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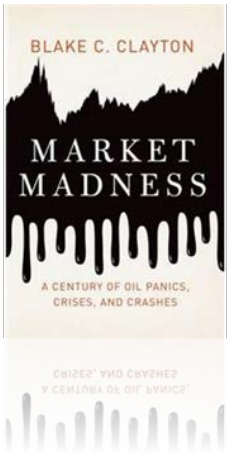
Market Madness: A Century of Oil Panics, Crises, and Crashes

Clayton, Blake C. (2015), Oxford University Press, New York.



"There is a tempting intuition to the idea that the real prices of nonrenewable goods should rise, more or less, forever. It sounds right: The world's population is growing bigger by the decade, the logic goes, consuming more and more scarce resources that can never be replaced. […] Thus, in this line of reasoning, unless we start to consume less of a given finite substance, it will forever get more expensive. The logic appears uncontestable at first glance. But it is wrong."

"Betting that some commodity is "running out", which will cause its price to move ever higher in the decades ahead, has simply never been a profitable way to lay the market – at least not in the last 500 years or so."

Summary

Stock market booms are cause for celebration. However, when the oil price soars because supply cannot meet demand, the response is almost always an apolitical one. Forecasts that the oil will run out worry Wall Street and governments, causing panic that we have reached 'Peak Oil' and that the oil price will rise ever higher. The author of Market Madness says these rumours are wildly exaggerated, but he argues their history may help fuel debates on energy's future and market pricing.

Blake Clayton believes that understanding what drives fears that oil is about to run out sheds light on how the oil market works. These scares are accompanied by the idea that the oil price will never cease rising as a result. From the beginning of the 20th century, we have seen cycles of hope and dread regarding oil reserves, which in turn have shaped our behaviour regarding oil. Boom has been followed by bust, with periods of high oil prices that have sometimes lasted years. However, the end of oil (that is to say, endless stagnation in oil production) has never occurred, despite the forecasts of the doomsayers.

Clayton argues in Market Madness that we cannot say what the future holds for oil production and oil prices - both may take unexpected turns. Nevertheless, reading past patterns is very useful when we try to peer into the future. That is why Market Madness takes the reader through the history of the four American 20th century scares about the end of oil. The pattern is clear: a surge in oil prices stemming from

fears of an oil shortage, with fears lessening as oil production climbs, followed by weaker oil prices. This pattern has characterised oil price shocks so far.

To avoid these shocks, Clayton insists on the need for more information, communication and transparency. Although this approach would not completely remove volatility and unpredictability, it would - argues Clayton - mitigate unnecessary oil price swings and improve both government and investors' decision-making. Last, Clayton says that while he believes fears that oil will soon run out are unfounded, we should realise that oil will come to play a secondary role in the near future as other energy sources (such as renewables) become more competitive and take the lead.

The author

Blake C. Clayton gained his PhD at Oxford University. He currently covers oil and gas companies and master limited partnerships as a Citigroup analyst in New York. He was formerly member of the Council on Foreign Relations, and currently remains an associate member for energy matters.

Key ideas and opinion

What explains the recurrent panic attacks about oil running out, even though they have proven to be unfounded time and again? According to Blake Clayton, their cause lies in a shift in market fundamentals, for example rising oil prices stemming from a drop in production capacity coinciding with rising demand. This price rise is seen as heralding a new era - perhaps one of permanent shortage. There follows a spate of analytical articles arguing that we have reached Peak Oil and that the days of rising oil output have come to an end.

Each of these panics is based on the same mistake, that is to say, the inability to see parallels in the past and to take account of the oil industry's cyclical nature. In such circumstances, experts become daring prophets who capture reader's attention and win public acclaim. The author of *Market Madness* criticises mass-media sensationalism and eagerness to spread panic. However, when oil production keeps growing and demand slackens, prices fall and with it, the panic subsides as quickly as it came.

In Market Madness, Clayton explores the patterns found in the four key 20th century scares in which the United States thought that a new age marking the end of oil had dawned. He also makes recommendations for not making the same mistake again when forecasting the future of energy and in drawing up policies to deal with it.

