

U.S. Climate Policy: Toward a Sensible Center

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Excerpt: Fred Bergsten, Director, Institute for International Economics

MR. McKIBBEN: Good morning. My name is Warwick McKibben. I'm senior fellow in economic studies at the Brookings Institution, and I've been asked to make a few preliminary comments on the economics of climate change in introducing our next speaker.

Economists have made a number of contributions -- [tape ends].

-- debate from developing the global economic models for undertaking the long-term projections that drive the climate models that produce the climate predictions, to evaluating the costs and benefits of alternative policies to deal with climate change. Brookings has been at the forefront of this research for the past decade.

Economists have also developed a wide range of policy proposals to tackle climate change, focusing not on mandatory targets but focusing on price incentives and price signals. Policies such as the safety valve and many others hopefully will be discussed at this and future conferences.

There are also a range of policy proposals from economists that deal directly with the problem of climate policy uncertainty and climate change uncertainty, and the ways that we need to recognize how to encourage developing countries to participate in global regimes in their own interests rather than in our interest. The Brookings Institution recently published a book called "Climate Change Policy After Kyoto: A Blueprint for a Realistic Approach," which is available outside this room for free. This blueprint approach recognizes some of these global issues, and I think it would be encouragingly part of this debate.

Unfortunately, much of the climate policy debate is still stuck in the mindset of the targets and timetables approach which created the Kyoto Protocol and in my view has held back sensible climate policy for many years. I hope this conference will move beyond that approach to consider the various other policy options that are out there and can move the world closer to a sensible climate policy.

As much as I would like to discuss the climate policy work that has been undertaken at the Brookings Institution over the past decade, this is not my brief today. Today, my role is to introduce our next speaker.

Fred Bergsten is known to everybody in this room. He has been the Director for the Institute for International Economics since its inception in 1981. He is Chairman of the Shadow G-8, which advises the G-8 countries on their annual summit meetings. He has held numerous distinguished positions in government such as Assistant Secretary for International Affairs in the U.S. Treasury, senior positions at the Brookings Institution, Carnegie Endowment for International Peace, Council on Foreign Relation. He's also been economic deputy to Henry Kissinger.

He has published numerous books on international economic policy and is probably the most widely recognized economist in international economic policy debates inside the Beltway and outside the Beltway. He is renowned as a great communicator of economic ideas to politicians, policymakers, and the wider public.

One feature of Fred which this audience probably doesn't know is that in Australia he has a reputation as being a great communicator with koalas.

Fred Bergsten.

[Applause.]

MR. BERGSTEN: Well, Warwick, thank you for the very kind introduction, and not only for what you said but for what you did not say. Sometimes when people note that among my past sins I was economic deputy to Henry Kissinger, they go on to add that that's something like being military adviser to the Pope.

I actually made that comment at a conference with Henry recently, and he said, "That is correct. And I want to add, Fred had a distinct economic and political terms to move ahead with decisive changes to deal with global warming and other environmental problems that are the focus of this conference today.

So I'm going to talk about that global energy regime. I'll come back then to suggest why I think that's so important for climate change and the environmental issue. But first I want to carry you through an analysis of why I think the current global energy regime is so dysfunctional, so costly to the U.S. and the world economy, and, therefore, why changes in it, though difficult, could be of critical importance for climate change and other environmental problems.

My argument is conceptually simple and has four main components. The first argument is that the world oil price--and I'm focusing on carbon-based fuels and the oil market in particular. The world oil price is determined to a very large extent by a producer cartel, OPEC, and by a single dominant supplier, Saudi Arabia, in a way that we would never tolerate domestically.

There is some intellectual debate about how great is the impact of OPEC and Saudi production controls on world energy prices, and other factors are obviously important. We're now in a U.S. and global economic boom. That obviously increases demand and increases world price. But there is no doubt--no doubt--that world energy supply has been suppressed by a large amount for prolonged periods of time by deliberate production restraints by the main producing countries.

The International Energy Agency in its latest report a month ago reiterated that publicly, and all we need for evidence is to see what happens now when the price does get up to a level that's causing concern throughout the world. The Saudis suddenly announced they'll use their surge capacity, increase production. OPEC goes along and the price will, in fact, come down. Simply, once again, demonstrating the powerful price impact that the producer cartel is costly for the U.S. and world economies. Every \$1 increase per barrel in the world oil price leads to a reduction of something like \$25-30 billion in global economic output, of which about \$8-10 billion per year occurs in the United States, about one-third of that total.

At excess, which I suggest it has occurred for 50 years and occurs today, of 50 to 100 percent -- that's a doubling over the market-oriented price -- has thusly severely dampened global economic growth on a long-term basis. Economists have puzzled for a long time over why there seemed to be such a sharp turndown in global economic growth after the early 1970s, a sharp decline in productivity growth, particularly in the United States.

