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The Rise of *Petro Exuberance*

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How oil today is in straits similar to those of the late-1970s U.S. economy.

Alan Greenspan coined the phrase "irrational exuberance" during his tenure as Federal Reserve chairman. He used it in a 1996 speech in reference to the excessively high prices of "dotcom" companies. He worried that assets were overvalued. Four years later, the dotcom bubble burst, confirming his concerns. As it deflated, many companies whose executives had been irrationally exuberant also collapsed.

Seven years ago, several home building firms acquired thousands of acres of vacant land on which to build new subdivisions. "Exurbia" became the location of choice for young middle-class Americans to settle. While this was occurring, executives of firms such as Ryland Homes told investors their business plans were sound. The housing boom was unstoppable, they said. These individuals also suffered the after-effects of irrational exuberance, as did their firms when the housing market collapsed.

Presently we are observing the last gasps of irrational exuberance in petroleum. Call it "petro-exuberance." This malady became apparent during a session on oil market issues at the World Economic Forum in Davos, Switzerland. Some panelists clearly had a case of irrational exuberance, an overenthusiasm no different from what we saw at the end of the dotcom and the housing crises. Claudio Descalzi, CEO of Eni, and the International Energy Agency's chief "economist" Fatih Birol

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showed the most distinct symptoms. Both seem under the illusion that oil price levels today are temporary rather than characteristic of a new ceiling that producers will welcome in a year or two.

In his remarks, though, Descalzi unintentionally advanced an explanation for recent developments and the likely way forward for global oil markets:

> *What we need is stability. … OPEC is like the central bank for oil which must give stability to the oil prices to be able to invest in a regular way.*

His observation, if correct, promises a prolonged period of low prices and a harsh climate for those producing oil.

Panel moderator Daniel Yergin joined the dialog and asked the participants whether the central bank of oil was making a mess of things. Their answers made one thing obvious: they had no concept of the role central banks play in economies. If they had, they might have said this:

> *Not at all. A major central bank of oil finally responded properly in November when a decision was made not to cut output. While the action came late, the bank took away the punch bowl, just as really good central bankers must do from time to time. Market participants had become irrationally exuberant, investing billions upon billions in high-cost projects.*

In refusing to cut production, one central bank of oil (Saudi Arabia) followed a script written by Paul Volcker thirty-six years earlier. Volcker became head of the U.S. central bank in August 1978 when inflation in the United States was out of control. Readers may recall that he took over as chairman just when inflation reached 13 percent. At the time, Volcker worried not just about inflation but also about "the important factor of expectations." His concerns regarding inflationary expectations might seem commonplace now since these expectations are a key focus of every central banker. The situation was different, however, in 1979.

Oil today is in straits similar to those of the U.S. economy in the late 1970s. The managers of the "central banks of oil," which include key producing countries and consuming nations that own large strategic stocks (especially the United States and Japan), should be concentrating on oil prices and the rate of oil price increases or decreases, just as Descalzi suggests. However, all have ignored this responsibility for the last ten years. This "dereliction of duty" on the part of oil producers and consuming nations allowed crude prices to rise to excessively high levels. As a result, an irrational exuberance grew in the oil industry, fueling larger and larger capital expenditures on gigantic projects to produce oil and, at the same time, prompting investment in expensive technology developments aimed at eliminating oil use. Investors in both camps received an additional boost from the quantitative easing advanced by central banks after the 2009 crisis.

Last year, the key OPEC members recognized the danger in these circumstances regarding their market share and the future of oil in general. By refusing to decrease output to sustain high prices at their November 2014 meeting, they acted as a central bank should. In spite of his words, this is not what Descalzi and others in similar positions desire. That is, he does not want oil-exporting countries to act as prudent "central bankers" worried about the long-term viability of the world oil and gas business. What he and executives of other major oil companies really would like to see is OPEC behaving like the imprudent banks of the early 2000s, the ones that kept layering credit default swaps upon mortgage loans upon other bad loans to keep their financial bonanza going.

