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Are low oil prices good or bad?

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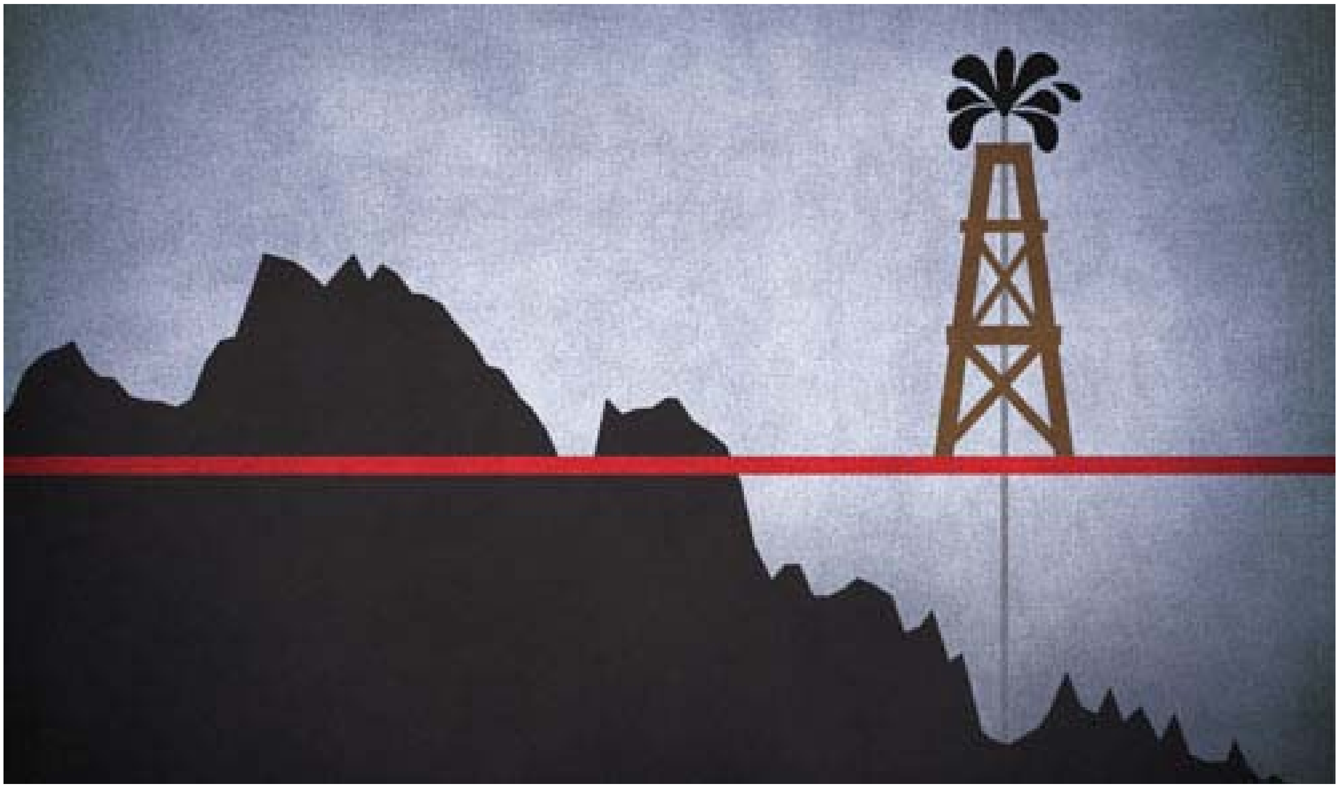

Oil prices have been falling — and with them the quality of reporting and writing about this periodic event. Stock market "guru" Laszlo Birinyi (just to select one of many annoying examples) claims that "It [the oil price drop] is just a black swan. It comes clearly out of the blue. Four standard deviations out of anything else [ie, exceedingly far from mean expectations]. In a case like that, there are no perimeters." This quote is remarkable only for its accumulation of indefensible claims, not for its overall tenor: falling oil prices have been generally treated as a shocking, unprecedented, and (most incredibly) a highly regrettable development that will end the rise of the US stock market and create unrest and uncertainty around the world.

What do those commentators want? When oil prices reached the all-time peak (in current dollars) of $145.31 on July 3, 2008 (using the West Texas Intermediate, WTI, oil values), they claimed that a rise to $250 a barrel was imminent, and that it would bring the end of modern high-energy economies — but by December 23, 2008, the WTI oil price was down to $30.28, dropping by 79 percent in less than half a year. Now, when the prices are falling, some so-called experts see no downward perimeters, and the very people who yesterday blamed OPEC for pushing prices too high are now wondering why the cartel (which has never had any easy control of the market) does not step in, drastically cut its output, and arrest the price fall because (in a white is black reversal) low oil prices are now widely seen as deeply disruptive.

But when the prices were rising between 2003 and 2007, the expert consensus, drawing on simplistic analyses of peak-oil activists, expected a continuous fall in global oil extraction and an ensuing fight over the remaining scarce resources — yet by 2013 global oil production was nearly 11 percent above the 2003 level, and in the intervening period the additional extraction easily accommodated the rise of China to the world's second-largest oil consumer and (by 2014) the world's leading oil importer. Peak oil nightmares have not come to govern the oil market, which has remained well supplied at affordable prices: when adjusted for inflation, oil prices in 2013-2014 were lower than they were in 1980-1981, and when also adjusted for the decreased oil intensity of modern economies they were a bargain. In 2013 the US economy produced a dollar of GDP with 57 percent less oil than it did in 1980, hence the 2013 price adjusted for inflation and oil intensity was lower than in 1974!

