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The Dynamics of Global Oil Prices

Alvin Chew

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Oil prices have declined in recent months in tandem with the slowdown in the global economy. Its significant tumble by more than 50 percent in a short span of three months has nonetheless triggered analysts to wonder if the current prices are in the stable range of trading.

EARLIER THIS year, analysts were projecting oil prices to climb to close to US\$200 per barrel by the end of 2008. However, the recent financial meltdown in the United States, unleashing a possible global economic recession, has seen a sharp downward trend on global oil prices in the wake of weaker demand. Global oil prices have tumbled in recent months from its historical peak of US\$147 per barrel in July. However, its current trading range of just above US\$60 per barrel is still significantly higher compared to its prices of around US\$20 during the previous recession in 2001. Are we now expecting oil prices tumble to below US\$50 per barrel?

Downward trend in oil prices

The surge in oil prices was partly due to speculation and trading options offered by financial institutions. A range of financial products in the form of derivatives allowed the commodity to be bought at a set price for future delivery, without any real crude oil being traded. With the recent woes in Wall Street, speculators withdrew from the market, resulting in massive price declines in the trading of crude oil. The economic slowdown sent oil prices tumbling further as global demand weakened.

The Organization for Petroleum Exporting Countries (OPEC) holds the key to global oil production and could affect oil prices by controlling oil output. However, it is also facing stiff competition from non-OPEC countries like Russia and Norway and needs to keep prices at a competitive level. In addition, with the global recession looming, high oil prices would dampen the economy further.

The advent of leading edge technology to extract more oil and boost production capabilities has punctured the myth that crude oil is running out faster than initially expected. More oil fields are being discovered, along with more accurate sensing technologies to assess the actual quantity of oil in current reserves. These developments as well as the downstream refining of crude oil will allow easier

access to a larger pool of resources available, increasing the potential supply and easing the pressures on oil prices.

Oil prices in the longer term

The primary reason for rising global oil prices is the market fundamentals of supply and demand. Rising powers like China and India will require large imports of oil to drive their economies. The demand for oil in the developing countries is also set to rise in the long term.

Oil is used mainly in the transportation sector. The growing numbers of car owners in developing nations, as a consequent of lifestyle improvement, will set off a boom in their transport industries. In time to come, hybrid cars running on alternative fuels could become more prominent. However, governments would require large investments to introduce 'green-car' policies and build the necessary infrastructure to support cars running on alternative fuels.

The price of oil is also sensitive to world events that threaten its production capabilities. The increasing frequency of natural disasters and man-made catastrophes on oil production facilities will lead to nations stocking up more oil for their strategic reserves to minimize any disruptions to their economies.

As more advanced methods are used to extract oil to meet rising global demand, the production cost of crude oil has also increased substantially. Factoring inflationary costs over a period of time, it is unlikely to lead to low oil prices as in the past.

Strategies for Importing Nations

The global spot market for oil is testing psychological benchmarks during this unsettling period of an impending economic recession. It is likely that the current downward spiral will lead to oil prices over-shooting, resulting in prices below the expected range. As the market functions on the basis of demand and supply, the implosion of oil prices could suggest the continuing level of speculation involved in oil trading. Any large purchase of the commodity is likely to result in a surge of oil prices, and the subsequent inflation of its downstream products.

Oil importing nations should strive to diversify their energy mix and continue to develop alternative sources even when oil prices are declining. It remains logical that countries most in need of oil as their economic drivers continue to pay for high oil prices. Nations that embark on alternative and renewable resources will however eventually see their efforts being paid off in the long run.

Alvin Chew, PhD, is Research Fellow with the S. Rajaratnam School of International Studies, Nanyang Technological University. Formerly with the Defence Science and Technology Agency, he has been working on defence-related issues and energy security in the Asia Pacific region.