New economics of oil

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Executive summary

As economists, our analysis and interpretation of oil markets are typically based on our beliefs of the main factors driving the behaviour of the oil market.

Four core beliefs or principles which are likely to condition many economists' thinking are:

- Oil is an exhaustible resource: oil will eventually run out, implying that the relative price of oil is likely to increase over time;
- Oil demand and supply curves are steep: demand and supply are relatively unresponsive to price movements in the short run, causing oil prices to be relatively volatile;
- Oil flows from east to west: most obviously from the Middle-East to Europe and US, with money flowing in the opposite direction;
- OPEC stabilises the oil market: eg in 2008/9 following the financial crisis.

But the oil market has changed very significantly over the past 10 or 15 years. Concerns about carbon emissions and climate change have increased materially. And, more importantly, the US shale revolution has introduced a new source of supply, with very different production and financing structures.

This speech considers the implications of these changes and argues that the principles and beliefs that served us well in the past are no longer as useful for analysing the oil market. We need a new set of principles reflecting the New Economics of Oil.

Oil is not likely to be exhausted: As such, there shouldn't be a presumption that the relative price of oil will necessary increase over time. A key factor governing the future price of oil is whether the standardised, repeated, "manufacturing-like" processes characterising shale production, with the associated rapid gains in productivity, can be applied to other types of oil production.

The supply characteristics of shale oil are different to conventional oil: Shale oil is more responsive to oil prices which should act to dampen price volatility. But it is also more dependent on the banking and financial system increasing the exposure of the oil market to financial shocks. These financial shocks have the potential to increase oil market volatility.

Oil is likely to flow increasing from west to east: with important implications for energy markets, financial markets, and geo-politics.

OPEC remains a central force in the oil market: but when analysing OPEC's ability to stabilise the market, it is important to consider the nature of the shock driving the change in oil prices and, in particular, whether it is a temporary or persistent factor.