Why oil prices keep falling — and throwing the world into turmoil...

Updated by Brad Plumer on December 16, 2014, 4:40 p.m. ET

The plummeting price of oil is the biggest energy story in the world right now. It’s bringing back cheap gasoline to the United States while wreaking havoc on oil-producing countries like Russia and Venezuela.

But why does the price of oil keep falling? Back in June, the price of Brent crude was up around $115 per barrel. By mid-December, it had fallen nearly in half, down to $59 per barrel (http://www.nasdaq.com/markets/crude-oil-brent.aspx?timeframe=10y):

Oil prices since 1987
Why oil prices keep falling — and throwing the world into turmoil ...

The short version of the story goes like this: For much of the past decade, oil prices were high — bouncing around $100 per barrel since 2010 — because of soaring oil consumption in countries like China and conflicts in key oil nations like Libya. Oil production couldn't keep up with demand, so prices spiked.

But beneath the surface, many of those dynamics were rapidly shifting. High prices spurred companies in the US and Canada to start drilling for new, hard-to-extract crude (http://www.vox.com/2014/10/2/6892781/how-the-oil-and-gas-boom-is-changing-america) in North Dakota's shale formations and Alberta's oil sands. At the same time, demand for oil in places like Europe, Asia, and the US began tapering off, thanks to weakening economies and new efficiency measures. On top of that, the conflict in Libya was slowly easing.

By late 2014, world oil supply was on track to rise much higher than actual demand, as the chart below from the International Energy Agency (https://www.iea.org/oilmarketreport/omrpublic/) shows. And, in September, prices started falling sharply.
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As prices slid, many observers waited to see whether OPEC, the world’s largest oil cartel, would cut back on its production to prop prices up. (Many OPEC states, like Saudi Arabia and Iran, need high prices to balance their budgets.) But at its big meeting in November, OPEC did nothing (http://www.vox.com/2014/11/28/7302827/oil-prices-opec). Saudi Arabia didn’t want to give up market share, and it hoped that lower prices would help throttle the US oil boom. That was a surprise. So oil went into free-fall.

The oil price crash is now upending the global economy, with ramifications for every country in the world (http://www.ft.com/cms/s/2/3f5e4914-8490-11e4-ba4f-00144feabdc0.html#axzz3M0pu7m13). Low prices are excellent news for oil consumers in Japan and the US, where gasoline is the cheapest it’s been in years. But it’s a different story for countries reliant on oil sales. Russia’s economy is melting down (http://www.vox.com/2014/12/16/7401401/ruble-collapse-interest-rates). Venezuela is facing serious unrest (http://www.buenosairesherald.com/article/177305/amid-economic-crisis-venezuela%E2%80%99s-maduro-directs-anger-at-us). And even
better-prepared countries like Saudi Arabia could face heavy pressure if oil prices stay low.

Read on for the longer guide to how we got here — and how countries around the world could be affected by the oil crash:

**Why oil prices plummeted in 2014**

Photo taken August 21, 2013 shows a pumpjack (also known as a Nodding Donkey) near Tioga, North Dakota. (Karen Bleier/AFP/Getty Images)

To understand this story, we first have to go back to the mid-2000s. Oil prices were rising sharply because global demand was surging — especially in China — and there simply wasn't enough oil production to keep up. That led to large price spikes, and oil hovered around $100 per barrel between 2011 and 2014.

But as oil prices increased, many energy companies found it profitable to begin extracting oil from difficult-to-drill places. In the United States, companies began using techniques like fracking and horizontal drilling to extract oil from shale formations (http://www.vox.com/cards/fracking/how-has-fracking-boosted-u-s-oil-and-gas-).
Why oil prices keep falling — and throwing the world into turmoil ... production) in North Dakota and Texas. In Canada, companies were heating Alberta’s gooey oil sands with steam to extract usable crude.

This led to a boom in "tight oil" production. The US alone has added (http://www.vox.com/xpress/2014/11/17/7236379/the-united-states-hasnt-produced-this-much-oil-since-1986) 4 million new barrels of crude oil per day to the global market since 2008. (Global crude production is about 75 million barrels per day, so this is significant.)