A major national crisis:
The US Geological Service (USGS) in the age of growing demand (1909-1927)

The first account of oil scarcity gained ground among American citizens and in political debates **between 1909 and 1927**. The bleak outlook painted by the USGS for oil reserves led various government leaders and geologists to warn the public that the country´s oil reserves were running out at an ever-faster rate. Rising oil demand and prices seemed to confirm these forecasts as US oil production soared to meet Allied demand during World War I and later to fuel the cars that began to fill American roads. The oil industry roundly rejected these forecasts, arguing that fear that oil would run out was baseless. It took some time before these fears subsided.

Technological progress and the discovery of vast new oil reserves in both the southern United States and abroad greatly boosted oil production in the late 1920s. This, combined with plummeting demand following the Wall Street Crash in 1929, drove oil prices down. With a surfeit of oil in the market, the story that oil was running out quickly vanished from national debate.

A new era of oil shortages and rising oil prices:
Wartime demand for oil and the end of US oil self-sufficiency (1940-1949)

The second scare that oil was running out took hold **between 1940 and 1949**. After the oil surplus seen in the 1930s, World War II drove oil demand up. Dire forecasts in 1941 of an oil shortage on the East Coast turned out wrong. Yet it was used to justify the rationing imposed by the Petroleum Administration for War to cope with a new era of permanent oil shortages. American reserves covered most of the Allies' oil needs during the war and it was in this context that the government and military leaders stated that US oil reserves would run out within a couple of years.

In most cases, the main fear was not a worldwide shortage of oil but rather that the United States would not be able to meet domestic oil demand from its own reserves alone. The prospect of America becoming a net importer of oil seemed to augur a new era of rising oil prices and the need to produce synthetic fuels. It was in this context and on the threshold of the Cold War that the US began to actively help American oil companies buy up foreign oil fields. A brief but intense shortage of refined oil products in 1947-48 caused by a variety of factors and a bitter winter led yet again to dire forecasts of the end of oil amid soaring fuel prices. However, at the end of the 1940s, oil imports soared, US production grew, and there was, again, an oil glut.

An unprecedented problem in US history: American fears in the OPEC era (1970-1986)

In the **1970s and early 80s**, a combination of factors fuelled fears of a permanent oil shortage and soaring prices. In 1972, growing demand made the surplus from US oil fields disappear. Various key oil producers in the rest of the world realised they had a strong bargaining position and decided to break free from the low prices fixed by multinational oil companies. The Organization of Petroleum Exporting Companies (OPEC) had been set up in 1960 and its members began nationalising oil companies in the 1970s. The experts' predictions of an imminent energy crisis cropped up for the first time in 1969 and lasted for several years. The US Department of State, the Club of Rome and others issued dire warnings of the consequences. Amid international tensions, government and public worries about permanent oil scarcity peaked in two oil crises throughout the decade - the first in 1973 and the second from 1979 to 1980.

Polls revealed that the American public increasingly felt that the country was running out of oil. This fear was particularly strong during the second oil crisis, which stemmed from the Iranian Revolution and the subsequent Iraq-Iran war, which too many Americans saw as bearing out the dire forecasts made throughout the decade. In 1985, Saudi Arabia decided to unilaterally put an end to OPEC production quotas (whose purpose was to keep oil prices high) given that other OPEC members were failing to abide by them. With Saudi Arabia now selling more oil, supply spiked and fears about whether production could keep pace with demand evaporated for another decade and a half.

A leap in oil prices: Fear of 'Peak Oil' grips Wall Street (1998-2013)

A new version of the oil scarcity tale emerged **between 2001 and 2009**. This time round, the arguments for an impending oil shortage caught the ear of the financial markets and the energy community as oil prices rose steadily until 2008. This price rise was driven by: demand from China and other emerging economies; a plateau in oil production among non-OPEC countries; lack of new investment to boost production among OPEC nations. The panic reached a peak when Brent hit an all-time high of $147 a barrel in the summer of 2008.

