World oil economy

Business, Industries

Energy has been the main concern of nations looking for progress and development throughout history, oil has always been one such means of energy that is capable of sustaining the large scale development projects many nations have undertaken, the utility generated by oil cannot be substituted with the same efficiency by any other energy generation means, oil today is used in transportation, manufacturing, infrastructure development, power generation etc.

All the uses of oil are so vital and important in nature that any hindrance in the supply of oil can wreck havoc in the world economic system. In recent years, we have seen the prices of oil reach to new heights and it’s an accepted fact that oil prices fluctuating always deal a blow to the economic system on a global level. Whenever there is uncertainty about oil supply due toviolencein the Niger delta or political turmoil in Iran or Venezuela or due to the Iraq war.

The world markets always react to it and we see a negative impact on the overall economy the prices of oil surge to record heights, such is the case we witnessed in 2008 and early 2009 until recession came into full force and due to dropping demand the prices of oil lowered considerable. But the fundamental question remained energy and the quest for energy and how the global oil economy is working having a direct and immediate impact on the economy of the world. (IEA, 2008)

The reason for this issue to come to the forefront are the oil shocks and their negative effects the world has witnessed in the last few decades, it all started with the Arab-Israeli war in 1973, then came the Islamic revolution in

Iran in 1979, then was the attack on Iran by Iraq and later the attack on Kuwait in 1980 and 1990, then was the operation desert storm for liberation of Kuwait in 1991, further down the line was the War in Iraq after the allegations of weapons of mass destruction being in possession of Iraq, the war in Lebanon with Israel and in recent times the Iran issue threatens to jeopardize the supply of oil to other countries of the world.

Right before the recession started effecting the economies in the year 2008, the world was experiencing a very healthy growth rate, countries like China and India were booming giving a rise to demand of oil and related products which naturally played a role in the rise of oil prices In recent years due to the economic crisis we see that the price of oil experienced a massive drop from the record heights it had managed to reach, and that prompted OPEC which is a organization of oil producing and exporting countries to undertake supply cuts in hopes of controlling the price and stopping it from dropping below and acceptable level. In the last few years, OPEC has made sure that it controls the supply of oil to the market in a tight manner and the recent surge in prices gave them a windfall of profit but it should be kept in mind that the global inventory of oil is low as well and it should not be forgotten that concerns do exist about a shortage of oil in the future which will effectively jam the growth of all countries of the world.

The fact that is most interesting that the prices of oil start depicting the effects of news and speculation even before anything actually happens which is also a reason that speculation plays a very big role in oil pricing mechanisms, since the whole game is about the supply and oil deliveries reaching their intended destinations that’s the core reason that prices get effected by the news and expected events or incidents. (Jesse et al, 2008) The market does possess certain complaints with the oil producing and exporting countries as well, it has been seen time and time again that whenever there is fear that the oil prices are going to experience a big drop OPEC immediately introduces production cuts to balance the effect but on the other hand when the prices of oil hit the ceiling there is very little or almost no effort done by the OPEC countries to control the situation and hence it creates a negative feeling about these countries in the non-OPEC nations.

It wont be wrong to suggest that the entire world economy is more dependent on oil and its resulting impacts then any other single factor, countries like China and India have been going through massive development and they supply their products to markets in the west as well as the east and hence the prices and fluctuations in oil prices and supply have a deep impact on these economies, on the other hand poor nations emerge as the biggest losers in case of major turmoil in oil markets. The rise in oil prices has a fundamental contribution to the increase in inflation and trade imbalances in various countries and the prices of oil start a chain effect hindering the abilities of a country to economically strengthen or at times even sustain the current economic strength.

On a long term basis we witness that nations are increasingly taking interest in resources that can be used as substitute to oil, development of ethanol is one such example of work being done in alternate energy sources, another interestingobservationis that most oil exporting countries are eager to maintain national control over the oil resources but such a strategy also logically leads to less investment in the sector and that's subsequently leads to maintenance of higher prices in the near future. (Jesse et al, 2008) " In an elegant and influential paper, it was shown that oil price spikes might lead to a high degree of subsequent uncertainty that causes firms to hold up their investment projects, thereby leading to a dip in overall output.

In theory, this effect could be important, though there is not yet much corroborating empirical evidence. "(Ben Bernanke, 1983) Some studies done by the IMF in 2003 suggest that a 5$ a barrel increase in oil price would lower the global output by 0. 3%, with Europe and Africa being the most effected areas since Asia, and Latin American does consist of oil exporting countries. The problem here is that the effect on fast paced developing countries is much more then as compared to other countries and secondly if we consider situation of a poor nation which is already facing a heavy import bill, the oil shock can end up being a back breaker for them with the impact being at least 4 times more intense.

