Flash by EIC

SCB Economic Intelligence Center

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Saudi Arabia and Russia agreed to freeze crude oil production levels

Event

- Russia and three OPEC members including Saudi Arabia, Venezuela, and Qatar (with a combined production of one-fourth of the world's total oil production) have agreed in an urgent meeting in Doha, Qatar on February, 16th, 2016, to maintain their oil production at their January levels. The deal is however contingent on other major producers joining the agreement.

Analysis

- **The deal disappointed investors who expected to see an output cut from the OPEC and Russia. Yet, the outcome signalled a more pronounced effort by the OPEC to stabilize crude oil prices.** The agreement reached in this urgent meeting disappointed the markets. After the announcement of the output freeze, the Brent crude price plunged by 4%. The European stock indexes, the first to react to the news, fell by more than 1%. Canadian dollar, which is highly correlated with crude oil prices, depreciated 0.5% within the first hour of the announcement. However, the impact on crude oil prices and the global financial markets is considered limited compared to the responses to failures to hold a meeting in the past. EIC therefore views this meeting's outcome as a positive signal for oil prices as it is the first attempt to reach a deal between OPEC and non-OPEC producers after a year of low oil prices.

- *Saudi Arabia's decision to hold production level signals its intention to maintain its market share and keep the pressure on the U.S. shale oil industry.* Even though the current level of crude oil prices is lower than shale oil production cost at around 40-50 USD, the decline in shale oil production volume is much smaller than previously expected. This is because U.S. producers receive support from domestic banks, and most expect oil prices to recover at the end of this year. However, a slowdown in investments for new shale-oil wells in the U.S. along with lower production for existing rigs will reduce supply from this group of producers more apparently in the next 1-2 years.

- **However, the strategy change by Saudi Arabia implies that the issue of budget deficits in the OPEC countries may be more severe than previously thought.** The fiscal balances of Saudi Arabia and some OPEC members are significantly affected by plunging oil prices. A report by the IMF estimates that Saudi Arabia could be bankrupt within 5 years if crude oil prices remain below 50 USD/barrel. The change in strategy will help stabilize and support crude oil prices, while also allowing the country to maintain the global market share and keep the pressure on shale oil producers.

Implication

- **EIC expects that crude oil prices in 2016 will be volatile, but gradually recover in the second half of the year as crude oil supply and demand reach an equilibrium.** The new agreement will keep the global crude oil supply close to the current level. EIC expects that, in the first half of 2016, crude oil prices will remain low, but will gradually increase in the second half of the year as supply and demand reach an equilibrium. However, further corporation of the OPEC and Russia in supporting crude price still needs to be closely monitored.

- **Nonetheless, persisting factors that keep oil prices low include a likely increase in crude production and export from Iran and weak demand due to fragile global economic recovery.** We expect Iran to ramp up its crude oil production by 0.6-1 million barrels per day, while its exports could increase by 1 million barrels per day, adding to the global supply. Additionally, the global economy shows no clear sign of recovery, implying lower crude oil demand than previously expected.

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