JOINT ECONOMIC COMMITTEE
CHAIRMAN ROBERT F. BENNETT

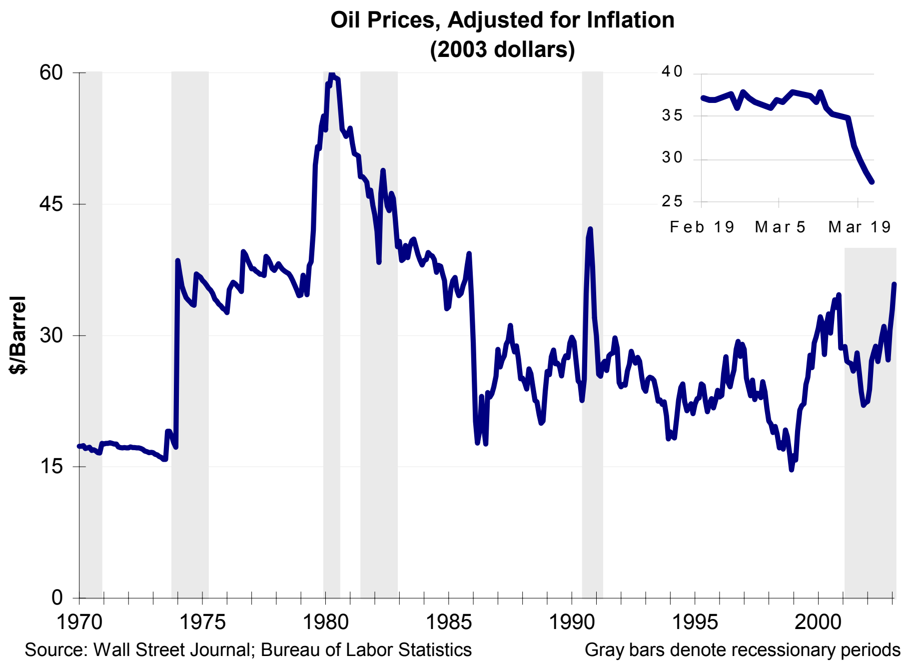
ECONOMIC UPDATE
MARCH 26, 2003

10 Facts About Oil Prices

No one can dispute that the high oil prices of recent months have been bad news for consumers and the economy. Particularly hard hit have been industries that rely on oil such as airlines, transportation companies, and chemical manufacturers, as well as consumers who purchase gasoline and heating oil. While these industries and consumers have suffered from high prices, it is important to put the current oil market into some context.

1. Historical Context. Oil prices reached a peak of nearly $40 a barrel at the beginning of March, and since the beginning of the Iraqi conflict prices have slid to under $30 a barrel. Adjusting for inflation shows that recent prices are well below the levels of the 1970s and early 1980s. Measured in today's dollars, prices topped out above $60 a barrel during that period and remained above $45 for most of the period.

Figure 1



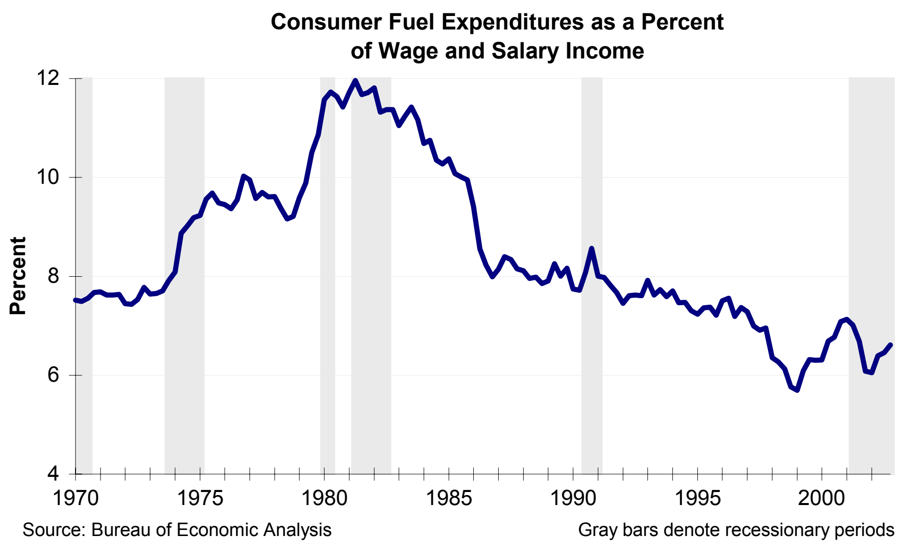
2. Oil Price Spikes and Recessions. Oil price spikes have typically been followed by recessions. Of the last nine recessions, oil price increases have preceded or accompanied eight.[1]

[1] Another supply-side shock in the form of a major strike in the steel industry preceded the 1960 recession.

