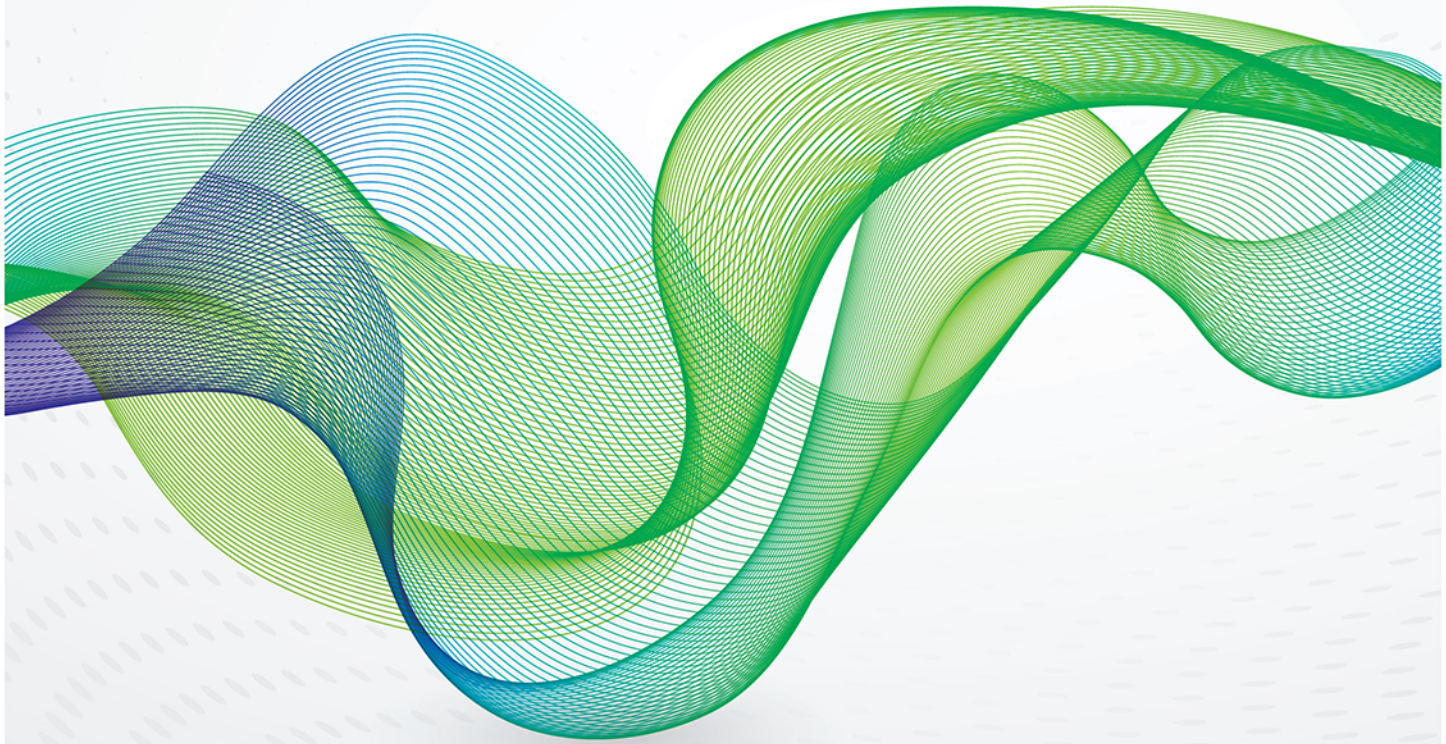
THE OXFORD INSTITUTE FOR ENERGY STUDIES

March 2019

OPEC Policy in the Age of Trump



OXFORD ENERGY COMMENT

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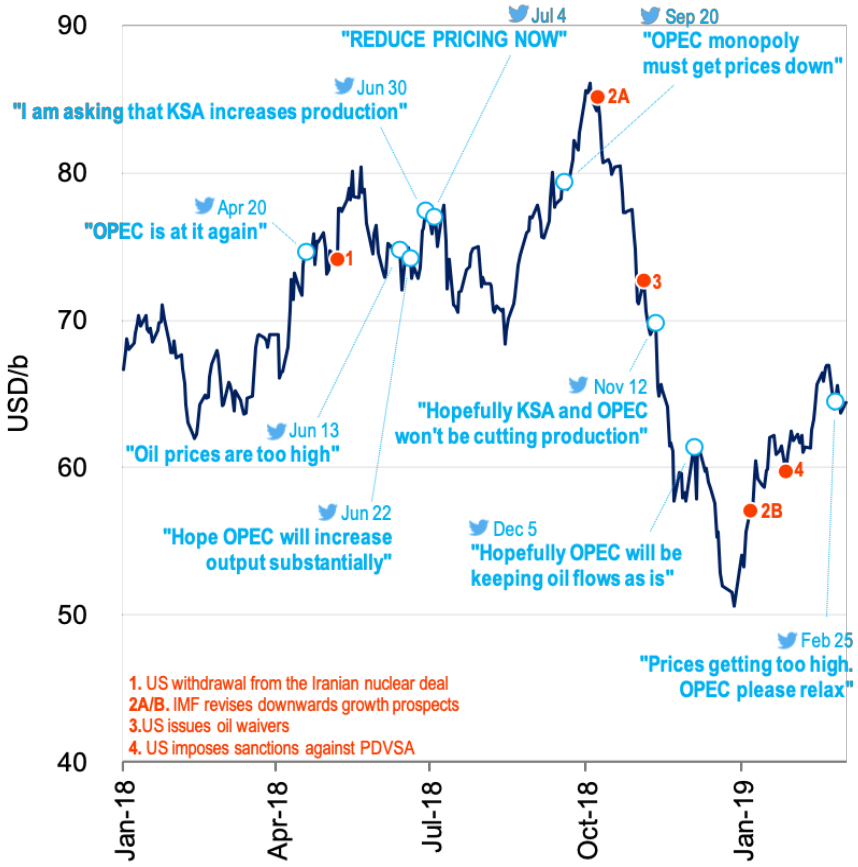
1. Introduction

President Trump's tweet on February 25 urging OPEC to 'relax' and to take it 'easy' with their cuts, and that a 'fragile' global economy can't tolerate a higher oil price, did have an immediate price impact, with the Brent price declining by 4 per cent on the day, from nearly $67/b down to $64/b (see Figure 1). But the 'Trump tweet' impact faded fairly quickly with oil prices gaining again towards the end of the same week. A clear signal from the Saudi energy minister Mr. Khalid Al-Falih in which he confirmed that OPEC and its partners would continue with their output cuts with the objective of achieving a more balanced market was a key factor behind the fast recovery. As argued in Fattouh and Economou (2019)[1], extrapolating Saudi Arabia's behavior in 2018 into 2019 is risky and the assumption that Saudi policy will reverse its current strategy under Trump's pressure does not reflect the shift in Saudi thinking and the current uncertainties and weaknesses engulfing the oil market. This Energy Comment sheds some light on the current market uncertainties pertaining to the drivers and prospects of global demand growth in 2019, the clearing of the stocks overhang and the dilemma that OPEC and its partners currently face.

Figure 1: Daily Brent price and Trump's tweets, Jan 18 – Mar 19



Source: OIES.

[1] Fattouh, B. and Economou, A. (2019), 'Oil Price Paths in 2019: Navigating Volatile Markets', OIES Energy Insight 27, February. Access: https://www.oxfordenergy.org/publications/oil-price-paths-2019-navigating-volatile-markets/