What makes oil products different from other commodities based on the demand and supply principle is that fact that it is used for energy purposes and the price effects for the oil producers and people who consumer oil are more difficult to be adjusted to in the short run then on the long run. Over a long run the factors induced by oil price uncertainty and the political uncertainties surrounding it can definitely be managed as societies are known to evolve over a period of time, needs and ways of getting the job done change from time to time, already we see that the world has become wary of the Oil weapon in the hands of a particular cartel which gives them an edge and a negotiating slip for their interests as they are fully aware that the dependence of the world is on the recourses provided by them. (IEA, 2008)

In relation to the countries which are heavily dependent on oil to meet their energy requirements the picture is not so good, as they are so dependent on oil even short run fluctuations have a major impact on the position of their revenues, Oil industry requires massive investments to setup and a long lead time is involved in making the ventures profitable this situation further complicated by oil price fluctuations make it a risky venture. One option for them is to try and diversify the risk they are taking by the sharing of the costs involved with countries they are allied with or the private sector, the existence of oil stabilization funds in countries like Norway can be made of use to stabilize the shocks arising from volatile fluctuations. (Rogoff, 2006)

Another good measure will be for other countries to exercise much more flexible monetary policies, countries that are into commodity manufacturing export like South Africa, New Zealand, Australia allow their exchange rates too adjust accordingly with the fluctuations in the prices for the commodities they export. Similarly oil producing countries will be able to induce exchange rate flexibility helping to avoid the sudden deflation that normally occurs. Another question that comes in every individuals mind is how long will the oil reserves last, every now and then we get estimates providing deadlines like oil will run out in about 50 years time or 100 years time but the fact is we just cant be sure about it, there is another circle of thought that believes that with the developingtechnologyand sophisticated methods it will be possible to discover more oil reserves which may last for a very long time.

Recently questions did arise about the size of reserves of particular countries or large corporate entities like Royal Dutch Shell but the point to be understood is the oil industry is covered with various complexities like the large scale work involved in identifying potential spots for oil reserves, undertaking massive investment to explore the marked areas and then judging the size of underlying reserves due to all these factors the experts tend to prefer taking a conservative approach instead of going full board and then coming up with disappointing revisions knowing perfectly that the prices of oil are directly effected by the discovery of new reserves. (Jesse et al, 2008) The Political side of the Oil game can never be ignored or downplayed since it’s a major factor, for countless years the world oil industry was being ruled by a limited number of corporate giants operating in collaboration and keeping away from each others territories all over the world. The companies had been able to obtain large number of areas in oil rich countries as their turf and were allowed to operate freely.

These corporate entities were operating like state’s functioning within state’s, their roles and ways of functioning have been documented on various occasions by investigative studies and new findings continue to arise on a more regular basis. These companies were allowed to use their massive budgets and resources to influence the elected officials in many of the countries and at certain points even gain outcomes in the political and legal arenas as per their wishes. What resulted from this strong influence were the fantastic terms of agreement and other concessions these companies were able to obtain with ease furthermore they were also able to protect the industry from nationalization policies which were attempted in various countries as well. (Mitchell et al, 2001)

Although today the situation is different from what it used to be as many countries have preferred to operate in the oil industry only with their nationally run entities, but there are other countries which seem to be opening up to international entities and the need to tight regulation and control arises from this situation if the mistakes of the past are to be avoided. It can also be said that the roles of the past have been somewhat reversed in current times, these days companies face far stringent regulations and terms to be met with by some of the countries. On other hand we can also see the example of sanctions imposed by the US on certain oil rich countries which directly hinders the American oil companies from undertaking any research and development of oil reserves in the territories being blocked by the American sanctions.