Up until very recently, however, that US oil boom had surprisingly little effect on global prices. That's because, at the exact same time, geopolitical conflicts were flaring up in key oil regions. There was a civil war in Libya (http://en.wikipedia.org/wiki/Libyan_Civil_War). Iraq was a mess. The US and EU slapped oil sanctions on Iran and pinched its oil exports. Those conflicts took more than 3 million barrels per day (http://www.eia.gov/forecasts/steo/data.cfm?type=figures) off the market:
But much of this was changing by mid-2014. Many of those disruptions started easing (http://www.eia.gov/todayinenergy/detail.cfm?id=18311). In July, Libyan rebels opened two key export terminals, Es Sider and Ras Lanuf, that had been shut down for a year. Libyan exports rose unexpectedly.

Even more significantly, oil demand in Asia and Europe began weakening (http://www.theguardian.com/business/2014/nov/13/oil-hits-four-year-low-in-response-to-china-slowdown) — particularly thanks to slowdowns in China and Germany. More broadly, oil demand has been stagnating in lots of places around the world. The United States, once the world's biggest oil consumer, saw big cutbacks in industrial oil use after the recession, while gasoline consumption has flattened as fuel-efficient cars became more widespread. At the same time, countries like Indonesia and Iran have been cutting back on fuel subsidies (http://www.wsj.com/articles/tracing-oil-price-plunge-back-to-texas-1418404579).

That combination of weaker demand and rising supply caused oil prices to start dropping from their June peak of $115 per barrel down to around $80 per barrel by mid-November. And that was only the start...

**OPEC's surprising response: Let prices keep falling**
Why oil prices keep falling — and throwing the world into turmoil ...

That brings us to OPEC (http://en.wikipedia.org/wiki/OPEC), a collection of oil-producing nations that pumps out about 40 percent of the world's oil. In the past, this cartel has sometimes tried to influence the price of oil by coordinating either to cut back or boost production.

At its big meeting in Vienna on November 27, there was a lot of heated debate (http://www.reuters.com/article/2014/11/28/us-opec-meeting-shale-idUSKCN0JC1GK20141128) among OPEC members about how best to respond to the drop in oil prices. Some countries, like Venezuela and Iran, wanted the cartel (mainly Saudi Arabia) to cut back on production in order to prop up the price. These countries need high prices in order to "break even" on their budgets and pay for all the government spending they've racked up:

Figure 4: OPEC median budgetary breakeven price

![Graph showing OPEC median budgetary breakeven price](http://www.vox.com/2014/12/16/7401705/oil-prices-falling)
On the other side of the debate was Saudi Arabia, the world's largest oil producer, which was opposed (http://www.reuters.com/article/2014/11/28/us-opec-meeting-shale-idUSKCN0JC1GK20141128) to cutting production and willing to let prices keep dropping.

Why was that? For one, officials in Saudi Arabia remember what happened (http://www.reuters.com/article/2014/10/14/us-saudi-oil-policy-analysis-idUSKCN0i229320141014) in the 1980s, when prices fell and the country tried to cut back on production to prop them up. The result was that prices kept declining anyway and Saudi Arabia simply lost market share. What's more, the Saudis have signaled (http://www.reuters.com/article/2014/10/13/us-oil-saudi-policy-idUSKCN0i201Y20141013) that they can live with lower prices in the short term. (The government has built up massive foreign-exchange reserves to finance deficits.)

In the end, OPEC couldn't quite agree on a response and ended up keeping production unchanged. "We will produce 30 million barrels a day for the next 6 months, and we will watch to see how the market behaves," said OPEC Secretary-General Abdalla El-Badri after the meeting.

That caused the price of oil to start crashing even further (http://www.vox.com/2014/11/28/7302827/oil-prices-opec). The price of Brent crude went from $80 per barrel to $70 per barrel in just a few days. And it kept tumbling to down below $60 per barrel by mid-December.
For all intents and purposes, OPEC is now engaged (http://www.bloomberg.com/news/2014-11-27/oil-in-new-era-as-opec-refuses-to-yield-to-u-s-shale.html) in a "price war" with the US. What that means is that it's relatively cheap to pump oil out of places like Saudi Arabia and Kuwait. But it's more expensive to extract oil from shale formations in places like Texas and North Dakota. So as the price of oil keeps falling, some US producers may become unprofitable and go out of business. And the price of oil will stabilize. At least that's what OPEC members hope.