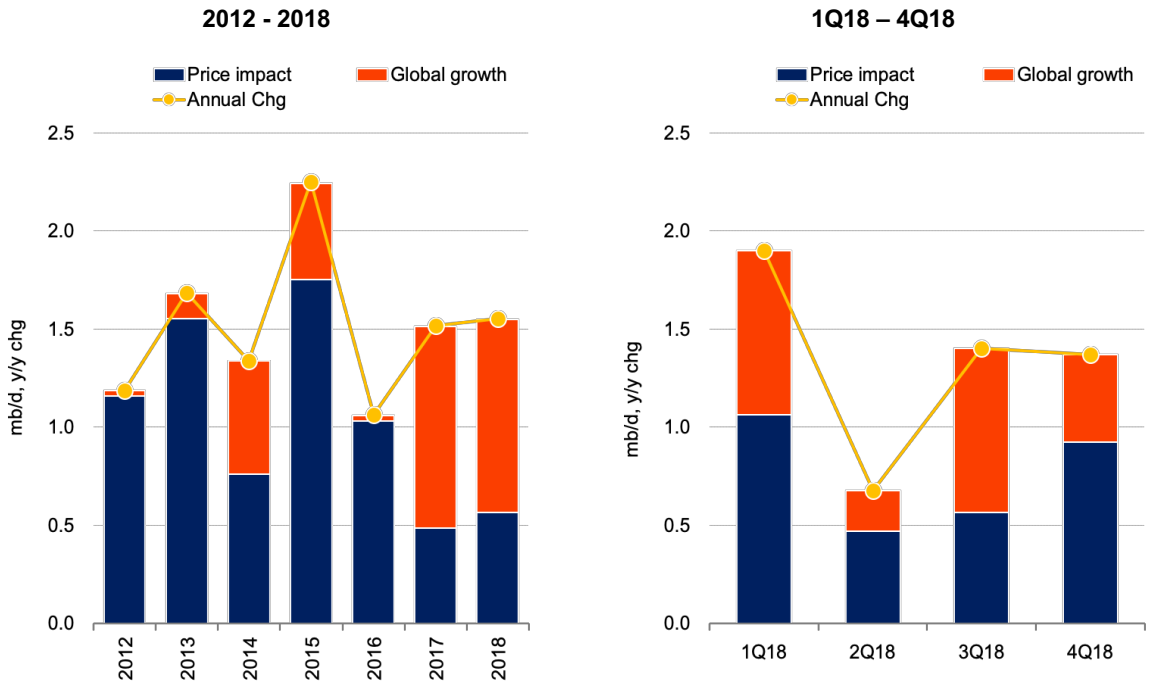
2. Decomposing global oil demand

As argued in Fattouh and Economou (2018)[2], oil demand growth in conjunction with OPEC+ cuts (voluntary and involuntary) has been one of the key factors that contributed to the market rebalancing between 2017 and the first half of 2018. Figure 2 disentangles the growth of global demand between 2012 and 2018 based on two main contributors:

- *Global economic growth*, which is associated with the demand for all industrial commodities due to fluctuations in the global business cycle; and
- *Oil price impact*, which is associated with changes in the price of oil that are channeled directly to immediate consumption and oil consumers behaviour.

Although the state of the global economy and oil prices are not the only factors affecting the growth of global demand (other factors may include income distribution, exchange rates, shifts in the composition of oil demand, price and income elasticities), analysis in this section focuses explicitly on these two contributors.[3] As can be seen in the figure, between 2014 and 2016, lower prices associated with OPEC's strategy of maximizing market share contributed significantly to global oil demand growth, with the global economy playing a less important role mainly due to its weak performance. However, as oil prices started rising in 2017 and 2018, this was reversed with the robustness of global economic performance driving most of the oil demand growth, while the oil price momentum due to the OPEC+ voluntary and involuntary output cuts began to negatively impact demand growth. The only exception was in the final quarter of 2018 where the sharp increase in OPEC and non-OPEC output and the associated price decline drove most of the oil demand growth in that quarter.

Figure 2: Decomposition of global oil demand growth



Source: OIES.

