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Oil Prices Decline as Concerns about Supplies Lessen

Expectations of shorter oil supplies in the case of a war in the Middle East pushed crude oil prices upwards for many months, but in March prices started to fall significantly even before the war against Iraq had started. Does the price peak lie behind us, and can oil consumers even hope – after the war – for a prolonged period of low oil prices?

Crude oil prices decreased from the high level reached in early March a few days before the US-led military attacks against Iraq actually began, when expectations of a short war with minimum oil supply disruption began to take hold in the oil market (see Figure 1). Even after the invasion started, oil prices did not increase. But volatility remained very high with changing information on the progress of the war.

Concerns about a possible disruption of oil exports had driven oil prices for almost a year. Actual world oil supplies remained ample though, albeit accompanied by relatively low stockpiles among oil processors and consumers. With the Iraq war drawing closer, and as a result of lower oil exports from Venezuela – which above all affected the USA as its major customer – the OPEC countries had increased their production levels early this year. The supply situation in the USA was particularly tense, where, at the end of February, partly as a result of the coldest winter for many years in the north-east of the country, the minimum level for maintaining efficient refinery operations was reported to have been reached.[1] Large volumes of crude oil bound for the USA are still underway by sea, so that the increase in oil production is only gradually beginning to be reflected in an expansion of oil stocks in the importing countries. The output ceilings of the ten OPEC countries[2] in place since the start of the year were raised one month later[3] and ultimately shelved to all practical intents and purposes.[4] The regular OPEC conference on March 11, which took place without the oil ministers of Iraq and Kuwait, resolved to leave the output quotas unchanged, but at the same time emphasised its determination to safeguard oil supplies to the market. A temporary quota suspension was finally announced on March 20, the day the war started.

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Short-term Direction of Price Changes

The short-term direction of oil price changes will depend decisively on the progress of the military actions in the Middle East and its effects on world oil supplies. Should the war spread to neighbouring countries and result in the loss of further oil supplies, e.g. from Kuwait, the capacity of the other oil producing countries to offset shortfalls with additional output would presumably be exhausted. While OPEC representatives assert that their members can supply the markets with an additional 2-4 million barrels a day,[5] sources outside the organisation suspect that production expansion in January and February has reduced available additional capacity to less than 1 million barrels a day.[6]

[1] Cf.: "Kriegsgefahr erzeugt Hysterie am Ölmarkt", in: Frankfurter Allgemeine Zeitung, 28.2.2003.

[2] Iraq is not a party to the agreements.

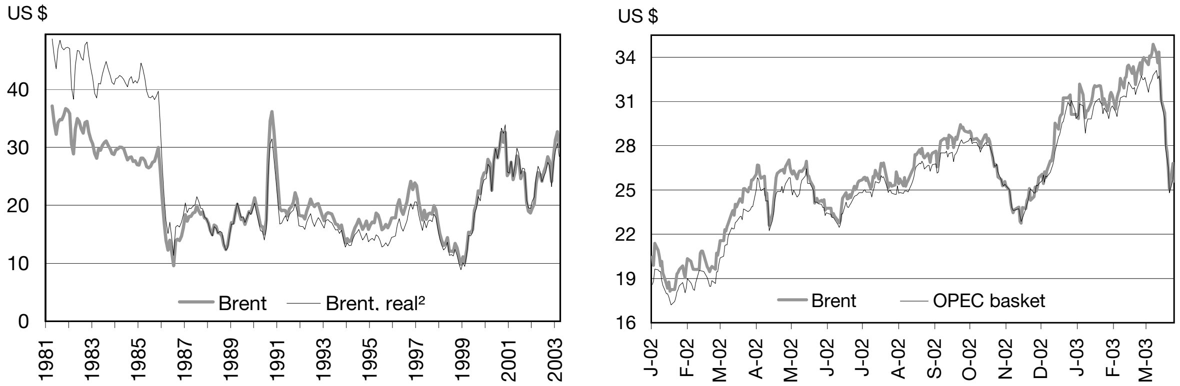
[3] From 23 to 24.5 million barrels a day for the member countries excluding Iraq.

[4] Cf. A. Fardan: Algeria: OPEC Has Tacit Deal For Maximum Output, Dow Jones Newswires, 3.3.2003.