The correlation with this sharp increase in world energy prices in the most important market of all is clearly a major factor involved in that.

For now, the excess of about \$20 per barrel in the world price takes something like \$500 billion -- that's half a trillion dollars -- off the world economy, of which roughly a third is in the United States.

There are brand new studies produced by the International Energy Agency, along with the OECD itself, and the International Monetary Fund. They are supplemented by a new

study from the European Central Bank, using somewhat different methodologies, and they all come to the same conclusion, though they are very conservative in their methodology:

They conclude that this excessive 50 to 100 percent, \$20 barrel at current level world price, takes at least -- at least -- and these are conservative estimates -- a percentage point a year off world economic growth, including in the United States. This is a huge economic effect. It cumulates over time.

And, incidentally, if you worry about the developing countries, as Jim Woolsey also mentioned, you should be really worried about that, because these studies show that whereas the excess energy prices are taking a percentage point a year off our growth, it's taking two to three times that off the growth of the poorer developing countries who are hit even more adversely by those excessive prices, and have much fewer response mechanisms in place.

Now right now, of course, as I mentioned, the U.S. and the world economies are growing well, can absorb the higher energy prices that we have, and it is also, of course, true, that U.S. dependence and world dependence on fossil fuels has declined sharply over the last 30 years, by about 50 percent in this country. So the costs are much less than they would have been in the past.

Nevertheless, that is taken into account in all the numbers and estimates that I mentioned. It does not diminish by any means those huge impacts that I indicated that are adversely affecting our own economic, that of the world, and particularly the developing countries.

In addition, of course, one has to note that the sharp increases in energy prices add to inflation probably by a percentage point per year on that side of the economic equation as well, and that can lead, particularly if monetary policy is erroneously conducted, it can lead to excessive tightening of monetary policy prematurely, which then can further dampen economic growth and have a second round of negative effects on all of our economies.

What I have talked about so far is price levels and excessive levels on a sustained period of energy prices in the world.

There is in addition the sharp volatility that results from the current global energy regime. No less an authority than Alan Greenspan has pointed out repeatedly that all three major U.S. and world recessions in the postwar period have been triggered by sharp price increases in oil prices.

Jim Hamilton, in his analysis of the issue, over time has shown that nine of the 10 world recessions that have occurred in the entire postwar period were preceded by significant increases in oil prices, again suggesting that the volatility as well as the excessive levels have been very important deterrents to strong global economic performance.

Hence, the bottom line is simple: If either presidential candidate came on this stage and asked me what would be the most successful economic expansion and jobs program that I could pursue, I would say a change in the global energy regime. To bring energy prices back down at least close to market-based level, you could get a huge payoff, a percentage point or more per year of growth, in our own economy, the world economy, and in addition it would be the most important development policy initiative you could take because you'd get two or three times that payoff in terms of the favorable effect on the poor countries around the world, particularly in sub-Saharan Africa and those that are highly indebted.

And so the need for change in these areas, I think, is very clear.

There's a third positive effect that I should mention, to echo Jim Woolsey. The fact is that the current energy regime does produce enormously excess transfers of revenues to a large number of countries in the Middle East which, as Jim said, are the financiers of

terrorism. Whether it's Saudi Arabia, Iran, or others, they are the big beneficiaries of the current world energy regime.

Indeed, I think it is fair to argue that a glaring hole in our entire antiterrorist strategy is our failure to come to grips with this set of issues, which provides much of the financial wherewithal to do the damage that Jim Woolsey talked about so eloquently and which we all know.

Now the final question, and the toughest one, is what to do about all this.

Incidentally, I do not put much weight on the notion of reducing our dependence on Middle East oil. Long term, technological change, obviously desirable if we could do that. But as long as we have a carbon-based, fossil fuel-based economic structure, we are unable to divorce ourselves from the fact that the key component of those resources exists in the Middle East.

And even if we were to become totally self-sufficient in some sense, we would still be part of a global market where price would be largely determined from that part of the world.

So whereas I strongly support the efforts to change the technology of the sector, I don't think in anything like the short to medium run we are going to be able to reduce our dependence on the Middle East in the sense I'm talking about of reducing price and therefore instability and costs from the global energy regime.

The goal of the reform, as I have clearly indicated, is to restore market-related prices somewhere around half where they are now, and to limit volatility around that level to ranges much lower than in the last 30 years.

In short, what I would suggest, with all the diplomatic ramifications that it would have, is a major new initiative between the consuming countries and the producing countries to replace the current producer-dominated regime with a cooperative regime that would aim to stabilize in a wide range, \$15-25 a barrel, OPEC's own range of \$22-28 a barrel, but to truly stabilize prices at those more market-related levels to a cooperative process of protecting the floor of the range and also protecting the ceiling of the range.

