OPEC, Russia and the Trump effect

by DIETER HELM

It is extraordinary how persistent the notion is that if the great men (mainly kings, sheiks and autocrats) get together, they can fix the oil price. It persists despite all the evidence to the contrary and it is believed by otherwise quite sane politicians and analysts.

OPEC never mattered much

Perhaps it is the conventional wisdom that OPEC fixed the oil price in the 1970s that underpins this. Yet even then, the reasons for the price hikes had much more to do with the fundamentals of supply and demand. OPEC did have a temporary effect in its embargo, and the Iranian Revolution (not an OPEC initiative) did boost prices in 1979. But the reason they temporarily worked was because the conditions were right: demand had raced ahead in the 1950s and 1960s, whilst the falling prices had undermined new investment.

A curiously unnoticed fact is that the real price of oil fell for a century between around 1870 and 1970. As the marginal cost of production fell with advances in technology, so did price. Demand grew and supply grew. The very temporary OPEC market power in the 1970s proved all too temporary: in the 1980s prices collapsed back to their long run trend. They rose again in the early 2000s as a result of Chinese growth, but again supply eventually responded ushering in the great shale boom.

They are at it again. Russia and OPEC want the market to believe they are going to cut production to rig the market. But it is hard to find any reason to believe this will work. The marginal costs for most OPEC countries (and Russia) are at or below $20 a barrel. The marginal cost of US shale is around $50, and continues to fall. Why would any OPEC member cut its production unless everyone else did too? And why would they? Iran and Iraq are upping production, and so too has been Saudi Arabia. If the costs of production are less than half the price, the incentive is obvious. That is why OPEC production keeps going up. The surprise is that anyone is surprised. Even the IEA has finally cottoned on, after years of falling for this assumption. The IEA completely failed to predict the price collapse in the 1980s or the 2014 price bust.

The game has changed

Some in OPEC are beginning to realise that the oil game is entering a new era, where not only is their market power largely illusory, but the fundamentals are moving against them. All the talk is now of peak demand not peak supply, as technology pushes away from oil for transport and petrochemicals. Supply just keeps going up, as technology marches on. Shale technology cannot be un-invented: it can only spread.

My books - The Carbon Crunch along with Burn Out: The end game for fossil fuels (due March 2017) cover this topic in more detail...

This leaves OPEC and Russia in a big fix, and this is where the new geopolitics comes into play. Russia is overwhelmingly a petro state, all the more so under Putin. Its financial position is weakening all the time, and it has little else to export except armaments. Putin's foreign military adventures are a consequence of economic weakness, not strength.

For the Middle Eastern OPEC countries things look very bleak. Saudi Arabia is running down its financial wealth funds rapidly (as is Russia), and it is now trying to...
sell assets and borrow too. With its very young population, which has grown extremely rapidly, it is hard to see how the 5000 princes can hold their autocracy together.

**Trump’s relative insignificance**

Onto this stage comes Trump. Again otherwise sane politicians and commentators think another “great man” will change the oil price. They point to Trump’s views on climate change and his desire to open up land for more oil production. His mantra of “pump baby pump” is assumed to be a game changer.

Yet a little reflection and a little bit of economics suggest that much of this would happen anyway. Trump will make a marginal difference to oil production only: what matters is the price and the costs. Under Obama, the US has indeed been accelerating its oil production a lot. Despite all the climate change rhetoric, Obama presided over a golden age for US fossil fuels. It does not take a Trump to change the arithmetic. Trump might give a further lease of life to coal, but oil is a different market.

All this points to a rather different narrative. Great men are rarely as important as they – and others who should know better – think they are. Economic fundamentals are what matter, even if they don’t make a great media story. They point to a continuation of the long-term trend – a gradually falling real price of oil. This plays out into the eventual end game for oil. All the more reason for the producers to keep pumping now – it may be worth even less tomorrow. Trump will make little difference in this respect.

**The writing is on the wall for Putin and OPEC leaders**

Grasp this, and a host of conclusions follow. OPEC does not much matter, and its members will scramble to hold onto market share in the face of mounting budgetary crises. Russia’s future (and Putin’s) looks a lot like the 1980s and 1990s, when falling oil prices did for both Gorbachev and then Yeltzin, first bringing down the Soviet Union, and the eventually bankrupting the country in 1998. Putin’s luck – rising oil prices from 2000-2014 - has already run out.

For the US the trend towards gradual energy independence pre-dates Trump and will post-date him too. The US is the luckiest country when it comes to energy, its costs and its economic impacts.

**Technology is what matters in the long run**

So when you read that OPEC is meeting, and you hear analysts saying the price is going up, remember that this is largely flotsam on the long run trend. Technology drives costs, technology drives the substitutes in transport and petrochemicals, and price drives both supply and demand. Trump, Putin and the OPEC autocrats bounce around on these fundamentals – and not the other way around.

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