Is another oil price shock coming?

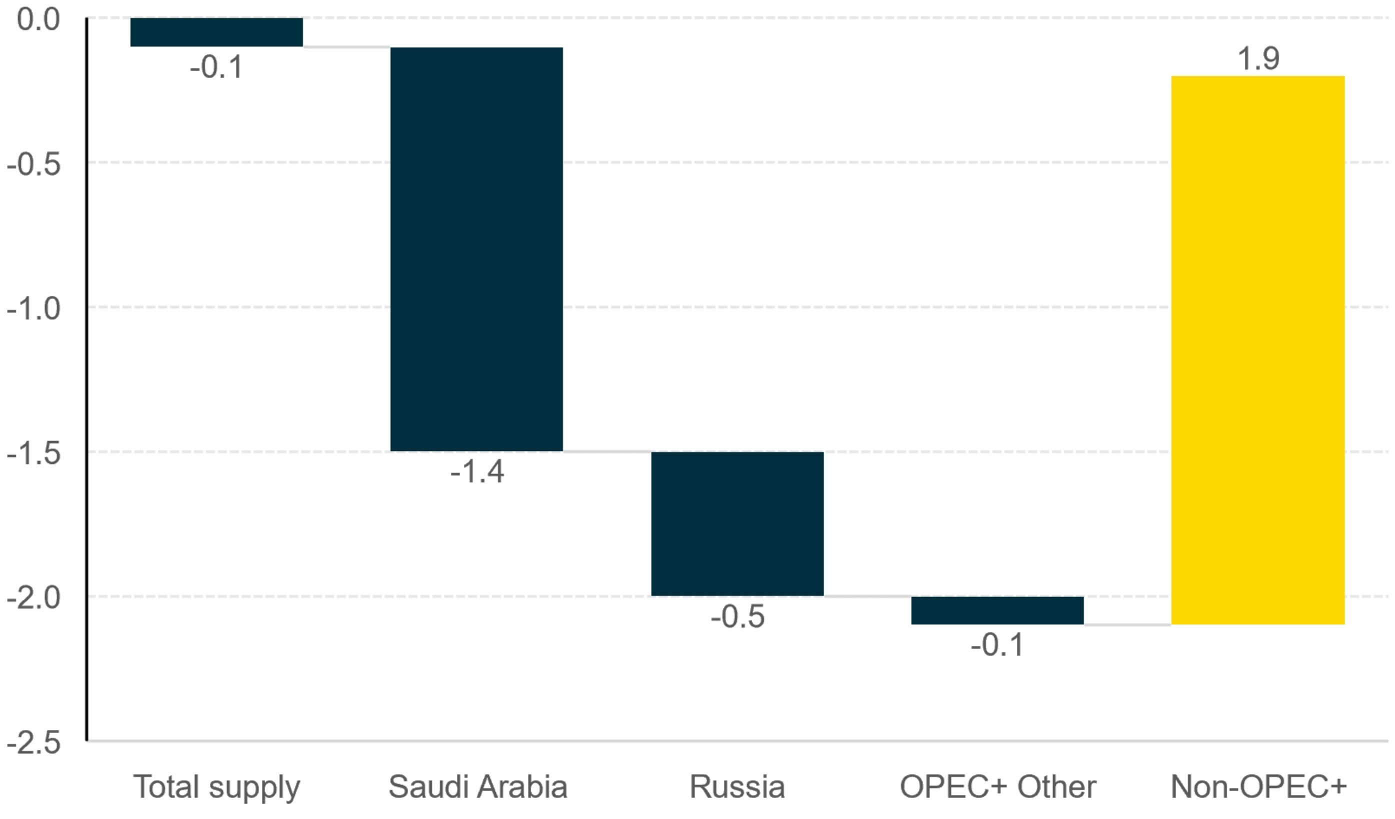
Thu Lan Nguyen

Since June, the oil price has risen by roughly 30%, rekindling inflation fears. However, given the weak global economy, further upside potential is likely to be largely exhausted, even if Saudi Arabia continues its production cuts. In fact, as soon as the US enters a recession, prices are likely to fall again. The oil price will therefore do little to prevent inflation rates from falling further.

