

Saudi Arabia and the limits of signalling

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‘Exporting countries, and more generally, the industry, have much to learn from oil developments in recent months. Lessons can be derived from an analysis of the causes of the oil price fall ...’ Robert Mabro wrote this in 1998, and added: *‘An opportunity has now arisen for oil-exporting countries, both from within and outside OPEC, to re-think the framework and substance of their co-operative policies. ... The oil price crisis may prove deeper than initially thought and may remain immune for a while to the remedy which OPEC and other oil-exporting countries are trying to apply.’*¹

The ‘oil market’ – this difficult-to-define collective entity, which, through its collective ‘sentiment’ or ‘consensus’, determines the going prices for various contracts or ‘paper barrels’, which in turn conditions the prices of physical barrels – has an extraordinarily short memory. Several commentators have rushed to argue that today’s situation is different from that in 1985–6, and again from 1998, while in fact there is a simple common feature: there is too much oil in the

market at prices that have for too long remained unreasonably high.

The dynamics of the oil market are characterized by a succession of delusions and corrections. Trading in paper barrels feeds some widespread delusions – beliefs that cannot possibly withstand critical analysis, yet which come to be accepted as received wisdom. Such delusions are not promptly corrected in a market which – rather than moving towards an equilibrium of global demand and supply – allows profits to be made by those able to guess in which direction collective sentiment will go.

As the price is driven further and further away from equilibrium by invented explanations, eventually reality catches up and a sharp correction ensues.

Events and beliefs leading to overproduction

Between 2010 and 2014, the market was influenced by the belief that the Arab Spring and consequent political turmoil in the region would affect global oil supply. There was little or no empirical

basis for this belief – as was recognized by all those who said that the price really should be lower, and attributed the difference between actual and equilibrium prices to a so-called ‘political risk premium’. But why and how such a premium should be paid was not clear. It was especially unclear how prices higher than equilibrium prices could avoid leading to overproduction.

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For at least three years it was evident not just that supply was exceeding demand, but also that the balance of possible developments was clearly in favour of further increases of supply in excess of demand. For several years we kept hearing that oil shale in the USA would constitute a revolution, but somehow it was assumed that the revolution would have no consequence on prices. Or we had the IEA stating that almost all potential



resources, including such high cost and speculative plays as the Arctic, would be commercially viable at current prices, while no one believed that prices could drop significantly.

The position of OPEC – and Saudi Arabia

Behind this inconsistency was the mistaken belief that OPEC – read Saudi Arabia – would cut production to defend the price level. The notion of ‘fiscal break-even’ was put forward to justify the belief that oil-producing countries needed a certain minimum level of prices, as if there is any good reason why market prices should validate what individual producing countries think they need. In the case of Saudi Arabia, the assumed fiscal break-even point was in any case significantly lower than prevailing prices, but ‘the market’ found comfort in the knowledge that government expenditure was increasing rapidly in the Kingdom.

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Expenditure was indeed increasing rapidly simply because the money was available, and it is difficult for a government to refrain from spending when a very large reserve has already been accumulated, at a time when several societal demands remain to be met. This does not mean, however, that a certain level of prices is needed; this is because expenditure can, to some extent, be reduced, reserves drawn down, and even possibly some government debt issued. Hence the notion that Saudi Arabia would necessarily reduce production to sustain prices was wrong.

The lesson about the limits to Saudi Arabia’s defence of prices should have been learned a long time ago. Writing in 1986, Mabro commented on the

speech given by Sheikh Zaki Yamani to the Oxford Seminar on 13 September 1985: ‘*The message, which is also the key to a correct assessment of Saudi Arabia’s position was simply that “Saudi Arabia is no longer willing or able to take that heavy burden and duty, and therefore cannot be taken for granted.” The burden was placed by “the non-OPEC producers relying on OPEC to protect the price of oil” and by “most of the OPEC member countries [which] depend on Saudi Arabia to ... protect the price of oil.”*’¹²

