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WHAT LOWER OIL PRICES MEAN FOR THE WORLD

by Daniel Yergin

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DANIEL YERGIN is Chairman of Cambridge Energy Research Associates, an IHS company. His Pulitzer Prize-winning book, *The Prize: the Epic Quest for Oil, Money and Power*, comes out in a new edition next month. The issues he raises in this article will be central to the upcoming CERAWEEK 2009 in February.

Oil prices are a barometer of the world economy. Rising prices between 2003 and 2007 reflected the best global economic growth in a generation. This high economic growth was brought to an end not only by underpricing of risk, excess liquidity, and overconfidence but also by an increasingly unsustainable commodity boom—of which oil was a crucial part. Now as the world has dropped into recession, oil prices have fallen by more than half.

This fall also reflects the power of price itself. For rising prices set in motion decisions by consumers, governments, and businesses that have changed the course of demand. Now the recession is also weighing increasingly heavily on demand.

Of course, a price “collapse” to the \$60–\$70 range is a collapse only if one forgets that the average oil price in 2007 was \$72 a barrel (and \$66 in 2006). The tight balance between supply and demand was not the only factor driving the increase in oil prices. The last explosion in oil and other commodity prices began in the late summer of 2007, as a weakening dollar set off a “flight to commodities.”

Certainly, oil prices were also driven up throughout July 2008 by psychology; what Professor Robert Shiller of Yale University describes as “contagious excitement about investment prospects.” It was almost like bets in a poker game, with a \$200 prediction being raised by a \$250 prediction, which would in turn be raised by a \$500 prediction. It was all self-reinforcing, creating its own reality.

Yet there were two hidden assumptions in this contagion of enthusiasm. The first was the belief in “decoupling”—that the rest of the world was insulated from a US economic downturn. The reality of the past several months has demonstrated the opposite: how closely economies are linked together in a globalized world. Brazil, Russia, India, and China became known as the up-and-coming “BRICs” by virtue of globalization.

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The second hidden assumption was that price does not matter. Both demand and supply, it was assumed, would not budge as prices soared. Yes, this was just possible, but it would have been the first time in economic history. As it turned out, cycles are still with us.

What was all the more odd about this contagious excitement is that while the price was going up, the energy fundamentals were declining along with the overall economy. Petrol consumption in the United States had hit “peak demand” in 2007 and was beginning to decline. On a global basis, estimates for demand growth for 2008 have fallen from as high as 2.1 million barrels per day at the beginning of the year to 200,000 barrels per day now. Or perhaps zero.

The world oil market is caught in what CERA two years ago described as a “Global Fissures” recession scenario. Total US oil demand over 2008 is down 1 million barrels per day compared with last year. The last time demand dropped this much was in 1981, on the eve of the recession that was—until now—known as the “worst recession since the Great Depression.”

The fall in oil prices is a great bounty to hard-pressed consumers. If you compare the average US gasoline price in July (\$4.14 a gallon) with October (\$2.26) on an annualized basis, the savings to American consumers are \$282 billion (€220 billion, £180 billion). The fall in oil prices is a sort of de facto tax cut—a stimulus package that does not have to be approved by the Congress or paid for out of the beleaguered Treasury.

What will happen to oil prices in a Global Fissures scenario? One of the most important determinants—just as in the 2003–07 increases—is the pace of global economic growth. But this time the question is how deep and long the recession will be and how big the hit on consumer spending. The other crucial question is oil supply itself. How large will be the flow of new oil supplies that have been stimulated by the rising prices and have been under development but were delayed by shortages of people and equipment? Watch what happens in 2009.

Lower prices are forcing energy companies to cut their budgets and hold back on starting some new projects. This will make itself felt in a new turn of the cycle after an economic recovery. In the meantime, it is not only investment in new oil and gas and electric power projects that will be restrained.

The energy policies of the new US administration, as in other countries, will emphasize greater energy efficiency and renewables. A “green stimulus program” is already high on the transition agenda. But the worried question around Washington now is to what degree lower prices will crimp investment in renewables and efficiency.

The answer will not be determined just by energy prices, important as they are. The biggest impact will come from the health of the economy, the nation’s fiscal position, and the availability of capital and credit. With the costs of two wars and a vast financial bailout, and with an impaired credit system, resources for other purposes are likely to be constrained.

In such circumstances, some kind of charge or auctioning for carbon permits may suddenly take on new attractiveness, not just for combating climate change but also as a revenue-raising measure for a federal government that certainly needs the money. ■