This time, those saying that we had passed 'Peak Oil' did not limit themselves to articles but also held conferences, made documentaries and wrote blogs. They also had their followers in academe (for example, the Princeton geologist Kenneth Deffeyes), in Wall Street and among politicians. When oil prices plunged at the beginning of 2009 as a result of the economic crisis, the tall tales about a new age of oil scarcity went out of fashion. Although oil prices soon bounced back over the $100-

dollar a barrel mark, the debate had moved on to the re-birth of the US gas and oil industry.

Lessons for Wall Street

For Clayton, these four oil crises — driven by the belief of an imminent age of oil scarcity — offer four lessons for investors, public agencies regulating the oil companies and shaping oil geopolitics.

The **first lesson** is simple: **never underestimate the power of the market to find new oil after periods of scarcity**. The author of *Market Madness* stresses that markets (even such an imperfect one as the oil market, dominated by a small group of powerful producers) work amazingly well when it comes to raising production. This does not mean that new crises will not blow up in the future even though markets work miracles in increasing production of scarce resources — something that is often a slow process. Sometimes it takes a decade or more for rising oil prices to spur improvements in extraction technology and riskier prospection. That said, those who have bet against technological advances have been proven wrong time and again. Today's 'non-conventional energy sources' will be conventional tomorrow, argues Clayton.

The **second lesson** to emerge from the 20th century is that **the oil market is characterised by dramatic shifts and discontinuities every now and then; they are the rule rather than the exception**. That is why those who treat the oil market as a static system that changes little from one decade to the next are doomed to get their forecasts wrong. As Clayton notes, it is precisely at those moments when the oil market seems calm (with high or low prices, as the case may be) that the next price shock is afoot. Politicians, investors and analysts should beware of long-term forecasts that fail to take account of the great uncertainties found in the oil market.

The **third lesson** Clayton draws from this is another truth about the way the market works: namely, **market forces can be counted on both to raise production and cut consumption**. In the author´s view, people overestimate their knowledge of the world´s oil reserves. They tend to conclude that if oil has not already been discovered, or if existing reserves cannot be extracted with the technologies at hand, it is unlikely to be found or extracted in the future. During each oil crisis, it is difficult to see how more oil could be produced. Investors who believe in simple economic principles (by which high prices boost production over time thanks to innovation and technology) are immune to scares over oil shortages.

The **fourth lesson** is that **reliable data are the best defence against unfounded fears**. Fear stalks when information is scarce. Wrong forecasts abound when the public has little access to accurate, exhaustive forecasts of world oil reserves, production and consumption. Conspiracy theories and confusion run riot in an opaque energy market.

Clayton therefore considers greater transparency is needed regarding both the physical and financial aspects of the oil market. Greater openness will dampen undesirable oil price volatility and help ensure that pricing obeys fundamental economic principles.

To achieve this, both oil producers and consumers must come reveal their data. On the consumption side, the first major step in this direction would be to find ways to **get China and India on board in the International Energy Agency (IEA)**. Growing demand for oil from these two nations means that China and India will account for half of world oil demand by 2030. On the producer side, **although information on reserves, production and exports is still fairly incomplete, the Joint Initiative on Petroleum Data (ICDP), set up in 2001, is a big step forward**. The ICDP is a voluntary system for providing data and covers over seventy countries, which furnish information on their oil production, demand and stocks. However, the numbers given often do not match those from official sources and there is an incentive for OPEC members to fudge the data to their own advantage. Another problem is the **lack of reliable public information on world oil reserves**. According to Clayton, the US, UK and other countries with big financial sectors should carry out regulatory policies to improve the transparency of the oil market. These policies should be combined with broader foreign policy aims so that these nations can exercise greater influence on energy market regulation and transparency.

Although it is only a question of time before better energy sources replace oil, those who forecast the end of this fossil fuel would do well to recall the words of a Riyadh expert on the future of fossil fuels: **"The Stone Age came to an end, not because we had a lack of stones, and the oil age will come to an end not because we have a lack of oil."**