

invasion, has, unwittingly or not, allowed Iranian influence to establish itself in Iraq. US complaints of the Iranian role in the country, particularly the assertions concerning the export of terrorism, baffle most Iraqis. Major Shi'a parties that had sought asylum in Iran and built close and cordial relations with various Iranian political institutions, including the Revolutionary Guards, returned to Iraq after 2003. Some of their members have assumed senior positions in the post-2003 governments.

Moreover, the USA decided to make Iraq a major theatre of war against al-Qa'eda. The presence of these extremist groups accentuated the sectarian conflict in the country, particularly in 2004 and 2005, leading to much bloodshed and communal strife. At the same time, Iraq witnessed the rise of local resistance forces against the US occupation.

The United States tried and did succeed in winning the support of some of the Iraqi opposition groups which – together with the Iraqi armed forces – have been able to deal major blows to terrorist and sectarian forces throughout the country, particularly in Baghdad, Basra and Mosul. Yet, the military victories have not stopped the daily carnage that is bleeding the country. There is now a fragile peace, and it is expected that any of the groups mentioned above will wait for the opportune time to resurface again, most probably with assistance from neighbouring states.

Much of Iraq's future security will depend on the SAFA agreement being negotiated between Washington and Baghdad. There are many issues under discussion: How many US troops will remain in Iraq? What will be their functions? To ensure security throughout the country, as they are doing now, to provide training to the Iraqi army or to remain idly in some military bases?

Other important questions concerning Iraqi security and relations with neighbours also arise. How is the USA or Israel going to deal in the future with the Iranian nuclear issue? What would Iraq's role be should a military confrontation take place? How would such a conflict impact Iraqi political parties, particularly in the oil-rich southern part of the country? Would there arise in Iraq a disciplined party loyal to Iran, similar to Hizbollah in Lebanon, a party that would act as a proxy to Tehran while occupying at the same time a significant place in the country's political system?

Finally, what role would the new Iraqi army play in the country's political system? The USA since 2003 has definitely introduced substantial structural transformations in the organisation of the armed forces. The system introduced by the British during the mandate in the 1920s has been changed. We do not expect the new senior officers to be aligned or sympathetic to Arab nationalism, as was the case in the past. Most of the new officers are either Shi'a or Kurds, who have different allegiances and political

sympathies than the Sunni Arabs who monopolised the top military positions under previous regimes.

Having said that, one can still assume that the newly formed Iraqi army would interfere once more in domestic politics, as happens in many Third World countries. One may wonder about the alliances with neighbouring states that the officers may want to establish; and about the reactions of these states to the creation of military regimes (or political regimes strongly influenced, albeit indirectly, by the army). Would they allow Iraq to create new political systems in the region?

It is doubtful that Iraq's neighbours will look on passively if Iraq were to forge alliances with Iran or Syria. Such alliances would adversely affect Iraq since both these countries exert much influence within Iraq. They represent a threat to its sovereignty. And there will be opposition from other neighbouring states.

Moreover, Iraq's economic security in the future depends very much on maintaining a more cordial, or at least much less hostile attitude, towards neighbours than was sometimes the case in the past. The bitter experience of the past three decades amply demonstrated that because Iraq is almost land-locked its oil exports could fall to a very low level in the absence of good and peaceful relations with the surrounding states. And this outcome will be obtained despite the huge proven oil reserves that the country possesses.

## Whither OPEC?

### Robert Mabro asks when OPEC is a cartel and when it is not

Since 1973, the year of the first oil price hike imposed unilaterally by OPEC, this organisation of oil-exporting countries has been continually labelled a 'cartel'. The *Financial Times*, for example, systematically follows every mention of the word OPEC in

articles or reports with the clause, the oil-exporting countries cartel.

The trouble with labels is that they seem to impart full information about the entity to which they are attached albeit in a short-hand form. In reality, they conceal as much as, if not more than, they reveal. Most people do believe that they know perfectly well what the label means. It is obvious, isn't it?

