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Oil markets in 2023: the year of the aftershocks

Oil markets were subject to a series of large shocks during 2022: Russia's invasion of Ukraine in late February and the ensuing sanctions, embargoes, and the price cap on Russian oil imports; a coordinated response by oil-consuming nations (led by the US) to control prices by a massive release of strategic stocks; recessionary and inflationary pressures weighing on the global economy; China's domestic demand shocks from its strict zero-COVID policy; and the massive transformations in crude and products trade flows, to name but a few.

Oil markets throughout the years have been subject to both supply and demand shocks, but 2022 also saw an increase in government intervention in global energy markets, including oil markets, as energy security and affordability concerns became key drivers of energy policy. These increased government interventions have elevated key uncertainties in the physical market, while oil futures have also witnessed a decline in liquidity and open interest, alongside rising costs of using these markets for risk management.

These shocks and elevated uncertainties shaped balances and market expectations. That said, the global oil market adapted quickly and physical supplies were little affected. In fact the market built a small surplus of around 500,000 b/d in 2022 following a -2.3 mb/d deficit in 2021. The unwinding of OPEC+ cuts, the release of SPR oil, the ability of Russia to redirect its exports away from Europe, which limited the Russian supply disruption, and weak demand growth particularly in Q3 and Q4 all contributed to a fairly balanced market in 2022.

The events that unfolded in 2022 have set the stage for another unpredictable year. Figure 1 below shows the balance of risks surrounding our reference outlook for 2023 (in our reference case, Brent averages USD92.7/bbl in 2023). Even in the bearish scenarios (e.g., deeper and prolonged recession, lower realisation of Russian supply disruptions, stronger US production growth) the oil price remains supported at around USD70/bbl as the low buffers in the system (i.e., low spare capacity and low commercial stocks) keep prices sustained. The bullish scenarios in which prices move above USD100/bbl capture a perfect storm where large supply disruptions from Russia amid heightened geopolitical risks elsewhere are confronted by a mild recession and a strong rebound in China's demand.

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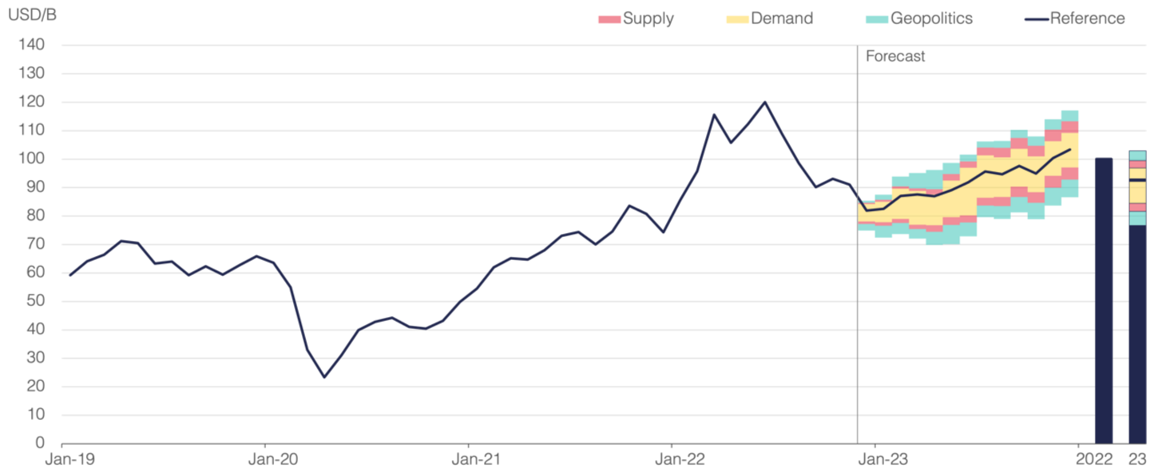
Figure 1: Balance of risks



Note: Brent price

Source: OIES (*Oil Monthly*)

In 2023, pressures on global oil demand are shifting from recessionary concerns to the uncertainty over the extent and duration of a global recession. And even though inflation is set to decline this year, it remains uncertain how soon central banks will feel comfortable about easing monetary policy as well as how much policy space there is to promote growth. But it is not all gloom for global demand prospects in 2023. The consensus continues to point towards only a mild recession in the US, and to Chinese demand growth in H2. Indian demand growth - a bright spot in 2022 - is expected to soften slightly.

In terms of oil products, the focus in 2023 will remain on middle distillates with jet fuel recovery a wildcard. Although jet fuel demand at the end of 2022 was only marginally improved from a year ago, estimated at around 20 per cent below pre-pandemic levels, we expect to see the recovery accelerating in 2023 even as the airline industry continues to face bottlenecks. Europe continues to rely heavily on Russian diesel imports (which accounted for an average of 45 per cent of the total in 2022). The upcoming embargo on imports of Russian products in February 2023 will force Europe to source supplies from other regions to substitute for nearly 500,000 b/d of Russian diesel import losses. Even the economic recession is unlikely to resolve the diesel supply deficit in Europe, while commercial stocks remain well below their five-year average.

On the supply side, Russia will remain centre stage in 2023 as the EU embargo on Russian crude and oil products takes full effect. In 2022, Russia redirected sanctioned crude particularly to India, China, and Turkey, allowing its domestic oil production to remain close to pre-war levels. But with the EU embargo on crude and products exports in full force this could change. The full impact of the EU embargo and the price cap on Russia's production and exports will not be fully understood at least until the end of Q1 2023 when the embargo on Russian products comes into effect on February 5.

With its October decision to cut output, OPEC+ set the tone for 2023 and sent a clear signal that it is willing to act proactively and pre-emptively to balance the market. In the past, such moves were limited by weak cohesion within OPEC and the time it took to negotiate output cuts. As a result, OPEC responses always arrived late after market balances had weakened sharply. But OPEC+ cohesion is now stronger and the group can respond in a more timely manner. In the October meeting, OPEC+ signalled that it will take action at any time by calling an extraordinary meeting. Also, the dynamics within the group are shaped by the fact that most OPEC+ producers outside the Middle East are producing at maximum capacity and below their quotas.

US shale continues to attract focus with the emergence of private operators as a new force within the shale industry while growth from public operators remains constrained due to investor pressure and bottlenecks, with US crude production growth projected to reach 800,000 b/d year-on-year in 2023 from 600,000 b/d in 2022. The use of the SPR as a tool for market management - a key feature in 2022 - is likely to remain relevant in 2023. This includes announced buybacks but also potential releases should the market tighten. This reflects a more fundamental shift in US policy towards using the SPR to influence market balances and expectations.

Lastly, geopolitical risks outside Russia in places like Libya also remain a wildcard, with a long speculated return of Iranian production now completely off the table in 2023.

Last year also saw a massive and structural transformation in crude oil and products trade flows with US, West African, and Middle Eastern crudes finding their way into the Mediterranean and Europe, while Russian Urals crude has been competing in Asia with Middle Eastern and West African crudes, as well as other sanctioned crudes from Iran and Venezuela. In terms of products, Europe has increased its imports of non-Russian products attracting supplies from more distant places including the Middle East, India, China, and Brazil. In effect, the oil market in its various layers has been performing the key function of redirecting crude and products in the face of a massive shock, but as the trade routes have become longer, the adjustment in price differentials sharper, the tanker market more segmented, a new class of trading practices and entities is emerging. Refineries are having to change their crude slates resulting at times in sub-optimal use of crudes. These shifts in trade flows will accelerate and consolidate in 2023, with wide implications for the structure of the market, geopolitical relations, and the dominance of the dollar in oil trade.

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