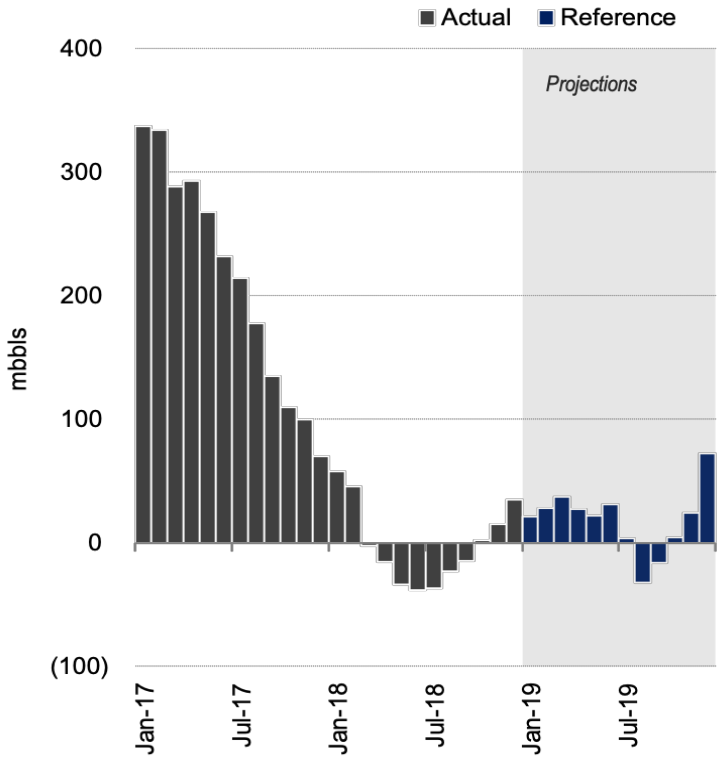
[2] Fattouh, B. and Economou, A. (2018a), 'Crude Oil Market in 2018 and 2019: How Did We Get Here? What Next?', OIES Presentation, September. Access: https://www.oxfordenergy.org/publications/crude-oil-market-2018-2019-get-next/

[3] The decomposition of global oil demand presented above is based on the structural VAR model of global demand due to Fattouh and Economou (2018b, 'OPEC at the Crossroads', OIES Energy Insight 37, June). Access: https://www.oxfordenergy.org/publications/opec-at-the-crossroads/

3. The fragility of oil market balances

Given that global economic performance has been the main contributing factor to global oil demand growth in recent years, the performance of the global economy is key for market rebalancing in 2019. In fact, the current uncertainties and pockets of weaknesses in the global economy (in addition to expectations that US shale will continue to surprise on the upside) are perhaps the main factors why prices did not increase faster despite the very deep cuts from Saudi Arabia (nearly 1.0 mb/d since November and 0.2 mb/d below the pledged target in February 2019), some large output disruptions and a deteriorating geopolitical context. In fact, in this environment of expected slower economic growth, 0.2 per cent lower than a year ago at 3.5 per cent, Figure 3 shows that all else remaining equal, current OPEC cuts are not enough on their own to move OECD inventories to below their five-year average and to balance the market (*Reference scenario*).[4] Indicatively, in the absence of unexpected supply disruptions, OECD stocks are expected to hover above the average in the first half of the year and reverse into negative territory only in the third quarter before exceeding the average again towards the end of the year.

Figure 3: Reference forecast of OECD stock v 5-year average in 2019, Jan 17 – Dec 19E



Source: OIES.

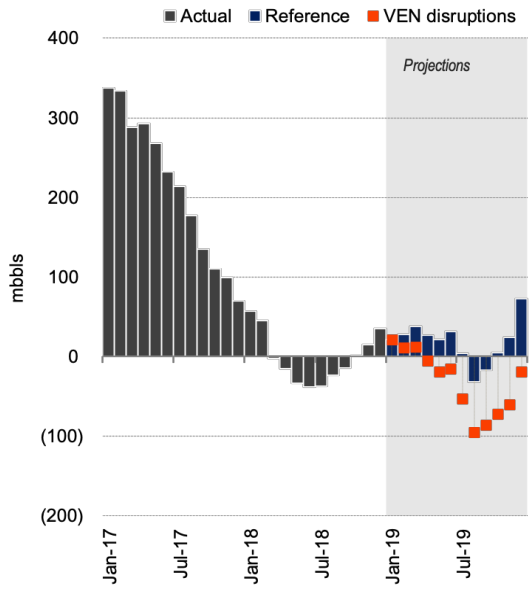
Only when geopolitical disruptions from Iran and Venezuela are included in our projections do OECD inventories fall below the five-year average this year, especially towards the second half (see Figure 4). In other words, the geopolitical disruptions could, in a way, confuse the signals and mask the current 'fragility' of oil market balances, which requires extreme caution to be exercised from the perspective of oil producers' behaviour and output policy.

