Why does oil prices rise and fall?

Of all industries in the world, oil industry is indeed an international business which affects most countries in the world. As the oil is the most consumed energy, it plays a vital role in daily lives as well as economy and social development. Also, the oil industry leads to new technology development both directly and indirectly. It has been deployed as a means for economy and political negotiation. Nevertheless, “crude oil” when refined into various petroleum products having different attributes i.e. gasoline, diesel, aviation fuel, kerosene, and fuel oil, and others, its value will be maximized. The price of crude oil is thus determined by the type and quality of the crude oil itself. Once distilled, heavy and light crude oil yield several refined products e.g. gasoline and diesel to serve demands at different quantities. In addition, sour and sweet crude are also priced differently.

Forecasting or estimating oil price in the future is sophisticated because oil is the commodity product which is available globally. Unlike other products, the quality of oil product can be made different to serve different needs of consumers. As the oil market is mainly regional activities which are born of cooperation from various countries and parties having different needs and environments, several factors then involve both directly and indirectly. Nevertheless, the price can be analyzed at both regional and global levels.

Main factors that affect the price

1. Fundamental factor

The fundamental factor of oil price determination, is demand and supply like other type of products. Demand and supply of oil products change according to situation and circumstances. In any market situation, imbalance between demand and supply can affect prices. For instance, in the case of more demand than supply (undersupply), the price is likely to rise. The variables which result in imbalance between demand and supply include:

- **Economic growth** is the factor that positively corresponds with the price of oil. When the economy grows, oil demand in our daily lives as well as demand to cope with economy expansion will increase. If the world’s production is unable to meet the growth, the price of oil is definitely on a rise. In an opposite vein, the price of oil will decrease if the economy growth is minimal in the light of oversupply of oil. It is noted that the world economy growth rate in every region must be taken into consideration.

- **Weather** Seasonal change is another factor which causes the imbalance between oil demand and production. Especially, the consumption patterns in Europe and the USA are clearly dictated by the season. That is, in winter, the demand of heating oil (mainly diesel and fuel oil) is higher than other types of oil. Normally, the oil traders start to increase inventory of heating oil in the fourth quarter of the year to prepare for the winter at the beginning of the year. As a result, the price of oil tends to increase during the said period. In addition, the demand is sensitive to the coldness. The colder it gets, the higher the demand is. Due to the
fears of the oil shortage, the consumers increase their oil inventories which also results in an oversupply and may affect the price as well.

Meanwhile, summer is the driving season for the western countries, starting in the third quarter of the year or around July. Given that the demand of gasoline is higher than other types, its price tends to increase in the second quarter of the year. In sum, the weather is another fundamental factor which contributes to the changing demand and supply and the price of oil.

**OPEC’s production capacity** If the production is not in line with the demand, the price of oil will be affected as witnessed by the price skyrocketing during the past world oil crises. Thus the countries with high reserves and production capacity have strong negotiating power for prices. Most of the producers are Organization of Petroleum Exporting Countries or OPEC which currently has 11 members i.e. Algeria, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, UAE and Venezuela. OPEC can manage and control production to meet the consumption. If the production of the member is too high or too low, the price will be accordingly affected. For instance, the growing and prolonged strike of oil workers in Nigeria can have consequences in decreasing production and rising prices.

**Policy of OPEC** The policy set by OPEC also impacts demand and supply of oil market at great length. As, the world’s largest oil producers and reserves, the OPEC’s announcement to increase or lower the production level, unavoidably triggers the oil price. As a major news, each OPEC’s meeting is always in the spotlight.

**Oil reserves of world’s major consumers** Typically, each country has to reserve oil for energy stability and security. Large consumer has to maintain the right inventory level just to sufficiently meet the demand in order to reduce the expense. The sufficient oil inventory will lessen the worry in the supply shortage. The price is likely to be softened. In the meantime, when the demand exceeds the forecast, the inventory then decreases as the consumption rises and results in undersupply. Under such scenario, the price will then adjust upward. As a result, the large consumer such as the USA or European countries, have paid a particular attention to the oil inventory.

**Alternative energy** The discovery and technology development to exploit other alternative energy sources such as natural gas, coal and nuclear and others to substitute oil at competitive prices and efficiently meet the consumers need, will decrease the demand and price of oil. As long as the technology and development is still limited, the price of oil will fluctuate and depend on the imbalance between demand and supply. Nevertheless, the world oil crisis alerts the people who suffer from the oil price to accelerate their plan to develop other alternative fuels. If alternative fuel can be developed to replace oil, the equilibrium between demand and supply will then take place.

2. **Sentimental factors**
The oil market is naturally more sensitive to news than other market. The sentiment of oil traders is the key factor to drive oil price to quickly respond to the news. The political and economy movement in any region can impact the world oil price. Particularly, in unordinary situation e.g. major war, the price is quite volatile. The news about the major oil producers
and users in the world especially in the Middle East, North Sea and the USA, etc predominantly impacts oil market more than the news about other regions. Therefore, monitoring unrest political situation, strike, coup d’etat, assassination of political leaders of OPEC countries or the decision of international organization which influences international politics, is thus critical. These news all affect the price adjustment due to the concern and worry despite the fact the production and export volume still remain unchanged.

3. Technical factor

To trade oil product in the market, apart from monitoring news and movement according to fundamental factors of oil market, the traders require information, statistic as well as average price record or history of the oil products to determine the price of today. This information also affects the decision of oil sale and purchase as well as poses an indirect impact of price level. Especially, the impact is greater in the future market which has a larger trading volume larger than the real existing volume in the market. The trading is mostly speculated for profit making. At present, there are five major future markets: New York Mercantile Exchange (NYMEX), New York, USA; International Petroleum Exchange (IPE), London, UK; Singapore Monetary Exchange (SGX), Singapore; Tokyo Commodity Exchange (TOCOM), Japan; and Shanghai Futures Exchange, China.

4. Miscellaneous Factor

Foreign exchange The oil is traded internationally and sold in US dollar. Therefore, the value change of foreign currency when compared with US dollar, affect the price of oil. When US dollar devalues, the price of imported crude and finished products will be cheaper when calculated in local currency. Conversely, the price when calculated in US dollar, will be higher. The stronger US dollar will also result in lower oil price. Furthermore, the fluctuation of foreign exchange will make it more difficult for traders to compare the price of oil in each market.

Conclusion

It can be concluded that no one can predict the price of oil in the future with certainty. But we may estimate the price and direction of oil price by taking into account various aforementioned factors. The oil price depends on a number of variables or situations occurring during a particular period. The understanding of price mechanism deems vital and most important for planning and managing energy utilization effectively and promptly.

However, the analysis of future oil price is complicated and the price is yet constantly indeterminable due to several factors. The direction of price rests upon designated hypothesis as of the day of analysis. That is why the analysis of the experts of different organizations may vary according to their views and hypotheses formed in the forecast.