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Oil Prices Out of Control?

In October 2004 a barrel of North Sea oil fetched more than 50 dollars for the first time. Hardly ten months later, on 1 August 2005, the spot price for Brent crude oil reached a new all-time high when it broke the 60-dollar barrier. Consumers facing this new oil price record may take some comfort from the fact that in real terms – i.e. in relation to export prices for manufactured goods – oil prices are currently still lower than the peak levels seen in the early 1980s. Buyers in the euro area profit from their still relatively strong currency, as 60 dollars were the equivalent of only 50 euros in early August.

The latest sharp price rise occurred at a time of slowing oil demand growth. Global consumption increased only half as much in the first six months of this year as in the same period in 2004. But the expectation of a strong demand for oil in the second half of this year, combined with the extremely limited idle oil production and refining capacities and continuing political and security problems in oil-producing countries that could result in disruptions of international oil flows, are keeping oil prices high and volatile.

The high short-term price volatility is generally attributed to increased speculative activities in the oil market. If this is true, a better knowledge of the market fundamentals should help stabilise oil prices. At their latest meeting, the G8 countries therefore proposed increasing the transparency of the oil market through the creation of a worldwide oil data base. The lack of reliable up-to-date figures on consumption, production and stocks is a problem that has plagued oil market forecasters and the oil industry for decades. Accurate figures are obtainable only with a time-lag of several months, even in the USA, the country with the most accurate data base. This became even more of a problem when oil consumption and prices started climbing two years ago. The revisions of past data increased and forecasts differed widely. The International Energy Authority (IEA), for example, stated in its latest forecast that the world will need less oil from OPEC in 2006 than the cartel has been producing so far this year, whereas the US Department of Energy saw the need for a lot more oil.

More accurate market information, according to the G8 proposal, will result in less oil price speculation. But a data base already exists: the IEA regularly collects data from its member countries and other sources. There certainly is room for improvement as with every data base, but there are doubts that price volatility can be reduced. The recent oil price rise to more than 60 dollars per barrel, for example, was triggered by (a) a fire at a large Texas refinery, (b) the announcement by Iran that it was going to restart its nuclear-enrichment programme, and (c) the death of King Fahd of Saudi Arabia. The latest increase in the ongoing tensions between the Iranian government and Western governments raised concerns in the oil market that Iran could raise the pressure and suspend the country's oil exports. A better oil data base would probably not have been much help here.

While oil consumers have to pay a significantly higher oil bill these days, oil producers have reason to be pleased. Record oil prices and record export volumes have increased net oil revenues in the OPEC countries substantially in recent years, from a low of US $120 billion in 1998 to US $338 billion last year. A further rise of about 30% is to be expected this year. In real, inflation adjusted, terms OPEC net oil export revenues are more than double the average level seen during the 1990s. But they remain below the peaks reached in the early 1980s following the second oil price crisis. The OPEC countries have adjusted easily to the higher oil price level. In January 2005, when actual oil prices had surpassed the OPEC target price band of 22 to 28 dollars per barrel for 13 months running, they finally suspended the target, and although no new official price target has yet been announced, the OPEC ministers unofficially raised the target to more than 50 dollars per barrel when they introduced a newly composed OPEC oil basket in June. The OPEC president declared that the basket price would have to remain above 50 dollars for at least seven days before OPEC ministers would start discussing any increase in production quotas. This translates to a barrel price in the upper fifties for Brent oil.

One reason for OPEC ministers' lack of misgivings with regard to the significantly higher oil prices is their impression that the negative impacts on economic growth in oil-consuming countries are less severe than expected, or at least have been until now. Nevertheless, the high oil price level prompted OPEC ministers in June to try to calm the market by raising their joint production limit for the second time this year. They also agreed on a further increase during the summer if oil prices should remain high. But since the actual OPEC production capacities are almost fully used currently, the quota increase can be seen as mostly symbolic. It therefore did little to calm concerns about whether oil supply would keep pace with demand next winter. Any short-term increase in supply has to come from Saudi Arabia, which claims it can produce 1.5 million barrel per day more than its current output.

Global oil demand will increase again this year and in 2006, with additional consumption concentrated, as in recent years, in Asian economies – China in particular – and in the USA, still by far the largest single oil-consuming country. However, the increase will be more moderate than last year as higher oil prices together with slower global economic growth will have a dampening effect on oil consumption. On the supply side we can expect an expansion of output capacity. The oil production of non-OPEC countries is estimated by the IEA to grow by more than 2 million barrels per day by the end of next year. But in order to keep pace with worldwide demand the OPEC countries will have to expand their output as well. According to the OPEC president, the combined spare capacity of OPEC countries will be raised by more than 1 million barrels per day in the course of this year. But expectations that oil production in Iraq could be raised significantly after the election of a new Iraqi government did not materialise. Ongoing acts of sabotage, frequent power failures and a general lack of security resulted in a daily crude oil production that runs at least one third below the pre-war level. US funds that had originally been allocated for reconstruction purposes such as electricity and water projects are being spent on security needs. The investment plans of private oil companies are hampered by political stability concerns and will remain so if the situation does not improve considerably.

Although, barring major supply disruptions, no bottlenecks are to be expected in world oil supplies, the level of idle production reserves that can be mobilised at short notice will remain very low in the short and medium term. Consequently there will be no marked drop in oil prices in the next months, especially as the OPEC countries will lower their production if prices should fall below the level preferred by them. The major "risk" of a bigger drop in oil prices is a marked slowdown in world economic growth.

The tightness in oil supplies due to scarce capacities will be with us for some time. There is a growing consensus that considerable investments in oil production and transportation facilities will have to be made in the future to satisfy the growing demand to be expected in the developing and emerging economies of the world. If higher oil prices are here to stay – as they probably are – the movement away from oil will gain momentum. To speed things up, incentives to use oil more efficiently should be improved. There is much room for improvement in most countries, but in particular in the USA with its low fuel taxes and in many emerging economies that currently subsidise energy consumption. Even so, the dependence of world energy consumption on oil will remain strong for a rather long time. That is true, above all, in the transport sector where oil products dominate as fuels and substitution on a large scale is much more difficult than in heating or electricity production.

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