[4] Forecast scenarios are constructed based on the 5-variable structural VAR model of the world oil market due to Economou et al (2017, 'A Structural Model of the World Oil Market: The Role of Investment Dynamics and Capacity Constraints in Explaining the Evolution of the Real Price of Oil', OIES Energy Insight 23, December). Access: https://www.oxfordenergy.org/publications/structural-model-world-oil-market-role-investment-dynamics-capacity-constraints-explaining-evolution-real-price-oil/

Figure 4: Geopolitical disruptions forecast scenarios, Jan 17 – Dec 19E

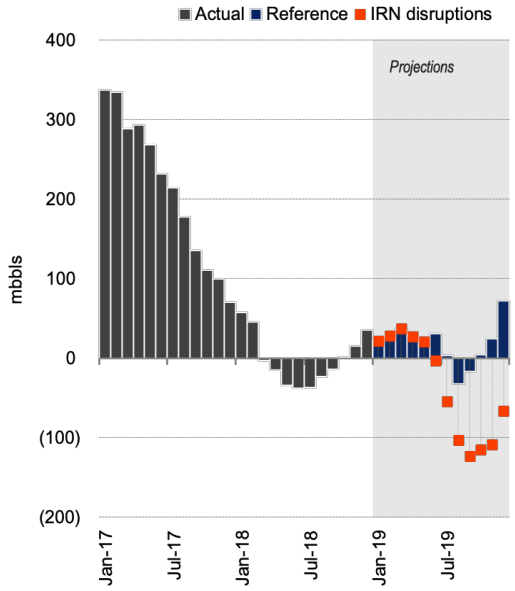
Venezuela scenario

Gradual decline by 0.4 mb/d year-end



Iran scenario

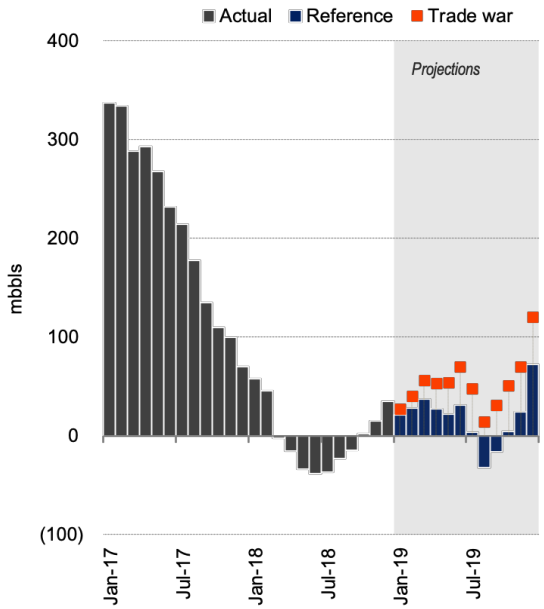
Loss of 0.55 mb/d as of May 18

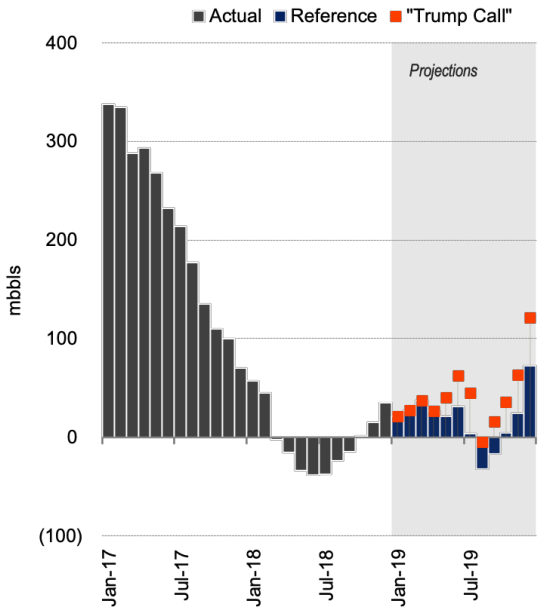


Source: OIES.