Oil price rises due to less supply from Saudi Arabia ...

The price of a barrel of Brent crude, which had traded between $70 and $90 so far this year, recently rose to just over $95. The move was triggered by the announcement by Saudi Arabia and Russia that they would extend their significant supply cuts, which have been in place since July, beyond September to the end of the year. These cuts have been the main reason why global production has fallen slightly so far this year (Chart 1).

Chart 1 - Global crude oil production down slightly since the beginning of the year thanks to OPEC+
Change in crude oil production between January and August 2023, in million barrels per day



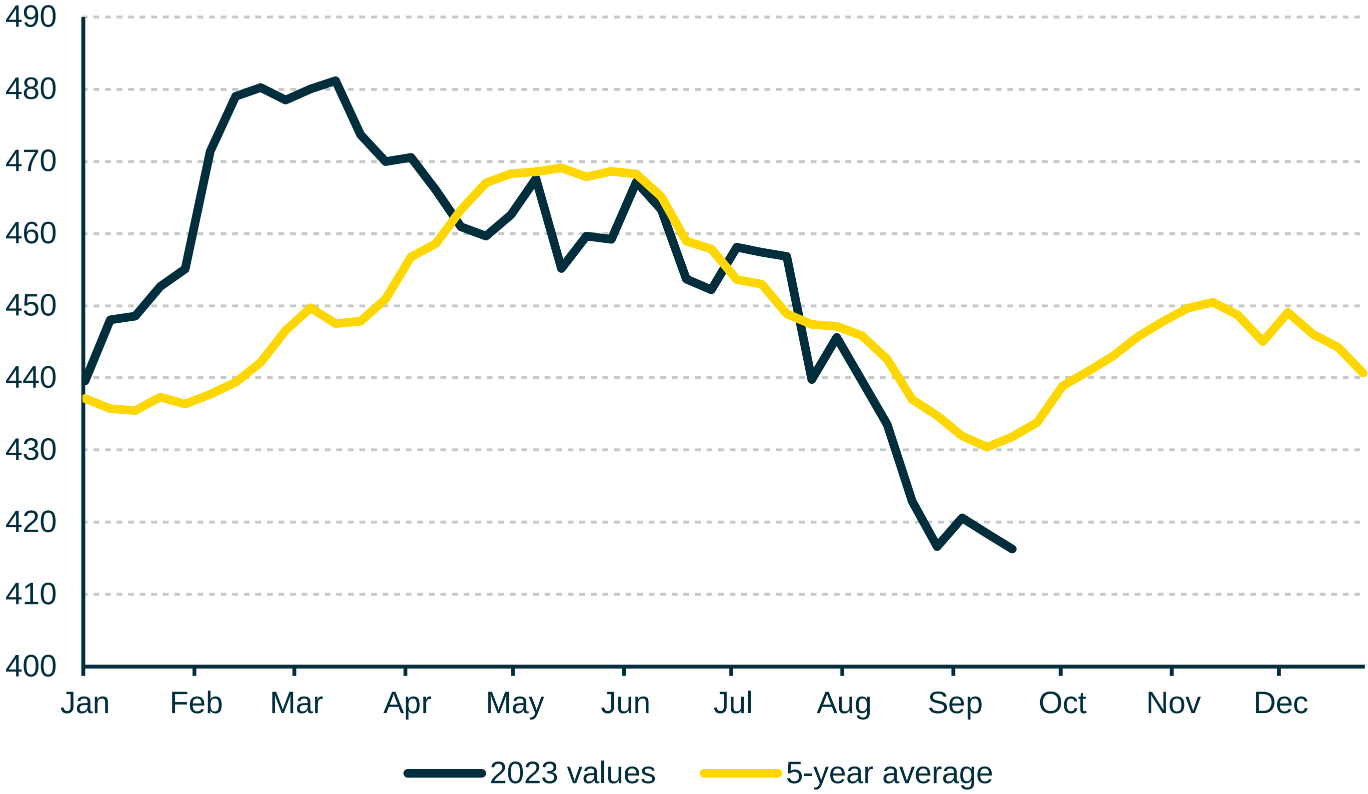
Source: IEA, Commerzbank Research

... and hope for a "soft landing" of the US economy, ...

