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Corona and the oil market

Erste AM Communications



The oil market won't escape the corona virus unscathed either. Within only two weeks, oil recorded its best and its worst day of the millennium so far.

On 9 March 2020, the most important oil benchmarks fell by more than 35%, a loss last exceeded at the beginning of the second Gulf War. On 20 March, prices increased by almost 24% – the biggest jump ever recorded. In order to understand the extreme volatility on the oil market, one has to look at its idiosyncrasies.

“Free market”

In contrast to normal markets, which are determined by supply and demand, the oil market is strongly influenced by a cartel that tries to stabilise the market.

OPEC, headquartered in Vienna, is an organisation of oil-exporting countries whose goal is to keep the oil market in equilibrium. This is largely achieved by voluntary production cuts, i.e. the various countries relinquish some of their potential production in order to ensure higher oil prices.

However, the power of OPEC has waned in recent years, which is why it has teamed up with Russia. Russia “ratifies” the decisions of OPEC and also participates in the production cuts.

Cue corona

At the last OPEC meeting on 6 March, Saudi Arabia suggested to expand the production cuts of 2.1mn barrels/day already in place to 3.6bn barrels/day. The reason cited was the falling demand resulting from the corona crisis. Russia only wanted to extend the existing cuts of 2.1mn barrels/day until the effects of the virus on the economy were better predictable.

The various parties became entrenched in their different points of view, and political escalation followed. The already agreed-on production cuts were cancelled, and Russia and Saudi Arabia started a price war and flooded the markets.

At the same time, demand declined at a rate the market had not seen before, with the need for oil plummeting due to the corona containment measures. This caused a precarious situation on the oil market: rising supply amid falling demand. The oil price fell by more than 50% within only 16 days.

Source: Barclays Resesarch. ‘Other’ refers to buildings, agriculture, transformation and other non-energy use, mainly bitumen and lubricants

The Art of the deal

Both Saudi Arabia and Russia can maintain a price war over longer periods of time, i.e. overcome extensive phases of low prices.

The country hardest hit by the low oil price is the USA. The shale gas boom made the USA the biggest oil producer in the world – however, the complex extraction is only profitable at prices above USD 45 per barrel. Many shale gas derricks have to be discontinued amid low oil prices, with thousands of jobs in the oil sector possibly lost.

This got US President Donald Trump involved, who announced that he would intervene in the dispute between Russia and Saudi Arabia if it were to continue unabatedly. The announcement alone was enough for the oil price to set the highest intraday gain in history: on 20 March, the price of the American oil grade WTI increased by almost 24%. Telephone calls with Vladimir Putin and Mohamad Bin Salman did result in a rapprochement, and OPEC announced an emergency meeting for 9 April 2020.

An Easter miracle?

In negotiations, which turned out difficult and lasted until Easter Sunday, OPEC agreed to cut production by 9.7mn barrels/day. In addition, other G-20 states (e.g. USA, Canada, Brazil, and Norway) also wanted to reduce their production without giving specific numbers. Whereas the oil price jumped 8% in reaction to the agreement, it later closed at -1%, i.e. in negative terrain, which reflects the critical attitude of market participants towards oil demand.

Despite Fridays for Future, Green New Deals, and promises from politicians to make the world “greener”, crude oil consumption has continuously increased in recent years.

**all data until 2019*

The corona crisis has turned many business trips virtual, and more people are working from home. Both aspects are good for the environment, and climate initiatives such as the 2-degree target of the Paris Climate Agreement finally seem achievable.

If we keep some of the habits the corona virus has forced us to adopt, we will be able to reduce our dependency on mineral oil.

The world would thank us for learning from this teachable moment!

Our dossier on coronavirus with analyses: <https://blog.en.erste-am.com/dossier/coronavirus/>

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