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ORIGINAL ARTICLE

OIL HEADS FOR ITS BEST YEAR AT $111. WHAT NEXT?

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Abstract:

The stagnant oil consumption, rising speculative investments and the consequent rise in oil prices are a matter of concern. Is oil shock round the corner?

The abrupt rise in oil prices in the past can be attributed to supply crisis caused by politics, whereas current oil price rally is more a "investment crisis". Though the supply constraints still exist due to changing political scenario globally, the oil demand is outpacing the supply. Eventually, the rising oil prices have occupied the top position in the list of major impediments to the global economy.

INTRODUCTION

It was just about 40 years ago that oil prices began climbing, sometimes steeply, and at times not so steeply from US$3 per barrel in 1972, to US$10 per barrel in 1974, and to US$25 per barrel in 1980. On each occasion, hands were thrown up in horror, but today oil price rise has became a habit with coming up of commodity trading.

Since 1980, oil prices keep on changing, the rising occurring more than the falling-, and since 2003, there has been a relentless rise. During May 2006, the price of oil even went beyond $70 a barrel and now they touched $111.78, but shocked reactions are scarce today. Only the worthies of international economics and finance, ranging from central bank governors to officials of IMF or World Bank talk of slowdowns in national growth rates or rise in inflation or unemployment Going by earlier prognostications, a 20-fold price increase of a crucial raw material would have been expected to play havoc with economies that were believed to be so sorely dependent on oil for growth. Nothing of that sort has happened, and oil prices are not screaming headlines any longer.

CHANGING DEMAND AND SPECULATIVE INVESTMENT

Among the foremost factors that caused the oil prices rising in mid 2000s were the burgeoning demand from China, India as well as from the US, and shortage of refining capacity in the US and Europe. Besides, the speculative investments in commodities, especially oil, have pushed the prices northwards. Alarmingly, the speculative investments in commodities have crossed $100 bn. Alexander Wostmann, Founder, Alexander's Gas& Oil Connections, says, "The 'Market', whatever this may be, is concentrating huge amounts of money to profit from the price rises they cause themselves due to 'fears' for possible happenings that might eventually disrupt supply that are broadly ventilated to the masses via the media, therefore, making 'understandable' that the prices need to rise". Though futures markets are essential for locking the risks associated with rising oil prices and assuring supplies, many blame commodity speculators for much of the recent oil price escalation. But speculators believe that prices are rising due to possible future disruptions in the supply side.

Saudi Arabia, being the Largest oil producer, has come to the rescue during previous oil price shocks by increasing capacity and production. But this time, the situation is different as the demand is almost stagnant and the speculators are the reason behind growing price. The present demand shortfall is not because we have found a suitable substitute for oil; rather, it is due to the global slowdown. In the previous oil crises Producers have not kept pace with the growing demand for oil. The entire world at that time has ignored the supply ceilings by OPEC. Moreover, in the past OPEC has created artificial supply constraints instead of making adequate investments to enhance production. In the past two decades, the industry has once again witnessed underinvestment in its entire value chain. Hence, any distraction in one part of the value chain caused oil price spike.

On the supply side, a preponderant proportion of the world's petroleum supply is now coming from relatively a few large and mature wells. Too many wells are past their prime life, and too many wells are being fast depleted. It is an economic fact that once about half of the capacity of the well is drawn the cost of further extraction begins to climb. Cost of maintaining the wells, cost of extraction, quality of the output, cost of refining, all mount. New discoveries have tapered off to virtually nothing now and even those few discoveries are difficult to explore and extract from.

Petroleum reserves are themselves a matter of some speculation and worry. And the speculative premium (or fear premium, if you will) cannot but be significant with increasing concern about depletion of oil reserves. Though many estimates of petroleum reserves have been put forth, one is not sure what the true situation is. And the oil market can be expected to be fairly jittery on that account. So, petroleum prices have reached a fair to amount around $100.However, one heartening thing is that the world is getting along, without too much discomfort, with these prices, for reasons cited earlier.

Though OPEC and Russia have been adding to oil supply in previous years when the demand has grown much faster than supply. China, India and US have been drivers of oil demand growth. Stephen Leeb, in his book The Coming Economic Collapse How You Can Thrive When Oil Costs $200 a Barrel observed, "As Chindia accounts for 35% of the global population, the combined. growth rate may be three times higher than the US; China, India will likely surpass the US in oil consumption before the end of this decade" but US is still the largest consumer. He also opined that conservation has always led to recessions and a rise in unemployment in the developed countries. Both China and India need to grow at 8% per year to provide jobs to the tens of millions ready to join the workforce each year. Hence, for China, India, growth is essential, that will require increasingly higher amounts of energy.

