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OP-ED COLUMNIST

The Oil Nonbubble

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“The Oil Bubble: Set to Burst?” That was the headline of an October 2004 article in *National Review*, which argued that oil prices, then \$50 a barrel, would soon collapse.

Ten months later, oil was selling for \$70 a barrel. “It’s a huge bubble,” declared Steve Forbes, the publisher, who warned that the coming crash in oil prices would make the popping of the technology bubble “look like a picnic.”

All through oil’s five-year price surge, which has taken it from \$25 a barrel to last week’s close above \$125, there have been many voices declaring that it’s all a bubble, unsupported by the fundamentals of supply and demand.

So here are two questions: Are speculators mainly, or even largely, responsible for high oil prices? And if they aren’t, why have so many commentators insisted, year after year, that there’s an oil bubble?

Now, speculators do sometimes push commodity prices far above the level justified by fundamentals. But when that happens, there are telltale signs that just aren’t there in today’s oil market.

Imagine what would happen if the oil market were humming along, with supply and demand balanced at a price of \$25 a barrel, and a bunch of speculators came in and drove the price up to \$100.

Even if this were purely a financial play on the part of the speculators, it would have major consequences in the material world. Faced with higher prices, drivers would cut back on their driving; homeowners would turn down their thermostats; owners of marginal oil wells would put them back into production.

As a result, the initial balance between supply and demand would be broken, replaced with a situation in which supply exceeded demand. This excess supply would, in turn, drive prices back down again — unless someone were willing to buy up the excess and take it off the market.

The only way speculation can have a persistent effect on oil prices, then, is if it leads to physical hoarding — an increase in private inventories of black gunk. This actually happened in the late 1970s, when the effects of disrupted Iranian supply were amplified by widespread panic stockpiling.

But it hasn’t happened this time: all through the period of the alleged bubble, inventories have remained at more or less normal levels. This tells us that the rise in oil prices isn’t the result of runaway speculation; it’s the result of fundamental factors, mainly the growing difficulty of finding oil and the rapid growth of emerging economies like China. The rise in oil prices these past few years had to happen to keep demand growth from exceeding supply growth.

Saying that high-priced oil isn't a bubble doesn't mean that oil prices will never decline. I wouldn't be shocked if a pullback in demand, driven by delayed effects of high prices, sends the price of crude back below \$100 for a while. But it does mean that speculators aren't at the heart of the story.

Why, then, do we keep hearing assertions that they are?

Part of the answer may be the undoubted fact that many people are now investing in oil futures — which feeds suspicion that speculators are running the show, even though there's no good evidence that prices have gotten out of line.

But there's also a political component.

Traditionally, denunciations of speculators come from the left of the political spectrum. In the case of oil prices, however, the most vociferous proponents of the view that it's all the speculators' fault have been conservatives — people whom you wouldn't normally expect to see warning about the nefarious activities of investment banks and hedge funds.

The explanation of this seeming paradox is that wishful thinking has trumped pro-market ideology.

After all, a realistic view of what's happened over the past few years suggests that we're heading into an era of increasingly scarce, costly oil.

The consequences of that scarcity probably won't be apocalyptic: France consumes only half as much oil per capita as America, yet the last time I looked, Paris wasn't a howling wasteland. But the odds are that we're looking at a future in which energy conservation becomes increasingly important, in which many people may even — gasp — take public transit to work.

I don't find that vision particularly abhorrent, but a lot of people, especially on the right, do. And so they want to believe that if only Goldman Sachs would stop having such a negative attitude, we'd quickly return to the good old days of abundant oil.

Again, I wouldn't be shocked if oil prices dip in the near future — although I also take seriously Goldman's recent warning that the price could go to \$200. But let's drop all the talk about an oil bubble.

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