

Oil tracing past patterns in its rise and fall

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The recent rise and fall of oil prices appears to be similar to trends in the past.

Oil prices rose sharply over an extended period in the late 1970s and early 1980s, then mostly fell in the 1980s and 1990s.

Similarly, oil prices rose steadily between 2002 and July 2008 (with occasional downturns), and after reaching their peak in July 2008 near \$150 (Dh550) per barrel, they have been declining steadily, reaching to a two-year low of around \$65 per barrel in the third week of October.

This sharp and unexpected fall has revived an old fear among the Gulf oil-exporting economies as to whether oil prices will sink to their post-1980 level.

Although government spending in the Gulf region, the main engine of economic growth, is based on a price assumption of \$50-\$60 per barrel, falling prices imply that the Gulf economies are not feeling quite as flush with petrodollars as they did not so long ago.

Oil prices are falling at a time when the world economy is suffering a nasty financial hangover. The credit crunch is not leaving the GCC's financial sector unscathed.

Amid today's financial crisis, foreign borrowing and refinancing of long-term projects in the region is becoming increasingly difficult.

Given these developments, the most relevant question is: what is the long-term outlook for oil prices?

As oil is the lifeblood of the Gulf Arab economies, assessing the factors behind price changes is crucial to the Gulf economies. The goal of this column is to shed light on this issue.

Before discussing the determinants of long-term forecast of oil prices, it is important to review the factors behind the past three important oil price shocks: the rise (1973-81), the fall (1982-2000), and the rise and fall (2001-08).

Same factors

This will help us to understand whether the same factors are at work in the determination of future oil prices. This column draws heavily on a recent European Central Bank (ECB) occasional paper (2008-98) by Robert Kaufman, Pavlos Karadeloglou, and Filippo di Mauro, who examine the behaviour of oil

prices since the 1970s.

The rise in oil price -1973-81:

It is well-known that oil prices rose in the 1970s and early 1980s mostly due to supply-side shocks. The supply of crude was reduced by the Opec countries in the wake of the Yom Kippur War, causing oil prices to rise more than 250 per cent from 1972 to 1974. Similarly, the Iranian revolution in 1979 disrupted the global supply, resulting in prices increasing by about 120 per cent between 1978 and 1981.

The fall of oil prices - 1982-2000:

By contrast, oil prices mostly declined between 1982 and 2000 due to falling demand and favourable supply conditions. First, OECD demand declined sharply. Except for the transportation sector, changes in demand by the farm and non-farm sectors were generally negative. Second, there was a marked increase in crude supply by the non-Opec countries. For example, in the former Soviet Union, crude production increased from about 8 million barrels per day in 1972 to 12 million bpd in 1988. Additional supplies also came from countries such as China, Mexico, and the UK.

In addition, there was also an increase in production of natural gas liquids which helped to increase the overall supply of oil.

The rise and fall of oil prices - 2001-08:

Beginning in 2001, oil prices have risen steadily, temporarily breaching the \$140 threshold last July. Various factors were at play behind this sustained rise. First, demand accelerated in the years 2001-07. For example, worldwide demand rose from 76.8 million bpd in 2000 to 85 million in 2007. It is worthwhile mentioning that in the last seven years Chinese demand rose from about 4.8 million bpd in 2000 to about 7.7 million bpd in 2007.

Second, there has been a dramatic slowdown in the growth of oil production by the non-Opec countries.

Although Russia's production has risen steadily since 1997, the increase in world demand has mostly been supplied by additional crude pumped by the Opec countries. This has also helped the Opec countries re-establish control over the marginal barrels.

Third, there had been a broad public debate that speculation may have contributed to the recent volatility in prices. Numerous analysts argue that demand and supply factors alone cannot account for this.

Despite the difficulty of identifying speculative or hedging-related trades to analyse their potential impact on prices, research findings indicate that, in general, price volatility triggered speculative trades, rather than speculation systematically contributing to higher prices. In other words, the causality runs from oil prices to change in speculative positions, not the other way around.

As the world economy slips into recession in the face of the most dangerous financial shocks in mature markets, oil prices have started to decline sharply on the back of slowing demand. As of the third week of October, prices have tumbled to their lowest level in more than two years.

Long-term outlook

As can be seen, both demand and supply played key roles in the changes in prices over the past three decades. It is therefore no surprise that future oil prices will be determined mainly by demand and supply.

Data indicate that oil demand is likely to remain solid, owing to strong economic growth in the non-OECD countries, especially Asia.

Forecasts by the International Energy Agency (IEA) show that world oil demand will reach 116 million bpd by 2030, about 34 per cent higher than today's level.

Second, to meet the higher demand, additional crude production will be needed. Projections indicate that crude output by the non-Opec countries is likely to increase to 61.5 million bpd by 2030, about 14 per cent higher than the 2005 level.

Importantly, the bulk of non-OECD marginal production is expected to come from areas around the Caspian Sea or South America.

Similarly, Opec output is also expected to increase by more than 60 per cent to 55 million bpd in 2030 compared to 2005.

Unlike the 1980s and 1990s, oil prices are not expected to decline considerably due to continuing strong demand.

With the right macro and financial policies, the world economy is likely to ride out the storm and begin a recovery in the course of 2009, albeit exceptionally gradually by past standards.

Despite recent cooling of momentum, emerging economies are still expected to provide a source of resilience, benefitting from strong productivity and improved policy frameworks.

In light of these positive projections, the ECB study forecasts that oil prices are likely to continue to exceed the \$70-\$90 range over the next 15 to 20 years.

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