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Oil Price Surprises

Oil consumers can relax for the time being: the end of the Gulf War after the liberation of Kuwait also means an end to the months of uncertainty as to whether the war would cause considerable supply shortfalls after all. The hostilities did not spread to Saudi Arabia as feared and the latest oil crisis, which had begun in August with fears of bottlenecks, culminated after seven months in oversupply. The way is now free for a post-war drop in oil prices, as generally forecast for a theatre of war confined to Kuwaiti and Iraqi territory – or isn't it?

Oil prices have already once in recent weeks not behaved as expected. The leap predicted for the commencement of the air assault after expiry of the UN ultimatum did take place but only lasted a few hours. Not only did prices then revert to their prior levels, they dropped beyond this to finish where they were in August last year before the outbreak of the Gulf crisis. The apprehension about the future supply situation on the oil market had evidently been finally dispelled by the first reports of successful allied air attacks, which signalled a probable speedy end to the war.

It should, however, be borne in mind in all this that oil prices had displayed a downward trend since reaching their peak in the first half of October, largely attributable to the favourable trend in oil supply. Apart from brief shortfalls immediately following the UN embargo, supply during the course of the Middle East conflict remained almost consistently high, contrary to initial fears. At the same time demand was curbed by higher prices, the slowing-down of global economic trends and the overall mild winter.

Unlike the events in August, which took the oil market largely by surprise, buyers and sellers were able to prepare for a possible military conflict well in advance. Oil reserves at the beginning of 1991 were higher than they had been for many years, so there was little reason for panic buying as at the beginning of the Gulf crisis. The announcement of the International Energy Agency (IEA) that oil would be released from strategic reserves certainly helped prevent a surge in demand from pushing up prices after the beginning of the air campaign.

The ceasefire six weeks after the start of operations does not mean a return to normality on the world oil market. The thorough destruction of the oil wells in Kuwait by the occupation forces will prevent a resumption of production for many months and at present civil war is raging in Iraq. Oil is not likely to be exported from Iraq until later this year – assuming the embargo is lifted – and from Kuwait, at any tangible volume, not until next year. For the other oil producing countries this means that they will have one problem less in their attempt to hold up prices by throttling output: whether the threat of a further drop in oil prices becomes reality or not in the course of the year will depend first and foremost on the production policy of the oil suppliers.

The expectation of a curtailment of supply initially sent prices up on the spot markets after the truce. The slight downward adjustment of the output quota agreed on at the latest

meeting of the OPEC ministers in mid-March could well prove to have been too small in view of the seasonal decline in the demand for oil which takes place in the spring. Without a lower target quota it is unlikely that even the present price, which is already several dollars below the agreed 21 dollars a barrel, can hold.

There is, however, evidently little readiness to cut output to keep up prices. With a view to its heavy financial war burden, Saudi Arabia in particular, which during the crisis expanded its production by more than half to offset the losses from Kuwaiti and Iraqi exports, seems loath to curb production again to any sizable degree. Whether this will change when Iraq and Kuwait return to the market remains to be seen. In any case, Saudi Arabia is determined to substantially expand its production capacity and will then want to put this additional capacity to use. It is thus unclear whether in future OPEC will be able to agree on any production quotas at all.

For the immediate term, then, oil consumers can look forward to continuingly low prices. It is thus doubtful whether the Gulf War will have any fundamental repercussions on energy policy in the oil importing countries. The fortuitous supply situation may quickly close policymakers' ears again to the warning reiterated more forcefully in recent months about the heavy oil dependence of many economies and the need to reduce the risks associated with the inevitable concentration of energy supply in the Gulf region. To do this would after all render oil consumption more costly, of necessity an unpopular measure. In many countries, particularly in the USA, serious measures to cut down on energy consumption, not least for environmental reasons, have so far been regularly blocked by cost arguments. This, however, ignores the costs of securing a sustained supply of enough oil from other countries, such as from the Gulf region for example.

Crucial to the long-term level of oil prices will be the development of production capacity. Exploration has been boosted worldwide by the Gulf War but it will hardly expand much more quickly for any length of time at present prices. Production will in future focus even more on the Middle East, where two-thirds of all proven oil reserves are located. Outside this region the output of the two largest oil producers, the USSR and the United States, has been on the decline for some time, in the Soviet Union due to technical bottlenecks related to the economic system and in the USA because of depleted reserves. Output is on the increase in many small producing countries but this will not suffice to offset the growing large-scale concentration on the Gulf.

As long as the dependence on oil remains at its present level – and little will change in this regard within this decade at least – all the importing countries can do is to improve their crisis management, concentrating on keeping and deploying reserves. The industrialized countries coordinate the necessary measures in the IEA. It performed this function in the latest oil price crisis. Its responses were, however, subjected to widespread criticism. Many argued for example that the IEA was inconsistent in refraining from market intervention when oil prices doubled in the late summer of last year due to the uncertainty of future supply, adducing the ample physical supply, and then in announcing the release of reserves in January when there was no current shortage, hence helping to push prices down.

The dilemma is that the demand for oil in crisis periods surges due to precautionary buying, radically inhibiting its elasticity to price rises. There is thus an obvious need to deploy strategic reserves not only to alleviate physical shortages but to cover the increased demand caused by precautionary buying so as to forestall price hikes. Considering experience with such measures on other commodity markets and on currency markets, however, the success prospects for such intervention in speculative trading are low. Even if the oil price could actually be kept down, this would mean suppressing those signals that also trigger an appropriate response on the part of oil consumers to greater supply risks. The strategic oil stocks should therefore essentially retain their function as "iron reserves" for emergencies.

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