The Oil Market: What's Up?

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Oil prices are currently at a very high level, having tripled since February 1999 when the OPEC basket price fell to a low of just under $10/barrel. This article assesses the implications of high prices and prospects for the oil market.

The Oil Market in 1999

At the beginning of 1999, the recovery of Asian countries from the crisis of 1998 led to a growth in demand for oil. This happened when prices were extremely low. On March 23, 1999, the Organization of Petroleum Exporting Countries (OPEC), excluding Iraq, agreed to a production cutback of 1.7 million barrels per day (mb/d), or 7% of production. Four non-OPEC suppliers — Mexico, Norway, Russia, and Oman — also pledged cutbacks of 0.4 mb/d. The goal: to increase prices which, in real terms, at $ 10 per barrel were at their lowest level since 1973. As a result the cuts coupled with strong demand and low reserves in stock, prices rose, reaching an average of just over $23/barrel in the fourth quarter of 1999.

Developments in 2000

This rise in price resulted in political pressure, mainly from the US, to rectify the situation. In the wake of this pressure OPEC (excluding Iran and Iraq) agreed on March 27-28, 2000, to increase production by 1mb/d in the second quarter of the year. This resulted in very brief and mild fall in oil prices which, within weeks, were on the rise again.

Continued pressure from consumers resulted in the calling of an extraordinary meeting of OPEC ministers on June 21, 2000 where a 3% rise in quotas, equal to about 700,00 b/d, was agreed to. Since OPEC producers had already exceeded their quotas when the decision was made, the real net addition was, probably, in the region of 200,000 b/d, which was not enough to make an impact on prices.

Prices continued to rise which, in turn, led to more pressure on OPEC to raise quotas. On September 10, 2000, OPEC oil ministers met yet again and increased their quota by 800,000 b/d or 2.7% to 26.2 billion barrels a day effective October 1,. The real increase in production, however, was less than expected because OPEC countries were, yet again, producing above quota levels in September. As a result, as well as of Iraqi threats against Kuwait and problems in the US refinery industry, oil prices rose again in the period following the OPEC meeting.

In September the US government announced that it would release oil from its strategic stockpile. Discussions on similar measures were held in Europe. As a result there was a temporary drop in prices.

Why have Prices Risen?

The simple answer is that demand has increased faster than supply. How long the current relatively high price level remains in place will be determined by two mechanisms that govern the range in which they move. High prices deter consumption and encourage the emergence of significant competition from marginal but potentially important oil and non-oil energy sources. Sharp fluctuations in prices also discourage reliance on oil. Persistently low prices have the opposite effects, discouraging marginal production. The Saudis are acutely aware of these effects. There is evidence that demand growth is slowing: the IEA has reduced its forecast of world oil demand for the second quarter of 2000 by 650,000 b/d (0.8%). Both the Organization for Economic Cooperation and Development (OECD) and the International Monetary Fund (IMF) have forecast a slower rate of growth for world trade in 2001 than in 2000.

The very sharp rise in prices in 1999-2000 has not changed long-term oil price forecasts. According to the US Department of Energy, current high prices are expected to fall for several reasons. While OPEC and several non-OPEC producers have successfully managed the market in order to boost prices and increase revenues, they are well aware of the negative effects high oil prices have on the world economy, essentially damaging the economic strength of consuming nations. This would adversely affect OPEC's objective of growing world oil demand. In the medium term, high prices fuel inflation, lead to an increase in interest rates, impacts on stock markets and, in consequence, on both consumer confidence and oil consumption.

In previous periods of high oil prices, non-OPEC producers could be stimulated to increase their output levels. The upward movement of prices in 1999-2000 encouraged and enabled oil companies to increase their spending on field rehabilitation and maintenance. In addition, many exploration projects delayed in the low price environment of 1998 were given the green light as they now meet profitability standards. North Sea and Russian production rose in 1999, this partly a result of higher prices.

