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MACRO COMMENT

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Where are energy markets headed?

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HIGHLIGHTED IN THIS PUBLICATION:

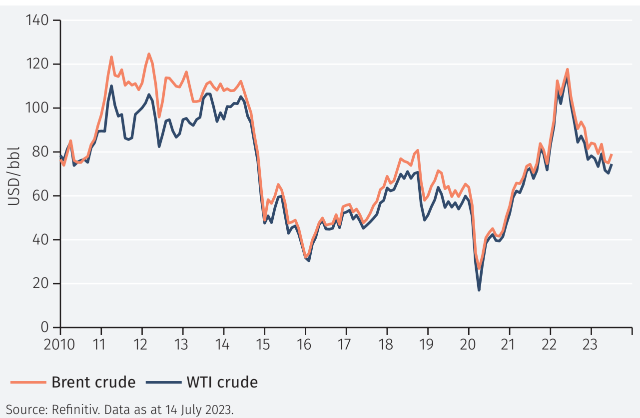
Falling energy prices have recently provided relief to consumers after large increases over the past two years. In this edition of *Infocus*, Senior Economist GianLuigi Mandruzzato looks at the fundamentals of oil and natural gas markets and considers the near-term outlook.

Oil and natural gas prices have fallen sharply since mid-2022 amid evidence of resilient supply exceeding demand as the global economy slowed. In particular, the weakness of the energy-intensive manufacturing sector reduced the demand for electricity and for the energy raw materials used to produce it. Furthermore, the growth of electricity production from renewable sources further reduced the demand for fossil fuels and added to the downward pressures on their prices.

The oil market

The oil price has returned to levels last seen prior to Russia's invasion of Ukraine in February 2022 (see Figure 1). This reflects the decline in demand due to the high prices of petroleum products reached in 2022, the weakness of the global manufacturing sector, and changes in consumer habits after the pandemic. This trend is evident in data for the US, the world's largest consumer of energy products (see Figure 2).

1. Oil prices, USD per barrel (bbl)

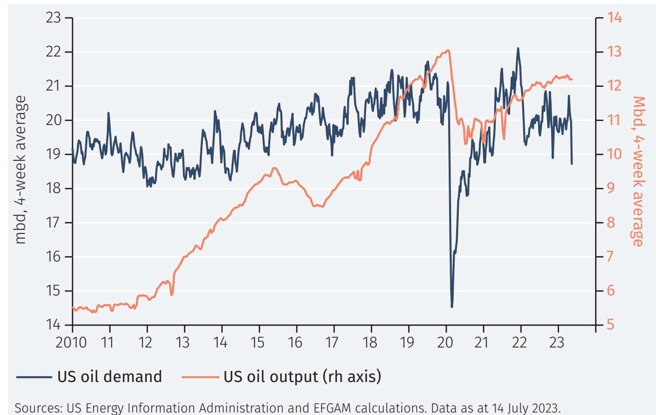


Source: Refinitiv. Data as at 14 July 2023.

However, prices remain sufficiently high to incentivise production in non-OPEC+ countries,[1] including the US, which in 2023 will see its highest annual production ever, exceeding 12.3 million barrels per day (mbd). Therefore, since the beginning of 2022, the oil market has seen an excess of supply over demand of around 0.5 mbd, which has weighed on prices.

This excess supply has persisted despite the efforts of the OPEC+ cartel, led by Saudi Arabia and Russia, to rebalance the market by reducing production (see Figure 3). The latest cuts, announced in April, June and July of 2023, reduced production quotas by a total 2.66 mdb, or almost 3% of global supply.

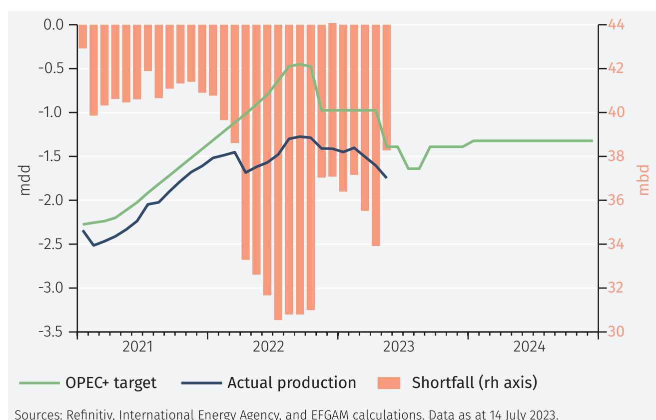
2. US oil demand and output



Sources: US Energy Information Administration and EFGAM calculations. Data as at 14 July 2023.