A big question: Will low oil prices kill the US shale boom?

The catch is that no one quite knows how low prices need to go to rein in the US oil boom. Analysts often focus on a metric called the "breakeven price" (http://cdn2.hubspot.net/hub/312313/file-374680987-pdf/Whitepapers/breakeven_costs-evaluateenergy.pdf) for oil-drilling projects. Here, for instance, is ScotiaBank's estimates (http://www.gbm.scotiabank.com/English/bns_econ/bnscomod.pdf) of the breakeven price for various US shale and Canadian oil sands projects:

![Crude Oil Cost Curve, Canada & United States](http://www.vox.com/2014/12/16/7401705/oil-prices-falling)
If oil stays around $60 per barrel, some US companies will cancel or scale back shale drilling (a number of big companies are already pulling out of Texas' Permian Basin for now). But other drillers may try to cut their costs, grit it out, and keep drilling. It really varies from company to company. That makes it very hard to predict how this all shakes out — or where global oil prices will bottom out.

The US Energy Information Administration still expects that overall US oil production will grow another 700,000 barrels per day in 2015 — though that's slightly lower than the prediction when prices were high. We're about to see if that's right.

How falling oil prices could affect Russia, Iran, and the US
The plunge in oil prices is having significant economic consequences around the world. A few examples:

**Russia:** Russia's situation is getting the most attention these days. The country's is hugely dependent on oil and gas production — with oil revenues making up 45 percent of the government budget — and the sharp fall on prices has been ruinous.

Economists now estimate that Russia's GDP will shrink at least 4.5 percent (http://www.bloomberg.com/news/2014-12-15/russia-sees-economy-shrinking-at-least-4-5-in-2015-with-60-oil.html) in 2015 if oil stayed at $60 per barrel. The plunging price of oil has also caused the ruble's value to collapse — which is leading to panic inside...
Russia and a rise in inflation, as imports become drastically more expensive. Many Russians, worried that their savings may vanish, are rushing out (http://www.nytimes.com/2014/12/17/business/russia-ruble-interest-rates.html) to buy cars and washing machines — anything that has more lasting value than currency.

So far, Russia's central bank has been struggling to deal with this crisis. On December 15, the country suddenly hiked interest rates from 10.5 percent to 17 percent (http://www.vox.com/2014/12/16/7401401/ruble-collapse-interest-rates) in an attempt to stop people from selling off rubles. But the ruble kept declining anyway and the rate hikes are likely to slow the country's economy down even further.

**Iran:** Iran's economy had recently started to rebound after years of recession. The International Monetary Fund had been projecting (http://www.bloomberg.com/news/2014-10-11/iran-central-bank-s-seif-says-sanction-won-t-stop-growth.html) that the country was on track to grow 2.3 percent next year. But that was all before oil prices started to plunge — a potentially precarious situation for the country.

One big problem for Iran is that it also needs oil prices well north of $100 per barrel to balance its budget, especially since Western sanctions have made it much harder to export crude. If oil prices keep falling, the Iranian government may need to make up revenues elsewhere — say, by paring back domestic fuel subsidies (always an unpopular move, at least in the short term).

**Venezuela:** There's growing concern (http://www.ft.com/cms/s/0/aaa13660-795e-11e4-a57d-00144feabdc0.html) that the oil crash could cause Venezuela, another major oil producer, to default. The nation's economy — heavily dependent on oil revenue — is set to shrink some 3 percent this year and inflation is rampant.
Saudi oil minister Ali Al-Naimi attends the Gulf Cooperation Council (GCC) oil ministers meeting in Kuwait city on September 11, 2014. (Yasser Al-Zayyat/AFP/Getty Images)

**Saudi Arabia:** There's no question that Saudi Arabia, the world's largest crude producer, will suffer financially from cheap oil. If oil stays at around $60 per barrel next year, the government will run a deficit equal to 14 percent of GDP (http://www.ft.com/intl/cms/s/2/3f5e4914-8490-11e4-ba4f-00144feabdc0.html#axzz3M0pu7m13).
For now, however, the Saudis are trying to grit this out — and show no sign of trying to prop up prices as they have in the past. The kingdom has built up a stockpile of foreign currency worth some $740 billion, which it will use to finance its deficits. Still, if low oil prices persist, Saudi Arabia may have to cut back on some of the social programs it had instituted after the Arab Spring.

