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Demand Shocks, Supply Shocks and Oil Prices: Implications for OPEC

Executive Summary

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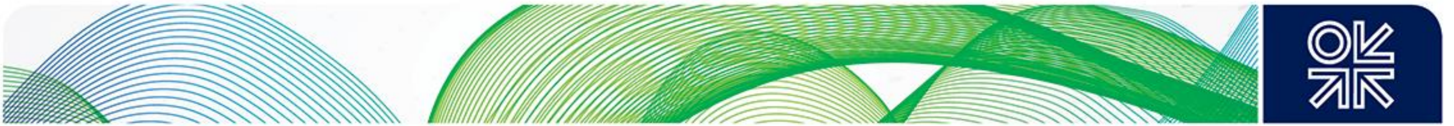
Nowadays, oil market observers often start their analysis by pointing to two sets of factors pushing the oil price in opposite directions. On the one hand, supply outages from Iran and Venezuela and the rising geopolitical risks in the Middle East as US-Iran tensions escalate are keeping an upward pressure on the oil price. On the other hand, the US-China trade war and a general deterioration in global macroeconomic indicators are preventing prices from moving higher. In the background, the usual factors, such as whether OPEC will extend its cuts to the end of 2019, or even beyond, and the performance of US shale, will continue to shape market expectations and price outcomes.

While it is relatively easy to construct 'bullish' scenarios in which oil market balances remain constructive and OECD stocks fall in the second half of 2019 - with the impact (in barrel terms) of supply outages from Iran and Venezuela and potentially Libya more than offsetting the impact of lower oil demand growth due to a weaker global economy, this type of analysis is too simplistic given that the shocks that hit the oil market are not alike. There is plenty of evidence to suggest that the nature of the shock matters and that demand shocks and supply shocks do not have the same impact on oil prices, with demand shocks being more persistent and having a bigger impact on oil price movements. In a similar vein, not all supply shocks are alike and historically the impact of exogenous supply shocks due to geopolitical outages has been shown to be short-lived, while demand shocks in the face of capacity constraints can have a persistent impact.

In this presentation, we provide evidence on the importance of identifying the nature of shocks when analysing oil market dynamics and oil prices and what these shocks imply for OPEC's next move. Our analysis shows that while geopolitical supply disruptions have been gradually and persistently increasing prices since May 2018, the most abrupt and important contributor in 2019 has been demand shocks. In contrast, speculative demand shocks aggravate volatility around a trend and in times of increased fears about supply-demand balances they can push prices higher as oil demand for precautionary purposes rises. If losses fail to occur OPEC could be facing problems looking into 2020 and beyond if these inventories are released back into the market and if some of the geopolitical outages ease.

Thus, building a case for a sustained rise in oil prices based on geopolitical outages and the 'war risk' premium on their own is not realistic in the current context of weaker demand prospects and not when key OPEC members are cutting output to levels below their agreed quotas. In contrast, any deterioration in global oil demand prospects remains the biggest drag on oil prices. In fact, one could argue that in so far as geopolitical tensions act as a dampener on global growth by undermining investors' confidence and pushing oil prices higher, as demand for precautionary purposes rises and the 'war risk' premium becomes more important, the recent rise in geopolitical tensions are not necessarily supportive of oil prices in the medium term.

What does this mean for OPEC and its key player Saudi Arabia? In such an environment of high uncertainty, Saudi Arabia's choices are rather limited. Increasing output to replace the lost barrels



from its fellow OPEC+ members risks prices falling sharply, and in an environment of weaker demand prospects and rising geopolitical tensions this would cause inventories to build fast. Deepening output cuts further would send a strong signal about the Kingdom's commitment to balancing the market but risks distorting other OPEC+ members' incentives, shifting the entire burden of rebalancing to Saudi Arabia. A simple extension of the current cut to the end of 2019 is already priced in and is perhaps the most comfortable option that OPEC would eventually adopt. In an environment of stronger demand conditions, the trade-offs between the various choices are manageable and Saudi Arabia has a good record in playing the balancing act. In contrast, if the expected weaker demand conditions do materialise, these choices become starker and the balancing act becomes more challenging even if political outages offer some respite. As argued previously[1], in such situations OPEC and its partners would have to face the hard choice of whether to accelerate or abandon their current efforts of cutting output. We still believe that the latter is a tail risk, but one that the market can't completely ignore, and one that should be given more weight if global economic prospects deteriorate sharply and if US shale surprises on the upside yet again.

[1] B. Fattouh and A. Economou, 'OPEC Policy in the Age of Trump', OIES Energy Comment, March 2019. https://www.oxfordenergy.org/wpcms/wp-content/uploads/2019/03/OPEC-Policy-in-the-Age-of-Trump.pdf