

Unstoppable?

Oil

How OPEC's fear of \$5 oil led to \$50 oil

WHY are oil prices so high? That is a question to which the International Energy Agency, a quasi-governmental agency representing oil-consuming nations, would like an answer. Oil, as headlines have been screaming, this week reached a new record of \$47. The agency's boffins are unimpressed. The title of the latest IEA report on oil, "Irrational Exuberance", was a phrase made famous by Alan Greenspan, chairman of America's Federal Reserve, as he pondered the elevated levels of the stockmarket in 1996, albeit well before the share-price bubble burst.

There are in fact good and fundamental reasons for the recent rise. Demand for oil is soaring. Consumption appears to be growing at about 3% this year, up sharply from the level of recent years, thanks in part to robust petrol-guzzling in America, which consumes a quarter of the world's petroleum. The real surprise, however, has been China. Its booming economy has sucked up oil for use in everything from power generation to petrochemicals.

If demand is strong, supply has grown so uncertain that traders talk of a "risk premium" of perhaps \$10 a barrel. In Russia, Vladimir Putin's murky assault on Yukos may lead to interruptions in exports. In Venezuela, Hugo Chávez, its president, survived a recall election last weekend but his opponents vow to fight on; last year, they shut down the oil sector completely. In Iraq, insurgents repeatedly disrupt exports. The greatest worry is that terrorists might damage the oil infrastructure in Saudi Arabia, the kingpin of OPEC and the only country with any spare capacity.

Other, less obvious factors have also pushed prices up. One is America's petrol market, where demand has been strong, but stocks low and supply constrained by environmental regulations and a lack of refining capacity. Pump prices have thus risen to levels that have Americans squealing. Philip Verleger, of the Institute for International Economics, argues that this tightness has had a knock-on effect on the price of crude oil everywhere because America is not only the world's biggest market, but also its most transparent.

Another powerful prop for oil prices may be the weak dollar, the currency in which oil is priced. OPEC complains that the recent fall in the dollar robs it of purchasing power (since its members buy things in yen and euros as well). This irritation may have led the cartel to take a relaxed view about the recent rise in prices.

On the other hand, a weak dollar has been good for consuming countries in Asia. According to market gossip, Asian firms have been making big bets on oil for future delivery on the assumption that the dollar will remain weak. If oil prices rise while Asian currencies remain strong versus the dollar, these will prove lucrative.

Such bets may help explain the dramatic recent rise in the price of oil futures (contracts delivered months or years from now). Previous spikes in the price of oil for immediate delivery were not accompanied by a strong rise in the futures market (see chart on next page), because consumers thought the spike was temporary.

Quite clearly, however, bets by Asian firms provide only part of the explanation, and a growing chorus argues that the rise in the forward price of oil means that consumers worldwide do not expect the oil price to fall below \$30 for many years yet.

Punters, too, have been pushing up prices. Official data show that oil contracts held by hedge funds and other speculators hit an all-time high earlier this year. Though these positions have been cut in recent weeks, traders say that speculative interest remains strong. With interest rates low and stockmarket returns disappointing, betting on rising oil prices has proved highly lucrative. Such players might cut and run, however, should prices fall sharply, thus driving prices lower still.

The biggest factor behind the extraordinary surge toward \$50-a-barrel oil may well have been OPEC's fear of \$5-a-barrel oil. On the eve of South-East Asia's financial crisis of the late 1990s, the cartel met in Jakarta and agreed to increase output. Alas, it misjudged the severity of the downturn. The result was a collapse in oil prices to \$10 a barrel—a financial and political disaster for the cartel. Mr Chávez has said that if he and his OPEC colleagues had not cut production sharply, oil would have fallen to \$5 a barrel.

Haunted by that memory, the Saudis pounced on the oil market with vigour. In the past few years, argues Mr Verleger, they have been propping up the oil price by keeping inventories down in consuming economies. By manipulating their production levels, he and other economists argue, the Saudis have ensured that firms in rich countries have had strong disincentives against holding stocks. That tightness inevitably buoyed oil prices.

Another factor related directly to the collapse in the oil price was OPEC's consequent reluctance to expand capacity. The cartel has not invested enough to keep pace with demand growth, so the world is virtually out of spare capacity. Growth in demand means that even Saudi Arabia no longer has enough to deal with two disruptions at once—as it did early last year when oil exports from both Venezuela and Iraq were knocked out.

So OPEC appears to have lost control of the oil market, for now at least. If demand cools, and especially if oil fields come online and restore the spare capacity of yesteryear, the cartel will regain its pricing power. In the meantime, the Saudis have little leverage. Ali Naimi, the Saudi oil minister, usually moves markets when he speaks. Yet when he promised a few days ago that more oil is on the way, traders ignored him and the rally continued apace.

The sceptics at the IEA may yet be proved right: oil prices could tumble at some point, especially if demand stops growing or declines. But as long as spare capacity remains so tight, high prices (and possibly even painful spikes) seem more likely. And even if prices do fall in coming weeks they may well stabilise at a higher level than in the 1990s.

Raymond Carbone, an oil trader on the New York Mercantile Exchange, assesses the supposed oil bubble this way: "This is not Nasdaq 1999. This bubble is not as fragile." He then hastens to add, "unless there is a worldwide recession." The irony is that the longer and stronger the current rally in oil prices, the greater the chance of such a downturn. That points to the best reason for OPEC to bring spare capacity online as quickly as it can. When high oil prices push consuming economies into recession, it is the cartel itself that suffers most.