What at first appears to be obvious

often turns out not to be obvious at all. Once a label is stuck on a person, an institution or a phenomenon the need to enquire about the real person, the true nature of the institution or the phenomenon at hand fails to emerge. There is no need for that need. In short, labels are the enemies of research, of serious attempts for better understanding.

It is important to know the exact nature of OPEC – is it a cartel or

something else? There are several types of cartels, in the same way as there are different types of oligopolies. They do not, all of them, operate in the same manner. How does OPEC operate? And did the nature of OPEC change from one episode to another of its 48-year history? Finally, how significant are the discrepancies between the OPEC reality and the perceptions of an outside world shaped by this 'cartel' label that fails to tell us anything of interest.

My first point is that the changing nature of OPEC related to the specific structure of the world petroleum market that obtained in each particular period. When OPEC was founded in 1960 its Member Countries (Iraq, Iran, Kuwait, Saudi Arabia and Venezuela) had no direct involvement in the exploration, production and exports of crude oil. These operations were entirely performed by a small group of international major oil companies under long-term concession agreements. The companies paid to the host country a royalty and a notional income tax per barrel produced. This system continued when other nations joined OPEC later in the 1960s and the beginning of the 1970s.

OPEC countries depended financially on the payments made by the concessionaires, and these revenues were a simple function of tax-cum-royalty per barrel and the number of barrels produced.

OPEC during this period was akin to a trade-union always engaged collectively in negotiations with the revenue provider for increases of per barrel income (the wage). Some members, as was the case with Iran under the Shah, will also repeatedly ask the companies to increase the volumes produced on their territory. The companies did not always oblige. The collective bargaining involved solidarity which would be weakened if individual attempts to increase market share at the expense of other members turned out to be successful.

The 'trade union' managed to obtain small concessions from the companies such as the expensing of royalties. The more important result of the establishment of OPEC, however, was that

the companies from then on never reduced the posted price which they fixed unilaterally. The posted price determined, given other parameters such as the tax and royalty rate and the nominal cost of producing a barrel, the per barrel take.

The very weak bargaining position of the 'trade union' characterised the relationship between governments and companies throughout the 1960s. OPEC's position became stronger at the end of that decade. A member country, in that instance Libya, taking advantage among many factors of favourable market conditions in the Mediterranean, managed to obtain increases in the posted price. This success was achieved by a member acting on its own, not by the collective action of the trade union.

The Gulf members of OPEC then obtained similar price increases thanks to a simple clause in the concession agreements which one often finds in bilateral trade treaties. This is the 'most-favoured nation clause'. Every country signatory of an oil concession contract must obtain all the advantages secured by another country. This led to the so-called Tripoli-Tehran-Tripoli agreement of the early 1970s. At that time, I quipped that OPEC was redundant. Favourable market conditions enjoyed by any individual country coupled with a most-favoured nation clause are all that is needed to secure generalised concessions from oil companies.

The power of the 'trade union' increased significantly in the early 1970s. This was largely due to two major factors: the very rapid growth of global oil demand that began to tighten the supply/demand balance in the world petroleum market, and a new rise of nationalism in most OPEC countries. There were threats of nationalisation of oil assets by some countries, and milder demands of equity participation in the investments of the concessionaires by some others including the politically moderate Saudi Arabia. Higher posted prices, tax and royalty rates were obtained. The strength of a trade union depends on the state of the relevant market and on the ability to strike.

## No cartel up to this point.

Things did change in 1973. The negotiations between the 'trade union' and the companies broke down. The petroleum market had become very tight. A number of market indicators – tanker freight rates, product price realisations and crude oil spot prices – were rising. The prices of all primary commodities were rising between three to five fold. The companies knew that oil prices must be significantly raised. They did not want to be part of such a decision however. They would run into trouble with the governments, the media, and public opinion of oil-importing countries. They asked for a long pause in the negotiations. This was unacceptable to their OPEC counterparts. Furthermore, the October war had broken out in the Middle East. A few days later, Arab oil-exporting countries (but not OPEC) meeting in Kuwait decided on an embargo against the USA and Holland, and production cuts across the board to make the embargo effective.

