

Unthinkably favourable

Imagination in stress testing demands unorthodox thinking, as even seemingly favourable events can have negative consequences. In the case of the oil markets, this means stress testing for a fall, as well as a rise, in oil prices, argues David Rowe

'It's an ill wind that blows no-one any good" is a common adage. Less common but equally valid is that "It's a benevolent breeze that blows no-one any harm." Stress tests around oil prices inevitably focus on a major increase, but a significant fall in oil prices would have selected negative consequences. A major increase is certainly the type of price shock that seems most likely.

Potential disruptions of supply are easy to imagine. They could arise due to political instability in the Middle East; continued uncertainty around the transition of power in Nigeria; further aggressive moves by Hugo Chavez in Venezuela or similar steps by the newly elected President Rafael Correa Delgado in Ecuador; growing chaos in Iraq; external confrontation with, or internal political conflict in, Iran – somehow the list just goes on and on. At the same time China's spectacular growth continues unabated, creating mounting demand pressure for an increased share of already tight global supply. It is no wonder that a major surge in prices is the easiest shock to visualise and rationalise. Nevertheless, a significant price decline should not be totally discounted.

The era of expensive oil can be dated from mid-October 1973. Following the Yom Kippur war between Israel and a coalition of Arab states, the Organisation of the Petroleum Exporting Countries (Opec) managed to hammer out a sufficiently well-observed internal agreement to make a supply embargo effective. Up until then, such attempts had foundered on the

inherent incentives for members to cheat in secret.

By early 1974, the price of West Texas Intermediate crude oil had soared from \$4.30 a barrel to more than \$10 a barrel. After increasing to almost \$15 a barrel by late 1978, prices soared again in 1979, reaching \$39.50 by mid-1980. I can testify from personal experience that nearly all the talk about future trends in the oil market at that time focused on how much prices would rise. Any forecaster who seriously argued that prices might drop by more than 50%, to under \$15 a barrel, just six years later would have been ridiculed. Nevertheless, that is exactly what happened.

Could it happen again?

It is true that China's spectacular entry into the world economy over the past decade is a significant factor in global energy demand that was absent in the 1970s and 1980s. Nevertheless, market responses do work. Investments in energy conservation were suddenly in vogue after the oil shocks of the 1970s – new buildings were far better insulated and heat far better controlled. The mix of new car sales shifted significantly towards smaller, more fuel-efficient cars – especially in the US, where cheap gasoline had been much more the norm than in Europe. New oil exploration and secondary extraction also bolstered supply from outside Opec. Two severe recessions in 1973–74 and 1979–82 also constrained demand. Nevertheless, by 1986, when oil prices virtually collapsed, economic growth was back on track. Clearly, a major factor influencing the supply/demand balance was the steady improvement in energy efficiency.

In the current period, the influence of economics, environmental concerns and national security priorities are converging to promote improved energy conservation. Even China appears to be realising that pollution and high energy costs pose a potential obstacle to the continuation of its economic performance. Over the next few years, these influences will continue to exert a slow, but cumulative impact on improved energy efficiency. All this says that a repeat of the dramatic collapse of oil prices seen in 1986 cannot be ruled out.

What would it mean?

Such a collapse in energy prices would, on balance, be favourable for the world economy. Nevertheless, some sectors would be adversely affected. The experience of the Texas economy in the late 1980s should serve as a warning. In the early 1980s, Texas banks were among the strongest and best capitalised in the US. By 1988, more than half of them were rated 'problem banks' by supervisors. By 1992, 506 Texas banks, including seven of the top 10, had failed or been forcibly merged.

A repeat of the type of oil price decline that occurred in the mid-1980s would again have selectively harmful effects. Forethought and planning cannot guarantee security against such effects but, as always, they can't hurt. Certainly, such a scenario needs to be part of any stress-testing programme. ■

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