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The Davos presentations also exposed the flawed thinking of those in the energy business, pretty much everyone it seems, who see OPEC as the dominant "central bank of oil." The central bank idea originated more than ten years ago at PFC Energy, a consulting firm since acquired by IHS. The firm popularized the view that OPEC members, particularly Saudi Arabia, had taken on in petroleum the role accepted for economies by the U.S. Federal Reserve, the Bank of England, and the European Central Bank.

A January 13, 2003, *Economist* article spelled out the roles of OPEC and Saudi Arabia. A few weeks before, the organization's members had agreed to cut output. Then, following disruptions in Venezuela and a decision by President Bush to send troops to the Middle East, the Saudis convened a second meeting and ordered a 1.5 million barrel increase in production. Saudi oil minister Ali Naimi offered this reason for the action: "Our commitment is to the stability of the market, not the cause of a shortage." Then the piece notes the PFC reference:

> *In effect, notes Robin West of PFC Energy, a consultancy, the Saudis have signaled they remain the "central bankers" of oil and they have the spare capacity to ensure that OPEC can deal with disruptions on two fronts.*

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West erred. Neither OPEC nor Saudi Arabia alone can act as the central banker of oil, just as no central bank, acting alone, can do much to affect global economic trends.

Yes, in the event of an oil shortage, Saudi Arabia and other Middle Eastern producers can moderate prices by boosting production of certain types of oil (generally sour, medium to heavy grades). They can also reduce supply for short periods. Such actions do not always succeed, though. These countries, for example, could not stop prices from tripling or quadrupling from 2003 levels when demand for light sweet crudes surged in 2007 and 2008.

In 2007 and 2008, OPEC needed help from other "central banks of oil." They did not get it. Prices were driven to $145 per barrel by ill-conceived environmental regulations and a lack of heavy crude refining capacity. The price increases could have been prevented had consuming-nation governments, particularly the United States, put large quantities of sweet crude from strategic reserves into the market. Such actions would have been precisely the type expected of a central bank. However, the managers of the U.S. "central bank of oil" did just the opposite, taking sweet crude from the market. Ironically, the oil the United States could have sold for $145 per barrel then is now worth less than $40.

The 2008 oil price crisis, as well as the subsequent problems associated with the Libyan supply disruption, demonstrated the importance of cooperative actions. A coordinated response was required to be effective, just as key central banks, including the Federal Reserve, the European Central Bank, the Bank of England, the Bank of China, the Bank of Japan, the Bundesbank, and the Bank of Canada had to cooperate during the Asian debt crisis and following Lehman Brothers' failure.

As in the financial world, the oil industry needed a concerted effort from the energy ministries of leading nations, the most important and powerful being Saudi Arabia and the United States followed by Kuwait, UAE, Japan, and maybe Germany. Middle Eastern countries can affect the market by removing supply when prices fall or boosting supply when prices rise. The United States, Germany, and Japan can moderate price increases by adding as much as two million barrels per day to the market from strategic stocks. They could, in theory, also help slow price declines by diverting oil to strategic stocks when prices drop.

These "central banks of oil" could cooperate. Strategic stocks could be sold when supply disruptions boost prices. Producing countries could raise output at such times as well. Then, when demand softened, nations such as the United States could purchase oil for strategic stocks as producers cut output.

Unfortunately, the managers of the U.S., German, and Japanese central banks of oil do not comprehend their role. No official at any of the world's leading energy policy institutions seems to understand markets. As a result, they have never intervened successfully. Consuming-nation governments have also never cooperated with producers in a crisis. Instead, officials resort to rhetoric. In 2011, during the Libyan civil war, for instance, they abdicated their authority, seemingly enjoying the higher and higher prices. A *New York Times* editorial written at the time captured the consensus view among consuming countries: global supplies of hydrocarbons would get even tighter in the future and steps needed to be taken immediately to reduce consumption. In the spirit of former President Carter, the world had to accept high prices. As the *New York Times* opined, President Obama acted correctly when he delivered "a measured tutorial on this country's need to make itself less dependent on foreign oil, while reminding Americans that a nation that consumes one-quarter of the world's oil while owning 2 percent of its reserves cannot drill its way to energy independence."