In addition, more and more market participants seem to believe in a soft landing of the US economy, i.e. that a recession will be avoided. Last week, the Fed added to these expectations by significantly raising its growth forecasts. These developments have raised concerns that supply in the oil market will not be able to meet demand in the coming months.

These concerns are further supported by relatively low inventories. In the US, they have now fallen by 13% since their peak in the spring and, like global inventories, are now below their five-year average, with the recent sharp rise in oil prices likely having accelerated the drawdown (Chart 2).

Chart 2 - US crude oil inventories down significantly since July
in million barrels, without strategic reserves



Source: US Department of Energy, Commerzbank Research

... which, however, is likely to be disappointed

Driven by these factors, the oil price could well continue to rise in the coming weeks. However, as we look to the end of the year and into next year, there is considerable potential for a setback. This is because demand estimates are likely to prove too optimistic. This is particularly true of demand from the US, the world's largest consumer of crude oil. **We expect the US economy to slip into a mild recession at the beginning of next year, despite the strong economic performance so far.**

Demand for oil is also likely to weaken in the other two major economic areas, China and the euro area. Oil demand in the European OECD countries is likely to fall this year as a result of the recession that is becoming increasingly evident in the euro area. In China, it is likely to grow, but at a much slower pace than in the first half of the year, when it increased strongly, mainly due to the end of the Corona measures, and was the main driver of global oil demand. This effect should now begin to fade.

