

## Next time the wolf is coming

by Charles B. Blankart

J. M. Keynes wrote in 1936 that "Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back." Theories from frenzy are mostly wrong. But Keynes has omitted to say that wrong theories can generate great harm. An example is peak oil theory as proposed by the geologist Marion King Hubbert in 1956. According to Hubbert, oil should no more be regarded as a normal good, but as a political good.

Hubbert has argued that the supply of oil can be depicted as a mountain on a horizontal time axis. Uphill oil is abundant. We live in the years of plenty. But beyond the peak the years of famine follow. The supply decreases and eventually drops to zero. The implicit assumption of this theory is that the marginal costs of the exploration of new oil are infinite. Therefore the geologist and Stanford professor Gilbert Masters can conclude that: "It's About Forty Years Until the Oil Runs Out". Similarly Claudia Kemfert, the chief energy economist of the German Institute of economic research reports that her investigations prove that the global oil reserves will last for another 15 years [up to 2019]. Should oil still be available beyond the terminal date the adherents of peak oil theory will say: "Not this time, but be sure, the next time the wolf is coming."

What does Hubbert's theory tell us when we walk downhill in figure 1 and this walk coincides with an interruption of oil supply. In such a situation a crisis is nearly unavoidable. The market fails because marginal costs to increase supply are said to be infinite. Politicians, on the other hand, are called on to do something. In the oil crisis of 1973 President Nixon has imposed gasoline price ceilings. Of course, price ceilings did not contribute to supply. But price controls made the crisis visible in that gas stations were closed and automobilists had to stay in long lines before the pumps until the Arab embargo was lifted in 1974.

Two years later, in 1975, US Government made a remarkable step in securing supply of oil. It established the strategic oil reserve of 713.5 million barrels or 43% of US annual consumption. The strategic reserve could substitute all US oil imports from OPEC for 2 years and 3 months and could therefore exert an enormous market pressure on OPEC and would challenge the coherence of its cartel. Therefore the establishment of a strategic reserve was a good idea. But under peak oil theory the US government did not understand its effect on demand and supply. It decided to use the strategic reserve as a negotiation chip to obtain OPEC's benevolence. It decided that the reserve shall not be used without Saudi Arab consent. So the US Government decisively contributed to the stability of OPEC which was relieved from allocating the costs of an embargo to its members.

What should the Americans do? They could simply observe how the market allocates reserves between supply and demand. Markets consider reserves an inventory which is extended up to the point where its marginal costs equal its marginal revenue. As oil is abundant all over the world, marginal costs of exploration and reserves are actually rather low and they did not change dramatically in the past decades. Therefore there was no reason to substantially increase the reserves to production ratio (see figure 2).

But how do private markets share the burden of reserves between demand and supply? The conventional view is that demanders and suppliers both hold some reserves in order to remain in exchange equilibrium. But this is different in a *dynamic private market economy*. On the one hand the ability for holding reserves efficiently has shifted from the demand to the supply side. People prefer heating with natural gas to heating with oil because they are disembarassed from holding reserves individually (and inefficiently). On the other hand, dynamic entrepreneurs hold reserves because they want to be in market *disequilibrium*. They are eager to contract and to contract immediately. The dynamic market economy is in a sharp contrast to the *political economy of oil reserves*. If the Americans give weapons for uninterrupted supply of oil, it is not because the Arabs are more efficient in managing reserves, but because it allows them to supply oil only as long as the flow of weapons to the Middle East is uninterrupted. Herein are the long lasting costs of a policy based on peak oil theory.

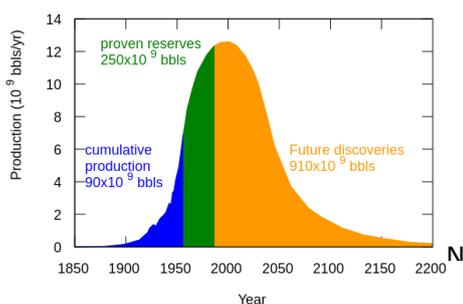


Figure 1

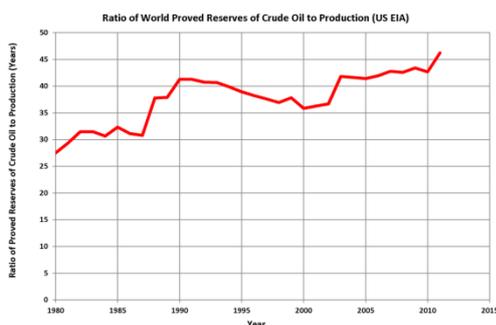


Figure 2