But now we are facing no perimeters. Really? Does Birinyi expect oil to go to a penny a barrel or perhaps be negative for a while (but that would still be a perimeter, albeit an abysmal one). And how about that black swan? The poorly worded intent was to stress that on the day of the comment (December 10, 2014), the WTI price was 43 percent below its June 20, 2014 peak, which is so rare that the probability of its occurrence is less than 0.01 percent (anything falling four standard distributions away from the mean will have frequency lower than that). But what is now unfolding is the eighth oil price decline of more than 30 percent during the past 30 years: the previous ones began in 1986, 1988, 1990, 1993, 1998, 2001, and 2008, and hence, on average, such a drop comes once in less than four years. That looks like a bevy of black swans, one that flies an undulating path: inevitably, during the past 30 years relatively sharp price rises followed the drops. Even when calculated with annual averages (rather than with daily extremes), WTI prices were up 24 percent in 1990, 57 percent in 2000, 34 percent in 2004, 39 percent in 2008, and 20 percent in 2011.

So we must be repeating, with the Romans, nihil novi sub sole (http://en.wikipedia.org/wiki/Nihil_novi) — but only those who have retained some historical memory will find that resonant: in the era of tweets, the memories of most observers have apparently shrunk to an equivalent of 140 characters, and historical perspectives have been replaced by twaddle about swans and non-existent perimeters.

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Nor is there anything new about the intensity of the latest shift: recurrent events show that small changes in the global supply or demand (or the anticipation of such relatively restrained movements) often result in disproportionately large price moves and, moreover, that there is no obvious, simple correlation (only more complex, time-specific explanations) between the two trends. In 1986, consumption rose by 3 percent as prices fell by 46 percent, and in 2009 consumption fell by nearly 2 percent as prices declined by 38 percent (amid a deep economic downturn). Conversely, in 1980 prices rose by 51 percent (driven by the take-over in Tehran) even though the consumption fell by 4 percent, and in 2007 prices rose by 39 percent while consumption rose only by 1.5 percent.

The latest (December 2014) International Energy Agency forecast cut the growth of global oil consumption by about a third but this still means that the world would consume 1 percent more oil in 2015 than it did in 2014 — and yet the price of oil has already fallen by more than 40 percent (and further decline is widely anticipated), confirming again the long-established reality of large price over-reactions to small demand shifts (in this case even with the aggregate demand growth).

As for the causes, there is an unusually large choice of straightforward explanations and recurrent conspiracy theories. The explanations include: soaring US shale oil production (undoubtedly the single most important factor, but still just one of many); the Saudis finally getting tired of playing the swing producer and refusing to cut their extraction and prop the falling price (but Ali Ibrahim al-Naimi, Saudi oil minister, simply says: “You know what a market does for any commodity. It goes up and down and up and down”); China’s economic slowdown resulting in reduced purchases of crude oil (undoubtedly a significant contributor); and efficiency gains and inroads made by green energies in the European Union (a negligible factor).

Conspiracy theories are fittingly intriguing, always involving the unfathomable Saudis. First, the price cut is engineered by the Sunni Saudis to weaken their despised fellow OPEC member, Shii Iran (Saudis can weather even a prolonged price cut, mullahs in Tehran are already in a precarious economic position). Second, the Saudis are trying to kill two flies with one swat: hurt the Iranians, and if not to put an end to, then at least seriously affect, the extent of the future US shale oil extraction by killing the fracking through low prices. Third, a totally opposite conspiracy, the Saudis are working in accord with the Americans, each pumping at the full tilt, in order to punish Putin's Russia (forcing it to live with low oil export earnings as retaliation for its Ukrainian adventure and for its support of Iran). Fourth . . .

Enjoy freewheeling cogitations based on your favorite theories, but be aware that falling oil prices are, as always, only a limited-time offer: we are not at the threshold of a new era of an oil-less civilization. We cannot pinpoint the onset of a renewed price rise any better than we can forecast the week or the month when prices will begin to fall, but the forces behind these shifts remain the same. On the supply side it is OPEC's still large capacity to export oil (and one that could become even larger once Iraq gets its act together and once Iran joins the world); new supplies from non-OPEC producers now ranging from equatorial Africa to the Arctic Ocean; and, particularly, the fate of America's hydraulic fracturing of oil shales: will it really eliminate the country's dependence on oil imports?

On the demand side it is the reduced need for automotive fuel in the United States (as the belated improvement in efficiency is finally adding up to significant savings); now near-chronically parlous state of the EU (the world's largest oil importing region with largely moribund economies); changing prospects in China (as its economic growth rate will soon be only half of the recent peaks); India's inability to emulate China's rapid rise (reality still has not caught up with the perennial promise of better performance, Modi or not); and Africa's still too low growth (if the continent as a whole had done half as well as China during the past decade it would have soaked up any new oil supply additions).

As always, it will be a complex combination of these changing factors that will determine how low the prices will go, how long they will stay there, and how rapidly they will resume yet another rise. Meanwhile my advice is to enjoy low oil prices, knowing that we are living through yet another down chapter of a prolonged undulating saga. What is the best thing to do? Old World herbalists and modern promoters of chamomile tea agree: the golden-hued beverage has a mild sedative effect, it eases anxiety and insomnia and it leaves a soothing aftertaste. I recommend increased doses of this classic tisane (with a touch of honey) as long as the current oil price fall lasts. By the time the trend, inevitably, reverses itself, your drinking of chamomile tea might become a new, and beneficial, habit — ready to ease the anxiety brought on by the rising prices.

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