

Exuberant Irrationality

In spring of 2003, Alan Greenspan, the Chairman of the US Federal Reserve, became the most senior and arguably the most effective energy policy analyst of the United States with his cogent remarks to US legislators about natural gas supply and prices and contradictory government policies. Last week, in reverse mimicry, the International Energy Agency—the developed countries’ energy policy coordinator, adopted Mr Greenspan’s phrase, “irrational exuberance”, which he famously deployed in December, 1996 as a signal to equity markets to cool off.

Signalling by those in charge of monetary policy is a fine art, done with great care and caution and usually intended for the general good. In oil markets, signalling is what the game is all about, and engaged in constantly, generally done carelessly and invariably in the signaller’s self-interest. That is fine: it is an auction, after all. In its August Oil Market Report last week, the International Energy Agency unabashedly titled its summary of the market situation, “Irrational Exuberance”. This title will have struck regular readers of the report as not only at odds with the data in the report, indicating that markets are in fact very tight, but as a departure from the Agency’s tradition of staying neutral as to what prices should be or not be. This is one of the few times since its somewhat awkward handling of the first Iraq war crisis in the autumn of 1990 that the IEA has made such a brazen, and clumsy, attempt to influence the price of oil. On that occasion, the IEA while in deep denial about economic fundamentals (that any additional supply, even strategic stock release, can affect the price), issued press releases and statements that strategic stocks were there to meet ‘physical shortages’ and were not ‘a buffer stock for managing prices modelled on those ill-fated commodity agreements of the 1970s’. The IEA puzzled everyone with Press Releases that “welcomed the attitude shown by oil companies for refraining from abnormal spot market purchases” (IEA/PRESS(90)2 31/8/90) and recommended that they “exercise discretion in purchases in order to reduce uncertainty and volatility in the world oil market” (IEA/PRESS(90)3 28/9/90). So, here we are with the IEA signalling in an already ‘over-signalled’ market.

When seen against its wise habit, albeit awkwardly practised, of avoiding being seen to fiddle with prices, the IEA’s implying in this month’s OMR that market players are irrational could have exactly the opposite effect from what the IEA and its members presumably had in mind. Surely capitals of IEA member countries pleaded with the Secretariat to “*do something*”! It would not be a stretch to assume that a few energy ministers asked (they certainly have in the past), “*Why do we pay to be a member of that thing if it can’t do something about these high oil prices?*” While they might have taken a look at their taxes on petroleum products if they really wanted to give their consumers a break, I suspect that debate lasted nanoseconds since high consumer prices are exactly what their environment colleagues need to help them meet their Kyoto commitments and, much more importantly, high excise taxes are vital for their treasuries. So, they punted the ball to the good old IEA, which did its best for the cause last week, with the following internally contradictory and oddly phrased closing plea:

“The market is tight, production and infrastructure capacity is less than desired and uncertainties continue to weigh on the market. But does this justify \$45 oil? Current oil prices are a concern and are causing economic damage.”

Yes, limited surplus productive and processing capacity and rising demand apparently do justify \$45 oil. And if there are further disruptions, the market—as taut as a piano wire—will sound even higher notes. If the IEA normally avoids talking about or implying what the price should be, and insists that government strategic stocks are only for emergencies, to break with tradition now surely leads to the conclusion that the IEA actually is in a panic and believes we are on the verge of a crisis. The market, then, should be expected to either ignore the IEA because the market is already ahead of it (and has priced in the crisis), or to believe the IEA, the custodian of world oil data, knows something the market doesn't (in which case, prices will be bid up further).

This oil crisis and the Agency's handling of it come at an interesting juncture of forces and events. Oil prices are high while we face a US election, which centres on the conduct, or perhaps more precisely, misconduct, of a U.S.-led war in a Middle East oil state, while IEA member countries are behind in their Kyoto commitments, and surging demand outside the IEA region has caught everyone by surprise as the capacity margin is very tight, with Iraq, Nigeria and Venezuela unable to get to capacity even if they wanted to. Gasoline demand in the US, despite these prices, continues to be robust and a 'cooling' in the growth in China's GDP reported last week to be down to 15% on the month, does not exactly mean its economy is in the deep freeze. However, sooner or later, these prices if sustained will begin to bite on economic growth and the 'economic damage' the Agency warns us of might become apparent.

This will be the first U.S. Presidential election since 1979/80 that oil prices have risen by more than \$10/bbl from August to August (1999/00 came close). And this is the first time since 1976 that a Republican administration has sought re-election against the background of such a major increase in oil prices. We have to wonder whether the IEA got a signal from Washington to engage in some exuberance, to irrationally ignore the facts to the contrary and talk down oil prices.

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