The buffer stock mechanism to do that is well known and, indeed, the fact that we in the United States and the consuming countries as a whole have already built huge strategic reserves which could then be used for that purpose puts us in a very strong starting position to do it.

Why would the producing countries do it? For several reasons:

One, they are terrified by the risks which they have frequently faced of sharp price decline which torpedo investment, torpedo a rational system even from their side. Protection against that would be enormously important.

And we could add a lot of additional attractive elements for them in terms of taking more value-added energy-intensive products from them so they can get a higher share of the total value of the ultimate energy dollar.

My colleague Phil Vellagro, who has worked on this extensively, has laid out a whole series of measure that would add to that idea. I don't have time to mention them all, but I'm happy to go into some, if you would like to do it later on.

So the idea would be to change the regime from producer dominated to producer-consumer cooperation in order to stabilize price around a wide range.

In order to get that cooperative regime, the United States and the consumer countries might, of course, have to offer sticks as well as carrots and threaten to use our existing strategic stocks to drive price down.

By contrast, our administration right now is continuing to buy for the strategic petroleum reserve and, indeed, its purchases have probably added another \$3-4 a barrel to the world price right at this time. So they're at fault somewhat as well. We should be selling, not buying, at the current time, but we should do so with a strategic purpose in mind of ultimately changing the regime to one that would be more stable and more balanced over time.

We could also invoke the Sherman Antitrust Act against the OPEC cartel and in some sense it is scandalous that that has never been done. Legally it's a slam-dunk because any reduction in production in order to increase price is a per se violation of the Sherman Act, an obvious but ignored factor.

Even a group meeting, as OPEC always does, to control output violates the law. They don't even have to succeed to violate the law. All they have to do is meet to try to rig the market. And there's no sovereign immunity involved because these are commercial acts of foreign governments, not political acts by sovereigns.

There are private lawsuits -- I don't suggest this would be the remedy to the problem, but if the U.S. government got serious about the issue, its support for legal action of that type would be a powerful signal. And we all know without elaborating that lots of diplomatic pressures could be brought to bear in order to promote the regime change of this type.

The final question obviously for this group is what does all this have to do with climate change and the issues that you are here describing.

A reduction in the price of oil to a more reasonable market-oriented stable level would, I think, be per se good for climate issues. It would reduce the ratio of prices between oil and coal. It would at least push demand in a less undesirable direction as a short to medium-term phenomenon.

But, to me, the more important thing is that a substantial reduction in the world price by leading to a substantial reduction in the U.S. price for gasoline and other derivatives from the oil market and the reduction of instability in the energy market that I have argued, all that would then produce a much different energy policy and energy price framework for environmental policy.

Suppose we could really limit and stabilize the world oil price to say half where it is now or has been for the last 30 years, and be fairly confident that it would stay there. At that point, it seems to me, we would be -- we who concern ourselves with climate change and global warming -- would be in an incomparably stronger position to push for a carbon tax, a gasoline tax, an energy tax, other measures that would have those effects because then the net effort on our economy of the package put together could hardly be charged as adverse.

By bringing the world price down, we would position ourselves to raise the domestic price, put in place measures that would be lasting, permanent, of which we could count as being consistent, and therefore totally, totally, I think, obviate the case that is made against such measures, that they are going to have adverse economic effects.

By putting it in this broad strategic context, we would in fact assure that the net impact on our economy was positive because even with a pretty healthy carbon or gasoline tax, we would only be taking back from consumers a part of the major gain we had achieved from the initial international regime change.

Moreover, we would then have a lot of revenue from the energy tax itself that we could use for other climate change or environmental initiatives, or for other purposes, recycling into our own economy to further mitigate the adverse impact of the whole system on our economic fortune.

And so to the extent that concerns about adverse economic impact have undermined or precluded the kinds of positive policy requirements that are needed to deal with climate change and other environmental issues, I would submit that seeing those topics in the broader context of energy policy as a whole, the global energy regime could provide a key to unlocking the door, moving forward and, as Jim Woolsey said, slaying multiple dragons at the same time.

Thank you very much.

[Applause.]

MR. : Well, not only are our speakers knowledgeable, so is our audience, and so now we would like to bring in the members of the audience. Looking around this room, I have to say this has got to be the greatest gathering of expertise on global warming since Spenser Hennius (phonetic), who identified the greenhouse effort, dined alone. And I'd like to just start with a question for each of the speakers on my right and left and then just throw it open, and to start with Professor Kennedy.

It has become commonplace in the media to refer to the scientific uncertainty around global warming, and to always talk about how some scientists believe that the greenhouse effort may be real, some scientists believe that greenhouse gas emissions may be changing the planet.