It is important to understand that in recent times the situation in the World oil industry has experienced a significant shift from what it used to be, the companies have started taking a more professional and business oriented approach, negotiations are done on the basis of mutual benefits. (Borenstein, 2008) Concerns about the future supply and availability of oil due to political reasons arise every now and then but it is very important to understand that the countries producing and exporting oil cannot hold it and disrupt supply for long periods as they themselves are significantly dependent on revenues generated from oil they sell in the world markets so any disruption can only be of a very small amount of time and not something very substantial to be a matter of great concern. (Jesse et al, 2008)

In relation to the growing demand of oil, it is predicted by many researchers that the oil prices will remain high but the high prices should be considered a permanent change in fact the growing awareness of substituting oil and energy based resources should be kept in mind as we know today that large amounts of coal reserves do exist which have not been discovered or are not being utilized at present, such alternative energy resources if brought into action in the future in large scale projects will definitely make the prices of oil dip significantly knowing that the current dip in prices is only because of the recession and demand drops being experienced all over the world, but the recession is temporary and it will pass but the situation will definitely become much more interesting when the alternative energy resources are brought into the market scenario. Obviously the level of oil supplies cannot be sustained indefinitely and some data obtained form research on this topic comes very handy here. (Kate et al, 2008)

In the month of November 2007, the World Economic Outlook 2007 of the international energy agency came up with a finding that was alarming for everyone, stated that a “ supply side crunch leading in the period to 2015 involving an abrupt escalation of prices cannot be ruled out , the findings further suggested that due to short term inelasticity a demand supply gap could open up a gap of about 13. 5 million barrels per day in the p of coming seven years, we also saw similar warnings coming from the CEO’s of Chevron, Total and the royal Dutch shell” Interestingly the paper attributed these findings to be more related to the economic and political circumstances around the world that could hinder the exploration and development of new reserves which are fundamental to the world oil economy.

Furthermore the paper goes on to state that the methods being used to calculate the current oil reserves in the world are variable and have the tendency to be incorrect which creates confusion since no comprehensive and accurate system exists till this point, most of the figures being quoted are nothing more then reasonable guesses. (IEA, 2004) In terms of the future outlook looking at the world political and economic situation it seems unlikely that a positive platform may get developed for wide scale exploratory and development work in potential spots around the world in search for oil reserves which basically advocates to the fact that the world maybe heading towards another oil price shock.

The paper sums it up as that although oil reserves may not run out any time soon and it wont be an abrupt affair as well, the reserves may last for quite some time before the crisis is at our doors but the it is important to develop a system to foresee any undesirable development and take steps to neutralize it before it triggers a crisis which could be one of the worst ones the world is going to see, and like it was suggested that the OPEC countries seem to be taking a lethargic approach towards development of new reserves for the future generation and this needs to be corrected and a more active approach is required from all the parties involved. (Jesse et al, 2008) A study done in the Netherlands also came up with some very interesting findings which are mentioned below:

The study suggests that if the world economy was not hit by the recession then at this point in time the prices of oil could have reached a whooping 200$ a barrel due to supply constraints, it is also suggested that after the recession such a situation of supply constraint and high prices could last well for a decade at least. (Barry, 2005) According to this paper, " Due to the supply strain the oil prices will oscillate between two variables: a) The cost of the marginal barrel of supply as determined by the most expensive barrel plus a margin for supply/demand fundamentals and geopolitical risks, driven by open markets in an OECD economic framework, and) The real User Value of oil – determined by increasingly closed markets (for new reserve exploitation; for bilateral oil trade flows; for refined products), as supported by several of the major OPEC countries and Russia. " The two options above are distinctive price regimes and as mentioned in the paper the prices wont follow one single regime entirely in fact with changing trends an conditions each of the two regimes will come in play time and time again. Some other factors in relation to it are about the oil futures market as it is the indicator and signaling mechanism of the future prices of oil in the international market.

From a traditional point of view high prices of oil should encourage producers to develop and supply more expensive oil and benefit from the high prices but we have not seen any such scenario developing instead the prices are just a test of the consumer behavior towards the changes and the resulting demand. Due to the political and social situation an uncertainty lingers and when such times of great uncertainty are in effect either the price really shoots up or shoots down depending on the conditions. We have already seen the prices shoot up drastically in the last year 2008. It should be understood that although in the short term the actions and reactions of speculators may have an impact on the oil prices but they have no impact in the long run and in the case of current oil prices it is the long run which is the driver behind the volatility. (Kate et al, 2008)

In a period of less the 15 years the consumer base for oil has doubled, the situation has changed rapidly from what it was in the early 1990's, Countries like China and India plus the other developing nations have substantial energy requirements which is naturally dependent on oil, further more the increase in the demand for oil was not exactly being matched by new discoveries of oil reserves resulting in a scenario where we have an extreme strain on the oil industry and the struggle of the industry to provide sustained supply can be understood. Although high oil prices do have an impact on the growth globally but the rate of responsiveness to high prices has not been as substantial till now, at present oil has become a necessity to meet fundamental energy requirements and the absence of substitute resources on a mass level is mainly responsible for the situation. In any given scenario we see that oil will remain the fundamental and the most basic resource for meeting the global energy requirements at least for a few decades.

