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The paradoxical oil shock of 1998

by William Engdahl

The all-time record highs in recent weeks on the stock markets of almost all European countries and the United States, and the deepening economic impact of the so-called "Asian crisis," share one element in common: the collapse of world oil prices.

From October 1997 to mid-March, world oil prices, measured by the price of North Sea Brent crude, had plunged 40%. At the low point, Brent was trading at $12.70 per barrel (a year ago, it was above $21 per barrel). The price collapse for less-high-grade oil, such as Mexican and many Persian Gulf grades, had fallen below $10 per barrel, the lowest price since 1988.

On March 22, oil ministers of Mexico, Venezuela, and Saudi Arabia met in Riyadh, Saudi Arabia, and announced a plan to cut production in order to revive fallen prices. How effective the plan will be remains to be seen. Organization of Petroleum Exporting Countries (OPEC) ministers were scheduled to hold a meeting in Vienna on March 31, to formalize the agreement. If that meeting fails to produce a convincing result, oil analysts predict that the price will begin dropping again.

The background

Oil prices began to fall in January, when demand from the economically devastated Asian region began to fall. In the first three months of this year, 500,000 barrels per day (bpd) fewer went to Asia. Given the mounting economic effects of the Asia crisis, the fall in demand can be expected to worsen. Exacerbating the weak demand for oil globally in the first quarter has been the extraordinarily mild winter weather in North America and Europe, which has reduced seasonal demand for heating oil by an additional 500,000 bpd.

In the face of this 1 million bpd loss in effective demand, OPEC made a bizarre decision in its annual November meeting, perhaps guided by economists who did not grasp the reality of Asian events. OPEC agreed to raise its member production quotas beginning on Jan. 1 by some 2 million bpd. But, Venezuela said that it found the present quota structure wrong and would ignore it. Before the Riyadh meeting, Venezuelan President Rafael Caldera had refused previous Saudi feelers for an emergency conference, and had sworn that Venezuela would "not cut a single barrel."

Obviously, the prospect of a repeat of the 1986 oil price collapse, when world prices fell below $9 per barrel, forced Venezuela and other countries to rethink their positions. Venezuela is now producing 800,000 bpd over its OPEC quota, and excess supply worldwide was estimated at 1 million bpd before the Riyadh agreement, i.e., Venezuela was pumping some 80% of the excess.

Whether the Vienna meeting will forge a workable deal, is open to question. Two OPEC members, Iran and Indonesia, have said that they will cut, not based on current output, but on the theoretically allowed official OPEC quota—contrary to the intent of the Riyadh accord. Non-OPEC producer Norway, the second-largest oil exporter after Saudi Arabia, has so far declined to make voluntary cuts.

"I would be very cautious about the outlook for the market," said Mehdi Varzi, chief oil strategist in London with Dresdner-Kleinwort Benson. "We need to know how many countries are really committed, from what level they are cutting output, and for how long the cuts will stick. The effects of the cuts could only become apparent in May or June."

The economic impact of the oil price fall on exporting nations could not come at a worse time. Mexico, which depends on oil exports as a major dollar earner, has been forced twice since January to announce savage budget cuts, as a consequence of oil revenue drops. Russia, also a major oil exporter, has seen the ruble come under pressure as the price of its second-largest foreign currency earner collapsed. And, throughout the Persian Gulf, the price collapse has damaged government plans. Saudi Arabia's Aramco, the world's largest integrated oil company, has announced that it is rethinking plans to invest several billion dollars in new refining and oilfield development projects.

Ironically, the oil price collapse which threatens to push several emerging economies to financial ruin, is fuelling the stock market speculative bubble. Since January, the stock markets of every major European country have soared to all-time highs, from London to Frankfurt to Paris to Milan to Zurich. The same on Wall Street.

Falling oil prices affect this frenzy in two ways. First, it has an impact on projected price inflation. Falling inflation leads investors to expect falling interest rates in bond markets. Falling interest rates, in many places at postwar lows, tempt speculators or large banks to borrow in hopes of making a killing in stocks, not unlike the Wall Street frenzy of 1927-29. The cheap oil prices, in effect, drive the stock bubble.

However, both effects cannot long coexist. The low oil prices, if they continue, will push several highly indebted nations, such as Mexico or Russia, over the brink. If oil prices rise because of the OPEC meeting, to a projected $18 per barrel, that would reverse the falling interest rates and make stock speculation far more expensive. Given the derivatives leverage of the stock markets in Europe and the United States, that could trigger a full-blown stock market chain-reaction collapse which would make the Asia crisis pale by comparison.

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