In this context OPEC no longer negotiated over prices with the companies. It decided to administer the prices on its own. It raised twice the official price (the replacement of the price previously posted by the companies), once in October and once at the end of December 1973.

This development was labelled the 'oil price shock' in importing countries. However this was not the most important event. The economic impact of this shock did not last for very long, at least in OECD countries. The significant event with long-term implications was a structural transformation of the petroleum system. The major oil companies gradually ceased to move oil produced by them in OPEC countries through their internal channels. Now, they bought it arm's length from the various exporting countries. The previously integrated structure had become de-integrated.

## The two major consequences were as follows:

First, OPEC became the administrator of the oil price. Between 1973 and 1985

OPEC used to determine the price of Arabian Light 34°API as the reference for transactions in international trade.

Secondly, de-integration caused the emergence of an open market for international oil. And markets always diversify over time. We thus saw the emergence, besides long-term contract transactions between companies and countries, of trades between companies, an expanding spot market, the famous 15-day Brent forward physical market, and sometime later futures exchanges in New York and London. This final development gave rise to an explosion of different types of derivatives many of which are traded over the counter.

A price administrator is not necessarily a cartel. Nobody accuses the monetary committees of the Bank of England, the US Fed or the European Central Bank, those who administer the interest rate which is after all the price of money, of being cartels. So long as OPEC fixed the reference price of oil and passively accepted the impact on the demand for its oil it was not acting as a cartel because it did not curtail production to support the price. It was a price maker and a volume taker. This was the case until 1982.

The structural transformation of the mid-1970s simply meant that OPEC has been facing complex markets, never fully transparent, instead of the small group of oil companies with whom it used to negotiate. Solidarity was more easily achieved in the former state of the oil world, even if some members of the 'trade union' made tougher demands than other members.

In 1979–81, a tight oil supply/demand balance pushed market prices above those fixed by OPEC. The market was leading, and the administrator lagged behind. OPEC was universally blamed for this second price shock. The important point that is missed when one rushes to the accusation that OPEC is responsible whenever oil prices rise is that the actual market may have played a role. Supply tightness due to the fall in Iranian production, the scrambling of consumer countries, particularly Japan and some European ones, in search for additional import volumes caused prices to skyrocket.

The paradox is that a price rise leads to the view that OPEC in such circumstances is strong. The truth is that when the market leads OPEC is in reality weak if it does not then have the means to rein in market forces.

And the symmetrical proposition is that often OPEC is *potentially* strong when it is generally perceived as weak because of stagnant prices. This is the only type of situation when it could, if it so wished, effectively intervene.

**“So long as OPEC fixed the reference price of oil and passively accepted the impact on the demand for its oil it was not acting as a cartel”**

The first episode when OPEC tried to act as a cartel, that is to restrict production in order to support prices, was in the period 1982–85. It introduced production quotas, but the fall in the demand for OPEC oil from 30 million barrels per day in 1981 to just above 16 million barrels per day in 1985 (due to considerable increases in non-OPEC production and a fall in world oil demand) was too big. No entity, however strong or sophisticated could cope with it. Agreements on quotas were not well implemented. Saudi Arabia took the brunt of the shock in its attempt to defend the OPEC price; its production fell over four or five years from more than 10 million barrels per day to just above 3 million barrels per day. This was unsustainable. Saudi engaged in an undeclared price war against both OPEC members and other exporting countries with the introduction of a devastating weapon, the netback pricing system.

Paradoxically, this is when OPEC was acting as a cartel because only cartel members engage in price wars to discipline other members.

OPEC took the view after the catastrophic 1986 events that it could no longer administer the oil price. It will instead follow the market by using

market-related formulae to price its oil in exports. This is where we are now.

