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Common Factors behind Past Crude Oil Price Plunges

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My special bulletin reports have reiterated that the crude oil price plunge since the second half of last year has emerged as one of the most important factors in analyzing the international energy situation. In this report, I would like to compare the latest crude oil price plunge with earlier ones in and after the 1980s and look into common factors behind those plunges.

In this regard, it may be interesting to compare the latest crude oil price plunge with two earlier ones from early 1986 and from late 1997. For the international energy situation, the plunge in 1986 had a great enough impact to produce the term "reverse oil shock.” It was viewed as the reversal of crude oil price spikes that were triggered by two oil crises in the 1970s and came as a great problem for the world economy and international politics. For the comparison, I here refer to the benchmark West Texas Intermediate crude futures price on the New York Mercantile Exchange. The WTI price, after standing above $30 per barrel in late November 1985, began to plunge in early 1986, fell below $15/barrel in February and bottomed out at $10.42/barrel in late March 1986. Later, the price remained slack below $20/barrel for a long time, excluding a period around the Persian Gulf Crisis and War in 1990/1991.

There were two major factors behind the crude oil price plunge. The first one is the easing supply-demand balance on the market. After crude oil prices rose sharply amid the second oil crisis, the world economy dived into a recession with global oil demand continuing to decline in the first half of the 1980s. High oil prices amid the oil crisis stimulated an increase in non-OPEC oil production in such regions as the North Sea and Alaska in the first half of the 1980s, helping ease the supply-demand balance in the international oil market. In those market environments, however, crude oil prices remained high. This was because Saudi Arabia clearly played as a swing producer to cut its output in response to the easing supply-demand balance. As a result, Saudi Arabia's output dropped to one-fifth to one-fourth of a peak at some 10 million barrels per day. In the face of the output drop, Saudi Arabia took initiative in a general OPEC meeting in December 1985 in vowing to “restore the market share”, adopting netback sales for a price-cutting race. The Saudi action was the second major factor behind the price plunge.

How was the price plunge from late 1997? The WTI price remained above $20/barrel until November 1997 before beginning to gradually fall from December. It slipped below $16/barrel in January 1998, below $14/barrel in March and below $12/barrel in June. The price basically stayed slack later, bottoming at $10.72/barrel in December 1998.

This plunge also resulted from supply and demand factors and the OPEC (Saudi Arabia) oil production policy. After driving global oil demand growth, Asian developing countries' demand growth slowed down under the Asian currency crisis triggered by the Thai Baht's free fall from July 1997 and remained weak in 1998. Even in such market environment, major oil producing countries were ambitious to increase output, including Venezuela that expanded oil production from 2.24 million bpd in 1990 to 3.32 million bpd in 1997 under its foreign investment promotion policy in the 1990s and was seeking to increase output further. Venezuela thus chronically violated its OPEC production quota.

At its meeting in Jakarta in November 1997 when the Asian currency crisis was deteriorating, OPEC decided to "raise" its production quotas by 10% instead of reducing them in the face of an easing supply-demand balance, surprising market participants. Some observers viewed OPEC as misreading the supply-demand situation in making the decision. But others believed that Saudi Arabia attempted to lower crude oil prices substantially in order to restore discipline in the oil cartel where production quota violations were chronic. In this way, the easing supply-demand balance and policies of oil producing countries (including Saudi Arabia) played a decisive role in leading to the crude oil price plunge.

These past cases in some sense remind us of the proverb that "history repeats itself." This is because a combination of an easing supply-demand balance amid growing shale oil production and last November's Saudi Arabia-led OPEC decision to refrain from cutting production quotas has been seen behind the present oil price plunge. As a matter of course, a detailed comparative analysis may point to not only such similarity and commonness but also differences in the degrees of futures market development and links to financial markets and in geopolitical conditions. Nevertheless, we can see some interesting points in and learn some lessons from the historical comparison.

One point is that an oil price plunge could lead to a price hike later by stimulating demand and holding down supply growth as oil price changes drive feedback effects on supply and demand with some degree of time-lag in the international oil market. In this sense, some price cycle always exists in the market. This may be a permanent trend. But there is another key point indicating that an OPEC production policy change can serve as a major factor behind large short-term oil supply and demand changes. In response to the 1986 oil price plunge, OPEC at its general meetings in late 1986 and in the first half of 1987 proposed its revival of the fixed oil price at $18/barrel and production cuts to that end, paving the way for oil prices to rise back later. OPEC also decided to reduce output at its general meeting in March 1999 in response to the oil price plunge from late 1997, triggering a later price hike. Furthermore, OPEC's decision on substantial production cuts at its general meeting in December 2008 worked to reverse the oil price plunge after the 2008 Lehman Shock.

OPEC and Saudi Arabia hold the key to how or whether crude oil prices will move in the future. If no change comes in their production policy in line with the current consensus forecast, a conclusion may be that supply and demand fundamentals will take some time to be adjusted in response to the current low prices.

Given that the crude oil price plunge from late 1997 triggered the realignment of the global oil industry into the present state of existing “super oil majors”, a focus of attention at present is how the current price plunge would influence the global oil industry after encouraging Royal Dutch Shell to purchase BG Group. In this sense, we may have to keep close watch on future international oil supply and demand and on Saudi Arabia where important personnel changes are taking place under new King Salman bin Abdulaziz Al Saud.

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