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# Steep Increase in Oil Prices as Gulf Crisis Lingers On

*Following a brief interruption, the recovery in world commodity prices witnessed during the first months of the year has continued. Crude oil prices reached their highest level for 16 months. The increase in prices for industrial raw materials that began early this year, however, came to a complete standstill. With the world economy recovering more slowly, can commodity prices be expected to fall again?*

Calculated using the HWWA index on a US dollar basis, world market commodity prices have risen by one third since the end of last year. Energy commodities were predominantly responsible for the strength of this increase, with the price of crude oil rising by about fifty per cent during the first nine months of this year. The price index for food and tropical beverages did not begin to pick up at an accelerated rate until the second half of the year when supply shortages led to higher quotations for cereals, oil seeds and cocoa. By September the price index for industrial raw materials had risen by around 7 % from its low at the end of last year, although the whole increase occurred in the first few months of the year (see HWWA Index of World Market Prices of Commodities, p. 280).

### Stagnating Prices for Industrial Raw Materials

The rise in prices for industrial raw materials at the start of the year took place against a background of increasing signs of world economic recovery, whereby a significant role was played by the extensive speculative commodity purchases carried out by numerous large commodity funds. In contrast, physical demand for most of these commodities tended to remain muted. In the second quarter of the year, the hesitant pace of recovery and increasingly pessimistic assessments of the economic outlook led to doubts in the commodity markets about the robustness of the increase in demand for industrial raw materials and triggered a change of strategy among futures funds.

Furthermore, a large number of industrial raw materials continue to be in abundant supply. On the metals markets, which tend to react with particular sensitivity to economic developments, production levels are currently sufficient in view of relatively large inventories to satisfy what are only very gradual increases in demand. Global consumption of non-ferrous metals picked up slightly in the first half of the year, following a 4 % decline in 2001. Recovery was particularly strong in the emerging economies of Southeast Asia and in China (see Figure 1). Especially in the case of aluminium, the supply side in Asia in particular is characterised by a further expansion of production capacity. This means that, where until just a few months ago shortages were foreseen, surpluses are now expected for both this year and next; this is also true of copper. This summer's market slowdown was least pronounced in the case of nickel. Nickel prices increased considerably this year, due above all to relatively optimistic demand forecasts for stainless steel.

A further increase in the consumption of industrial raw materials can be expected as the world economy continues its slow, if fragile, recovery. In some Asian countries in particular – which, with the exception of the Asian crisis, accounted for a substantial part of the world's additional metal consumption during the 1990s – there are signs of a further increase in demand. Prices for industrial raw materials can thus be expected to resume the upward course started

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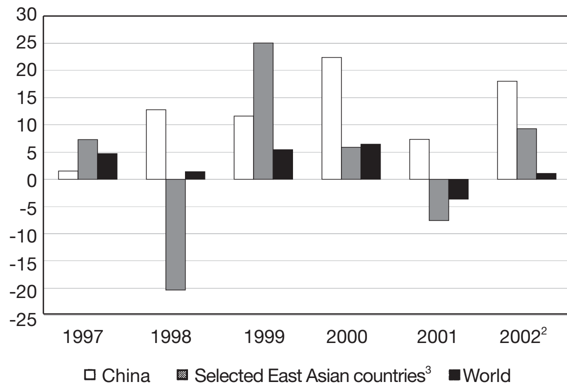
**Figure 1**
**Metal Consumption 1997-2002**[1]




[1] Base metals (aluminium, copper, lead, nickel, tin, zinc); year-on-year change in %.
[2] January to June.
[3] Hongkong, Indonesia, Malaysia, Philippines, Singapore, Taiwan, Thailand.

Source: World Bureau of Metal Statistics; author's calculations.

earlier this year. However, in view of the fact that output continues to remain restrained and any replenishment of stockpiles is likely to be slow, and given that there is an extensive amount of free capacity available, this upward trend will be moderate at first; for as prices pick up, production facilities that were mothballed when price levels were low will soon be reactivated. Stronger price increases are not likely to set in until economic growth becomes stronger again in the latter part of 2003. On average this year there will again be a decline in prices for industrial raw materials, though this decline will be considerably less pronounced than that of 2001 when prices fell by 9 %.

