

# The good news about oil

Think crude prices can only increase from now on? Don't bet on it



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In 1980, economist Julian Simon made a famous bet with environmentalist Paul Ehrlich. Simon's bet was that a US\$1,000 basket of any five metals chosen by Ehrlich would be worth less (in constant dollars) 10 years later. Ehrlich lost. In 1990, the value of the basket at current market prices was down more than 50 per cent, and Ehrlich sent a US\$576.07 cheque to Simon, representing the drop in the basket

value. In fact, the prices of all the metals chosen by Ehrlich had fallen.

Simon also showed that the real price of crude oil, calculated either in terms of salaries, or in "real" or constant dollars (after taking inflation out), had decreased since the 1870s. Despite the price run-up that started in 1999, oil is still less expensive in constant dollars than it was in the late 19th century, and much less expensive relative to our salaries.

A barrel of crude oil (West Texas Intermediate grade) reached a peak of US\$39.50 in April of 1980, in the wake of the Iranian Revolution and production cuts by the Organization of Petroleum Exporting Countries (OPEC). In today's dollars, this translates to US\$98.30, quite below the recent surge to US\$72.

Another reason to defuse, or redirect, the popular wrath against gasoline prices is to remember that if half the price of gasoline comes from the cost of crude, more than a third is made of indirect taxes.

Economists do have a crystal ball of a sort. It comes from assuming that people behave rationally—that is, in a way to improve their situations according to their own preferences, which generally means selling high and buying low. This applies to all fields of life. If the cost of having children out of wedlock decreases, the economist will forecast an increase in the illegitimacy rate (other things being equal). Similarly, burglars prefer to burglarize seniors' houses rather than police stations, because the expected cost (the risk of being arrested or shot) is much lower.

Once the rationality assumption is made, you look at supply and demand to predict how prices will move. As the saying goes, prediction is difficult, especially

with regard to the future. However, we know that if oil supply increases more than demand, the price will get back on its long-term downward trend. If, on the other hand, demand increases more than supply, we would expect the price of oil to climb, relative to other prices.

In the past few years, demand for oil has grown faster than supply, pushing prices up. Tensions in the Middle East have generated fears of future supply cuts, and thus more demand in the short run (in anticipation of price increases). Another reason for higher demand is the economic takeoff of China and India: upward pressure on resource prices has followed. Chinese demand for oil now amounts to more than eight per cent of world demand, compared to less than six per cent 10 years ago. On the supply side, hurricanes have caused disruptions. More generally, the supply of oil is very much influenced by politics, if only because 40 per cent of oil comes from OPEC countries.

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Julian Simon would argue that human ingenuity and entrepreneurship will find new ways to increase supply (with, for example, new recovery technologies, like in the oilsands), and that the cost of oil will fall relatively to the cost of the other inputs (such as labour) that enter into consumption goods. Whether or not this turns out to be right, and how much time it takes, we have no alternative but to think in terms of supply and demand.

Speaking of predictions, I must explain a big glitch in my last column. I wrote, "With the creation of an advisory group on firearms, announced a few days later, Stockwell Day made another small step in the right direction." Many readers must have wondered why they hadn't heard of this advisory group.

There had been a persistent and credible rumour about its imminent creation. I put the sentence quoted above in my piece expecting to take it out at the last minute if the announcement had not been made. Unfortunately, it got overlooked. My apologies. **WS**