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Organization of the Petroleum Exporting Countries

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Organization of Petroleum Exporting Countries (OPEC)

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OPEC would like to assure the distinguished delegates to the IMFC of the Organization's ongoing commitment to **oil market stability**. This has been reflected in recent efforts to help reduce excessive volatility, which have mainly been caused by factors outside the physical oil market. With the world economy going through one of its most challenging times, broad cooperative efforts on the part of the international community are needed to minimise the adverse impact of financial market turmoil on the world economy.

Since the Spring meeting of the IMFC in April, **crude oil prices** continued to rise to a record high in July, with benchmark WTI reaching $147/b. Paradoxically, the steady upward trend came at a time when the actual performance and outlook for the global economy were deteriorating leading to significant downward revisions to incremental world oil demand. Since mid-July, oil prices have experienced a sharp reversal, falling more than $59/b to a low of $87/b in mid-October.

The shift to bearish market sentiment has been precipitated by a growing awareness of weakening oil market fundamentals, due to deteriorating economic prospects, an associated decline in oil demand growth and the healthy supply situation primarily from increased OPEC production. Indeed, the price rise seen over the first half of the year was mainly driven by **non-fundamental factors** including the financial market flows, perceived supply tightness and geopolitical factors.

The emergence of **oil as an asset class** has exposed the oil market to volatility in the wider financial markets. A prominent example is the impact that US dollar fluctuations have had on crude oil prices. The dollar exchange rate and crude oil prices have shown an unusually strong inverse relationship since August 2007. From the fourth quarter of last year until mid-July 2008, **US dollar weakness** attracted further investment into commodities, particularly oil, as a hedge against inflation and dollar devaluation.

Perceptions of tightness, mainly promoted by investment bank reports predicting ever higher oil prices, added to supply fears in the market. With the easing in market fundamentals, it has become increasingly difficult for financial players to convince the market that supply is tight and will lead to a price spike. As the supply shortfall perceptions have turned out to be illusive and unjustified, and the US dollar found strength, prices have corrected to the downside.

Geopolitical factors are a constant feature in the oil market and influence crude oil prices with varying magnitudes. Similar to weather-related disruptions, geopolitical developments tend to have a short-term influence on prices and their effects do not persist unless they have a significant and lasting impact on supply and/or demand. The degree to which geopolitical shocks influence prices also depends on prevailing market conditions. When the market is in a tight balance, geopolitical factors can place strong upward pressure on prices but will have less of an impact in a bearish market. This can be seen in the market's mild reaction to recent geopolitical events.

Recently, hurricane-related disruptions have temporarily reduced crude and product output in the US and, as a consequence, have slowed the downward price movement. However, the overall **bearish sentiment** in the market is expected to persist, particularly since there seems to be no quick end to the current financial market crisis or the worsening economic outlook.

The outlook for the **world economy** has continued to deteriorate in the last few months as more evidence of a global slowdown emerged and continued turbulence in equity and credit markets reflected a persistent lack of confidence. The economic slowdown has now spread beyond the US to Europe and Japan with contagion risks to other regions. The **US** financial sector crisis has continued to spread to other parts of the world and poses the main risk to the global outlook, as was witnessed recently by the government takeover of the two giant US mortgage lenders, the radical change in the landscape for investment banks and the enormous bailout plan for financial firms. The housing sector downturn is still to reach bottom as seen from the continued fall in sales and prices. Looking ahead, the housing sector and tighter credit are expected to remain a drag on the US economy in the coming quarters. Data in the **Euro-zone** and **Japan** also point to stagnating economic activity, as consumers and businesses retrench amidst falling confidence and exports.

Growth in the **emerging markets** is decelerating from the very high levels seen in the past years as lower exports and potential fallout from the financial crisis begins to impact growth in the coming quarters. The risks from the financial market crisis are quite significant. Stock markets in the emerging economise have fallen sharply, creating negative wealth effects and undermining confidence. Significant risks from banking and credit market difficulties in the emerging and developing countries could curtail investment, consumer demand and consequently economic growth. The problems in the banking and credit markets in the US and Europe may also impact the availability of international credit and result in a slowdown in foreign direct investment. While there is evidence of a partial "recoupling," the severity of the impact will largely depend on the internal dynamics of consumption and investment in the developing economies. However, the recent deepening and widening of the financial crisis may take a greater toll on growth this year and in 2009.