As well explained by Bassam Fattouh in this issue, OPEC cannot directly get the market to deliver its preferred price. It is essentially a price taker who tries to signal to the market to stop a price decline or to raise current levels when prices are either falling or deemed to be too low. The only signal it can use is the decision to reduce production quotas. Markets can receive the signal and act upon it or simply ignore it and indulge in scepticism. There are so many negative views about OPEC that can easily feed this scepticism. A market positive response to an OPEC decision on production cuts can be delayed because of long time lags between a decision and the actual changes in oil flows in the final market. Oil travels for a long time toward destinations and it then needs to be refined and distributed in product markets.

To the extent to which OPEC uses production as an instrument to influence prices, the cartel characterisation applies. But the episodes when this behaviour has been effective were rare and usually of short duration. Once again OPEC was indeed a cartel in 1998 when prices were brought down through a price war launched by Gulf countries against other members.

Finally, OPEC has been more often passive than in the instances mentioned by Fattouh – the situation when markets push prices up and up. It behaved passively on many occasions in the late 1980s and in the 1990s despite the fact that prices then were low.

At that time many commentators prepared OPEC obituaries. But OPEC is still alive.

To quote Mark Twain, OPEC could say 'The reports of my death are greatly exaggerated'.

In short, things are not as they appear to be. Simplifications and labels lead to gross misunderstandings. An oil price rise is not a proof that a cartel is in operation. Gordon Brown was misled by this wrong criterion when he accused OPEC of causing the price explosion of the first half of 2008.

A price fall due to a price war is an unmistakable sign that a cartel is in existence. And one always needs to remember that the market plays a major role, and that it is strong when it is considered weak and weak when it is believed to be strong.



## Bassam Fattouh describes OPEC's dance with the market

### Introduction

In its emergency meeting on the 24<sup>th</sup> October, 2008 OPEC decided to cut oil output by 1.5 million barrels per day (bpd) from existing quotas. This reduction amounts to around 1.8 million bpd as some members were already producing above their quotas. After the meeting, OPEC president, the Algerian oil minister, announced that the cut will be '100 percent effective' in stabilising prices. The immediate response from the market was negative: WTI prices tumbled to a low of \$62.65 on the OPEC announcement but then settled at \$64.15 by the end of the trading day. But this reaction may still prove to be at odds with future responses.

The OPEC communiqué revealed deep concerns about the fall in oil prices describing them as 'unprecedented in speed and magnitude'. It added that the 'slowdown in oil demand is serving to exacerbate the situation in a market which has been over-supplied with crude for some time'. The communiqué sent a warning to oil importers that falling oil prices 'may put at jeopardy many existing oil projects and lead to the cancellation or delay of others, possibly resulting in a medium-term supply shortage'. It also sent a clear message to non-OPEC suppliers that 'OPEC cannot be expected to bear alone the burden of restoring equilibrium' and it called

on non-OPEC producers/exporters to contribute to efforts to restore prices to reasonable levels and eliminate harmful and unnecessary fluctuations. Finally, OPEC sent a signal to the market that it means business by 'strongly emphasizing their firm commitment to ensuring that the volumes they supply to the market are reduced by the individually agreed amounts'.

The decision that OPEC would cut output was widely expected though some media reports were interpreting Saudi Arabia's silence before the meeting as an unwillingness to reduce its production. Whether these output cuts will succeed in preventing oil prices from falling in the short term is a separate matter altogether. As argued below, the shift to the futures markets for price determination that occurred in the early 1990s means that OPEC's influence on prices does not depend only on the signal sent about its intention to reduce production but on how market participants interpret the signal.

This does not mean that OPEC is irrelevant to oil prices in the current context. Since the early 1970s, the organisation's role has been central to understanding the dynamics of oil prices. With the shift to the futures market for oil price determination, OPEC maintained its influence although its interaction with the market has changed in nature. The events of the past four years or so portray an evolving and dynamic OPEC behaviour.