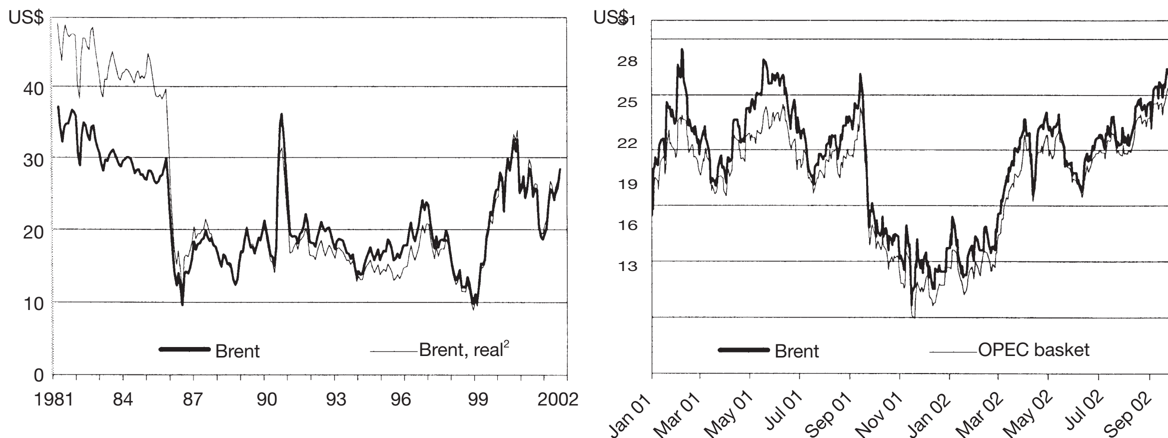
### Oil Price Rise Despite Ample Supplies

The price of crude oil increased during the course of this year to its highest point for more than a year (see Figure 2), despite a drop in oil consumption and an ample level of supplies. Global demand, which last year increased by 0.3 %, fell during the first half of this year, although it is now showing signs of renewed growth. Oil supply, which saw virtually no expansion last year, also declined during the first half of this year following the OPEC resolution at the beginning of the year to cut production quotas in reaction to the marked decline in oil prices. Meanwhile, however, member countries' production has once again reached the level prior to the restrictions made in January.[1]

The price increase was primarily due to tensions in the Middle East and related concerns about the security of oil supply from the world's most important supply region. The prospect of possible US military action against Iraq, which had already led to higher quotations in the spring, sent the price for Brent

[1] Cf. IEA Oil Market Report, September 2002.

**Figure 2**
**World Market Prices for Oil**[1]




[1] Spot prices fob per barrel, monthly figures (left) and daily figures (right).
[2] Deflated with export prices for manufactured goods from industrial countries; base year 2000.

Sources: IEA, Thomson Datastream, OPEC; authors's calculations.

**Table 1**

**OPEC: Crude Oil Production Targets and Actual Production**

(in million barrels per day)

| | Oil quotas from | | Production in | | Production variation since December 2001 (%) | Sustainable production capacity |
|---|---|---|---|---|---|---|
| | January 1 2002 | December 2001 | January 2002 | August 2002 | | |
| Algeria | 0.69 | 0.86 | 0.79 | 0.87 | 1.2 | 1.1 |
| Indonesia | 1.13 | 1.18 | 1.15 | 1.12 | -5.1 | 1.3 |
| Iran | 3.19 | 3.40 | 3.43 | 3.41 | 0.3 | 3.9 |
| Kuwait | 1.74 | 1.98 | 1.87 | 1.91 | -3.8 | 2.4 |
| Libya | 1.16 | 1.30 | 1.27 | 1.34 | 3.1 | 1.5 |
| Nigeria | 1.79 | 2.09 | 2.00 | 1.99 | -4.8 | 2.2 |
| Qatar | 0.56 | 0.60 | 0.57 | 0.65 | 8.3 | 0.8 |
| Saudi Arabia | 7.05 | 7.59 | 7.27 | 7.74 | 1.9 | 10.5 |
| UAE | 1.89 | 2.00 | 1.91 | 1.98 | -1.0 | 2.5 |
| Venezuela | 2.50 | 2.67 | 2.57 | 2.39 | -10.5 | 2.7 |
| OPEC 10 | 21.70 | 23.67 | 22.83 | 23.39 | -1.2 | 28.7 |
| Iraq[1] | | 2.00 | 2.26 | 1.56 | -22.0 | 2.8 |
| OPEC total | | 25.67 | 25.09 | 24.95 | -2.8 | 31.5 |

[1] Iraq is not a party to the production agreements.

Sources: IEA; OPEC; author's own calculations.

crude climbing again to just under 28 dollars a barrel by the end of August. Diplomatic efforts by the UN aimed at defusing the situation helped ease the tension to a certain extent at times and succeeded temporarily in lowering the price of oil. Even so, quotations picked up again by the end of September to 29 dollars for Brent oil. The price for the OPEC basket of seven crude varieties rose above the OPEC target range of 22 to 28 dollars for the first time since December 2000. This renewed increase was influenced in part by lower inventories in the OECD countries.

The temporary calm in early September was supported by prospects of an increase in OPEC supplies. Concerns that the elevated oil price level could impede an economic recovery led to the expectation in the oil consuming countries that the member countries would raise production limits. However the OPEC ministers decided at their September summit meeting to leave the current quotas unchanged for the time being and review the situation in December. The prevailing view among member countries was that oil was in adequate supply and that the recent gains reflected not fundamentals but the talk of a US-led war against Iraq.