However, it is an exaggeration to say that increases in oil prices alone caused these recessions. Other negative macroeconomic events often accompanied these oil price increases—restrictive monetary policy, sudden geopolitical conflict, or other supply-side factors such as a world-wide grain shortage in 1973-74.

3. Oil's Role in the Economy. Another factor mitigating the impact of oil price increases is that energy makes up a smaller proportion of gross domestic product today than in earlier decades. One manifestation of our economy's decreased dependence on energy is shown in Figure 2, which shows that over the past 20 years expenditures on fuel have made up a shrinking proportion of our incomes. The U.S. economy has become much more fuel-efficient in the past 30 years, and can produce many more goods and services on a unit of energy than before. The increase in fuel efficiency has left our economy less susceptible to energy shocks.

Figure 2



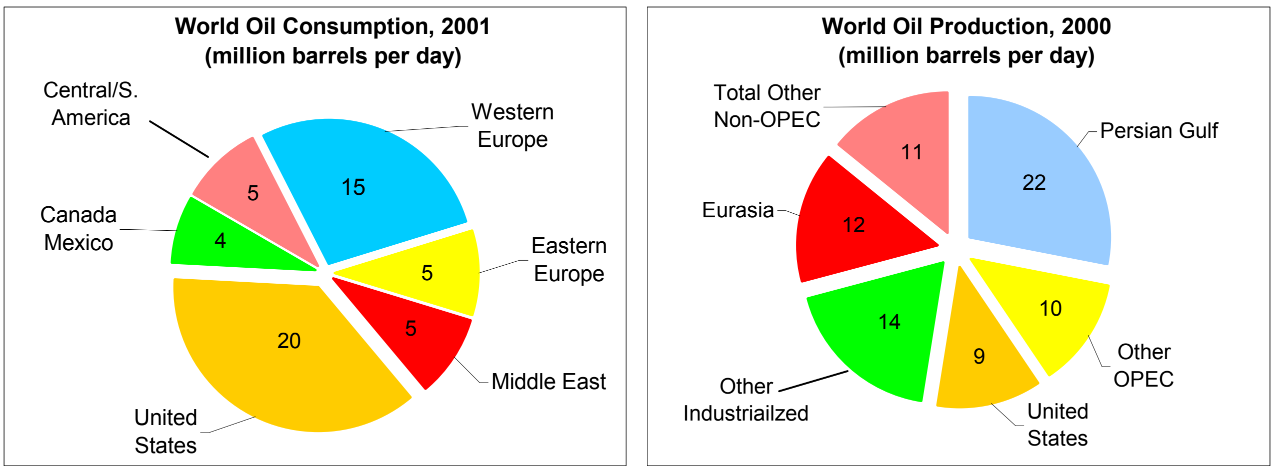
4. Other Factors Affecting Oil Prices. The recent increase in oil prices is due to more than just the uncertainty surrounding the Iraq situation. The Venezuela strike and an unusually cold winter across the northern hemisphere have also impacted the market. Venezuela's output fell by nearly three million barrels a day to less than one half million barrels a day, a drop greater than the current daily Iraqi production. As of mid-March its output had recovered to 1.8 million barrels a day. Some regional problems have contributed to the spike in gasoline prices, such as in California where the phase-out of the additive MTBE has caused production and distribution problems.

5. War Premium. The common perception is that there is a "war premium" of about two to five dollars per barrel. That is, expectations of higher prices in the future due to the impending conflict have resulted in prices increasing *today*. The recent decline in oil prices is largely due to the reduction in the oil premium, as the markets become more certain that oil shipments from the Middle East will not be disrupted.