Ever since, Saudi Arabia has consistently rejected the role of swing supplier – one which somehow keeps being attributed to the Kingdom. Again in 1998 Mabro noted: ‘*Saudi Arabia, in a very unusual way, has been playing the role of fixed-volume supplier, very different in essence from that of a swing producer who varies output according to changes in world demand, since a big fixed-volume producer does not mitigate the impact of excess demand or supply which emerges from time to time on the world market.*’¹³

The role of ‘price takers’

In fact, the Kingdom has repeatedly demonstrated that it feels responsible for increasing production whenever there are unforeseen supply shocks elsewhere in the global oil system and for this reason it maintains a reserve of unutilized capacity of approximately 2 million b/d. But Saudi Arabia is not ready to decrease production below what it considers ‘normal’, and in any case it makes any decrease conditional on cooperative behaviour on the part of other producers, OPEC and non-OPEC. ‘*At some point during this period [1997] Saudi Arabia began to observe that a small number of OPEC countries, and many more outside OPEC, were benefiting from substantial production increases. ... To see others increasing production while you are staying put [or*

expected to decrease yours] is not a pleasant experience. ... Sooner or later Saudi Arabia was bound to respond.’¹⁴

Why is it, then, that ‘the market’ systematically appears to misread the intentions of Saudi Arabia? Mabro then wrote: ‘*To reduce the likelihood, or at least the intensity of future price crises, the exporting countries need to improve their understanding of market behavior and to develop the skills of how to talk to markets.*’¹⁵ The problem lies in the fact that Saudi Arabia, together with all other major oil-exporting countries, is not active in the market, it just talks to the market. Saudi Arabia and other such countries have thus confined themselves to the role of ‘price takers’ when they should in fact be ‘price makers’.

Signalling and active engagement with the market

The art of ‘talking to the market’ is one that loses effectiveness as it is practiced, because the market comes to expect certain statements and no longer takes them at face value. The strategy of signalling is doomed to failure if it is not coupled with active engagement in the market. One cannot blame Saudi Arabia for not trying. In fact, in May 2009 King Abdullah took the very unusual step of declaring that a price of US\$75–80/bbl would be ‘fair’ for both exporters and importers. This was a very important statement – obviously of more importance than similar statements habitually extracted by journalists from the Minister of Petroleum whenever he appeared at a public event. The price band indicated by the King was also strikingly close to the level of prices then advocated by major political leaders in industrial countries.

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But the market was not impressed. Prices climbed well beyond the higher end of the band indicated by the King, and nothing much happened. Rather, on several occasions the Minister just declared that whatever price was prevailing at the time was 'perfect', thus ratifying the collective wisdom of 'the market' and implicitly acknowledging that the Kingdom was powerless to steer prices in the desired direction.

It is clear that 'talking prices down' is something that Saudi Arabia finds difficult to do, because this attitude is easily interpreted as being politically motivated and subservient to outside interests. Even now, notwithstanding the evidence of excess supply, there is no lack of proponents of various conspiracy theories, according to which the Kingdom has engineered a collapse in prices to break the back of this or that country in order to please Washington, or to pursue its own regional goals. Signalling is, by definition, something that can only be done from time to time and entails discrete policy shifts, it is not an efficient way to steer the market on a day-to-day basis. The latter requires being active in the market – in other words, being a price maker rather than just a price taker and occasional commentator.

Approaches to active engagement and 'price discovery'

I have argued elsewhere⁶ that Saudi Arabia should resort to frequent (weekly) auctions of its crude on a forward basis (three to four months in advance of delivery) in order to generate price signals that would balance and influence the price signals generated on Nymex and Ice on a continuous basis. This approach would be especially effective if other major Gulf producers did the same; in this way, an auction would take place almost every day, and price

signals responding to physical barrel transactions would be generated accordingly.

