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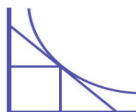

"THE OPTIMAL BUNDLE"

SPRING SEMESTER 2014: VOLUME TWO
WEEK OF FEBRUARY 17, 2015

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Special Report on the Oil Supply Glut

What is the oil supply glut? The oil supply glut is an ongoing situation where the global supply of oil exceeds the demand. Economic theory dictates that prices must fall in these circumstances and that is precisely what happened last year. Since June 2014, the price of Brent Crude—a major benchmark of worldwide oil prices—has fallen by more than 50%. But is the gap between supply and demand really large enough to cause such a vast price decline? Read the two op-eds on the back page and decide for yourself.

Investors and Consumers: A Conflict of Interests

Oil prices have increased 5% this month, and whether that is a good sign depends on who you are asking. High prices benefit investors who gain from a positive externality, as prices for other commodities have a positive correlation with oil prices. However, higher oil prices do not bode well for consumers. In a recent *Wall Street Journal survey,* 69 economic forecasters speculated that there is a net positive outlook for a country as a whole when there is a drop in fuel costs, particularly in gasoline, there is a net positive outlook. "Lower oil prices and income gains could unleash faster consumer spending," chief economist Lynn Reaser of Point Loma Nazarene University explained. For now, investors might be the ones who will be enjoying the benefits, as consumers will be forced to accept higher gas prices. Since markets have been reacting poorly to the consistent dip of oil prices though-it fell over 300 points in January-a little less consumption might be a necessary tradeoff if markets, and subsequently the U.S. economy, are going to stabilize.—RG

The zero-sum game: one side's loss is another's gain.

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An Uneven Playing Field

Are low oil prices good for the United States? It depends which states you are talking about.

Drilling can be thrilling—that is, until falling oil prices hurt your state's economy. The eight oil-exporting U.S. states--Alaska, Louisiana, New Mexico, North Dakota, Oklahoma, Texas, Wyoming, and West Virginia--will not enjoy the energy boom from recent years. One certainty of declining oil prices is that many oil drilling projects will be unprofitable and not move forward, and Scotiabank research indicates that the weighted average breakeven price is about $60 for most projects across the U.S. and Canada. Sluggish oil revenues hurt the eight states who are net-exporters of oil. The other 42 states, however, are seeing net gains. Environmental economics researcher Stephen Brown estimates that the overall U.S. economy as well will get a 1% net boost in GDP this year due to cheaper oil. The uneven effects of U.S. oil production will then be largely beneficial for the country as a whole. Such a boon is not just a cheap thrill.–CL

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(We Are Not) Drilling Our Own Grave

When you are in a hole, keep drilling. That notion seems illogical for the oil and gas industry. Brent crude prices have fallen by more than 50% since June 2014, yet there is merit to the strategy for some firms. Despite suffering declines in profit last year, Exxon Mobil and Chevron can afford to produce more oil because they are large firms involved in both the drilling and refining stages. This means they are less sensitive to price shocks than their smaller competitors. The oil supply glut has reduced industry demand and, consequently, the cost of services from firms who work for oil and gas companies. Eight of Exxon's large projects came on-line last year, and there are more to come. Meanwhile, Chevron intends to expand production up to 20% by 2017. Production from these firms' projects will last for decades, so short-term losses will likely amount to long-term gains. These companies would be foolish not to twist the knife while their competitors are wounded.–JK

Major integrated oil companies like Exxon Mobil and Chevron that are involved in several stages of oil production can withstand falling prices better than smaller competitors.

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Do Market Fundamentals Explain the Oil Price Decline?

Pro: Supply and Demand Are Guilty Until Proven Innocent

When it comes to the reasoning behind falling oil prices, there is only guilty until proven innocent. As crude oil prices float around $50, it is important to consider what caused this 50% decline from less than a year ago in the first place. While consumers in oil-importing countries rejoice at lower gas prices, Venezuelan economist José Toro Hardy worries about the reasons behind the sharp decline. Hardy identified the 2 key reasons: slowing global demand and a surplus of oil, brought in part by increased American production. Supply and demand are driving the market. It is simply basic economics.

The Organization of the Petroleum Exporting Countries (OPEC) reported that it expects global demand for its crude oil to fall in 2015 to 28.92 million barrels per day (bpd)--the lowest level in decades. This would cause a surplus of over 1 million bpd in 2015. An easy fix is to cut output, yet Saudi Arabia is urging fellow members to combat the growth in U.S. shale oil, thus making oil prices plunge even further. As OPEC members refuse to decrease their production, the supply remains high and prices remain low. Thus, it is inaccurate to suggest that the excess supply of oil is irrelevant to falling oil prices. Fracking (the process of drilling and injecting fluid into the ground at a high pressure to release natural gas inside) has increased in the United States by 3 million barrels a day. As a result, the U.S. has reduced its oil imports by nearly 30%, so traditional suppliers like Nigeria are not exporting to the U.S. And the U.S. is not the only eager country! Brazil and Russia are pumping oil at record levels. With figures like these, it makes no sense to minimize the role of either increasing oil supply or decreasing oil demand.

There is no doubt that supply of oil and dismal demand are to blame for the plummeting prices. U.S. production of shale oil is increasing and OPEC members are attempting to outlast this production. Supply and demand are guilty. Case closed.—CM

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Con: Don't Forget the Animal Spirits

U.S. oil production is booming and global demand is cooling. That is the story, at least. But when you look at the data – it just does not hold up. As of the end of 2014, daily supply exceeded demand by 800,000 barrels per day in a market that consumes more than 92 million every day. The world is producing only .85% more oil than we are consuming. Are we really to believe that such a minimal "oversupply" has resulted in a nearly 60% drop in oil prices? If traditional supply and demand cannot adequately explain the seismic shift in prices, behavioral economics might.

If the numbers do not add up, there must be other exogenous factors influencing prices. What are they?

Fear, anxiety, and uncertainty - as Professor "Chud" Chuderewicz would say, animal spirits. The market reaction has as much – if not more – to do with people's emotions than it does with fundamental economics. Investors just want information. They want to know who is going to win. They want to know if Saudi Arabia will stay on top. They want to know if America is for real. They want to know how long this battle will last. Uncertainty in financial markets creates hysteria. It produces emotional responses. It drives people to make judgment calls on the spot that may not be fully informed. And passive investors get caught up in the mix. It is psychology that says we like to follow the crowd.

Sometimes our "fight-or-flight" reactions get the best of us. But maybe we should just look at the fundamentals. Does this "oversupply" of less than 1% really justify the wild drop-off we're witnessing? Or are we just scared?—KGM

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Interested in attending a PSUEA general body meeting to learn more about the economy and experience great networking opportunities? Come to 73 Willard at 8 p.m. on Tuesday.

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