OIL AS A POLITICAL WEAPON

OPEC countries produce about 49% of world's oil and about 50% of oil traded internationally their actions have significant impact on oil prices. OPEC says oil demand is stagnant over the past year-registering a rise of a less than 1% due to global slowdown. All along, OPEC has claimed that there are no supply constraints and it is even reducing output to 30.8 million barrels per day because of stagnant demand. OPEC has also complained about the poor refining margins in Europe due to debt crises, which may result in stagnation in further investment in oil industry. Appropriate investments are needed in the entire value chain of oil industry to keep the prices at normal level in the future. As oil exporting nations are experiencing the windfall of petrodollars, with $ 1trillion annual revenue for the second straight year they are hesitant to invest to enhance the production. OPEC says uncertainties associated with future demand for oil have been complicating its investment decisions. However, countries like Saudi Arabia fear that high oil prices will increase the need for the alternative energy, hence the fall in oil prices.

Economists in the past always believed that oil prices beyond $50 per barrel are driven by more supply side effects from the countries such as Iran, Nigeria, Venezuela and refining capacity in the oil producing countries. Moreover, some countries are using oil supplies as a political weapon. Few years back the political imbroglios such as the Russia-Ukraine gas deal and Venezuela's supply bottlenecks have pushed the prices further up. Incidentally, Iran's nuclear program have initially created a fear of shortfall but that have not affected much. Even with global slowdown and stagnant demand there are growing numbers of speculators in the US and Europe to buy oil future contracts which has eventually driven up the prices to $ 111.78 per barrel. The Iraqi production has also been added to global markets even due to the constantly desecrating security situation in the country. The oil supply is falling in Nigeria as the local activists want a bigger share in the revenues causing shut down of few production facilities.

ELASTIC GLOBAL ECONOMY

It has been felt in the past few years, the global economy has been accustomed to living with higher oil prices. Yet, the global economy has not seen the worst of high oil prices. Similar to the past oil shocks were followed by recessions; but this time, on the contrary, the global economy is more deteriorated.

The liberal monetary policy, low interest rates and cheap imports from low-cost countries have all acted as a lid on inflation in the previous oil price rally but, how long the global economy will show the resilience towards high oil prices is a question that needs attention. Of late, the oil consuming nations are slowly waking up to the possible spillover effects with oil prices reaching triple digits.

The US economy which is already suffering from slowdown and under pressure compared to previous oil shocks of the 1970s and 1980s as the proportion of oil consumption in the GDP is stagnant (even the largest in the world). This can also be attributed to an increase in fuel-efficiency and increased service sector contribution to the GDP In 2005 when oil prices are near $70 per barrel a survey of American CEOs and politicians stated that rise in oil prices is likely to be the biggest threat to the world economy in the next two years. Even at that time senators are blamed oil companies for high prices and US released its strategic reserves for the first time in 20 years to ease the spiraling gasoline prices at that time. Much Pressure has not seen on US President to even in this election year. All these developments have prompted President Obama not to stress much on new energy policy, which emphasizes more on renewable energy sources. Being the largest oil consumer, any action by the US is likely to have an impact on oil prices. As a signal towards the conservation, interest in small cars is increasing as SUVs consume more gasoline. Given the steady increase in the per capita GDP and ownership of automobiles, there are no signs of reduction in the oil demand by China, India even if the prices go up further On the other hand, there is some emphasis on conservation and alternative fuels in these economies. Further, China and India are acquiring oil assets abroad for securing future supplies.

HOW DOES ONE EXPLAIN THIS CHANGED REACTION?

The world is coming to have a more realistic understanding of oil's place in the world economy. The world has come to realize that oil prices are really quite low, and even steep increases in the prices can be taken in stride.

Oil is, doubtlessly, a crucial and vital commodity. It is the lubricant for industrial economics. Also, all new and rapid plans of industrialization in the developing economies are predicated upon petroleum as the source of energy. Its price elasticity of demand could be expected to be low. But here enters the anomaly. A lifeblood of industrial economies, with low price elasticity of demand, one which could be expected to be a supplier's market, has a fairly stagnant price (in real terms, that is) and forms a tiny part of the GDPs of nations. Crude petroleum is the most widely traded substance constituting from a sixth to a fourth of world trade (depending upon the vagaries of price movements of the commodity), but oil imports constitute a very small proportion of the GDP of nations as low as 2%, as in the case of many industrialized nations, but in case of developing countries like India it is a matter of concern where oil imports are nearly 8% of GDP (In 2008 they touched 16% of GDP).