[5] Cf. S. Jones: Algeria Oil Min: Sees 2Q Demand Fall Of 2M B/D, Dow Jones Newswires, 9.3.2003.

[6] Cf. the recent OPEC letter published by the Energy Information Administration (EIA) of 6th March 2003 at http://www.eia.doe.gov/emeu/cabs/opec.html

Figure 1
World Market Prices of 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 2002.

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

Venezuela's output, which in December collapsed almost entirely as a result of the strike, had only reached around two thirds of its previous volume by the beginning of March. It will take several more months before it is back to earlier levels. How serious the effects of the recent outbreak of violence in Nigeria on the country's oil exports will be cannot be predicted at present. In late March daily oil output was said to be half the normal volume. As far as compensating for possible production shortfalls is concerned, it is Saudi Arabia's output capacity that is ultimately of greatest significance. Saudi Arabia itself puts this capacity at 10.5 million barrels a day – a volume, however, that was last realised in 1980. The country's production volume at the beginning of March this year is estimated at 9.2 million barrels a day. [7]

There is little doubt that the other oil producing countries are prepared to compensate for the loss of supplies should the need arise. The Saudi Arabian oil minister characterised OPEC as a "very responsible organisation that reacts to the requirements of the market".[8] Compared to 1973, when, in reaction to the Arab-Israeli war, the Arabian oil producing countries imposed a boycott on supplies to the USA, the Netherlands and other "unfriendly" countries, most OPEC members today are keen to maintain a strict separation between the oil business and politics. Their primary interest is securing constant revenues from the export of their most important source of income. The renewed deployment of oil as a weapon – as was recently "considered" at a meeting of Islamic countries in connection with the Iraq war – is very unlikely, even though the war takes place without a UN mandate. The positions of the relevant countries are too divergent for this to be a realistic proposition. In any case, it is virtually impossible to deploy oil against specific targets, since calling a halt to supplies to individual countries would lead to higher oil prices worldwide.

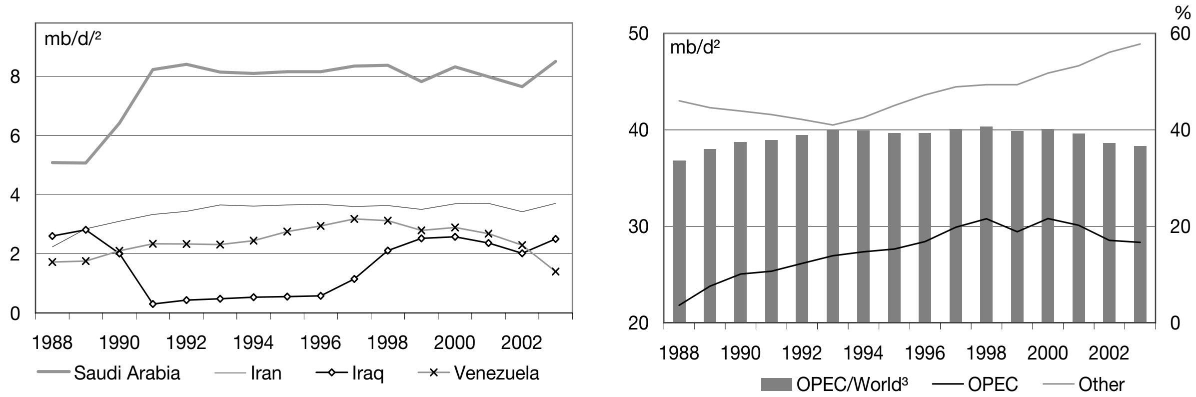
With additional production capacities being limited, the importing countries would fall back on their substantial emergency reserves in order to counteract anticipated oil price rises by increasing supply volumes. The reserves maintained by the industrialised countries organised within the International Energy Agency (IEA) were created in order to avoid supply bottlenecks such as those experienced during the Arabian oil embargo of 1973. The volume of reserves is calculated to be sufficient to replace a loss of oil imports for a minimum of 90 days; the actual state-owned and private inventories of crude oil and oil products within the IEA at the beginning of the year amounted to the equivalent of 115 days of net oil imports.