6. Production Capacity. Many experts feel that OPEC, the Organization of Petroleum Exporting Countries, has enough excess capacity to replace Iraq's production for an extended period of time, should its wells be destroyed. The Energy Information Administration estimates that the excess production capacity of OPEC is between 2 and 2.5 million barrels per day, more than enough to replace the loss of Iraq's daily exports of 1.8-2.4 million barrels a day. OPEC's president has stated that its excess capacity approaches three million barrels per day. However, it is important to note that OPEC is deliberately opaque about their true production capabilities for strategic reasons. There are oil analysts who believe that OPEC's excess capacity is less than one million barrels per day. Total world output is roughly 75 million barrels per day.

7. Production and Consumption. Total daily oil production and consumption broken down by major region of the world are shown in Figure 3.

Figure 3



Source: Energy Information Administration

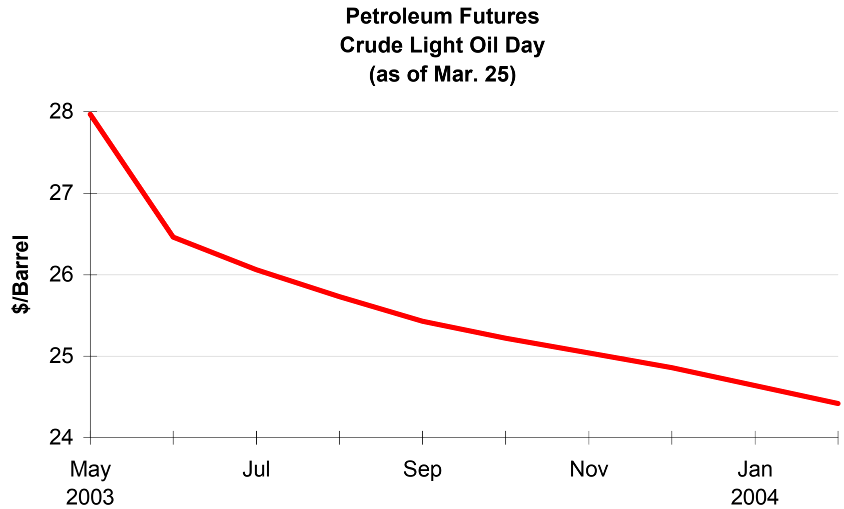
8. Strategic Petroleum Reserve. Our strategic oil reserve is 600 million barrels, and can be tapped should Middle East oil shipments be delayed for a period of time. Within ten days the U.S. could sell as much as four million barrels a day.[2] The implicit agreement between OPEC and the industrialized nations is that they will step up production as long as we do not tap our reserve.[3] Saudi Arabia is walking a very fine line; while it has an incentive to exaggerate its ability to meet any output decline should Iraq's wells go offline, it also has a great incentive to meet that implicit commitment to keep the U.S. and the International Energy Administration from releasing strategic reserves on the world market, which it fears would cause prices to plummet.

9. Oil Futures Markets. Attempting to forecast the effect of a U.S.-Iraqi conflict on the price of oil is a difficult venture at best. Predicting future price changes is challenging, even for the near future, since the result depends greatly upon the outcome of the conflict in Iraq. Futures prices suggest that the market believes that oil prices will fall to more reasonable prices in the

[2] John Fialka, "U.S. Waits to Draw on Own Oil Reserve," *Wall Street Journal,* 14 March 2003.
[3] David Bird, "Oil Price Drop Clouds US SPR Policy," *Dow Jones Newswires,* 19 March 2003.

near future. Figure 4 shows that the market for oil delivered in the next few months suggests a moderating price.

Figure 4



Source: Wall Street Journal

10. Future Oil Production. Long-run projections forecast expanding oil production world-wide. For instance, total non-OPEC output is forecast to increase by 1.4 million barrels per day, according to the Energy Information Administration, half of which will come from Russia alone. A stable Iraq could increase output within the next few years to its pre-Gulf-War production of over five million barrels a day, tripling current production.

Outlook: A large part of what will determine oil prices in the near future will be the reaction of Saudi Arabia to any major Iraqi oil disruption. While it claims to have ample excess production to replace Iraq's production, some analysts are skeptical that it has much room to increase output. However, its ability to replace Iraq's lost output may not be necessary; even a short disruption in oil shipments from the Middle East would bring pressure on the U.S. to turn to its 600 million barrel Strategic Petroleum Reserves and the International Energy Agency to tap its reserves as well, which amounts to nearly four billion barrels. Considerable political pressure exists already to tap both reserves.

A useful site to get timely information on oil prices and on energy-related matters in general is the home page of the Energy Information Administration, which is at www.eia.doe.gov.