Remember Peak Oil?

During another misguided panic over energy prices, it's good to revisit the fundamentals

BRET SWANSON > December 3, 2014

During the "energy crisis" of 2006, we wrote the following Wall Street Journal commentary, hoping to calm fears of peak oil and other such nonsense that often accompanies big price swings. We said oil prices likely would recede. We said vast stores of oil, especially in shale, were about to be found and extracted. We said alternative energy schemes in part justified by high oil prices were a bad idea. (We also said a big financial disruption was likely.) The macro environment is very different today — prices are low instead of high — but we reprint this column as a reminder of the economic fundamentals…and energy's abundance. —BTS

The Elephant in the Barrel

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by Bret Swanson

Nigerian pipeline explosions, Chinese demand, Arab angst, Venezuelan volatility, peak oil and a Putin premium: These are the usual explanations for high petroleum prices. But our discussion of the "energy crisis" has ignored the elephant in the barrel — monetary policy. Today, high oil prices are the backdrop for Middle Eastern chaos and calls for bad energy policy. It was much the same in the 1970s, when high prices yielded similar violence against our fellow man and against economics. This is no coincidence. A weak dollar is the culprit, now as then.

When the Yom Kippur war was launched in October 1973, the price of oil had been rising for two years. For decades, oil's price had been remarkably stable, like the prices of most other goods. But in 1971 Richard Nixon broke the dollar's links both to gold and to key foreign currencies. Bretton Woods — and the dollar — collapsed, and a decade-long inflation began.

By July 1973, gold had deviated from its long-time price of $35 per ounce and soared to $120. Oil also responded quickly to dollar weakness and doubled in price by the early autumn. The Mideast nations complained that the Western oil companies were accumulating massive "windfall profits." Having negotiated agreements in the previous environment of price stability, the Arabs and Persians were stuck with much lower prices and royalty payments. You know the rest of the decade's news: embargoes, gas lines, inflation, wage and price controls, hostages.

Today, commodity prices across the board, from coffee to carbon fiber, remain near 25-year highs. High oil prices are not a unique phenomenon, but just another commodity whose price is determined primarily by the value of the dollar. Expensive oil isn't *exclusively* a monetary event, of course: Risk and demand matter, too. But in comparing oil to other commodities, especially gold, we find that elevated risk and demand explains only $10-$15 of the higher oil price; $30 of the price is explained by a weak, inflationary dollar. The entity most responsible for expensive oil is thus the Fed.

For more evidence of the centrality of the dollar's value, consider what happened to oil just a few years ago. In 1998 the price of crude plunged to $10 per barrel. At the time, China had been growing at 10% per year for 20 years, the U.S. economy was growing fast at 4%, and the Middle East was typically if not maximally volatile, with Saddam testing the U.N. inspection process and the U.S. sending Tomahawks back his way. Demand and

geopolitical volatility were fairly high in 1998, and ominous "peak oil" theories had been around for a while; yet oil was just a seventh of today's price. Other commodity prices were also at multidecade lows, with gold sinking below $275 per ounce (versus today's $640). The common factor was a superstrong currency — a severe shortage of dollars. This deflation roiled world markets and bankrupted many companies and nations with dollar debts: Thailand, Indonesia, Korea, Turkey, Argentina.

The deflationary dollar sent a struggling but oil-rich Russia over the edge into default. Russia today supposedly has some magical power to set world prices, yet in 1998 oil was $60 less expensive, and a desperate Russia was helpless to achieve higher prices. Even after 9/11 and the take-down of the Taliban, oil still traded at $20 per barrel. Adjusted for inflation, this was the price of oil in 1970 — and in 1960, and 1950.

Then the Fed started making inflationary mistakes. Alan Greenspan's liquidity injections after 9/11 had mercifully relieved the deflation of 1997 to 2001, but the Fed overdid it. By leaving interest rates at 1% for far too long in 2003-04 and then raising interest rates far too slowly through 2006 — even though the economy and commodity prices had long since recovered — the Fed weakened the dollar and juiced oil prices. The Fed can make these mistakes because it watches old data like the personal consumption expenditures (PCE) deflator, possibly the most backward-looking of all price indicators. It can take five years or more before Fed actions find their way through the web of global commerce and contracts and finally show up in the PCE deflator. The dollar weakening of 1985-86, for example, did not cause a peak in measured inflation until 1990. By then the damage was done.

People say oil supply-lines are "tight," but that's what happens with all goods in an inflationary environment. Buyers buy before prices further rise. Monetary velocity — the turnover of currency — takes off. It looks like there are "shortages," but in fact there is only a shortage at the old price. The opposite happens with a strong, or deflationary, dollar. As currency becomes more valuable, buyers hold on to the money, waiting for cheaper prices later. Velocity plummets. The apparent result is "gluts" of goods. Markets and supply-lines appear "loose."

Because dollar weakness hits commodities first but eventually filters through every product, service and asset in the world economy, high oil prices won't yield as much real wealth to suppliers tomorrow as today. The prices of things they can buy with oil money will have risen as well. **Rogue oil nations will thus not enjoy as much of an increase in power as it might appear today**. **Alternative fuel sources and schemes, supposedly now in play because of high oil prices, also become less economically feasible** if most of the increased oil price is due to dollar devaluation. Moreover, if the Fed gets control of the dollar, the price of oil could fall substantially. **It is these periods of transition, where the value of the currency is changing fast, but before price changes filter through all commerce and contracts, when financial and political disruptions often take place.**

A third oil flashpoint dominates our thinking. We are told there is a race to secure scarce resources, a zero-sum struggle that points to an inevitable clash between the U.S. and China. **But there is no inherent shortage of oil**. **One tiny shale formation right in America's backyard** — the 1,200 square mile Piceance Basin of western Colorado — **contains a trillion barrels, more than all the proven reserves in the world.** Vast open spaces across the globe remain unexplored or untapped. None of this is to say we don't need more energy from more diverse sources. We do, and we should encourage the entrepreneurial pursuit of a range of new technologies. **But basing our energy policies on a misunderstanding of why the oil price is so high could severely jeopardize our economy and international security.** EE