Economic Analysis

Oil Prices: Can the new output deal save producers?

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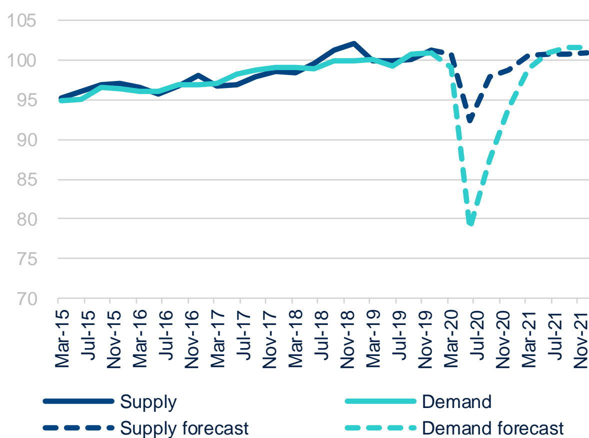
The OPEC+ alliance supported by the G20 negotiated an agreement by 23 countries to cut global petroleum output by 9.7 million barrels per day (b/d) -around 10% of the total- through the end of June. The cuts will taper to 7.7 million b/d in 2H20 and to 5.8 million through 2021. Cuts will be implemented relative to October 2018 levels for most countries, except Russia and Saudi Arabia, which will depart from 11 million b/d each. The agreement effectively put an end to the price war between Russia and Saudi Arabia that, along with the COVID-19 pandemic, brought crude prices down by more than 50% since early March. However, markets reacted with skepticism to the deal. The price of crude oil went up significantly before the news but erased some of the gains achieved later on for Brent and all of the gains for WTI, which even declined slightly throughout the day.

Despite the magnitude of the deal, the committed output cuts won't be enough to compensate for the contraction in demand caused by the pandemic. Our estimates suggest that demand could contract by an average of 15 to 25 million barrels per day in 2Q20. Moreover, we expect demand to remain subdued through the rest of the year since global growth is not expected to return to pre-crisis levels until 2021 and the lagged effects of fiscal and monetary stimuli. Therefore, rather than boosting prices in the short-run, the production agreement could set a floor to prices, resulting in less volatility and more stable conditions for the market to recover.

Figure 1. **Oil Supply and Demand** (million barrels per day)



Source: BBVA Research and Haver Analytics

Table 1. **Crude Oil Prices** (USD per barrel)

	Brent	WTI
2018	71.1	64.9
2019	64.4	57.0
2020	**39.3**	**35.2**
2021	**49.8**	**47.0**
2022	**56.5**	**54.2**

Source: BBVA Research

However, risks are still tilted to the downside. As economies remain locked down, stockpiles are reaching their maximum capacity, which could keep prices low. Futures are still in contango, incentivizing inventory accumulation. Moreover, as it is normally the case with OPEC+ deals, implementation is subject to a high degree of uncertainty. Out of the 9.7 million b/d committed, only the biggest OPEC producers (Saudi Arabia, Kuwait, and the UAE) have the capacity to withdraw their quota from the market in a short period of time. Moreover, most non-OPEC countries

will comply not by conducting voluntary adjustments, but by letting their production decline organically as a result of lower prices, which could take several months.

The U.S. has not offered firm production cuts but the adjustments will materialize as drilling declines in response to lower prices. Already, production has declined by more than 200 thousand b/d from February (record-high). By the end of the year, U.S. production could be down by 2 million b/d or more. Moreover, there is a possibility that the Texas Railroad Commission may end up taking an active role in managing an orderly adjustment that prevents value destruction and another wave of bankruptcies in the shale industry.

We think that in a best-case scenario, only a fraction of the committed cuts would materialize in the next couple of months. In other words, the agreement was already late and thus, adjustments to production won't happen when they are most needed.

Therefore, we maintain our baseline scenario for crude oil prices. In particular, there is still a significant probability that prices could retract from current levels. The group of nations will meet again on June 10, and further intervention could be needed if the decline in demand turns out to be worse than expected.

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