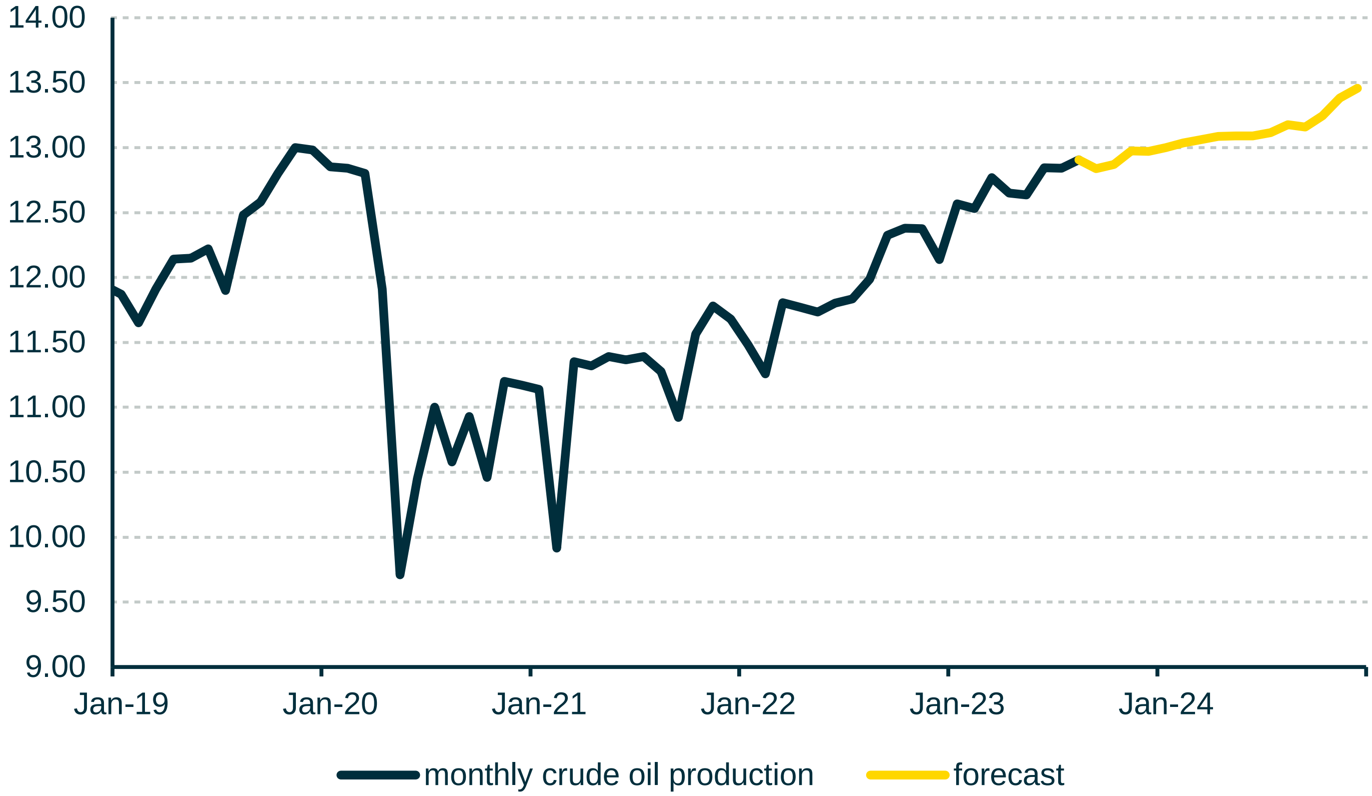
Supply is more likely to increase

At the same time, supply is likely to increase. We of course cannot exclude that Saudi Arabia would maintain its supply cuts for longer or even cut production further if prices were to decline again, which would obviously support the oil price. However, the hurdle for this is likely to be high. After all, lower production in the oil sector has caused the economy to contract, despite strong growth in the non-oil sectors. Against this backdrop, the leadership in Riyadh is likely to aim for a slow exit from the cuts early next year.

Moreover, the current higher oil price increases the incentive for higher production outside OPEC+. This applies first and foremost to the US, which is one of the largest oil producers alongside Saudi Arabia and Russia. Over the past three years, production there has made up for the slump at the start of the Corona pandemic and is close to its record high of late 2019 (Chart 3). Recently, production has fallen slightly and the US Energy Information Administration (EIA) expects production to fall in October as well. By 2024, however, the agency expects US production to be much higher.

Chart 3 - US crude oil production near record high

in million barrels per day, EIA forecasts



Source: EIA, Commerzbank Research

More crude oil could also come onto the market from Iran and, to a lesser extent, Venezuela. Production in both countries has risen in recent months, in some cases substantially, despite sanctions. According to the IEA, the increase in Iranian crude oil production has more than compensated for Russia's supply cuts since the beginning of the year. So far only a portion of this reaches the global oil market due to sanctions, however, estimates based on tanker data suggest that Iranian exports have increased significantly in recent months. Iran seems to be increasingly successful in circumventing the sanctions, which may also be due to the fact that the US, in particular, is no longer enforcing the sanctions as strictly in order to dampen the oil price by allowing an increase in the oil supply.

Oil prices with downward potential, …

Oil prices are likely to fall again at the latest when it becomes increasingly clear around the turn of the year that the US economy is teetering on the brink of recession and that no significant recovery in demand from China and Europe is expected for the time being. However, Saudi Arabia would likely prevent prices from declining strongly by extending its production cuts. We expect the price of Brent to trade just below $90 per barrel on average next year. Only a further significant supply cut from Saudi Arabia or a soft landing of the US economy would likely be able to prevent this from happening.

… which is why they should not jeopardize the downward trend in inflation

According to our forecast, the average oil price next year would be a good $5 higher than this year, which would tend to weigh on the economy on both sides of the Atlantic and further dampen the economic outlook. But the effect would be small.

The same goes for inflation. In the euro area, it will continue to fall in the coming months as food prices rise much more slowly than a year ago and the effects of supply bottlenecks and more expensive raw materials fade. In the US, this correction has already largely taken place, so inflation is likely to move sideways with considerable volatility in the coming months.

Of course, the impact on the inflation rate would be greater if the price of oil were to continue rising and move significantly above $100. According to Fed Chairman Jerome Powell, the Fed believes that a $10 rise in oil prices will add 0.2 percentage points to the inflation rate. However, for the inflation rate to show a clear upward trend, the oil price would probably have to rise to $120.

In the euro area, the impact on the inflation rate is somewhat larger, at 0.3 percentage points per $10 higher oil price. On the other hand, the downward pressure on inflation from the above factors is likely to be greater, so that the oil price would have to rise well above $120 for inflation not to fall further in the coming months.

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