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Market Forces: What Next for Oil Prices?

By Nikhilesh Bhattacharyya in Sydney
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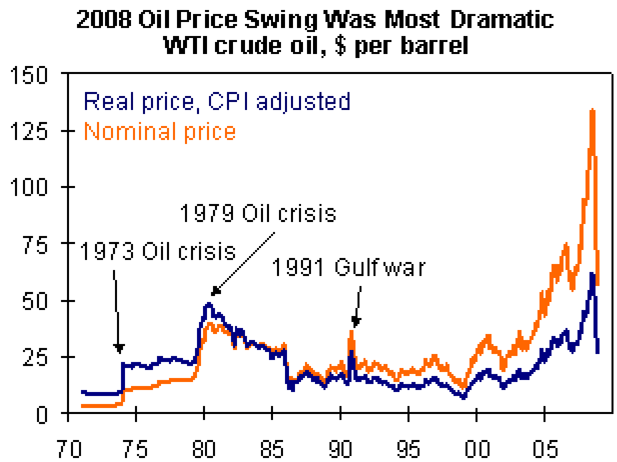
- Oil prices rose to record levels in 2008, driven by financial speculation and overestimation of the global economy's prospects.
- At the time, peak oil theorists blamed contracting production and falling reserves.
- But with the global economy in the doldrums and speculators having reversed positions, oil prices crashed in the second half of last year.
- In 2009, supply issues are likely to play a larger part in determining oil prices, which are expected to rise as the year proceeds.

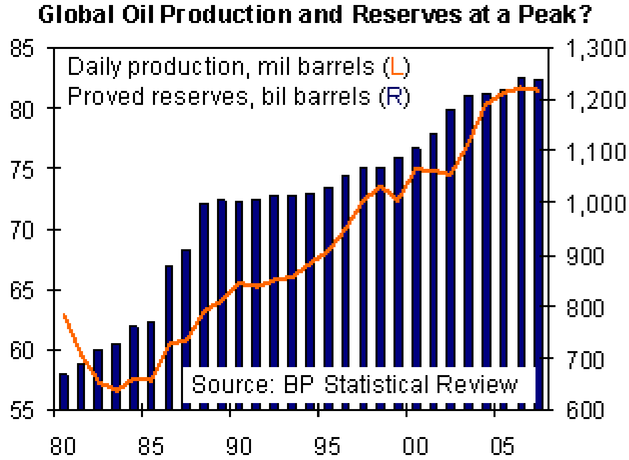
Year 2008 will go down in history as the year of the third oil shock, where prices rose higher in both nominal and real terms than in 1973 and 1979. It may also be remembered by some economists as the year in which the theory of peak oil prices was both rekindled and burned. Rather than issues of supply and scarcity, last year's oil prices were driven mainly by financial speculation and economic demand. Both forces subsided in the second half of 2008 and led to a massive slide in prices.



With oil producing nations cutting output in response to last year's slumping prices, it is expected that supply issues will begin to exert a greater influence on prices in 2009. That being said, exceptionally high oil prices last year have wreaked havoc with planned budgets in many oil producing nations and it will be interesting to see if OPEC governments continue to make good on planned pledges to cut production, therefore sacrificing revenues. Overall, Moody’s Economy.com expects oil prices to rise this year, averaging approximately $60 per barrel in the fourth quarter.

Peak oil prices

Between 2004 and 2008, peak oil theory began to gain popularity in the media as oil prices rose while production and reserves growth slowed and began to contract in 2007. Peak oil theory broadly states that oil production will be characterised by a bell shaped curve, where production will fall year after year having reached its peak. It assumes that the issues of scarcity and higher costs of extraction will result in prices rising as production contracts, possibly sharply after reaching a tipping point, with obvious dire consequences for the global economy.



With oil production and proved reserves dropping in 2007, many speculated that we had reached the tipping point, where prices would begin to rise sharply matched by falling supply. Indeed during the first half of 2008 peak oil theorists gained credence in the media as prices rose to record levels. Many blamed rising oil prices on a fundamental mismatch between oil supply and demand, blaming the rapid growth of consumption in developing nations as driving prices higher. But in retrospect oil prices were actually bubbling, driven higher in part by financial speculation as well as overestimation of the global economy, which is expected to contract in 2009. The experience of oil prices plummeting in the second half of last year has shown that global demand and financial speculation are important issues for oil prices, which peak oil theorists largely ignore.

