Our View: Financial Contagion in a Restructured Oil Market

Neither OPEC nor Saudi Arabia acts as a central bank of oil.

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There was a time when banks were irrelevant to oil markets. Multinational oil companies monetized their oil only when the product went into cars or trucks, and inventories did not need to be financed.

That economic world vanished more than 40 years ago. However, oil ministers and executives from US oil companies seem to have ignored the change. Thus, they blame dramatic crude price declines on "speculators" and large investors deciding to abandon their positions in futures markets. They also ignore the financial condition of refiners and traders, their primary customers, who must borrow from banks to purchase crude.

Given the specter of customer runs, banks are cutting back on loans and raising their lending rates. Consequently, their oil refiner and trader clients must pay higher costs when financing their crude purchases. Not surprisingly, they will now borrow less and buy fewer barrels.

This occasion is the fourth time oil-exporting countries have ignored the financial markets' role in funding oil transactions during periods of contagion.

> In the 1980s, the oil-exporting countries dallied as interest rates rose and economic activity slowed. They were oblivious to the potential market effect of the failure of Penn Square bank in Oklahoma and the following closure of Continental Illinois. Eventually, oil prices collapsed to $10 per barrel.
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> They ignored the Asian debt crisis as well, even though oil prices were low by today's standards, only taking action after oil dipped below $10.
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> Oil ministers also largely disregarded the financial contagion after the Lehman Brothers collapse. While OPEC announced a production cut in October 2008, it did nothing more until the end of the year as prices dropped from $110 to $40 per barrel.

This also is the fourth time that oil prices have collapsed. In the past, some have described Saudi Arabia as the central bank of oil. The absence of a prompt Saudi or OPEC prompt to current events demonstrates the fundamental error of this view. Central banks take responsibility for market stability and move quickly to address problems regardless of their cause. Oil ministers, in contrast, do nothing and blame others for market developments.

A quote incorrectly attributed to Albert Einstein is appropriate here:

> **Insanity is doing the same thing over and over and expecting different results.**

Those in OPEC—and many in the oil industry—have once again responded to contagion by saying the same things and expecting different results. Consumers are the winners, benefiting from the price decreases. Oil company shareholders and those who live in oil-producing countries are the losers.