The recently revised figures by the international energy agency show that over the next 22 years the supply of oil will only increase at half the pace then it was originally anticipated to which will be about 13 to 18 million barrels per day as compared to previously anticipated 29 million barrels per day. The figures further suggest that the development and discovery pace of new oil reserves and supply of new oil to the market will require serious efforts if the world demand for oil has to be met and a global energy crisis has to be averted. The scenario suggests that if some drastic discoveries are not made, oil rationing will be done in countries to accommodate the need for growing and developing countries, further more countries will have to take effective steps in withdrawing oil products subsidies without triggering massive inflation so as to curb the growing demand for oil.

A fierce battle will also begin for domination over scare resources, this can range from tough price wars to even geo political tensions and ultimately even leading to wars. A deep and prolonged recession can be one of the likely outcomes if an energy crisis takes the world in its grip. Quickly shooting up oil prices may not be the only fate the world may face if countries which are non-OPEC but they do possess significant oil reserves step up to the plate and in collaboration with major oil consuming countries make the oil available in the international market, currently these resources are not being developed and made use of due to the massive investment needed in developing them and the uncertainty relating to demand, not to forget the economic crisis the world has been gripped by.

If these countries are able to collaborate and make use of the idle resources then the predictions of massive rise in oil prices in the next decade will fade, although the prices of oil will rise in the future but in a more orderly and controlled fashion without causing any economic turmoil or crisis. (Kate et al, 2008) Steps and measures will be required to change the scenario from an Oil supply constrained condition to a more energy sustainable globe. It is a fact that the world needs time to adapt itself to new measures and steps to reduce the dependence on oil and use the latest technology to develop renewable energy resources and supplement oil with the alternative fuels so that the strain on the oil supply be relieved.

Iraq is one of the major producers of oil in the world but the Iraqi oil producing and exporting capacity has been negatively affected by the constant turmoil and violence in the country, if the conflict is resolved and the violence subsides then the capacity development and supply by Iraq can play a big role in calming the international oil market. (Kate et al, 2008) What needs to be understood that the size of the world oil economy is huge, it produces about 84 million barrels a day which is a huge size by any metrics. A resource being generated and utilized on such a large scale cannot be substituted over night, it will take a very long time for any viable alternative to be developed and for it to be available in a mass quantity.

Only suitable alternatives being developed by using latest technology are the 1st generation bio fuels and by the estimates it becomes clear that although the supply and size of this option will increase but there will be no dramatic and significant rise in the bio fuels to have a big impact on the strain being experienced by the oil supply side. In recent years we have seen attempts made by geo-economic layers to secure access to oil reserves by getting into understanding with oil producing countries not just by business to business contact anymore but by a government to government contact. The importance of geo-politics and international relations can not be ignored In this scenario when the challenges to transform the world into an energy sustainable entity are mammoth and the complexity is expected to increase we set forth on the path to reforming the world oil economy.

We see that the world is in the grip of a credit crisis, very high rates of inflation, imbalances in the balance of trade and a weak dollar, many economies are suffering from the resulting recession and they will find it very difficult to incorporate new measures to adapt themselves to the new situation that has arisen today. The recent windfall earnings made by the oil producing and exporting countries is also something that brings them to the forefront in the global arena, it remains to see whether these funds are used to develop new oil reserves so that the strain on the current reserves is reduced or these funds are withheld and used for other purposes. (Kate et al, 2008)

The geographical and political tensions are already on the rise in the quest for energy and resources, specially since these recourses are in the hands of a small number countries with high concentration, the question that arises is whether the oil exporting countries and the oil consuming countries will be able to collaborate and co-operate with each other to turn the situation towards an energy sustainableenvironmentor will things take a turn towards the worse resulting in conflict and competition for the dominance over resources by all means necessary. The situation will of course be dependent on the condition of the gap in supply and demand the level of growth being experienced in the world.

Confrontations can be expected between these countries as one group will be of the countries holding the keys to al the resources and the other group will be the one in need of these resources. In recent times we have also seen threats by countries like Iran to not only halt petroleum supplies but also block the channel through which oil is supplied to the rest of the world from the middle east, this is one scenario which we are likely to witness incase there is war in Iran. In recent times King Abdullah of Saudi Arabia invited oil consuming and producing countries to the Jeddah summit to discuss the developing situation in the oil markets and the impact of oil prices on the world economy. Hopefully this can be the start of the collaboration and co-operation hoped for between the countries to a better tomorrow.