**The United States:** In the US, meanwhile, a fall in crude prices would have more varied impacts. For many people, it will offer a nice economic boost: cheaper oil means lower gasoline prices — which have fallen to $2.51 per gallon, the lowest in five years:
The EIA projects that US drivers will spend about $550 less on gasoline in 2015 than they did in 2014, assuming prices stay low. That will give consumers more money to spend on other things — a nice economic boost.

But it’s not all good news. Oil-producing states like Texas and North Dakota are likely to see a drop in revenues and economic activity. (For more, see: "Which states get hurt most by falling oil prices?" (http://www.vox.com/2014/10/9/6952533/oil-prices-falling-map-states-employment-north-dakota-texas)) The falling price of oil is also putting severe pressure on Alaska's state budget (http://www.latimes.com/nation/la-na-alaska-oil-20141216-story.html). And, meanwhile, the economic turmoil around the world seems to be making US credit markets jittery (http://www.ft.com/cms/s/0/29020472-852f-11e4-bb63-00144feabdc0.html).

The price drop could also, at the margins, spur people to start using more oil. Case in point: In recent years, high gasoline prices have spurred many Americans to buy smaller, more efficient cars. But if gasoline prices fall, bigger cars and SUVs could make a comeback. (Overall US fuel economy will still keep rising over time — because the federal government has imposed new standards (http://www.vox.com/cards/obama-climate-plan/what-are-u-s-fuel-efficiency-standards-for-cars-and-trucks) on cars and light trucks through 2025. But this might now happen more slowly.)

Will global oil prices stay low?

That's hard to predict. The world is full of potential surprises. War could break out again in Libya or Iraq, which would hamper oil
production. China's economy could come roaring back. Europe could suddenly rebound out of its malaise. Saudi Arabia could decide that enough is enough and cut back on production all of the sudden. Any of those things could increase prices.

If history is any indication, oil prices will eventually rise again. And some experts think we should be preparing for that day. In the Financial Times, energy expert Michael Levi wrote a piece (http://www.ft.com/intl/cms/s/6cbfa7de-71a0-11e4-b178-00144feabdc0.html?_i_location=http%3A%2F%2Fwww.ft.com%2Fcms%2Fs%2FO%2F6cbfa7de-71a0-11e4-b178-00144feabdc0.html%3Fsiteedition%3Dinternal%26siteedition=internal&_i_referer=http%3A%2F%2Fwww.ft.com%2FCYn2y5sZgQ%23axzz3KHwev6d2) on how the US (and other countries) could take advantage of low oil prices to make needed energy-policy reforms — such as ending wasteful fossil-fuel subsidies or putting in place new efficiency measures. That would help countries insulate against future price shocks.

But that's hardly guaranteed to happen: Many policymakers might just decide low oil prices are here to stay and use it as an excuse to cut back on efficiency measures or energy alternatives.

Further reading

Oil prices keep plummeting (http://www.vox.com/2014/11/28/7302827/oil-prices-opec) as OPEC starts a price war with the
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What the huge drop in gasoline prices (http://www.vox.com/2014/12/2/7319307/gas-prices-falling) means for America

A look at North Dakota’s efforts to prepare for an oil price bust (http://www.vox.com/2014/12/11/7328019/north-dakota-fracking-money)

How far do oil prices have to fall (http://www.vox.com/2014/12/3/7327147/oil-prices-breakeven-shale) to throttle the US shale boom?

Right now is a perfect time to raise the gas tax (http://www.vox.com/2014/12/4/7332625/gas-prices-falling-tax)

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