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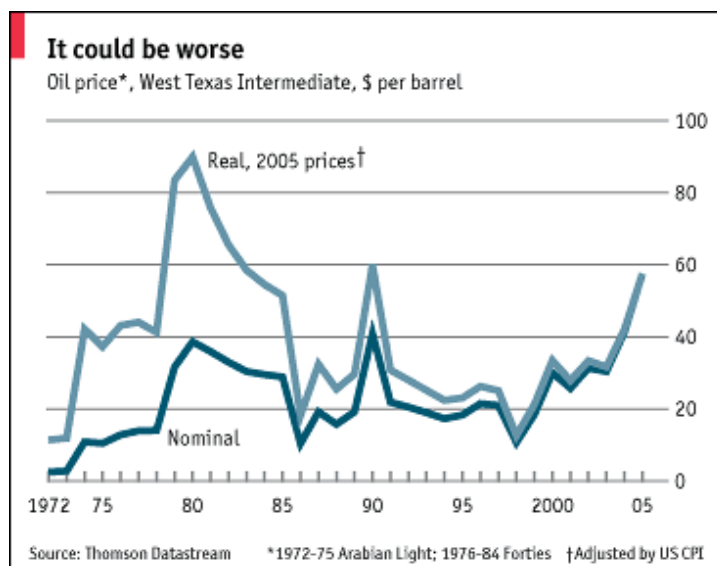
A titanic struggle between supply and demand

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From The Economist Global Agenda

Oil has hit another new high, and OPEC has promised to raise its production by another 500,000 barrels per day to help ease the pain. But with capacity tight and demand continuing to grow, high oil prices may be here to stay

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TALK about record oil prices is beginning to get a bit tedious; oil seems to be hitting new highs with the regularity of a metronome. This is, naturally, more than a bit tedious for consumers, who are having to dig ever more deeply into their pockets. More frightening still, it might get worse before it gets better. Last week, Goldman Sachs released a report predicting that oil prices may stay above \$50 per barrel for several years. Oil prices obliged by jumping. On Monday April 4th, light crude hit \$58 for the first time ever.

OPEC has responded by promising to open the taps. The oil cartel's acting secretary-general, Adnan Shihab-Eldin, said on Monday that it was ready to produce another 500,000 barrels per day (bpd) if prices stay high. But according to experts, the market is so tight that this may be of little help. Oil prices, remember, barely paused for breath following OPEC's last production hike, of 500,000 bpd, on March 16th.

Only six years ago, many, including *The Economist*, were predicting that oil would stay at a lowly \$10 or so per barrel for the foreseeable future. Nonetheless, as the authors of the Goldman Sachs report point out, the laws of supply and demand are catching up with an oil-hungry world. There is barely any excess capacity in the oil industry, which makes it hard for the market to meet new demand. Russia, the producer to whom markets have been looking for salvation, has seen its rapid production growth level off in recent months, and the other non-OPEC nations are thought to be producing about as much as they can. Meanwhile, even OPEC has little margin to spare: by one estimate, the cartel can pump only another 1.5m bpd—a small fraction of its members' current quotas of 27.5m bpd—before it smacks up against its production ceiling. With the International Energy Agency (IEA) forecasting oil demand to grow by 1.81m bpd in 2005, supply and demand would seem to be heading for a showdown.

The analysts at Goldman Sachs think the only thing that can restore equilibrium in the market is a sustained period of high prices that forces a cutback in consumption. This would give producers time to build more capacity, which could sate demand and cushion supply shocks, such as the Iraq war. Part of the reason that prices are so high is that today's tight margins mean that a natural disaster or political unrest can leave the world without enough oil to go round. With big producers like Nigeria, Venezuela and Iraq looking unstable, people selling contracts to deliver oil in the future are demanding a hefty premium to cover the risk that the contract may mature in the middle of a shortage.

So far, however, that premium does not seem to be translating into lower consumer demand. When oil spiked in the 1970s and early 1980s, consumers responded by using a lot less of it. This time, however, they seem blithely unconcerned. Economies have become a lot more fuel-efficient over the past 20 years; as a result, spending on petroleum products is a smaller percentage of income. Governments have also begun taxing fuel more heavily, so that the price of crude makes up a much smaller fraction of the price consumers pay at the pump. And in Asia, where a lot of the demand growth is coming from, fuel prices are generally controlled by the state, so consumers aren't feeling the pinch as much as they should. In 2004, international energy prices went up by 40%, but in oil-guzzling China they rose by only half that.

For all of these reasons, the Goldman analysts reckon that prices need to go—and stay—higher still before demand begins to weaken. In real (inflation-adjusted) terms, oil reached its all-time high in 1980, of around \$90 a barrel (see chart). Back then, OPEC saw revenues plummet as consumers cut back sharply. This time around, Goldman thinks that it might take prices of more than \$100 per barrel to make consumers retrench.

Demand-side economics

These sorts of price levels are a big problem for oil-importing nations, particularly if they are sustained. Long bouts with high energy prices bring on stagflation, the combination of high inflation and low growth that erodes incomes and undercuts economic stability. With that in mind, the IEA has issued a draft report on how countries can build emergency programmes to deal with high oil prices.

Some of the report's ideas are worn-out. It proposes a rapid expansion of car-pool lanes, for instance, despite these having failed to get people sharing vehicles in America. However, in an interview with the *Financial Times*, Claude Mandil, the IEA's executive director, suggested something that could make a difference: ending fuel subsidies. Asia is forecast to generate 40% of the global increase in oil demand in 2005; letting the market's price signals get through to consumers would help demand align with supply before a crisis develops.

Over the longer term, global capacity will need to expand. High prices should eventually attract companies looking for new oilfields to exploit. As oil majors such as Shell have been forced to restate downwards their estimated reserves of unpumped oil, the pressure to find new fields has grown further. This week, ChevronTexaco announced that it was buying Unocal for \$16.4 billion, a

move heralded largely for beefing up the American oil giant's exploration and development business.

But new capacity takes years to come onstream; in the meantime, the woes of the world's oil consumers seem likely to grow. Surging oil prices could stall the fragile recoveries of many industrial nations, particularly Japan, which is a heavy oil importer. Europe is somewhat more insulated by its high fuel taxes, and by the euro: since oil is priced in dollars, the dollar's depreciation against the euro has mitigated the damage. But with German and French economic growth still weak, rising fuel prices might yet be the straw that breaks the camel's back.

Perhaps the biggest worry of all is America, which is highly exposed to the price of oil, because of its low taxes, and because oil is priced in its currency. America has led the way out of the global slowdown. If oil prices hit hard, might it lead the way back into the next one?

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