From OPEC's perspective, these geopolitical disruptions are beyond its control and are highly unpredictable which complicates its policy. Instead, it is US foreign policy and sanctions that are, in large part, influencing the size of the disruptions and their duration. If one adds the potential impact of trade tensions on global economic growth, then it is Trump and not OPEC that holds most of the 'wildcards' that could shape market outcomes in 2019. Figure 5 shows that if trade tensions between US and China are not resolved and result in slower global economic growth (e.g. weakening further to 3.2 per cent in 2019), this would cause a significant build-up in stocks. Similarly, if OPEC where to reverse its output cuts in response to the "Trump call" and the US decides to extend the Iran waivers, this would again cause stocks to build, in a similar fashion to the second half of 2018.

Figure 5: US diplomacy forecast scenarios, Jan 17 – Dec 19E

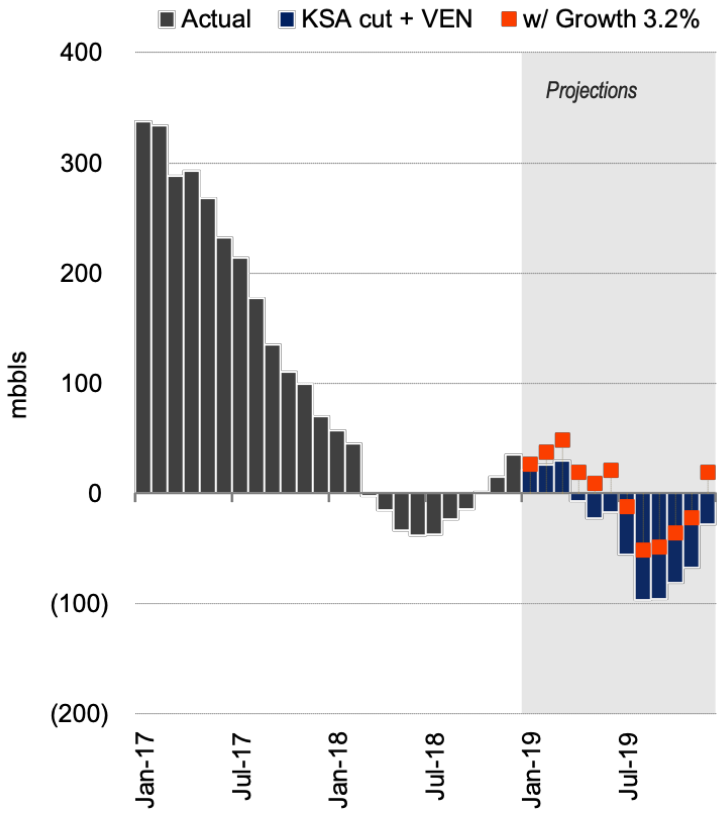




Source: OIES.

In such an environment of heightened uncertainty, it would be prudent for OPEC and its key player Saudi Arabia not to change course and to maintain their output cuts for now. But our results also show that such a strategy does come at a cost, as higher oil prices in the current context of a more 'fragile' global economy, would have the effect of slowing demand growth, therefore OPEC has a key interest in moderating oil prices regardless of Trump's tweets. As can be seen in Figure 6, even in the presence of geopolitical disruptions and the deeper cuts announced by Saudi Arabia (to 9.8 mb/d in March), OECD stocks could still build above their five-year average ending-2019 due to an unexpected slowdown of global demand. Further, as past experience has shown (e.g. in November 2014), in this situation OPEC and its partners would have to face the hard choice of whether to accelerate or abandon their current efforts. The latter is a tail risk that the market simply can't ignore.

Figure 6: KSA cuts deeper forecast scenario, Jan 17 – Dec 19E



Source: OIES.