### The OPEC Cycles

It is best to describe OPEC's behaviour in terms of cycles. Interestingly, the role of OPEC changes cyclically from being an active player to a passive one. As argued by this author elsewhere,

OPEC's response to changes in oil prices is asymmetric. In a rising market, there is a tendency towards adopting the more passive approach of supplying upon demand. On the other hand, in a declining market, there is a strong bias towards cutting supplies regardless of the context. This

asymmetry in response implies that the perceived risks associated with a potential collapse in the oil price are too high for any of the members to be willing to bear and seem to outweigh any economic or political risks of adopting a more active strategy of cutting output.

In what follows, we analyse OPEC behaviour for the period 2004–2008.

### 2004–2006: OPEC the Passive Player in a Rising Market

One of the most defining features of the recent behaviour of oil prices has been that expectations about the long-term price have been unlocked. This is reflected in the parallel shift of the back end of the futures oil price curve. While the back end of these curves very rarely strayed outside the \$20–\$22 range for all of the 1990s and early 2000s, this anchor has been lost since 2004. In fact, in the past few months the back end of the curve exhibited high volatility almost matching the volatility observed at the front end.

The conventional framework that dominated the thinking about oil prices was based on the belief that there are strong feedbacks from oil prices to oil demand and supplies. High oil prices would have an adverse impact on oil demand and economic growth, reducing global oil demand or slowing down its growth. High oil prices would also create feedbacks through supply and investment responses in non-OPEC countries. It would encourage inter-fuel substitution at the margin, although with a long time lag. An important part of this conventional wisdom of the early 2000s was that OPEC in response to price rises will have a ceiling in order to avoid demand destruction for its oil in the long term, and to limit the entry of substitutes such as tar sands and ethanol. This view was supported by an OPEC decision to introduce a price band which involved production adjustments if the OPEC basket price moved above \$28 per barrel for 20 consecutive trading days or below \$22 per barrel for 10 consecutive trading days.

The conventional framework had profound implications on the behaviour of oil prices. It resulted in a high degree of determinacy in the long-term oil price relating to supply/demand ‘fundamentals’, and it anchored the back end of the crude oil futures curve at around the \$20–\$22 range. Governments and financial markets thought in terms of that range, and for most of the 1990s no one questioned the validity of this framework, especially at times when spare capacity was sufficiently big to provide a cushion against adverse geopolitical supply shocks.

While there is a current debate about the size of demand and supply feedbacks, and the time lags involved, and on whether the current demand feedbacks resulted from the credit crunch, high oil prices or both, there was an interesting observation which is not widely recognised by oil markets commentators. This relates to the asymmetry of OPEC response to oil price movements. Specifically, the boom of late 2007 and first half of 2008 showed that the main OPEC objective is to defend oil prices from falling below some level deemed unacceptable by its members. OPEC’s role is not to prevent oil prices from rising. More accurately, OPEC assumes a passive role in a rising market. It is reluctant to reduce oil prices by auctioning part of the available spare capacity or to engage in heavy discounting of its heavy crude oil. OPEC does not have an official mechanism to perform the role of reducing prices. Early on in the boom, it has become clear that a price ceiling in a band was never relevant. Yet, at times, the perception that OPEC would respond to limit price rises has been important for anchoring long-term expectations about oil prices.

The latest cycle has raised various hypotheses about OPEC behaviour. Some argue that OPEC has realised that higher oil prices did not have adverse effects on the growth of the global economy and/or inflation, and that oil demand is more price inelastic than they originally thought. The world economy has proved fairly resilient to high oil prices. More sceptical observers argue that OPEC

is not concerned about long-term effects on global oil demand given that there is no sign of an urgent or serious political economic response by OECD countries, and that the climate change agenda is unlikely to seriously undermine demand for oil in the absence of alternative transport fuels. Others have noted that OPEC is concerned about high oil prices but that influencing oil prices is beyond its ability especially since the market perceives that OPEC spare capacity is less than the figure announced and not of the right quality. Yet others have argued that OPEC is concerned about high oil prices and has the ability to influence oil prices but is politically constrained as actions to reduce the price of oil by any one of its members are likely to be met with criticisms from the local population and other members. There are also fears that any action of OPEC may induce a downward spiral of oil prices which the organisation may not be able to control.

