Are we on the eve of another oil crisis?

The 40% increase in the price of crude oil will have few consequences on the growth of the American and Canadian economies

With the price of oil hovering around US$40 to $42 a barrel in the past few weeks, most analysts have been forced to acknowledge they did not have on hand all the analytical factors when they made their predictions early in the year. Nevertheless, the supply of oil exceeds demand: OPEC (Organization of the Petroleum Exporting Countries) currently yields two million barrels a day, above the officially established quotas, and the entire group of producing countries have not reduced their flow. So why are prices not dropping and rising instead?

In addition, the extent of the demand was underestimated. The need for fuel in China and India have amazed observers by their scope; we are seeing more and more that it is a structural, not just a contextual, demand. The growing demand adds to concerns in terms of the availability of the quantities produced and boosts the prices traded.

Finally, we fear that the supply in oil for the summer will be very tight or insufficient in the United States. Keep in mind that our neighbour to the south accounts for 5% of the world population, but consumes close to one-fourth of the world’s oil supply. Analysts predict a hefty demand for oil since the economy is pumping at high speed. However, the level of inventories is relatively low compared to previous years. Simultaneously, the production capacity of refineries is nearing 96%, which does not leave much wiggle room to boost the quantities produced. Due to the fuel legislation in various US states, we know of twenty or so types of oil with different specifications. We can imagine all the scenarios possible of the non-availability of oil or problems in shipping. Although the refinery capacity of the United States is greater than what it was two years ago, its rate of present-day output is interpreted by the market as an element of vulnerability. Will motorists come up dry this summer? Nothing is less certain, but markets have reached a fever pitch and the price has been reacting in kind. As well, Canada and Quebec are part of this North American dynamic and cannot escape the price increases.

A risk premium is added

The answer to that question is manifold, so allow us to point out three major factors. There are many who agree that the current price includes a risk premium. Fears linked to the delicate situation in the Middle East (Iraq and border countries) and in the Near East (Palestine and Israel) as well as the terrorist attacks near oil facilities or terminals make us fear a breach in the supply from that region of the world. Some of these concerns have indeed materialized and acts of sabotage have been carried out in Iraq and Saudi Arabia this spring, which bumped up the price of crude oil. In addition to these apprehensions are the political instabilities in Venezuela and Nigeria, two major oil-producing countries. In short, tension has a price, and it must be paid.
Other items come into play

Beyond the factors evoked above, other items come to colour the analysis. The issue of reserves is being increasingly bandied about. In recent years, certain major development companies have painted a less rosy picture in terms of future development capabilities. In fact, reserves are less copious than initially estimated. The debate is coming to a head: will the pivotal moment when the supply of crude oil stops growing be reached within 5 years, 10 years or 30 years? Some affirm that that point has already been reached, and that the current prices are nothing compared to those we will have to pay in the near future since we were not able to pave the way for a transition to other types of energy. Although the jury is out on that question, such concerns on the longevity of the resource are in addition to the current concerns and can add their share to the soaring price of oil.

Furthermore, a great number of oil fields have already reached their maximum and it is increasingly costly to extract the resource. New oil fields in operation require more effort since the resource extracted is much deeper underground and this requires a more costly technology (for example, bituminous sand, platforms, and thousands of kilometres of pipelines). This increase in development costs is significant and is eventually reflected in the price paid. That is why expectations around US$20 a barrel, for a long period, are increasingly illusory.

Other items come into play in the current price dynamic. The US situation is the best documented. In view of the high prices and wide refinery margins for gas, some companies have opted to dedicate a more substantial portion of their operations to gas production, leaving – for the time being – a lower production capacity for the markets of heating oil, fuel for airplanes and diesel. The relative scarcity thereby created helps raise the prices of these types of fuel. What is more, there are new expectations of a future shortage in heating oil in the third and fourth quarters of this year, and this is adding to the jumpiness of today’s markets.

We must point out that the soaring prices of oil additives (ethanol, in particular) add to the current burden. The market seems to be turning any news that is unfavourable to the price of oil, or any hesitation, into an increase. For instance, the Bush administration’s intention not to make available to the public the strategic US reserves have helped prop up the high prices. Will this resolution be held until the fall? We’ll be watching.

Are we now in the midst of an oil crisis?

From the outset, the answer is no. Oil crises, as they were dubbed in the 1970s and 1980s, are more the outcome of a fast and furious rise in prices rather than an increase as we are now witnessing. In fact, the price of oil broke through the $US30-a-barrel threshold more than a year ago. A few spikes up to US$26 and $27 a barrel occurred in 2003, but they were short-lived. We must keep in mind that in 1980 the price of a barrel hit more than US$100 per barrel in today’s dollars. We haven’t reached that point yet.

Globally, the International Monetary Fund (IMF) estimated that an increase of US$10 a barrel (approximately US$30 to $40 barrel), taking place over one year (a situation quite similar to the one we are currently experiencing), would reduce real global GDP by 0.5% in 2004 and 2005. Predicted growth would then dip from 4.6% to 4.1% in 2004, and from 4.4% to 3.9% in 2005, which does not resemble a lull in the economy. On the contrary, a rise in oil prices could be viewed as a constraint to the vigorous economic recovery, especially in China, which in the end would be beneficial to global economic growth over the medium and long term.

