Article

Commodities

Oil: a cheap but scarce resource?

Content available in
Spanish Catalan

Jordi Gual

The price of oil is a key variable for the world economy and that is why it is essential to understand its main determining factors in the medium term as well as its long-term tendential trend. This month we have devoted the Monthly Report's Dossier to this very issue. As with other products that also function as a financial asset, economists refuse to even attempt to explain very short-term movements. Such a refusal may be a sign of ignorance but perhaps also of wisdom.

In the medium term the price of crude oil follows what are known as super-cycles; in other words, periods of ups and downs whose overall duration is approximately 10 or 15 years. Essentially these super-cycles are the result of different responses by agents (producers and consumers) over different time spans to an initial change in the price. In the short term the reaction of both is moderate (i.e. supply and demand are relatively inelastic to price) but we do see extensive modifications in production and consumption behaviours over the medium term. Put another way, low prices may continue for some time but this very phenomenon provokes the forces that lead, after a few years, to structural increases in demand and reductions in supply, resulting in significant rises in price. In the last 45 years we have seen two phases of sharp price rises (1973-1980 and 2002-2011), two phases of sharp drops (1980-1986 and 2011-2015) and an unusual phase of low-price stability (1986-2002). This last period is evidence of the oligopolistic nature of the international crude oil market, a factor that also crucially determines its fate. The super-cycle diminishes if, in the phase of potentially limited production, the oil cartel loses cohesion and this, given the pressure of demand, stops producers from responding by restricting the supply.

From the super-cycle perspective, this month's Dossier argues that we are probably coming to the end of the period of falling oil prices, a total slump of approximately 75% since the peak reached in 2011, a similar figure to the one seen in the 1980s. If OPEC is capable of restoring a certain degree of internal discipline under Saudi Arabia's leadership we should see higher prices in the future, returning to 60 dollars over the next three years and exceeding 70 within five.

With regard to the long term, economic analysis suggests we should see a rising trend in price in real terms; i.e. the relative price of oil in the economy. A finite resource should get more expensive as its stocks run out. In practice the real price of oil has fluctuated widely over the last few decades, as we have already mentioned, but curiously it has now returned towards its mean price of approximately 55 dollars (in current purchasing power parity). Four decades are classed as long term but oil reserves have turned out to be larger than expected and this is probably why the upward trend in the price has been almost inexistent in the last half a century.

Such an upward trend is unlikely to emerge in the future either. Not because there are huge reserves still to be discovered or because great technological advances are expected to exploit oil more efficiently. What will probably prevent this long-term increase in price will be the environmental impact of oil consumption: if humanity wishes to meet its goals of controlling CO_2 emissions an important part of the reserves of fossil fuels yet to be exploited will actually be stranded assets. Competition among energy sources will hence emerge. This provides a strong incentive for oil-producing countries to place their reserves on the market in good time, giving up prolonged monopolistic agreements that might only result in short-term gain but long-term pain.

Jordi Gual

Chief Economist

29 February 2016

Jordi Gual

Tags
Oil