“One of the most defining features of the recent behaviour of oil prices has been that expectations about the long-term price have been unlocked”

#### Early 2007: OPEC the Active Player

OPEC’s passive behaviour was interrupted in 2007 when it became highly concerned about the rapid accumulation of inventories. The organisation feared that high inventory levels can induce sharp falls in oil prices if physical traders decide to unwind their position and flood the market with supplies in response to a change in market sentiment. OPEC responded by cutting supplies. Although in 2007 the growth in global oil demand was positive, the growth of oil supply turned out to be negative, mainly because of a reduction in OPEC output. This meant that oil-importing countries had to tap into their oil stocks, reducing the level of crude oil inventories. This caused

the spot price to rise and changed the shape of the futures curve from contango into backwardation.

#### The First Half of 2008: OPEC the Passive Player

For most of the first half of 2008, when oil prices began to rise sharply, OPEC resumed a passive role supplying the market upon demand at oil prices ‘determined by the market’. It did not attempt to bring down prices by auctioning its spare capacity or offer discounts for refineries to lift its heavy sour crude. In a way, OPEC was comfortable with its position. A market in backwardation meant that there was no incentive for oil importers to accumulate inventories. At the same time, spot prices kept rising as the market perceived low stocks as an indicator of low oil supplies. Furthermore, concerns about long-term supplies intensified. Although there were clear signs of weakening demand in OECD countries, excess supplies did not manifest themselves because OPEC passively adjusted its output in line with the demand for its oil.

#### The Jeddah Meeting: A Concerned Saudi Arabia

The sharp rise in oil prices during the first half of 2008 created serious concerns about the potential impact of oil prices on OECD economies which were already showing signs of a slowdown and potential financial problems. The data on US oil demand released by the EIA were pointing towards a sharp contraction. The year-on-year change in US oil demand turned negative in August 2007 and has remained negative since then. This, however, did not dent the rise in oil prices as oil traders continued to condition their decisions on the weak dollar. Amidst rapid rises and sharp volatility in oil prices, Saudi Arabia called for a meeting in Jeddah in June and announced that it would increase its output by an additional 500,000 bpd outside OPEC quotas in an attempt to calm the oil market. This decision was made despite Saudi Arabia’s repeated statements that the ‘market is well supplied’.

The decision to add 500,000 barrels per day can be considered as a change in the supply-upon-demand policy towards a more active approach aimed at curbing the rise in oil prices. Whether this additional output was taken by the market and whether it was responsible for the subsequent decline in oil prices is highly debatable. Oil prices reached their highest levels after the Jeddah meeting and there was not a rapid rise in inventories despite the slowdown in the growth of global oil demand. The more plausible story is that once market sentiments turned negative, news about the extent of the decline in US demand intensified. The fall in oil demand became the main public signal on which traders started coordinating their decisions. In any case, this experiment to put a ceiling on oil prices was very short-lived and by September Saudi Arabia was back on its passive policy of supplying ‘whatever the customers want’.

### OPEC Dancing with the Market

The organisation’s latest decision can be best described as ‘OPEC dancing with the market’. This involves a series of moves, some that have already been made and others that are expected in the future.

In the first step, traders talk about the amount that needs to be cut. Anything below that amount is considered as ‘worthless’ or ‘not enough’ to alter price expectations. It is very difficult to explain how certain numbers come to dominate the market’s psyche. But the number of ‘more than 1 million bpd’, later raised to 2 million bpd, became the barometer to test whether OPEC’s output cut is big enough.

In the second move, OPEC responds by announcing cuts of more than 1 million bpd. If the signal is successful in stabilising expectations, OPEC will not have to resort to output cuts. Instead, it will continue to supply upon demand at a price that the organisation is comfortable with given current market conditions. However, OPEC signals are rarely successful in stabilising short-term expectations in a falling market.

