ENERGYWATCHGROUP

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Why Oil Prices Are Dropping

The correlation and interplay among oil-market supply and demand, falling oil prices, and the financial crisis

Why are the oil prices falling?
The oil price reflects supply and demand on the global market: A fall in oil prices can be due to either increasing supply or decreasing demand.

Supply factors:
How can production be on the increase when the Energy Watch Group (EWG) assumes that the peak of global oil extraction has already been reached? In its report "Crude Oil – The Supply Outlook", the Energy Watch Group explained that advanced technologies make a temporary production increase possible. In some cases, though, employing these methods leads to an even-more-rapid decrease in output in the long run and sometimes actually reduces the total amount of extractable oil from the affected fields.

Demand factors:
The unprecedented spike in the price of oil in the period of a few months in mid-2008 provoked a global shockwave among consumers that was reflected in the automobile and aircraft industries even before the "outbreak" of the financial crisis. In fact this price jump may have actually been an important contributor to the crisis because American home buyers were forced to divert money to cover increased energy costs. As a result oil consumption, and in turn the price, collapsed.

Economic developments:
The already perceptible drop in economic growth has led to an initial slackening on the oil markets and - particularly in the face of ongoing turmoil in the financial world - could help dictate prices. Confronted with an economic recession or depression, oil-producing companies and countries will have even less incentive to invest in advanced exploitation

and extraction. The result could be a more rapid reduction of oil delivery in the medium term, which could actually stimulate a rise in oil prices, even in the midst of an economic crisis. And in a post-crisis economic upturn, the gap between supply and demand would become even greater, causing yet another price rise.

Conversely, the financial crisis is also influencing oil prices: Some institutional investors in the capital markets are choosing to remove raw materials from their portfolios in their efforts to raise liquidity to help pay off debt, even though they incur losses due to declining values.

On the other hand, oil buyers are finding it more difficult to pre-finance their orders (transportation, storage, etc.) because credit has become harder to find and more expensive. This also initially weakens the demand for oil, but will later lead to more severe price fluctuations and higher costs for consumers.

Thus sinking oil prices are yet another sign of the institutional investors' dire financial straits and in no way offer an all-clear in regard to a secure supply. On the contrary, with the oil producers' reduced inclination to invest, sinking oil prices will exacerbate the expected shortage and should be exploited as a chance to expand conservation and the development of renewable energies.

The events of the past few months have made one thing crystal clear: Fluctuations in crude oil prices will widen, becoming incalculable to an extent that will render both long-term economic decision making and energy planning next to impossible. Renewable energies, in contrast, represent incomparable potential for secure investment.

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