What can be done to lower oil prices?

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What can be done to lower the current oil prices? Key international players -- G-7 Ministers, directors of the IMF, central bankers as well as the International Energy Agency -- are worried about the global impact of high oil prices. They have called for lower prices but so far, without success. Why?

At $50 a barrel and more, these prices are too high and thus the world economy suffers. As an IEA report demonstrated six months ago, higher oil prices since 1999 partly the result of OPEC supply-management policies contributed to the global economic downturn in 2000-2001 and are dampening the current cyclical upturn. We consider that the world GDP growth would have been at least half a percentage point higher in the last two or three years had prices remained at their mid-2001 levels.

According to the results of a quantitative exercise carried out by the IEA in collaboration with the OECD and with the assistance of the International Monetary Fund, a sustained $10 per barrel increase in oil prices from $25 to $35 would result in the OECD as a whole losing 0.4% of GDP growth in the first and second years of higher prices. The adverse economic impact on oil-importing developing countries is considerably more severe than for OECD countries.

Pay attention to fundamentals

Let us try to understand what is happening in the market. Reading the commentaries, it seems that the market operators feel that we live in an unpredictable and dangerous world (Middle East, Nigeria, Venezuela, Russia and hurricanes) and that there is no buffer to cope with any unexpected event. There is not enough investment while demand keeps surging; the oil industry and even more acutely, the refining industry operate at nearly total capacity; and commercial stocks are too low as the winter heating season begins. The many active players in the market take all of these tension-creating factors into consideration, incorporating them into technical analyses that project even further increases in the price of oil. We believe these doomsayers are not paying sufficient attention to market fundamentals which tell a different story.

First of all, during the fourth quarter of 2004, global oil production is expected to be about 2.0mbd more than the average consumption. World production capacity is expected to increase by 1.8mbd by the end of 2004 and by an additional 1.7mbd in 2005. In parallel with supply growth, the first signs of weakening demand are beginning to be apparent, especially in China. In a word, the market is regaining comfort.

A second development is that commercial stocks in OECD countries are building and, at least in Europe and North America, are now near five-year average levels, even though hurricanes have temporarily interrupted some production in the Gulf of Mexico.

The IEA strategic stocks

A third element should not be overlooked. The market needs to remember that there is one very powerful buffer: the IEA countries' strategic stocks. With four billion barrels, they represent more than one year of total output from Saudi Arabia and can be immediately released in case of a supply disruption. Indeed, some strategic stocks were quite rightly released last September in the United States, offsetting a temporary crude supply disruption due to hurricanes. These stocks can be used again in the event an unforeseen event creates a shortage.

The IEA was formed in the wake of the 1973-74 oil crisis with oil security as a core activity. IEA net oil importing countries have a legal obligation to hold emergency oil reserves equivalent to at least 90 days of their net oil imports of the previous year and at present IEA net importing countries are holding an average of at least 112 days of net imports.

The Agency's emergency response systems include maintenance of national emergency oil reserves and plans for co-ordinated use as well as other national measures which include demand restraint, fuel switching, surge oil production or a system for reallocation of available supplies.

Indeed, during the period end-2002 and beginning 2003, global oil markets were tight, affected by low inventories and high uncertainty with strikes in Venezuela, disturbances in Nigeria, and the war in Iraq. The IEA's experience in oil market assessments and emergency response management during this period highlighted the appropriateness of IEA emergency response policies and procedures.

On the other hand, using strategic stocks to lower the price of oil, as some have suggested, would only provide an artificial and temporary respite that speculation would soon erase. Strategic stocks are not tools to intervene in the market.

Proposal for action

Does that mean we must remain passive spectators during this frenzied increase in oil prices? Inaction would render a disservice to our market economies. On the contrary, here are several proposals for action.

First, attention should be paid to market signals. As prices are high, the time is ripe to launch or develop strong energy efficiency policies in all consuming countries, including more stringent fuel conservation standards. The time is ripe also to invest boldly in new capacities, upstream and downstream, especially in refining. Some positive recent decisions are very welcome (particularly in Saudi Arabia), but all governments should carefully review their investment framework policies, withdraw bans on private investment, dispel regulatory uncertainties and take steps to overcome opposition from local communities to new investments. Light-to-heavy crude spread is increasing? This should be a good incentive to invest in conversion facilities, as some refiners have recently announced. This market promises to be sustainable as demand is increasingly for light crude while supplies are increasingly of heavy crude.

Next, it is essential that markets remain comfortably supplied throughout the coming months. The second quarter of 2005 will be particularly important in this regard, due to the fact that oil demand generally weakens seasonally at this time. OPEC countries must use this period to allow stocks to build and not reduce production again, as they unfortunately announced they would do in 2004.

And, last but not least, it is critical to improve data transparency. Too often the market does not have confidence in the figures published by companies or by governments. The Joint Oil Data Initiative(JODI) launched by the IEA in cooperation with OPEC and four other international organizations is an important step toward increasing market confidence. The G-7 Finance Ministers recently called attention to the importance of this initiative and urged the IEA to continue its efforts to improve data transparency. The Agency is ready to take on this challenge, but needs the support of governments around the world, since they provide the fundamental information on which the data is based. The assessment of geological resources and reserves is another area of uncertainty and dispute and thus also creates additional tension in the oil market. The IEA will take on this issue as well, working with other specialized organizations.

Calling for lower prices is not enough. It is time for governments, industry and individuals to act. Do not let technical analysis and pessimism rule the market alone.