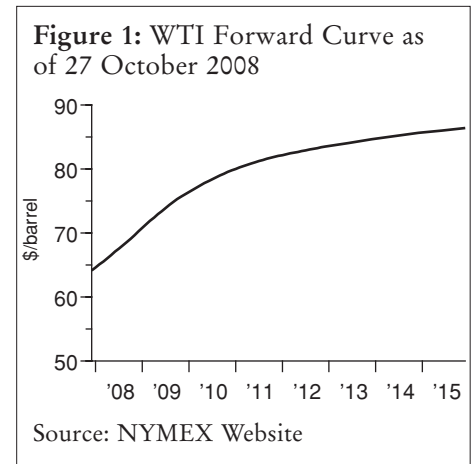
As expected, this latest decision has

had a limited impact on oil prices so far. As discussed above, one major feature of the current oil markets is that prices have entered a phase of indeterminacy where market participants including oil companies and oil producers do not know where to anchor the oil price that balances supply and demand in the long run. This is affecting the behaviour of short-term prices as long-run and short-term prices seem to be co-determined. This has become apparent in recent price behaviour when both short- and long-term prices rose and declined simultaneously (although the falls were less pronounced at the back end of the curve).

In such a market, traders watch public signals. Even if news does not convey accurate information about the fundamentals of supply and demand, they tend to be misinterpreted, causing oil prices to overreact to news in either direction. As there is an abundance of news and information, traders will limit their attention to few signals that they think other market participants would also consider as relevant at every particular point in time. Until July 2008 traders conditioned their decisions on news about inventories, potential supply disruptions, and the weak dollar. The situation has now changed and the market has switched to coordinating on public signals about the demand for oil and health of the world economy. In these current circumstances, OPEC signals about output cuts are likely to be washed out by news about the depth of the recession, the decoupling of Asia, and the impact that these have on global oil demand. This is likely to keep a downward pressure on oil prices in the near term.

The extent of undershooting will be affected by the term-structure of futures prices. While both the front end and the back end of the oil price curve have seen sharp declines in the past two months, long-term oil prices have fallen more slowly. This may be due to concerns about long-term supplies as the market expects that the current crisis will induce a slowdown in investment and tighter oil market conditions in the future. Alternatively,

this behaviour may be unrelated to long-term expectations about supply and demand and is due to the current weakness of the market in the short term where the bulk of the trading activity is concentrated. Either way, the term-structure has shifted to contango with the price of the first month futures contract falling below the prices of subsequent contracts for each maturity as shown in the figure below. A steeper contango could result in an accumulation of inventories leading to further falls in oil prices as high inventory levels are usually interpreted as reflecting a supply glut.



In the third move, traders demand to see actual cuts in productions. After all, OPEC signals do not involve a cost and are often perceived by the market as not credible. Traders think that OPEC signals in a falling market are some sort of cheap talk that they could ignore. This is the phase when the market starts doubting the viability of OPEC. In the past, OPEC’s announcements of output cuts and the phrase ‘the death of OPEC’ went hand in hand. For instance, in 1998, when the Dubai price approached \$10 per barrel, many observers claimed that OPEC had lost its ability to defend oil prices with many observers predicting its demise. This time is no different. Many commentators are questioning whether OPEC will be able to implement these cuts given the ‘divisions’ within OPEC, the different needs of their members, and the difficulty of sustaining an unanimous production decision in face of falling demand.

In the fourth move, as oil prices

continue to fall, OPEC will succeed in implementing production cuts. Despite their divergent needs and interests, the source of the pain (falling oil revenues) is the same. Some members may be more able to withstand the fall in revenues than others, but eventually as oil prices fall, all oil-exporting countries (including non-OPEC) will feel the pain. The main difference from the 1998 situation is that the oil price that OPEC wishes to defend is much higher now than it was ten years ago. This may affect OPEC's resolve to act swiftly, and in the current context it may take a long time before Member Countries adhere to their quotas. However, falling oil prices will eventually induce OPEC members to react, and more

often to overreact, by implementing excessive cuts for traders to take them seriously. Since these cuts take time to feed through to the system, there is a risk that they will tighten supplies at a time when the global economy is about to bounce back from recession. This would worsen the global economic outlook.