Price discovery is a game of equilibrium between expectations and current realities. Today, however, expectations – embodied in the price of futures – generate a much stronger signal than current realities, which are frequently unknown. We do not know how much physical oil enters into, or is withdrawn from, the market on a daily basis, nor what the change in stocks is (except for the weekly US data). Being blind to (or ill informed about) current realities, the market responds to inappropriate signals: thus, for example, information about the declining number of rigs active in the USA causes an increase of front month futures prices, even though it is not at all clear that this decline will cause a decline in production, and in any case not in a month's time! 'Another fallacy,' Mabro again wrote in 1998 'is to believe that withholding information, say on production, investment or stocks, improves the producer's position vis-à-vis the market. Transparency pays much higher dividends.'⁷ This calls for better and more frequent statistical information; but first and foremost it calls for producers to be seen to be active in the market, engaging in transactions that will generate the desired and needed price signals.

Mabro's proposal for price management

In September 1999, Mabro proposed that prices should be managed within a band. He wrote: 'In a market that naturally causes prices to collapse or to explode in response to either ill-informed expectations or small physical imbalances between supply and demand, production policies are unlikely to yield the desired price effect. Exporting countries, unhappy about a particular price situation, may change production volumes by too little or too

much. The price target will therefore be missed. Furthermore, market's views about what production policy ought to be rather than what the policy actually is have a significant bearing on the price outcome.'⁸ It is clear today that the fine-tuning of OPEC's quotas is not an effective instrument for steering prices and for avoiding excessive fluctuations.

'THE LONG-TERM PROSPERITY OF THE INDUSTRY ... REQUIRES GREATER PRICE STABILITY AND PREDICTABILITY.'

At the same time, it is also clear that we are witnessing excessive volatility. Price shifts of such magnitude have real costs in terms of: losses in the value of multiple assets, increased uncertainty, and negative impact on long-term investment decisions. The long-term prosperity of the industry, and indeed of the global economy, requires greater price stability and predictability. 'Stability does not imply fixed prices. A certain amount of flexible variations is both necessary and beneficial. What is required is a market that signals correctly the state of the current and the expected future balance of the demand for and the supply of oil. There is clearly a need for a fundamental market reform. This will require the co-operation of all the major players. We are not yet there: the understanding of the issues leaves much to be desired and the political will is very weak. Sooner or later, however, the adverse effects of excessive volatility and damaging price shocks will induce a search for remedial action.'⁹

It is patently far-fetched to expect that some kind of international negotiation encompassing OPEC and non-OPEC exporters, and now also US shale oil producers, may reach a consensus about the stabilization of oil prices. The necessary remedial action can only come through the initiative of the leading exporter (Saudi Arabia) possibly with the support of neighbouring countries such as Kuwait



or the UAE. Others may follow in adopting the same methodology – as they have done so many times in the

past. Once the market regains a credible equilibrium, the Kingdom should accept that major crude oils are

traded and set the stage for such trading, in order to stabilize prices and give credibility to its signalling.

Notes

¹ 'The Oil Price Crisis of 1998', Robert Mabro, OIES Working Paper SP10, 1998, page 1.

² *OPEC and the World Oil Market: The Genesis of the 1986 Price Crisis*, Robert Mabro (ed.), Oxford: OUP/OIES 1986, page 8.

³ 'The Oil Price Crisis of 1998', page 17.

⁴ *ibid.*

⁵ *ibid.*, page 2.

⁶ Giacomo Luciani, 'From Price Taker to Price Maker? Saudi Arabia and the World Oil Market', in Haykel, B., Hegghammer, T., and Lacroix, S. (eds.), *Saudi Arabia in Transition: Insights on Social, Political, Economic and Religious Change*, Cambridge: Cambridge University Press, 2015, pages 71–96.

⁷ 'The Oil Price Crisis of 1998', page 2.

⁸ 'Managing oil prices within a band', Robert Mabro, Oxford Energy Comment, September 1999.

⁹ 'Does oil price volatility matter?', Robert Mabro, OIES Monthly Comment, July 2001.

