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Oil - A Question of Economics

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Despite the political instability in parts of the MENA region, supply has managed to keep up with demand. This is largely due to the emergence of shale oil in the United States, which has ramped up its production to 8.7 mbd, which is 1 mbd more than last year. Some commentators even suggest that US oil production may reach up to 12 mbd by 2015. Meanwhile, Russia has also been putting record volumes of crude oil on to the market.

The recent debate over falling oil prices has become an over simplified economic question of supply and demand, ignoring other interrelated economic theories. Despite the global recession and, oil demand has remained at 90-91 million barrels per day (mbd) over the past 5 years. However, due to the recession, Western nations have slowly reduced their demand. Meanwhile low growth, fuel efficiency, and demand in Asia has risen to compensate for this fall. The International Energy Agency (IEA) has reduced its growth forecasts for 2015 suggesting that demand may grow modestly by a 1 mbd to nearly 93 mbd.

A decrease in demand and an increase of supply has caused oil prices to fall over the past five years from an average of $110 to $85 per barrel this year. The oil & gas media are full of doom and gloom about how these prices are unaffordable for the Middle Eastern nations who will now rack up budget deficits if the current price level persists. Some media outlets have even placed the blame of the price fall on OPEC's shoulders, citing the revival in production in Libya and Iraq for the current demise. OPEC has consistently produced around 30 mbd, reaching a peak in 2012 of 31 mbd and remains near to that today. However, the largest increase in world supply was brought on by the US and its drive for self-sufficiency. The US's investment in shale oil has lead to an ever increasing supply coming on stream. This ultimately reduces the US's need for high priced imports, and leaves large quantities of West African oil looking for buyers. Under these conditions, the US may soon be exporting oil into the market, although many commentators remain skeptical that the US export ban will be lifted any time in the near future. Yet with or without the ban, the US is already exporting record amounts of refined products and incidental condensates from its shale oil, leaving great impacts on prices in the oil markets.

With western media suggesting OPEC should reduce production and avoid deficit financing, there seems to be an issue of double standards arising. Should we ask the US to abandon plans to export oil? Surely, the MENA countries could follow America's lead and ask China to finance its deficit as well and allow market capitalism to run its full course. The competition theory in economics tells us that high costs and inefficient producers will be driven out of the market as prices fall. Doing so would eventually drive out the high cost and environmentally threatening deep water, arctic, tar sands and shale oil fields. In the long run, higher output at lower prices will finance and in due time reduce the deficit of the low cost oil producers. In addition to this, the true cost benefit analysis of these environmentally threatening, high cost shale oil fields might be recognised if we follow this path.

Many economic commentators are failing to see the benefits of lower oil prices. Virtually all businesses will benefit from lower transportation costs by expanding their profit margins or passing the benefit to consumers at lower prices. The lower income groups, who spend a higher proportion of their incomes on transport, will see their disposable incomes rise, benefiting retailers who serve their needs and thereby increasing demand in the economy. Food prices are also likely to fall, as food production, processing and sales distribution are energy intensive activities, thereby benefiting lower income groups further. Increased consumption will stimulate aggregate demand, creating investment opportunities and economic growth. Governments in the west may also have the opportunity to increase fuel taxes to cover the real cost of the negative externalities of carbon emissions, or raise revenue to improve public transportation systems. Furthermore, governments in the Middle East and Asia will reduce spending on their fuel subsidies and may take the opportunity to improve the workings of market forces, which the IMF and Western powers have been seeking for them to do.

As many Western economies are seemingly slowing down again, with most of them still struggling with stubbornly high unemployment levels, they will only benefit from the current sharp drop in oil prices which will stimulate the global economy. Moreover, countries now have the opportunity to replenish stocks and protect themselves against future price hikes. Stockpiling begs the question: how long will prices remain relatively low compared to recent years? Will they fall further? $60 would certainly kick start substantial economic activity or will supply be rained back?

In the past, we have seen the US and its Western partners put pressure on OPEC, and the world's only swing producer Saudi Arabia, to increase supply so as to lower prices or maintain price stability. Are we about to see them create further price fixing market imperfections by asking the Saudis to cut production so as to create a return to higher prices? Much of the Western economic commentaries are suggesting the Middle East will fall apart as falling oil revenues will create unaffordable budget deficits, cuts in government spending, and political uprisings amongst their populations and ultimately scare Middle Eastern governments into considering cutting back on OPEC supply.

The recent period of high but stable oil prices has induced an economic recovery in the US based on lower oil and energy prices, propped up Putin's government and economy which has become more heavily dependent upon its oil revenues, and increased the sovereign wealth funds of the GCC countries of the Middle East. Meanwhile, the rest of the world has suffered economic malaise consigning a generation to a life of unemployment and it appears that some commentators may want to maintain this status quo. Lower oil prices would likely benefit all via economic growth, and not just a few nations self-interests. This brings us to ask: have we been sacrificing economic efficiency for US energy self-sufficiency?

If we can enjoy a period of sustained low oil prices where consumer disposable incomes rise and increase world aggregate demand, we may witness recovery in Europe and rising growth rates again in Asia. This would fuel economic activity at a time when a generation has been lost to unemployment, and maybe allow them to regain for a better future. In this case oil prices will either recover, or rise in demand may equally bring about a rise in supply, ultimately increasing the revenues of oil produces.

Economic theory suggests that a lower price delivered by lowest cost producers is economically efficient. The lower prices will either force high cost producers out of the market or encourage them to seek lower cost technological solutions to stay in the market. The economic solution to our energy requirements is to invest in low cost producers instead of preventing them from reaching the market by financing chaos in the Middle East and Africa. Instead, supporting the development of low cost oil reserves in the Middle East and Africa would benefit these populations. The wealth created from oil revenues could be used to develop infrastructure, education, and health systems, rather than being frittered away by corruption and cronyism. However, this requires international oil and gas companies as well as the US government to rethink their geopolitical strategies and adopt the capitalist model of economic efficiency, rather than supporting a model of imperfect competition and short term self-interest. As the world's largest open economy, the US would benefit more in the long run from encouraging world economic growth, rather than trying to protect its high oil price by fair means or foul.

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