I'm wondering on whether you could just comment on the nature of the scientific uncertainty around this nature and the nature of the scientific consensus around this issue, and as somebody who has been both a scientist and a policymaker, how policymakers should react to the nature of scientific uncertainty around this issue.

MR. : Well, you have asked a question I get asked most often by people who have a problem with the uncertainty.

Of course, there's uncertainty. There's uncertainty in the models. I tried to outline some of those difficulties.

I think there is also an excess uncertainty that tends to be communicated to people who read about this subject in the newspapers. I sometimes refer to the two-card Rolodex that seems to be in the hands of many of the people who write about this problem.

There's Jerry Rowland (phonetic) or somebody who is known to be a knowledgeable sort of representer of the consensus, and then there's one of three or four persons who argue, sometimes convincingly, that the uncertainties are sufficiently great so that it's much too early to do any particular action.

I guess my answer is the consensus is so strong about what has already happened and about the general direction of what is going to happen that the argument that we should postpone is not a very good argument.

MR. : Thank you.

Dr. Bergsten, I went to Foreign Affairs to read your very interesting article on the economic agenda for the President and came across in the most recent copy of Foreign Affairs another interesting article by Lord John Browne about this very issue on climate change. I just wanted to read a passage from Lord Browne's article. He wrote:

"Counterintuitively, BP found that it was able to reach its initial target of reducing emissions by 10 percent below its 1990 levels without cost. Indeed, the company added around \$650 million of shareholder value because the bulk of the reductions came from the elimination of leaks and waste."

Now as I listened to your remarks, it occurred to me that there may be an analog here at the national policy level and that you may be suggesting that the experience that BP has

already had corporately is replicable in national policy, and I wanted to ask whether that is an appropriate conclusion to draw from your remarks, and then ask about the diplomatic feasibility of your very provocative proposal, could this really be achieved.

MR. : Well, on the first, I don't pretend to be an expert on the technology at BP or some of the other aspects of that that were discussed, including by Jim Woolsey, but it has been clear from the examples of a number of companies that there are win/win changes that are quite possible from use of technology, even management changes, and pricing patterns of companies to achieve simultaneously environmental and economic goals.

So I think that is demonstrably correct. The question is scale. I think the question is how far that gets you. My suggestion obviously goes to the other end of the extreme and is very macro in suggesting here we are talking about trillions, many trillions of dollars of potential improvement in the world economy, our own economy, and thus the framework for dealing with the environmental issues. So I would go almost to the other end of the extreme, not to suggest it's one instead of the other. Both should be pursued. As companies can pursue efforts like that immediately, they of course should do so, should be encouraged to do so, but I don't know that that's going to get us nearly as far as we feel we need to go, as Dr. Kennedy was suggesting.

On the diplomatic feasibility, this is obviously a rather tough time for U.S. policy toward the Middle East or the Middle East situation more broadly. But start from the premise that it is in shambles, and that some significant change is going to be required.

I would make what may strike you as a counterintuitive suggestion that a new initiative on the energy policy front of the type I suggested would be a very positive component of a new approach by the U.S., but multilaterally, it would have to be multilateral, consuming countries working together in my model toward the Middle East.

And the reason, as I suggested, is that the basic objective is to work out a cooperative producer-consumer regime that would together try to provide a more stable economic and rational global economic framework. It would be explicitly aimed at a cooperative structure.

Now I acknowledge that it would not be easy to get there. There would be hurdles. There would be costs to some of the producing countries, at least in the short run in some respects, from going in that direction.

But I think even for them, and many of them realize it, there would be long-term benefits and therefore if sincerely and multilaterally pursued by the U.S. and the rest of the consuming countries -- incidentally, including China and other key countries in the Far East who are main drivers of increased global demand are themselves just now starting to build strategic reserves, and therefore are not only natural but essential players in the kind of regime I have in mind.

I think all that would not only be extension of a cooperative initiative, but would actually be a way to draw the Middle Eastern countries into a cooperative international network which just doesn't exist now. We're doing a major study at our Institute for International Economics on the economics of the Middle East, and one of the first factors, first facts that strikes you just glaringly in the face when you look at the economics of the Middle East over the last 30, 40, 50 years is how despite what I described in the energy regime, it's the one region of the world that has deglobalized in an era of globalization, when globalization is essential to achieve modernization and economic progress.

But the Middle East on every indicator has deglobalized. The countries of the Middle East get less foreign investment than Sweden. They have fewer patents taken as a group than Brazil. They have deglobalized. And this would be one way to try to help overcome that,

bring them into a broader global pattern of cooperation, and I think if done correctly -- that's a big if these days -- but if done correctly, that could be a very positive element in the next administration here trying to recoup our position in that part of the world.

MR. : Thank you.