The slower world economy along with higher retail fuel prices has affected **world oil demand** in 2008. Particularly in the US, oil consumption has fallen by close to 1 mb/d so far this year, most notably in the transport sector. In 2009, world oil demand is expected to increase by 0.9 mb/d, which is below the 20-year average.[1] This forecast is subject to considerable downward risks due to the ongoing economic turmoil. The negative trend in OECD demand growth, which began in 2006, is expected to continue with a further drop of around 0.3 mb/d in 2009. In recent years, higher non-OECD demand growth has managed to offset the decline in OECD. With non-OECD growth expected to moderate further, it would become increasingly difficult for world oil demand growth to continue at the levels seen in recent years.

While demand growth has slowed, the performance of **non-OPEC supply** is expected to improve in 2009. Following weaker-than-expected

[1] All figures based on September *OPEC Monthly Oil Market Report*. The next report will be published on October 15. Preliminary estimates point to a further downward revision in demand.

growth this year, non-OPEC supply is projected to increase by 0.9 mb/d in 2009. The Caspian region, Brazil and the US are expected to continue as a major source of non-OPEC growth in 2009 while the declining trend is expected to persist in the North Sea and Mexico.

Despite market fundamentals indicating little need for additional supply, **OPEC** has boosted **production** to help calm the market. In August, OPEC output reached 32.5 mb/d, representing an increase of 600 tb/d since April and more than 1 mb/d over the previous year. With current production, OPEC output remains well above the demand for its crude. **OPEC Natural Gas Liquids** (NGLs) have also continued to rise and now represent close to half of the growth in total non-OPEC supply, up from around a third last year. As a result, **OECD commercial stocks** have remained in line with the five-year average in terms of forward demand cover. The healthy supply situation has been reflected in the shape of the forward market, which has shifted into contango since late May, indicating prompt supply is more than sufficient to meet demand.

With the growth in total non-OPEC supply expected to outpace the increase in demand, there is a broad consensus that **demand for OPEC crude** will be lower in 2009. With current production levels well above the expected demand for OPEC crude, there is the risk of an excessive oversupply in the market in the first half of 2009, which requires continued close monitoring, especially over the winter season.

As a result of the continuing deterioration in the world economy, OPEC will hold an **Extraordinary Meeting of the Conference** on 18 November to discuss the global financial crisis, the world economic situation and the impacts on the oil market. This comes in addition to an already planned meeting to review the oil market situation on 17 December in Oran, Algeria.

The world oil market has been increasingly affected by financial market shocks from outside the physical oil market. The recent wild swings in oil prices demonstrate the need for concerted action to reduce the impact of financial markets, which are damaging for the oil industry as well as the global economy as a whole. The existing regulatory framework has proved insufficient to properly contain the negative **impact of speculative activity** in the market, which highlights the need to consider further measures. The recent moves by some consumer governments to enhance regulation and oversight are welcomed, but more needs to be done. Specifically, this would include:

- **Extension of** US Commodity Futures Trading Commission (CFTC) **monitoring procedures** to the other regulated exchanges and the unregulated over-the-counter market.
- **End regulatory loopholes** that allow speculative positions to exceed existing limits.
- **Strengthen and enforce regulation** aimed at minimizing potential distortions to economic fundamentals of price discovery (excessive speculation, fraud, manipulation).

As an effort to enhance understanding of this complex issue, **OPEC** and the **EU** commissioned a joint study this year on the impact of financial markets on the price of oil and volatility, which will be followed by a workshop with broad international participation in 2009.

Finally, it is important to note that OPEC Members have continued to undertake enormous **investments** to ensure that supply is sufficient to both meet growing future demand as well as to provide an adequate cushion of spare capacity. These investments have taken place despite the considerable uncertainties regarding the demand for OPEC crude. As always, OPEC welcomes and encourages efforts to **reduce demand uncertainties**, including **increased transparency of energy policies** in consumer countries, which should help ensure timely investments over the longer-term and promote greater oil market stability.