But is the theory of peak oil prices dead or irrelevant now? The current shock throws a spanner in the works despite a pretty decent geological argument. However, the laws of economics and history show that when the price of a good rises—even the ones thought as irreplaceable—to prohibitive levels, substitutes that were previously unviable become plausible alternatives. Greater use of substitute goods spawns technological innovation and facilitates a movement away from goods that are highly priced. Already there are products that can reduce society's oil dependence, but their viability is dependent on higher oil prices as well as technological innovation.

For the time being however, oil is a vital necessity and substitutes that will facilitate a transition away from oil dependence are a long way from being widely available. The recent sharp slide in oil prices had made the transition process harder, but in the short term this should be aided as oil prices are expected to rise. The governments of many oil producing nations have formulated budgets that are reliant on oil prices for 2009 well above current levels. Some oil producing nations have been taken by surprise at the sharp drop in oil prices and are highly vulnerable.

OPEC Prepared to Create Supply Shortage in 2009

Many of these governments are part of OPEC, which accounts for around 40% of global oil production and is sure to make further cuts if oil prices do not begin to rise soon. Venezuela is highly dependent on oil prices moving above current levels, as like some other OPEC nations it failed to set up a rainy day fund when oil prices rose earlier this decade. If oil prices do not begin to rise soon, the cartel may well reduce production further to help boost prices. Taking into account the most recent announcement of production cuts—which were effective from January 1—OPEC already considers there to be a fundamental mismatch between global oil demand and supply.

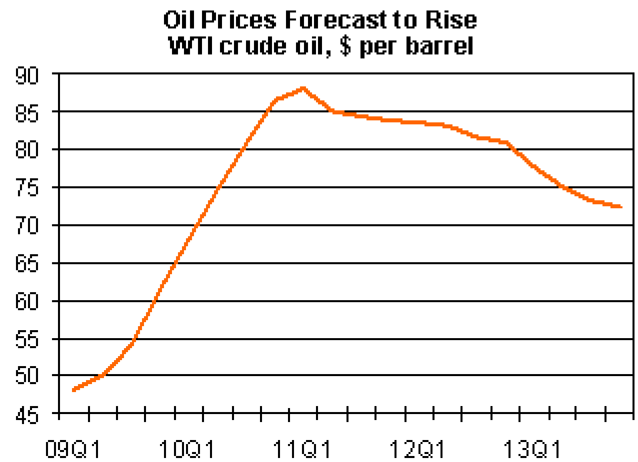
OPEC Predicts Large Shortfall in 2009, millions of barrels/day

	Global Demand	Non-OPEC Supply	OPEC Supply	Total Shortfall
2004	82.5	52.3	30.6	-0.4
2005	83.9	52.5	31.6	-0.2
2006	84.9	52.9	31.4	0.6
2007	85.9	53.7	31	1.2
2008	85.8	54.2	32*	-0.4
2009f	85.7	55.5	24.8**	5.4

* Estimate based on first three quarters of 2008, f= OPEC forecast, **Production target announced at 151st meeting of the OPEC conference. Source: December OPEC monthly oil report

Outlook for oil prices

Although cutting supply may be easy, the rise of oil prices earlier this decade showed that ramping up production when demand is strong is far from easy. With oil prices now at such a low level, planned investment in production infrastructure has been put on hold or curtailed till prices recover. This will amplify the effect on oil prices when demand does recover, as supply will only be able to rise slowly to meet demand. If a quick recovery does ensue in 2010 oil prices could rise sharply.



At the present juncture Moody's Economy.com expects oil prices to average $53.42 in 2009 and rise higher in 2010. However, there is a high degree of uncertainty attached to this forecast as the global economy is expected to undergo its slowest pace of expansion in the post-war period. Like the outlook for the global economy, risks to the oil price forecast are weighted to the downside.

Nikhilesh Bhattacharyya is an associate economist in the Moody's Economy.com Sydney office. He covers Indonesia, Malaysia and the Philippines for the World Workstation and is a regular contributor to the Dismal Scientist web site. Nikhilesh received his bachelor of economics degree (honours) from Macquarie University, where he also worked as a research assistant.

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