### Increasing OPEC Overproduction

OPEC's decision to leave quotes unchanged will not necessarily affect actual output figures, though. Overproduction of the ten participating countries[2] had risen to about 2 million barrels per day before the September meeting. In August, excess production amounted to 10 % of the agreed volume (see Table 1). Nonetheless, total output of the eleven OPEC countries in August was below that of the previous month, since Iraqi deliveries dropped significantly as a result of a – later resolved – pricing dispute between Iraq and the UN. If oil prices remain strong, it can be expected that the quota violations will increase in the 4th quarter of the year, thus eroding further the credibility of the group on output policy. A decision to raise production limits, as favoured before the September meeting by Saudi Arabia, could have largely legitimised overproduction, but other members obviously feared it could create conditions similar to the steep price fall following OPEC's autumn 1997 conference.

[2] Iraq is not included in the agreements.

**Figure 3**
**Oil Prices in 1990/1991**[1]

[1] Brent spot price fob per barrel, daily figures.

Source: Thomson Datastream.

As US military intervention against the Iraqi regime draws closer and the oil markets are nervous, the price of oil will remain high. Once military action begins, oil prices can be expected to rise further. During the Gulf conflict in 1990, which led to a disruption of oil deliveries from Kuwait and Iraq – their combined oil production was 4.7 million barrels per day before Iraq invaded Kuwait – spot prices for Brent crude reached a peak of more than 40 dollars at times. This price level was not maintained for long, however, as Saudi Arabia soon made up for the supply shortfall by expanding its own production.

In the current situation, Iraqi oil exports – which had been much reduced recently anyway – are of less significance than deliveries from Saudi Arabia and other important oil-producing countries in the region. While OPEC has given repeated reassurances that its member countries can and will compensate any Iraqi deficit – OPEC's short-term available free capacity, excluding Iraq, amounts to around 5 million barrels a day, more than half of which is in Saudi Arabia (see Table 1) – possible developments could significantly reduce their ability or willingness to make up a shortfall. The extent and duration of a price increase triggered by an assault on Iraq will be decisively determined by the effects of military measures and possible countermeasures on the oil supply in the Middle East. Should the conflict spread to neighbouring countries we can expect oil prices to remain high – with corresponding consequences for world economic recovery. By the same token, the situation on the oil markets will quickly return to normal – i.e. the "crisis premium" would also no longer apply – if oil supplies are not affected or if shortfalls involve Iraqi oil only. This was the case during the Gulf war at the beginning of 1991 when the crisis-induced oil price increase, which had begun in the previous summer, came to an end as air attacks by the USA and its allies on Iraqi targets had begun and it became clear that Iraq's invasion of Kuwait would soon be over (see Figure 3).

Doubts concerning the possibility of limiting the conflict to Iraqi territory are reflected in the current "crisis premium" on oil prices. Taking the fundamental market situation into account, quotations would probably be nearer to the 25 dollar mark were it not for this premium. Oil demand is bound to accelerate in the remaining months of this year and next year with the economic recovery gathering momentum. The IEA projected[3] a rise of 1.4 % in 2003, after an estimated 0.3 % this year. Oil supplies from outside OPEC will continue to grow, as the relatively high price level is encouraging production increases, and output in the countries of the former Soviet Union is bound to rise further next year. OPEC countries are supposed to stick to a policy of production adjustments in order to keep oil prices within their price target band, although this will probably result in a further erosion of OPEC market shares.

Initially, the loss of substantial volumes of oil production would have no effect on physical oil supplies, since the oil-consuming countries generally have considerable emergency stocks at their disposal. The oil-consuming countries of the IEA hold stocks of crude oil and oil products which would safeguard supply for at least 90 days should oil deliveries dry up completely. If supplies were to be disrupted, the strategic reserves would be depleted in accordance with prepared emergency plans.

### Using Strategic Reserves for Calming Prices?

The release of IEA strategic reserves merely on the grounds of oil price increases – to calm the markets – is not foreseen in the emergency plans. Nonetheless, in view of the "crisis premium" currently included in oil prices, the EU energy commissioner has made a

[3] Cf. IEA, op. cit.

[4] Cf. European Commission, Directorate-General for Energy and Transport: The internal energy market: improving the security of energy supplies, Memo, Brussels, September 2002, p.3.

[5] Quoted by Daniel Dombey: Brussels seeks more control of oil stocks, in: Financial Times, September 5, 2002.

case for using the emergency reserves for the purpose of market intervention too.[4] This initiative is justified on the grounds that "the physical risk of disruption of supply is only likely to come about as a result of exceptional circumstances ... the economic risk has therefore become the real issue."[5] Therefore, it is argued, the EU Commission should be given the right to release oil reserves for the purpose of mitigating sharp oil price increases once a certain price level has been reached. An oil price increase beyond the 30 dollar mark has been identified as a possible juncture for intervention in the current crisis. The Commission consequently proposed in September[6] that "security stocks representing at present 90 days' consumption could in future be used in the context of solidarity in the event of a general perception of a risk of disruption of supply giving rise to dangerous market volatility." So far, however, the initiative has received no support from the member states. It is also highly questionable whether EU Commission intervention to calm price developments can be successful in times of crisis.

[6] European Commission, Press release IP/02/1288, 11/09/2002.