Medium and Long Term Scenarios

According to the EIA, when the economic recovery in Asia is complete, demand growth in developing countries throughout the world is expected to be strong. In the medium and long term, OPEC producers are expected to be the major beneficiaries of increased production requirements, but non-OPEC supply is expected to remain competitive, with major increments to supply coming from offshore resources, especially in the Caspian Basin and deepwater off the coast of West Africa.

Economic development in Asia will be crucial to long-term growth in oil markets. The evolution of Asian oil demand projected will strengthen economic ties between the Middle East and Asian markets. The EIA, like other experts, forecast an increased regionalization of energy markets, with the Gulf supplying Asia. The USA and Europe will be supplied from sources closer to home.

Although OPEC's share of world oil supply is projected to increase significantly over the next two decades, competitive forces among energy producers are expected to remain strong enough to forestall efforts to escalate real oil prices significantly. Competitive forces operate within OPEC, between OPEC and non-OPEC sources of supply, and between oil and other sources of energy (particularly, natural gas).

Oil in the Caspian region will not replace Middle East oil. It may have an impact in the medium term (five years) if political developments within and between the countries of the region improve. The economic incentives, in terms of export revenues from oil and gas, already exist and would increase if prices rose in real terms. This, however, cannot be guaranteed.

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Reliance on Middle East sources of oil in Europe and elsewhere is rising. There will be a period during which oil demand will rise, non-OPEC supplies will fall and technology for converting non-conventional sources of oil into oil may not yet be available. In this phase, oil prices are likely to rise and consumers could be subject to pressures from Middle Eastern producers.

The Effects of High Oil Prices on the World Economy

In December 1999, OECD made the following calculations in its *Economic Outlook.* If the then prevailing oil price of $22/barrel was sustained for a year and the volume of trade in oil remained unchanged, then oil importing countries in the OECD would face a rise in their import bill of about $80 bn or between 0.25% and 0.5% of GDP. This would be slightly less than the effect felt in the Gulf Crisis of 1990-91; one sixth of the size of the effect of the 1979-80 price rise and one third to one quarter of the effect of the 1973-74 price rises, due mainly to the reduction in the reliance on oil in Western economies. In September 2000, the IMF stated that a $5/barrel price rise reduces GDP in the industrialized countries by 0.2%, and increases their import bill by $40 bn. Most of the extra oil revenues are spent on imports from Western countries and so oil wealth is eventually transferred back to consumers.

Table 1

Israel: Fuel and Total Imports, 1980-1999 ($bns)

Year	Total Imports	Fuel Imports	Fuel as share of total
1980	8.1	2.1	26.0%
1990	15.0	1.5	10.0%
1998	26.9	1.8	6.7%
1999	31.3	2.1	6.9%

The Effects on the Israeli Economy

In Israel the rise in oil costs has increased the import bill and worsened the balance of payments. In 1999, the economy was in recession and so the demand for all imports was limited. The current account deficit, although large, did not form an immediate constraint.

In 1998, when oil prices were low, Israel imported $1.8 bn of fuel (mainly crude oil). In 1999, imports of fuel came to $2.1 bn, a nominal increase of almost 17%. In 1998 fuels accounted for 6.7% of total imports and in 1999, despite the increase in prices, they accounted for 6.9%. If the economy had grown then the import bill would have increase faster. A comparison with the situation in 1980 and 1990 shows how much healthier Israel's oil position is now.

In 1980, Israel imported $2.1 bn worth of fuels that accounted for 26% of its total imports; in 1990, it imported $1.5 bn, equal to 10% of total imports. Current levels represent a much smaller share of imports and are therefore much lighter burden on the economy. Although the price of oil and quantity imported will rise in 2000, this is not expected to cause a major financial burden as it did in the 1980s. (see Table 1)

The discovery of large gas reserves off Israel's Mediterranean coast offers the prospect of reduced reliance on oil and thus on imports. This will, in the medium term, lead to environmental and financial benefits.

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