, our federal government is in charge of “distributing” the riches across the country, but this happened after decades and even a century that took the country through one of the worst civil wars ever recorded. Of course, times have changed, and we don’t expect any loss of life even close to what happened during the U.S. civil war, but that does not mean that the road toward democracy or another type of political system will be easy and/or smooth.

Furthermore, in the United States, freedom of religion was one of the driving forces of the creation of the country. In these countries, freedom of religion will probably not be a driving force in the new political system. Not only will those who are not Muslim suffer as they move to a new political system, but even within the Muslim religion, the problems between Shiites and Sunnis likely will remain and will create serious issues, especially if there are claims to oil riches from one group compared to the other, which is already happening in many Arab countries.

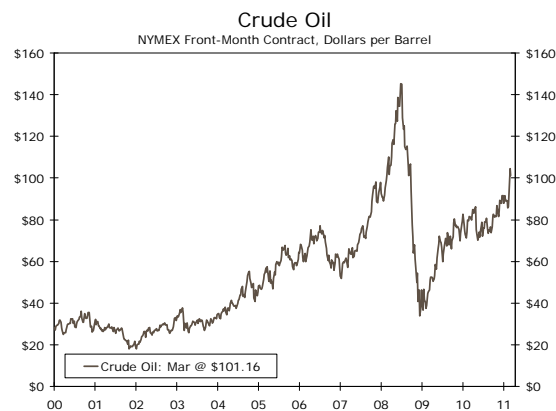
The sector that is able to control the natural resources—in this case, the sector that controls the extraction of petroleum—will probably dominate other sectors in the same country. If there is no common national goal, then the most probable outcome is that one sector will impose its will over the others.

### Implications for Petroleum Prices

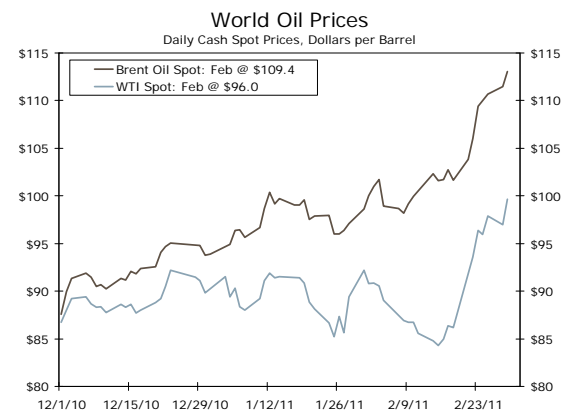
**What are the implications of all this turmoil for petroleum prices?**

What are the implications of all this turmoil for petroleum prices? The short answer is that it is very difficult to know, other than prices will remain high and will probably head higher if the current environment persists. Today, petroleum price forecasts are made on a day-to-day basis. There are so many variables affecting the price of petroleum today that there is not a dull moment to think about what could happen to petroleum prices going forward. Not only do recent events make the future of petroleum prices highly uncertain, but even if these events clear somewhat in the next several months, the new forces acting on the MENA petroleum-producing region are probably here to stay and will keep the price of petroleum on edge. The fact of the matter is that before the MENA crises started, this region was supposed to be one of the most stable regions in the world. Now that several of the old autocratic governments are out, the future does not seem as stable.

**Figure 1**



**Figure 2**



**Source: Bloomberg, IHS Global Insight and Wells Fargo Securities, LLC**

So many things could “go wrong” in the next several months in the MENA region that anything could happen to the price of petroleum. Likely, one of the only certainties we have is that

petroleum prices will remain elevated for the foreseeable future, and this high price will allow other energy alternatives to continue to develop further.

The degree of uncertainty in the market for petroleum is such that we have heard petroleum price forecasts ranging from \$70 per barrel to \$200-plus per barrel, depending on what ultimately happens to the countries of the MENA region and to the interrelationship of forces at play in the region.

