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Abstract
Oil prices have been increasing dramatically in recent years. As a result, consumers are forced to endure increased costs for energy and gasoline. Oil prices affect the economy as a whole. Increased oil prices have an impact on costs involved in the manufacturing and transporting of goods; as such, they tend to result in aggravating inflationary trends.

Explaining High Oil Prices.

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The laws of supply and demand can be used to explain changes in oil prices. Increased demand will raise prices and increased supply will lower prices. Higher prices will decrease demand and provide an incentive for producers to increase supply. Current high oil prices may be due in part to increase in demand. Global demand for oil has been growing steadily (especially from the rapidly developing economies of China & India). Winters have been exceptionally cold in certain parts of the world, a factor that has increased the seasonal demand for oil. Meanwhile, some nations are stocking up their supplies to hedge themselves against possible future shortages.

However, exceptions can be found regarding the expected effects of demand and supply. For example, higher prices have not had a substantial impact on the demand for oil. Theoretically, the demand for oil should change as a result of consumers' sensitivity to fuel price changes. This change has not occurred because the price elasticity of demand for oil is relatively low. An increase in oil price will not reduce the demand for oil because oil is a necessity. The only way to reduce the demand for oil is to find viable substitutes i.e. alternative energy and fuel sources.

Contrary to the laws of supply and demand, the increase in oil price has not increased supply. It is not an actual lack of oil supplies, but rather problems that are due to supply disruptions. For example, the flow of oil from Iraq has been reduced due to the ongoing war. In 2005, oil supplies from the Gulf of Mexico were disrupted as a result of devastating hurricanes. There are concerns about possible disruption of oil supplies from Iran. Western nations have tried to exert pressure on Iran from proceeding with its programme to develop nuclear energy capabilities. Threats of economic sanctions loom, and there is the possibility that Iran could retaliate by withholding supplies of oil. The political situation in Venezuela is also another major concern.

OPEC (Organization of Petroleum Exporting Countries), a cartel that has traditionally been regarded as an oligopoly, has muscles in terms of adjusting supply quotas and thereby setting prices. OPEC's prowess was particularly notable during the

1970s, when minor reductions in the cartel's supplies led to "oil shocks" and thus to global increases in price.

In March 2006, an official OPEC statement pointed out that downstream bottlenecks and geopolitical tensions bear chief responsibility for high prices, rather than actual supply shortages. Analysts have noted that the apparent problem of oil supply is due to refinery constraints and a lack of production capacity rather than to a lack of supply, per se.

Other economic factors have also played a role. For example, the price of oil is impacted by the behavior of market investors. It doesn't matter if oil supplies are actually low or if threats to oil supplies actually exist. The mere perception of a possible threat to oil supplies can lead to an increase in trading, thereby driving up the price.

Commodity traders have recently been concerned about "geopolitical risks" in Iran, Nigeria and Venezuela and the low level of spare OPEC crude oil output capacity. Then there is existence of a trend known as "contango." A contango situation has existed in the oil market since the autumn of 2004. Because prompt cargoes are at a discount versus later deliveries, it pays to buy crude and refined products now, store them and use them later. This tendency to stockpile surplus oil has resulted in an increase in demand, which, in turn, has helped to keep oil prices at their current high level.

In certain ways, current high oil prices do reflect established economic principles, and in other ways they do not. In accordance with the laws of supply and demand, the high price is due in part to a high level of global demand. However, contrary to expectations, the demand has persisted despite the dramatic increase in price. This is because oil is a commodity with low price elasticity. Oil is a necessity rather than a luxury and there is a lack of viable substitute products at this time. The high price of oil is related in part to a decrease in supply. However, this is not actually due to a decrease in supply, per se, but rather to supply disruptions and a lack of production capacity. Because of such factors, oil producers have not been able to substantially increase the supply, despite the persistent demand and despite the incentive provided by high prices. The perceptions of investors and market traders also have an impact in terms of keeping oil prices high. Changes will have to occur in order to bring oil prices back down. These include resolutions to conflicts that are causing supply disruptions in places like Iraq, Nigeria, Iran, and Venezuela. The market would not only need to see a significant drop in demand, but also a steep rise in crude oil and product stocks, along with even higher investments in new capacity.

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