### Another Missed Opportunity

The recent behaviour of oil prices has raised the issue of whether policy via the oil importer–oil exporter dialogue should seek to establish a stable medium-term expectation of the oil price that can help dampen the cycles. Unfortunately, this is not likely to work as the interests of the two

groups remain highly misaligned. In a rising market, OPEC switches to a passive mode. In a falling market, oil consumers switch from an active to a passive mode. This is clearly reflected in Mr Gordon Brown's recent plans to downgrade the international oil summit (to be held later in December 2008) to ministerial level as the 'most worrying situation in the world' a few months ago (i.e. high oil prices) is no longer a pressing issue. The current cycle has confirmed once more that oil producers and consumers cannot agree on a 'fair' oil price that satisfies the needs of both parties and that oil price cycles which have always been the defining feature of the oil market in the past will continue to prevail.

## Letters

Dear Editor,

### The Oil Price Conundrum:

#### A comment

Robert Mabro provocatively raises the question as to whether oil prices can safely be left to the market, concluding that they cannot. He suggests a new regime involving an agreement between large importers and exporters involving a system of price administration consisting of a committee to examine and comment on the fundamentals and which would 'define a reference price at regular intervals'. The system would need to be backed up by the physical capacity to intervene. Effectively, Robert Mabro is calling for the reestablishment of the consumer/producer dialogue with a cooperative research and intervention mechanism on top. He rightly notes that 'political vision and much goodwill' would be required!

There is always a temptation to intervene, often in a heavy handed way, to control prices which are too important to leave to the market. But the history is not favourable. Domestic agricultural protection, on just these grounds, is a sorry tale. Commodity agreements have come and gone. International attempts to manage exchange rates

– such as target zones – have proved fragile at best. Why should oil markets be any different?

The answer, according to the article, is that the oil market is not fit for purpose. Avoiding the loosely used term 'speculation', the suggestion is that financial markets (including the trading arms of oil companies) play an undue role in the determination of the oil price. Drifts or 'bubbles' may lead to overshoots (in either direction) and extreme volatility – which is damaging to investment and supply capacity and to producer and consumer countries alike. A system which gives a greater role to the 'fundamentals' (including institutional help in determining what they are!) would be of benefit to all.

I see the situation rather differently. What appears to have happened since 2004 is that the market became detached from any idea of what the longer-term fundamentals actually are. The whole futures curve moves up and down in parallel fashion. With no anchor in the future, the oil price, within wide (and apparently ever wider) limits, driven by small pieces of news, can be almost anywhere. The system is close to indeterminacy.

An explanation for this recent volatility is the *lack* of feedbacks in the

international oil market. Famously, demand and supply elasticities are very low in the short run. Increasingly, they appear low in the longer run as well. (For example, non-OPEC supplies have been disappointing despite high prices; investment, for all sorts of reasons, cannot or does not respond). Much of this is not new, though the extent of non-response has surprised analysts. What is new is the *lack* of response to high oil prices via the world economy. In OECD countries, the recent impact, larger than the great oil shocks of the 1970s, has not led to the expected inflationary recession that was widely anticipated. (The credit crunch is another matter). This is startling. First, it means that demand does not fall nearly as much when oil prices go up as previously anticipated. Second, indirectly, producers and particularly OPEC, have learned that this is so and market operators see that this is so. So the potential feedback via market perceptions that OPEC would limit price rises for fear of longer-term 'demand destruction', has also gone out of the market. Add to this the fact that any expectation that the Strategic Petroleum Reserve (SPR) would be used to lower oil prices (or to quell a rise) has gone, since, surprisingly, this