**The Spread between WTI and Brent**

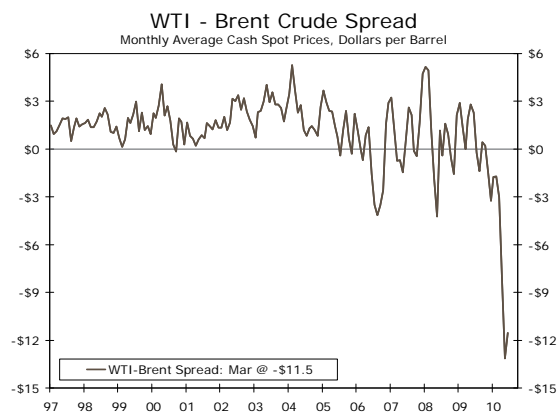
Another issue that has developed during the past several months and has gotten a lot of media attention is the widening spread between the U.S. benchmark West Texas Intermediate oil price and the North Sea ICE Brent oil in favor of the latter. Historically, the spread between WTI and Brent has been in favor of the former by an average of approximately \$2.00. The historic arguments for this positive spread between WTI and Brent have been explained by the differences in quality of both crudes. That is, WTI is a lighter and sweeter crude than the Brent crude and thus it commands a higher price versus Brent. However, the traditional positive spread has been partially reversed in the past several years, and the reversal has become permanent since late 2010. Furthermore, since December 2010, the spread has widened considerably to hit \$13.15 in February of this year.

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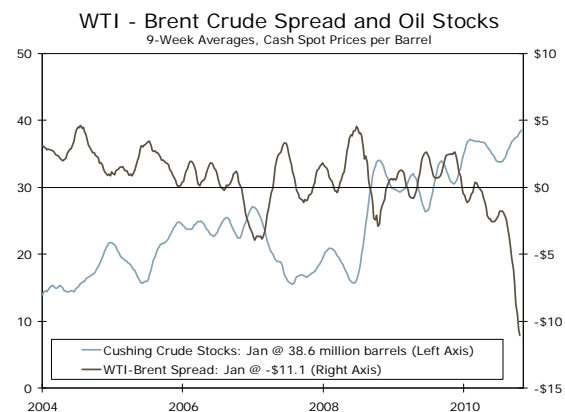
The explanation given by several analysts covers a wide range of reasons, from the political upheaval in the Middle East and North Africa to the characteristics of both WTI and Brent markets. WTI is land-locked and Brent is the most traded oil in the world, accounting for two-thirds of all oil traded in the world. In addition, a new pipeline is delivering oil from the Canadian oil sands into Cushing, Okla., and Cushing is awash in oil. Inventories are surging, putting downward pressure on WTI compared to Brent.

Out of all the potential explanations, the one that sounds the most reasonable is the argument that too much oil is flowing into Cushing and the ensuing increase in inventories of oil is preventing WTI oil prices from remaining close to Brent crude prices. Even representatives from OPEC have questioned the role of WTI crude prices as a correct measure of oil prices in the world. Of course, if you are a producer of oil you will take, today, the price of Brent as your benchmark rather than the price of WTI. The opposite is true for buyers of oil. On the other hand, Brent prices are probably more affected by recent geopolitical events in the MENA region and by the fact that Brent crude production has started to dwindle.

**Figure 3**



**Figure 4**



**Source: Bloomberg, IHS Global Insight and Wells Fargo Securities, LLC**

At the same time, as Brent is a benchmark, that is, it is a reference used to price other types of petroleum across the world, the perceived potential disruptions to oil production and transportation in the Brent area of influence, i.e., in the Europe region due to the MENA crisis, are affecting more the price of Brent than the price of the WTI, which is actually having just the

opposite problem, i.e., there is plenty of petroleum in Cushing, Okla., and some estimate that this oversupply is actually going to worsen before it gets better.

The biggest issue for WTI as a benchmark is not the actual price of WTI, which is in excess supply at Cushing, Okla. The biggest issue with the current price of WTI is for those other petroleum types that compare or price at a discount from WTI. Let's say, if Argentine crudes normally trade at a discount of \$2 versus WTI, at the WTI price on March 18, the Argentine crude would price at about \$99 per barrel. However, if the Argentine crude was benchmarked to Brent, then it would sell at approximately \$109 per barrel or a little less, because WTI is lighter and sweeter than Brent. However, it is still a very large price difference per barrel of oil.