The impact on the US and Canadian economies

If we look more closely at the case of the US economy, we cannot draw the conclusion either that the recent upturn in the price of oil has become an imminent risk thwarting economic...
growth. Of course, Americans remain greedy energy consumers and any hike in oil prices, and hence in gas prices, cannot be good news in itself. We must point out, however, that in proportion to the economy, oil consumption has been practically cut in half since the late 1980s. It is not very likely, then, that the economic jolts sustained by the skyward trends in oil prices in the 1970s and 80s could take place again now.

We must not assume that the rising price of oil is entirely harmless. US consumers and enterprises consume close to 20 million barrels a day. This means that a hike of close to US$10 in the price of a barrel is equivalent to a “tax” of US$70 billion on the entire year’s economy. Since a year’s economy is worth approximately US$11,500 billion, the “energy tax” represents a little more than 0.6% of the economy. That is not the net effect, however, since Americans still produce 30% of the oil they consume and a certain substitution between the various energy products and/or various products requiring oil can also occur over the medium term. Given these factors, along with the bolstered growth that is foreseen for the United States this year and in 2005, we can be reassured straight away about the relatively marginal character that the current rising oil price will have on the US economic cycle. The risk of the economy of our southern neighbour getting off track is therefore very small, especially in a context where inflationary pressures are comparatively moderate.

In Canada, as elsewhere, the soaring oil prices will obviously be felt on the economy. On the one hand, the increase in the price of oil could have an adverse impact on consumer spending in real terms. Nevertheless, we must remember than a net improvement in energy efficiency over the past few decades has desensitized our economy to wide fluctuations in energy prices. On the other hand, without being a primary player on the international scene, Canada is still an oil, gas and coal producer. For example, in 2003 Canada had an output of 3 million barrels of oil per day, which represents a little less than 4% of the world’s production, and puts Canada in eighth place on a global scale.

Since Canada’s demand for oil is less than its output, Canada is a net exporter of oil, and our companies generally come out winning in a situation of rising oil prices. That is to say that the drawbacks encountered by consumers are to a great extent offset by the advantages to the corporate sector. At the end of the day, the fallout on the Canadian economy of an increase in oil prices is less damaging than one would think. According to a study by Finance Canada, an increase of $1 in the real price of oil generates a decrease of 0.05% in real GDP after four quarters, and 0.1% after eight. This means that the recent rise of approximately $10 in the price of oil could, if it were maintained long enough, curb real Canadian GDP by close to 0.5% over the short term.

The future price of oil: Pandora’s box

How will the price of oil behave in the near future? In all likelihood, the heightened production proposed by Saudi Arabia (of 8.35 million barrels/day in April to 9 million in June) will not ease concerns. Why not? Because the type of additional oil that country is prepared to market is not the most popular now for oil; it requires specific (read: more costly) processing owing to its high content of sulphur. The other OPEC members are pondering whether to follow in its footsteps and raise current quotas. None of them individually has an excess production capacity as impressive as that of Saudi Arabia. They will make their decision officially known on June 3rd, at their upcoming Beirut meeting. Until then, the markets will assume a trend, and will be greatly perturbed.

Those who are counting on a hike in prices in the next few months are arguing that the summer driving season has not yet begun in the United States and hence prices will rise over the summer because of the heightened pressure on demand.
Some have even wagered that a barrel could reach, and even top, US$50 this summer. Those betting on a barrel at US$50 and higher are not very numerous.

Still others fear that the current conduct of some US refineries, which “divert” their output to gas rather than heating oil, will not keep the pressure on high prices in the autumn.

Some observers believe that the current value, fluctuating around US$41 - $42 a barrel, will encourage non-producing members of OPEC to supply the market and raise the supply from countries whose safety is less a concern – at least, for the time being. This extra source would help lower prices. Although very attractive, this thesis was sorely tested this past year, when an expected drop in prices, attributable to a considerable contribution of the production by non-OPEC members, did not materialize.

Analysts fear that the current hike will generate an overly high rate of inflation that would spark a rise in interest rates and, thereafter, an economic slowdown. A cooling of the global economy would lower the demand for oil and force prices to sink closer to US$30 a barrel. It is a little early to lend this hypothesis much credence, unless there is a lingering hike in prices beyond US$50 a barrel).

Most analysts believe that the price of oil beyond US$30 a barrel is here to stay. Despite supply that is greater than demand, the uncertainties surrounding supply are omnipresent and cannot be brushed aside in a context of the transfer of power in Iraq in late June, where more than two million barrels are extracted on a daily basis. Tension could mount even higher in the weeks surrounding the event. Furthermore, the escalating confrontations between Israel and Palestine could add to market jitters. In addition, there are rumours that OPEC will raise its price spread for a basket of crude oil (7 different types of oil) with a target more in line with US$30 than $25 a barrel. In the same breath, rumours surrounding a slowing pace of production in China could have the opposite effect. In short, all factors are present to keep prices high for a few more months – close to the US$40-mark – but, above all, with a great deal of fluctuation.