If the war does not result in larger oil losses and only Iraqi oil exports are interrupted temporarily – an outcome that looks more probable at the time of writing (26 March) – a seasonally reduced world oil demand will meet ample supplies. OPEC members were concerned about a looming oil glut even before the war. They will have to reduce oil production significantly in the second quarter in order to keep oil prices from falling below the preferred range of 22 to 28 dollars per barrel for the "OPEC basket". The rise in world oil demand is bound to accelerate somewhat this year and next. The IEA recently projected an increase of

[7] Cf.: "US Energy Secy: Won't Speculate On Saudi Oil Capacity", Dow Jones Newswires, 6.3.2003.

[8] Cf.: "Saudi-Arabien will in einem Krieg die Ölversorgung sichern", in: Frankfurter Allgemeine Zeitung, 24.2.2003.

Figure 2
Oil Production in the Opec Countries 1988-2003
annual averages[1]



[1] Oil production, without NGLs; OPEC and World: including NGLs. 2003: February. [2] Million barrels per day. [3] OPEC percentage share in world production (right scale).

Sources: IEA; EIA/DOE; author's calculations.

1.4% in 2003, after 0.6% in 2002.[9] The faster growth of oil supplies from outside OPEC will be repeated this year, as the high price level is encouraging production increases. OPEC countries are therefore expected to lower production targets in order to keep prices from falling too steeply. In view of the high level of oil revenues in recent months the willingness on the part of OPEC members to subject themselves to strict output discipline will probably be relatively strong. It is expected here that they will succeed in limiting output in such a way that the oil price – after a presumably larger decrease during the second quarter – will return to within the target price band later this year.

Expansion of Oil Supply Expected

With an end to the UN embargo against an Iraq under a new government, many oil consumers hope for a marked expansion of oil supply and considerably lower oil prices in the near future. This assessment is based on the current poor condition of the Iraqi oil industry and the country's extensive oil reserves. Iraq has the world's second largest oil reserves, and in addition to the known oil fields in the east of the country, further considerable deposits are believed to exist in the western desert regions, which have yet to be explored. Production costs in Iraq are among the lowest in the world, with estimates ranging from 50-75 US cents per barrel, compared to 2.50 dollars in Saudi Arabia.[10] The exploitation of these reserves was impeded for a long time as a result of the Iran-Iraq war that began in 1980 and the UN sanctions following the Gulf crisis of 1990/91. This situation could change rapidly once sanctions are lifted.

However, a marked expansion of Iraq's oil production will still take a number of years. The first target will be to return to the level of mid-1990, prior to the invasion of Kuwait, when Iraq's production capacity stood at 3.5 million barrels a day. This will take at least two years according to an estimate made by Iraq's ex-oil minister al-Chalabi. The Iraqi government's plan, drawn up in 1990, to expand capacity up to 6 million barrels a day is unlikely to be realised under a new government much before 2010 even if political conditions are stable. Only thereafter would further growth be conceivable.[11]

Saudi Arabia will thus for the time being remain the world's most important oil supplier, and in view of its extensive production capacity will continue to play a significant strategic role, particularly in times of crisis. However, there could be a shift in the structure of the customer portfolio supplied by Saudi Arabian oil in future. Should the USA look increasingly towards Iraq for its oil imports, then dependency upon Saudi Arabia would move from the USA to other purchasers. The world's strong dependency upon oil from the Middle East will remain, however.

Once UN sanctions are lifted, Iraq can be expected to reclaim the share of OPEC production to which it was entitled before the Gulf crisis of 1990/91, a quota

[9] Cf. IEA Oil Market Report, 12 March 2003.

[10] Cf. C. Hoyos: Big players anticipate Iraq's return to fold, in: Financial Times, 20.2.2003.

[11] Remarks made by Issam al-Chalabi in February 2003, cited in: Middle East Economic Survey, 17.2.2003.

