Oil Markets on the Brink

Oil markets teetered on the edge of a precipice as *TIE* went to press. The benchmark Brent crude price had declined 33 percent from an August peak of $115 per barrel to a mid-November low of $74. Further decreases seem likely. Any attempt to paper over the crisis at OPEC's November meeting, the results of which are unknown as yet, is irrelevant.

Saudi Arabia has caused the fall in oil prices. The Saudis have watched as increased production from the United States and Canada has slowly but steadily whittled down OPEC's market. Initially, they apparently thought they could ignore this effect. However, as time passed the threat became larger and more immediate.

All OPEC members must know one other troubling fact: they no longer have significant market power.

The Saudi response has been to offer refiners a bargain they cannot refuse. The Kingdom does not set an absolute price for output. Instead, it offers customers deals tied to their markets. In the past, Saudi Arabia established price discounts no other suppliers could beat. They are doing that again today.

The declining demand for OPEC oil has led the Saudis to this action. Projections of the future "call on OPEC" (and hence on Saudi production) have been steadily cut. Three years ago, the International Energy Agency wrote that OPEC production would need to surpass 32 million barrels per day in 2015 to keep prices stable at $110 per barrel. The IEA prediction has been dropping ever since. Most recently, the agency warned that OPEC output would have to be less than 29.5 million barrels per day to keep prices stable at $80.

The earlier forecast of 32 million barrels per day lulled the fears of oil exporters. The large exporters were also probably reassured by forecasts of stronger global economic growth and by output disruptions in countries such as Iran, Libya, Nigeria, and Syria. They were not yet worried about increased output from the United States.

More recent events have awakened producers, particularly Kuwait, Saudi Arabia, and UAE. They have recognized the present need to defend their market share, even if that means allowing prices to fall to very low levels for a time. The leading OPEC members understand that such prices will gradually suppress rising U.S. and Canadian production. They also realize that falling prices may hurt other countries such as Venezuela. In truth, they probably do not care who has to cut. They care only that it happens.

All OPEC members must know one other troubling fact: they no longer have significant market power. The market elasticities are such that a

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The ExxonMobil oil refinery in Baton Rouge, Louisiana, the second-largest in the United States.

significant reduction in OPEC output will have an almost insignificant impact on their revenues. OPEC's exports, which today amount to around 21 million barrels per day, are worth a little less than $600 billion at $75 per barrel. A reduction in exports of 10 percent that raises prices to $90 might boost revenues 3 percent or 4 percent at best. In short, OPEC has lost its leverage over the oil market.

Restoring oil prices to higher levels will require a prolonged period of lower prices or an agreement between several of the larger non-OPEC oil exporters (Canada, Norway, Russia, and Oman) to join in reducing production substantially. At this point, I anticipate the first scenario will come to pass. Lower oil prices will slow investment in new oil production across the world. They will also provide a needed boost to the global economy.

Back in 2011, I warned in these pages that the world would see three price cycles before 2020 (see "Blundering to $300 per Barrel," *TIE,* Summer 2011). While I did not predict the precise cause, we are stumbling toward the bottom of the first cycle. The loss in investment in new production caused by low prices in 2015 will lay a foundation for much higher prices in 2016 or 2017.

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Two Views: Either China's Buying Up the World…Or the Elite Are Rushing To the Exits

"China's outbound direct investment is for the first time set to exceed investment into the country, highlighting the ongoing shift of global economic influence to the east. Outbound direct investment rose 21.6 percent in the first nine months compared with last year to $75 billion and on Wednesday a senior Chinese official said that on current trends it would probably exceed inbound investment by the end of the year."

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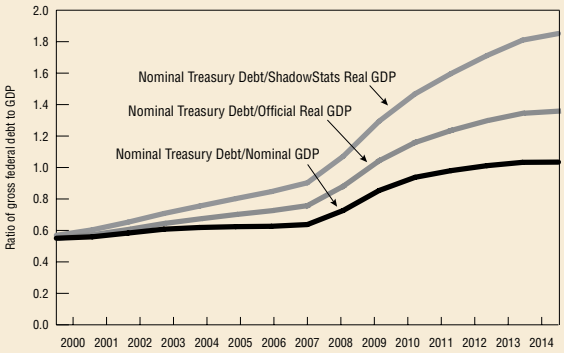
"China's economy grew at its slowest pace since the depths of the global financial crisis in the third quarter and is on track for its worst annual performance since 1990, when the country was under international sanctions in the wake of the Tiananmen massacre. … Chronic overcapacity, particularly in industries that supply the real estate sector such as steel and cement, has led to China's longest period of producer price deflation on record, with prices falling at the factory gate for the 32nd straight month in September."

—Financial Times

Department of Corrections

In the article "The Inflation-Debt Scam" by Paul Craig Roberts, Dave Kranzler, and John Williams in the Spring 2014 issue, the bottom line in this figure on page 43 was incorrectly labeled. Below is the corrected figure.

Figure 1: Debt-to-GDP Ratios



Sources: ShadowStats.com, U.S. Treasury, Bureau of Economic Analysis