Economic Perspective

THE PRICE OF OIL

by David Simpson

In the last decade many people have become familiar with a statistic of which prior to 1973 they were blissfully ignorant, namely the world market price of crude oil. The thirty-fold rise in the nominal price[1] between 1970 and 1980 has affected appreciably every household in the Western world. First, there is the direct effect on the household budget through the higher costs of heating and transport. Then there are the costs of other goods required by households which use oil or substitute fuels for their production. Finally, the two sharp rises in the oil price which have taken place since 1973 have precipitated two world-wide recessions. These facts alone are sufficient to warrant an interest in the future path of the price of oil, even if at the present time public attention has been temporarily diminished by apparent stability in the market for crude. While forecasting the path of future oil prices is an exercise upon which few economists can agree, nevetheless all commentators are united in agreeing that, whatever else may happen in the oil market, the present stability is unlikely to last very long.

Prior to 1973, the seven major oil companies handled about three quarters of the world's supply of traded crude oil. They carried out the functions of production, transport, refining and marketing in a vertically integrated way which allowed them to exercise a stabilising influence on prices, at least in the short run. But from the early nineteen seventies onwards the control of production passed from the companies to the governments of the producing countries. Thereafter this stabilising role passed into the hands of OPEC for a short period. However, since the middle nineteen seventies OPEC has had only a limited effect on the movement of oil prices, because of that organisation's inability to enforce strict production quotas. Following the second major rise in the price of oil in 1978/1979, the influence of producer governments and major oil companies on the oil price was loosened still further by the entrance onto the market of a large number of agents attracted by the discrepancy between the market price of around $40 per barrel compared with a cost of production at the margin of around $10 per barrel. (It is one of the paradoxes of the oil market, that the present marginal areas of production are comparatively high cost, while the bulk of proven but unexploited reserves are in relatively low cost areas.) Since 1980, therefore, the oil market has become more like other primary commodity markets, i.e. characterised by marked short-term price fluctuations in which exogenous disturbances are amplified by the effects of changing price expectations on speculative inventory holdings. By a tacit agreement earlier this year between some major producers, notably Saudi Arabia, the United Kingdom and Mexico, a degree of price stability has temporarily been achieved, but it is unlikely that this will last much beyond the summer. What will happen after that?

1. After deflation by an index of the price of manufactures, the increase is about ten times.

The price of oil has confounded so many commentators so often in the past that there are few people close to the industry who are willing to make any public predictions. Although conscious of rushing in where more prudent economists have feared to tread I would nevertheless offer the judgement that the world market price of crude oil might be expected to decline modestly in real terms over the remainder of this decade. "The price in real terms" means that the nominal price of oil will not rise as fast as an index of the nominal price of manufactures during the period concerned.

There are two reasons which may be offered in support of this view. First of all, there is the consideration that, as Professor Colin Robinson has pointed out[2], when the price of oil was declining relative to that of other fuels in the 1950's and 1960's, a very substantial substitution in favour of oil took place. It is difficult to believe that the larger upwards movement in the relative price of oil which has taken place since 1970 should not have the opposite effect of curtailing its consumption.

Secondly, on the supply side, the rises in the oil price in the 1970's triggered off a huge increase in exploration activity, whose benefits may be expected later this decade. Those who, in 1978, predicted that within a few years the demand for oil by the industrialised world could not be contained within the bounds of existing supplies have been proved wrong by events, and those who took the opposite, then less authoritative, view have been vindicated. It should also be pointed out that the time lags in adjustment to relative price changes in energy markets have historically been very long, and it therefore may be that the greater part of the adjustment in terms of both supply and demand has yet to take place. In this connection, too, it could be suggested that people's price expectations have perhaps been altered permanently by the 1978/9 round of price increases, something which the 1973/4 round failed to achieve.

Thus, if we were to confine our attention to economic factors alone, our outlook for the price of oil in the 1980's would be of short term fluctuations around a declining trend. However, it must be recognised that political factors have potentially a far more significant role in determining possible changes in the price of oil throughout the rest of the decade, and that these factors are much less predictable. If the present war between Iran and Iraq were suddenly to cease, it has been suggested that between 5 and 8 million barrels per day of crude oil could be added to the market supply, which would undoubtedly act as a powerful force driving down the price. If, on the other hand, as seems more likely, this war continues and still further political upheavals take place in the Middle East, then such events could drive the price of oil up to levels quite beyond the influence of ordinary commercial forces.

Given the vulnerability of the Western world to abrupt changes in the price of oil, then it may be asked what preventive action can Western governments take to cushion themselves from some such future shock? Two possible scenarios have been put forward in answer to this question. In one the governments of oil importing countries would get together with the governments of the major oil exporting countries and form long term political agreements to secure orderly supplies of oil.

2. Colin Robinson, "The Future of Crude Oil Prices", **Surrey Energy Economics Discussion Paper No.12**, November 1982

More likely, however, is the second scenario according to which the industrialised countries themselves form a common energy market within which the price of oil and other fuels will be much higher than in the rest of the world, but where uninterrupted supplies can be guaranteed. Such is the force of inertia in human affairs that any action along either of these lines is at the moment unlikely. However, should political events bring about another significant increase in the price of oil in this decade, then one or other of these schemes would be a natural consequence.