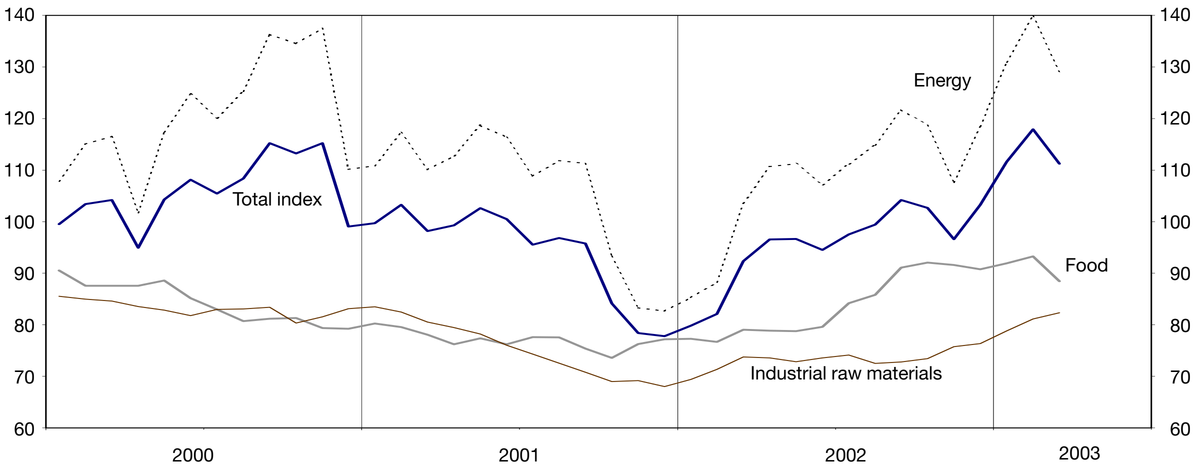
as large as that allotted to Iran (see Figure 2). Should Iraq be capable of raising its oil production in line with that ceiling, a return to the output allocations of early 1990 would chiefly demand restrictions on Saudi Arabian production levels. This would re-ignite the debate on the correct distribution of production quotas – an issue that had to be repeatedly deferred in the past due to differences of opinion.

Lower Oil Prices in the Longer Term?

It is debatable whether oil consumers can place justified hope in lower oil prices – below the OPEC target corridor of 22 to 28 dollars per barrel – in the longer term following a change of regime in Iraq. It is hardly realistic to expect Iraq to practise its own production policy independently of OPEC and to seek lower prices. In view of the country's massive investment requirements, a new Iraqi government must aim for high income from its most important export commodity and will thus attach importance to coordinating its production policy with OPEC – whether as a member or as a country with non-member status. The advantages of a moderate oil price level are recognised in many quarters, not only by the oil exporting countries. The USA – which is not only the largest consumer, but also one of the largest producers of oil – also has little interest in very low oil prices such as those seen at the end of 1998.

HWWA Index of World Market Prices of Commodities[1]

(1990=100)



Commodity Groups[1]	2002	Sep. 02	Oct.02	Nov. 02	Dez. 02	Jan. 03	Feb. 03	Mrz. 03
Total Index	95.4	104.2	102.7	96.6	103.2	111.6	117.9	111.2
	(1.1)	(8.8)	(22.0)	(23.2)	(32.7)	(39.8)	(43.6)	(20.5)
Total, excl. energy	75.9	77.4	78.1	79.7	80.0	82.1	84.2	83.9
	(0.1)	(7.6)	(11.4)	(12.4)	(13.7)	(15.0)	(15.8)	(11.7)
Food total	83.8	91.1	92.0	91.6	90.8	91.9	93.2	88.5
	(8.7)	(20.8)	(25.1)	(20.1)	(17.6)	(19.0)	(21.6)	(11.9)
Industrial raw materials	73.2	72.8	73.4	75.7	76.3	78.8	81.1	82.3
	(-2.8)	(2.8)	(6.5)	(9.5)	(12.2)	(13.5)	(13.7)	(11.6)
Agricultural raw materials	71.5	71.8	72.7	74.8	75.5	78.7	81.0	83.7
	(-3.1)	(3.8)	(7.7)	(12.4)	(17.9)	(19.3)	(17.3)	(16.6)
Non-ferrous metals	70.0	67.4	68.0	71.6	72.0	73.6	76.1	74.6
	(-3.7)	(1.6)	(6.9)	(8.2)	(7.2)	(6.4)	(9.3)	(3.6)
Energy	108.2	121.7	118.7	107.6	118.4	130.9	139.9	129.1
	(1.5)	(9.4)	(27.2)	(29.1)	(43.3)	(53.4)	(58.6)	(24.6)

[1] On a US dollar basis, averages for the period; figures in brackets: percentage year-on-year change.

Further information: http://www.hwwa.de → Commodity Prices