### **Lessons from the Previous Spike in Oil Prices: The Consumer Is King**

The previous run up in prices showed us that the U.S. consumer will not be willing and/or able to sustain gasoline that is higher than \$4.00 or so per gallon at the national level. This translates to a price of oil of approximately \$150 per barrel. Thus, if that happens again, quantity of petroleum and gasoline demanded will likely start to come down, and then petroleum prices will start a downward correction and the U.S. economy may go into a new recession.

Thus, it is very unlikely that petroleum prices could be sustained at \$200-plus in the near to medium term, because the same forces of the economy would bring them down. Of course, this does not mean that oil prices couldn't reach \$200-plus, especially if something serious happens in Saudi Arabia. However, it is very unlikely that those prices could be sustained at those levels, especially if the U.S. economy continues to post moderate growth rates and the U.S. consumer continues to save rather than borrow and consume as was the case before the housing meltdown in 2008.

### **Is Nuclear Energy on the Endangered Species List?**

It was no more than three to four days after the Japanese earthquake and the ensuing tsunami occurred that conflicting reports were coming out saying that this was the last stint for nuclear energy in the developed economies, while other reports were saying that emerging markets would continue to push for nuclear energy development independently of what was occurring in Japan. The truth, as it is always the case, will probably lie between these two extremes, and nuclear energy will probably continue to be an alternative with other energy sources as it has been for almost half a century.

As in any other investment in alternative energy sources, the efficiency of the source of energy and the different risks involved in each technology will be some of the major factors determining whether different energy sources will be a viable solution in the future, and nuclear energy will not escape from this. But, there are positive things that will come out of this disaster. Scientists will understand better the risks of having nuclear plants and the potential risks if confronted with a similar event like that hitting Japan. The biggest problem, and probably the most costly one, will be the regulatory environment that could develop after this disaster. The regulatory issues would add to the cost of new nuclear plants and have the potential to continue to price nuclear energy out of the competitive market. Today, several governments across the world, including the U.S. government, subsidize new nuclear plant construction, because it is too expensive to build and already not competitive without subsidies. However, once nuclear plants are built, they produce, together with coal, the cheapest energy in the market and could be operated at full capacity continuously. Many times, politicians like the concept of nuclear plants because the generation of electricity is "made in the U.S.A" and contributes to one of politicians most coveted objectives, energy independence.

As we said before, many times the decisions to build nuclear plants are not only economic but also political, so there is a possibility that even if the economic equation is not competitive, the political equation may still make nuclear energy an acceptable alternative. This is more so in those countries in the process of development that have different valuations of the risks that these plants represent versus the "political" benefits they bring. Furthermore, the current experience could help improve future plants so they can sustain severe acts of nature as the one that affected Japan. What is probably true no matter what happens to the future of nuclear energy is that the

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price of energy is going to go up and remain high across the board. Two trends will contribute to this outcome. One is the new regulatory environment for the construction and administration of nuclear plants and other alternative sources of energy, and second, the new sources of energy being introduced across the world are not as efficient in producing energy as the traditional sources of energy, such as nuclear, coal and oil, are.

### **Conclusions**

The energy markets are in turmoil and the current geopolitical environment could deteriorate even further as unrest in the MENA region continues to spread across the different countries. To this, we have to add the recent military intervention in Libya by a coalition of European powers and the United States in an attempt to try to defend the civilian population from the attacks by the Libyan president's forces.

These "old" conflicts plus the new conflict in Libya will continue to put pressure on an already disturbed petroleum market. Thus, we should expect petroleum prices to remain high and increase in the next several months as it is still not clear how the Libyan scenario will progress and how long it will take to be finalized.

Meanwhile, the rest of the autocratic regimes in the region are following their own path to quenching dissent in their own respective countries, while praying that it does not get out of hand and perturb the highly volatile MENA environment even further. But, what is clear is that this process is going to be a long one and that the end result is anybody's guess with democracy being touted as the objective but one for which achievement is highly uncertain. In any case, the process that started with Tunisia early this year is fast changing the face of MENA, and the world.

Thus, expect volatility to remain very high and for petroleum prices to remain on edge during the rest of the year.

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