Vindicating Volatility

Why Fluctuating Oil Prices Are Here To Stay

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Three years ago, in an essay for Foreign Affairs [1], we predicted a new era of volatile oil prices. The market laughed at us: the next three years were the smoothest in decades. Oil prices, on average, moved just three percent each month and even less from year to year. The calm was so eerie that analysts began to hail a new era of oil price stability [2].

The past month, however, has upended that confident view. What began as a gradual slide, from $115 a barrel on June 19 to $100 a barrel by September 8 [3], turned into something more serious, with prices plunging as low as $84 by mid-October. Volatility is back—and our 2011 essay explains why.

The story began this summer, when oil prices began to fall due to weak economic growth worldwide and increased oil production in Libya. More supply and less demand normally lead to lower prices, but traders assumed that Saudi Arabia—the largest oil producer in OPEC—would curb its own production to keep the market stable, creating a price floor of about $90 per barrel. Instead, Saudi Arabia shocked the market, hinting that it could live with lower prices and would not rush to cut production. As a result, prices dropped precipitously.

If they had been reading Foreign Affairs, traders might not have been so surprised. In our essay, we argued that Saudi Arabia and its partners in OPEC were no longer able or willing to hold and use spare production capacity to stabilize the market as aggressively as before. In the past, as we wrote, if demand rose unexpectedly or if supplies were disrupted, OPEC producers with spare capacity, most prominently Saudi Arabia, would release more oil, balancing supply and demand and keeping prices stable. During the 2000s, however, Saudi spare capacity slowly dwindled, shrinking Riyadh’s ability to prevent price swings. The Arab Spring didn’t help: With demands for domestic spending on the rise, cutting production and sales became even more difficult for a country dependent on oil revenue.

THE PHONY PEACE

So why were oil prices so stable for so long? Many observers have attributed stability to the unique properties of U.S. tight oil production. Drilling and completing a tight oil well takes far less time than developing a traditional...
conventional well, and tight oil wells can produce and stop producing large volumes of oil in a shorter amount of time. Many thus believed that tight oil would be more responsive to changes in the market—that it would be easy to cut back on drilling when prices fell and spur new investments and production when they rose—thereby keeping prices relatively stable.

Unfortunately, however, tight oil production isn’t as responsive as advertised. Dozens of shale oil companies with vastly different economic and financial profiles won’t coordinate with one another, making their collective response to falling prices far less effective than Saudi Arabia taking the lead. No one knows how far prices have to fall to start reducing tight oil supply substantially, but analysts expect most drilling to continue even if prices fall further. On the flip side, responding to rising prices with far greater tight oil production could take years.

In the end, the most compelling explanation for the recent stability is dumb luck. Over the past few years, the world has seen a series of significant oil supply disruptions, from the civil war in Libya to sanctions on Iran to turmoil in Nigeria. Normally, these would have sent prices soaring, as Saudi Arabia could not have offset them alone. Instead, however, the disruptions were almost perfectly counterbalanced by unexpected gains in U.S. tight oil output. Lackluster GDP growth also helped tamp down global oil demand.

Central banks also deserve some credit. It isn’t just oil markets that have enjoyed relative stability in the last few years. Financial markets have as well [4]. For this, analysts typically credit the massive liquidity that the Federal Reserve and other central banks have pumped into the financial system to spur economic growth. Indeed, it would have been surprising had oil been the one volatile market in a sea of relative calm.

In the past month, however, financial markets have become less stable, leading investors to worry about what central banks will do next. Add to this Saudi Arabia’s unwillingness to cut its own oil output and, as we warned in 2011, oil prices are suddenly swinging.

DANGER AHEAD

The return to volatility poses an immediate risk to the global economy. It is volatility, rather than high prices, that endangers global economic growth; right now, for example, falling prices are a positive, as consumers with more money in their pockets can buy more and stimulate the economy. But with Saudi Arabia and OPEC less able or willing to moderate oil prices, consumers can expect more price spikes alongside sharp price declines. Volatility also scares investors and consumers, deterring them from investing in oil infrastructure and from buying more efficient cars and trucks. Policymakers should therefore not view falling prices only as a sign of relief, but also as an indicator of trouble.

In 2011, we compared the stable oil market of yore to the Disney ride “It’s A Small World”—gentle and unremarkable—and warned that consumers might soon find themselves on the scary and unpredictable “Space Mountain.” A bit of good luck handed them a three-year trip down a soothing waterway. But the roller coaster ride has returned with a vengeance. It would be wrong to dismiss the possibility of another spell of calm, but it would be equally foolish to assume that the ride is over.