Four years later, the error of the *New York Times* editorial is obvious. Today, hard-pressed Americans are getting a huge benefit from lower gasoline prices. The markets are offering consumers the relief neither President Obama nor other consuming countries would. Markets may also be derailing the cleaner energy future sought by the president. Indeed, the hope for a "saner energy policy and a cleaner energy future" is being washed away by a tidal wave of fracking fluid. This is a tsunami of record proportions. The carcasses of hydrogen-powered vehicles and many electric cars, perhaps even the Tesla, will end up in the flotsam.

By not working together with producing countries when prices rose, consuming-nation officials fueled the "irrational exuberance" of those exploring for oil and gas. The exuberance was further driven by quantitative easing, which gave investors every incentive to seek new investment alternatives. In short, government officials allowed

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an "anything goes" attitude to spread through the industry. The oil sector and its consultants caught the fever just as investment bankers had when they papered the world with financial instruments built around worthless mortgages between 2005 and 2008.

Today, however, Saudi Arabia and the other Middle Eastern nations have acted as prudent central bankers and snatched the punch bowl away. In doing so, the oil-exporting countries emulated the U.S. Federal Reserve and U.S. Treasury measures that forced Lehman Brothers into bankruptcy.

Eni could become the Lehman Brothers of oil. Maybe it will merge with another company such as Total. Maybe it will survive as is. The point, though, is that major oil firm executives, most energy policymakers, and economists in energy departments, as well as most experts at the IEA, have yet to recognize recent developments for what they are: a classic cyclical response to the effects of irrational exuberance, effects that cannot be repaired in a month or a year or possibly even a decade.

To his credit, Saudi Arabia's Naimi, the obvious head of the Saudi "central bank of oil," spotted the warning signals. At an OAPEC conference in late December 2014 in Dubai, he noted the increasingly aggressive pressures aimed at curbing oil consumption. In a quote reported by *Petroleum Intelligence Weekly,* he was plainly thinking of

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such programs adopted in California, the United States, Europe, and now China:

> *There are many things happening in the energy sphere—technology on the one hand and efficient [sic] on the other, there are politics. All of these are good for humanity, but they will definably be a threat to oil demand in the future. My question to the panel—is there a black swan that we don't know about which will come by 2050 and we will have no demand?*

Naimi also made this observation: "I attend all the climate change discussions, and I get the sense that people want to get rid of coal, oil, and gas." He added that a cap on global warming of 1.5ºC to 2ºC would mean "goodbye oil." One can imagine Paul Volcker making a similar comment regarding the consequences of not addressing inflation in 1980.

Key oil producers, then, have taken steps similar to those a prudent central banker might take were he or she concerned that the economic situation was getting out of control. In the current circumstances, three of the key "central banks of oil" realized that the irrational exuberance of the market participants threatened to create an excessive oil supply even as the largest consuming nations were working aggressively to "get rid of coal, oil, and gas." Their anxiety likely increased when China and the United States agreed to take further steps to address global warming. No supercomputer was needed for Saudi officials to see a quickly shrinking market on the horizon. The action they took was logical because their cost to produce oil is lower than costs for the rest of the world's oil producers. By refusing to cut output, they will force high-cost producers such as Canada to choose between absorbing large losses and shutting down expensive projects. Many new developments will be shuttered as well. These nations and firms might experience the worst pain but the consequences of lower prices will be felt by everyone in the energy industry.

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It will take years if not decades for the full impact of the price decline to be felt, just as it took decades for the full effects of Volcker's achievements to become apparent. Eventually, many high-cost production sites will be mothballed and many large expansion projects will be delayed or canceled. The market competition for OPEC producers will diminish. Low prices will also stimulate additional demand, addressing Saudi oil minister Naimi's fear of "goodbye oil."

As yet, however, we have only begun to observe the first minimal adjustments in investments, especially outside the United States. Forty-five years ago, crude oil averaged $12.87 per barrel as measured in constant 2013 dollars. Given the world's sluggish economic growth, especially in Europe, prices could remain near 1965 to 1972 levels, adjusted for inflation, for several years if not longer. ◆