The failure of OPEC+ to push oil prices higher further undermines its credibility as a market stabiliser. That role is already diminished after the cartel has undershot its production targets and yet global oil supply has continued to exceed demand (see Figure 3). Furthermore, frequent revisions to the cartel's production targets highlight the difficulty in determining how much oil is needed to balance the market in the post-pandemic economy.

3. OPEC+ production shortfall, million barrels per day (mpd)



Sources: Refinitiv, International Energy Agency, and EFGAM calculations. Data as at 14 July 2023.

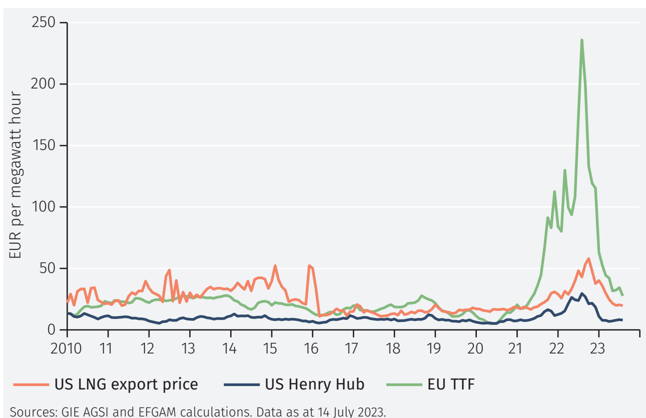
[1] OPEC comprises the five founding members of the Organisation of Petroleum Exporting Countries – OPEC – Saudi Arabia, Iraq, Iran, Kuwait, Venezuela and Libya, Congo, Gabon Algeria, Nigeria, Angola, Equatorial Guinea and the United Arab Emirates.
OPEC+ comprises those 13 OPEC countries above plus Russia, Kazakhstan, Azerbaijan, Mexico, Oman, Brunei, Equatorial Guinea, South Sudan, Sudan and Malaysia.

At the same time, the cartel's strategy of cutting production to increase prices risks being self-defeating. High oil prices support production outside the cartel and accelerate the transition to renewable sources of energy, creating the conditions for a longer-lasting excess supply of oil. In this context, only a significant recovery of the global economy could rebalance the market in the next few months and support significantly higher oil prices, although this seems unlikely.

The natural gas market

The collapse in the price of natural gas was as spectacular as its surge from mid-2021 to August 2022 (see Figure 4). In Europe, after exceeding EUR300 per megawatt hour (MWh) last year, the price has dropped close to EUR25 MWh, a manageable level albeit at the high end of the pre-pandemic range. In the US, the price on the domestic market and that of exported liquified natural gas (LNG) both fell to the low end of their pre-pandemic ranges.

4. Natural gas prices



Sources: GIE AGSI and EFGAM calculations. Data as at 14 July 2023.

The drop in European natural gas prices reflects a 24% reduction in local consumption in the first half of 2023 compared to 2021 and the diversification of suppliers to replace imports from Russia after the invasion of Ukraine. As a result, in early July EU natural gas storage was at 80% of capacity, much more than in the same period over the last two years (see Figure 5). High storage capacity implies that a daily pace of accumulation of less than half that of the April-June period will be enough to achieve the target of 95% of capacity at the end of October. The resulting moderation of natural gas demand from Europe will help keep prices low globally.

Gas prices received further downward pressure from record US production. According to US Energy Information Administration estimates, US excess supply over domestic demand will be 50% greater in 2024 than in 2022, increasing the availability of US LNG for exports and keeping the global natural gas market well supplied.

5. EU percentage use of natural gas storage capacity

Sources: GIE AGSI and EFGAM calculations. Data as at 14 July 2023.

Conclusions

Energy prices, including those of oil and natural gas, have fallen sharply since mid-2022 due to weak demand and despite measures taken by OPEC+ to support oil prices. With the energy-intensive manufacturing sector being particularly weak, energy price risks remain skewed to the downside over coming months.

In turn, lower energy prices will help lower inflation. Over time, this should filter through to the core components of consumer price indices, creating the conditions for less restrictive monetary policy.

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