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 policy weapon has not been used, even as a threat. Finally, on a longer time scale, the fear that high oil prices would trigger political initiatives, for example on climate change or security, and thus lower future oil demand, has greatly attenuated.

If the story of near indeterminacy is right – that quite large changes in prices don't have very much effect any more – what are the implications? The first is that there is extreme uncertainty about the future oil price. This is both a cause and a consequence of the way the market functions. It would be quite wrong to blame finance or financial operators for this. The industry is just as uncertain about future oil prices and the 'fundamentals' as financial operators. A second is that the market is likely to 'coordinate' on apparently small or even irrelevant public signals. Everyone is trying to out guess everyone else. Or, in Keynes's famous words: 'We have reached the third degree where we devote our intelligences to anticipating what average opinion expects average opinion to be'. The third is that anything that helped to establish a market view of what the 'fundamentals' are (or to limit the range of uncertainty) would help the market to function in a better way.

What kinds of intervention or political change would help? Some aspects of the Mabro Scheme fit directly within this framework. The idea that better public research and analysis of the 'fundamentals' would be helpful is straightforward: it is a public good. What is needed, however, is that markets should coordinate their medium-term perceptions on the results of such research – which might be problematic given the genuine uncertainties. (The Mabro response is a reference price backed up by the capacity to intervene.)

My view is that the key lies elsewhere – in an essentially political commitment to support a broadly agreed range of policies and prices for the future. The political commitment itself is the factor that should stabilise market perceptions. The mechanisms to police the policy could be relatively informal – stopping short, for example of target ranges and intervention arrangements. In other important markets, such as for the dollar in the 1980s, policies of 'benign neglect' have led to serious instabilities which have been reversed as policy changed.

Oil markets have been through a period of 'benign neglect', or, more accurately, something worse – a stand off between producers and consumers (what Mabro calls the blame game). Clearly the establishment of a credible set of international policies towards oil markets is going to be very difficult. For obvious reasons, OPEC finds it politically difficult (even if they have the capacity) to stem a price rise. Moreover there are fears that price falls would get out of control. On the other side, the United States has proved very reluctant to use the SPR, for fear that it would not work.

Any credible framework must involve at least the recognition that prices can be too high, for both parties, and too low, for both parties. In practice, a commitment by consumer countries (especially the USA) to help prevent oil prices falling below some level (say $60), e.g. by building up the SPR, would have a large effect on the prospects for cooperation. Moreover, given concerns over other agendas, such as security and climate change, it would not be hard to make the case for a lower bound – in the interest of consumer countries. With that in place, help from OPEC to prevent price rises beyond a reasonable view of the longer-term fundamentals would also be much more likely to be forthcoming.

Given the recent volatility of oil markets, it is quite possible that even the start of such a constructive dialogue – the end of the blame game and the search for common ground – would make a big difference to the dynamics of the oil market. What is needed is for market operators to start thinking about what kind of regime will be in place in the medium term – which hopefully would start to stabilise short-term prices as well.

Christopher Allsopp

christopher.allsopp@oxfordenergy.org

Dear Sir,

Regarding Peter Fox-Penner and Matthew McCaffrees 'The Oil Climate Bargain: How Fuel Economy Standards May Help Global Climate Policies' (*Oxford Energy Forum* 74, August 2008, pp. 14–17), I agree with the authors' claim that it is in the interest of the United States to reduce domestic oil consumption, and I find the idea of a concomitant 'climate bargain' with the developing world intriguing, but probably slightly unrealistic. Its potential really depends solely on the relative pricing of coal and oil after the US induced price reductions suggested by the authors:

> *Oil and, more specifically, gasoline-saving-policies can have a very large and direct impact on prices... Lower oil prices will carry even greater benefits for the economies of emerging nations*. (pp. 15 and 16)

In other words, if the price of oil makes this fuel more economic than coal, then developing countries will be experiencing a dash for oil without the need for an explicit 'bargain'.

If oil remains more expensive than coal, then it is unlikely that developing countries will be willing to pay for the incremental mitigation costs. However, the situation is not as bleak as might seem, for there are many ways in which mitigation in developing countries could be financed short of bothering the much beleaguered treasuries of the North, such as the Clean Development Mechanism and other (win-win) private sector initiatives.

Yours sincerely

Dr Benito Müller

benito.mueller@philosphy.ox.ac.uk