The objective conditions of petroleum consumption are now substantially different from those 25 years ago. National economies are reducing dependency on oil than before. Petroleum conservation and substitution measures have caught the fancy and started yielding results. For example, share of petroleum in utilities have now dropped considerably: Electricity generated by petroleum, which was 17% in 1973, dropped to 3% in 2003 and is declining further. Shares of homes heated with oil fallen from 32 to nearly 10%. Miles Per Gallon (MPG) ratings of cars and other transportation vehicles have climbed up somewhere from 50 to 100%. The trend of mixing of natural oils with petrol is highly observed countries like Brazil.

Stagnant oil demand is also the result of present oil price. It is being increasingly appreciated that adjusted for inflation, oil is almost as expensive as it had been at certain times in the past. It is important to realize that due to speculation today's oil prices are on the way to reach their historical peak (in 1981), if adjusted for inflation. At present oil prices are at a level where demand and supply is almost at equilibrium presently.

The 1981 experience is cited as evidence when big spurt in oil prices led to recession then. But, while some economists have contended that oil price shocks caused economic recessions, according to some others it was not the oil price shocks, but the monetary policy countermeasures in the wake of the oil shocks, that were responsible for the ensuing recessions.

OIL AT THREE DIGITS

With the dependency on oil being more, the higher oil prices will dampen the hopes of global recovery. The rising oil prices may create ripple effects on the global economy in the years to come. Wostmann has said, "The effects on the world economy are very hard to predict. It will bring vast amounts of money to the speculators and the producers, which will cause changing money streams, changing geopolitics and changing energy-policies".

Though in nominal terms oil prices are at the $111.78 per barrel level, in real terms they are on the way of reaching their historical high. Taking into consideration the dollar prices and previous oil crises when oil prices went from $1.35 per barrel to a high of nearly $35 between 1970 and 1982.That was a 26-fold increase. Looking at present oil prices, falling refining margins, investments and efforts for global recovery an oil supply shortfall is expected in the next few years. If there is robust global recovery then the next crisis will be permanent".

'Historically energy has become the driving force behind the inflation whenever energy expenditures reached 10% of GDP. The rising oil prices (with oil heads for its best year at $111.78) will mean accelerating costs for almost everything. Another side effect of energy crisis and inflation is higher unemployment. Thereby, rising oil prices result in both inflationary and deflationary pressures. The most likely scenario for the next decade is the soaring oil prices will lead to stagflation – a combination of high unemployment, high inflation and economic recession." The money spent by the oil importers would flow to oil producing nations and mainly the speculators, thus worsening the trade deficit of importing nations. If recycling of petrodollars to offset the trade deficits doesn't happen, it may worsen the global economy and made global recovery a distant dream.

As history suggests, the only remedy to impede the surging oil prices is through conservation and increasing the proportions of renewable sources of energy, thereby curbing the rise in oil demand. Higher prices may encourage new investments in the oil industry, but it takes many years for the new oil fields and refineries to come on stream. Economists predict off prices to be stagnant around $100 per barrel during the next year and caution that small disruptions in the supply side and variations commodity markets will have disproportionate impact on the oil prices. So if emerging markets continue their growth story as a result of globalization the demand for oil will continue to rise, leading to a price rise.

As oil prices are hovering at over $100 a barrel many wonder why the impact is not as severe as the two OPEC-induced oil shocks that shook the world economy in 1973 and 1979. In fact, if we go by real terms oil is still cheaper when compared to the first oil crisis. After these two crises, the global economy was well prepared and since then there has been a steady progress towards greater fuel–efficiency and development of other energy resources. At this juncture, how the galloping oil prices will impact the global economy remains to be seen.

LAST WORD

Doubtless oil prices must and will go up in the coming years. The prices now, in contemporary times, are clearly below par, as testified to by the meager impact of even the current "high" price. But then how much higher is the equilibrium price or reasonable price. At what level would it meet serious "price resistance"?

Innumerable factors, economic, technological, logistical, and even political will influence that. That is a matter for future study. But let this be said in full earnestness. It is not honest or fair (from economic perspective) to argue, as many economists are doing, that petroleum is crucial to national economies and, hence, it needs to be kept down to "tolerable" level. Oil is like other and commodities, and it must be granted its legitimate, egular price rise. Just because petroleum is more crucial to national economies than any other commodity, it cannot be denied that margin.

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