

# The World Needs OPEC, but OPEC Can't Go It Alone

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## Instant Insight

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## About KAPSARC

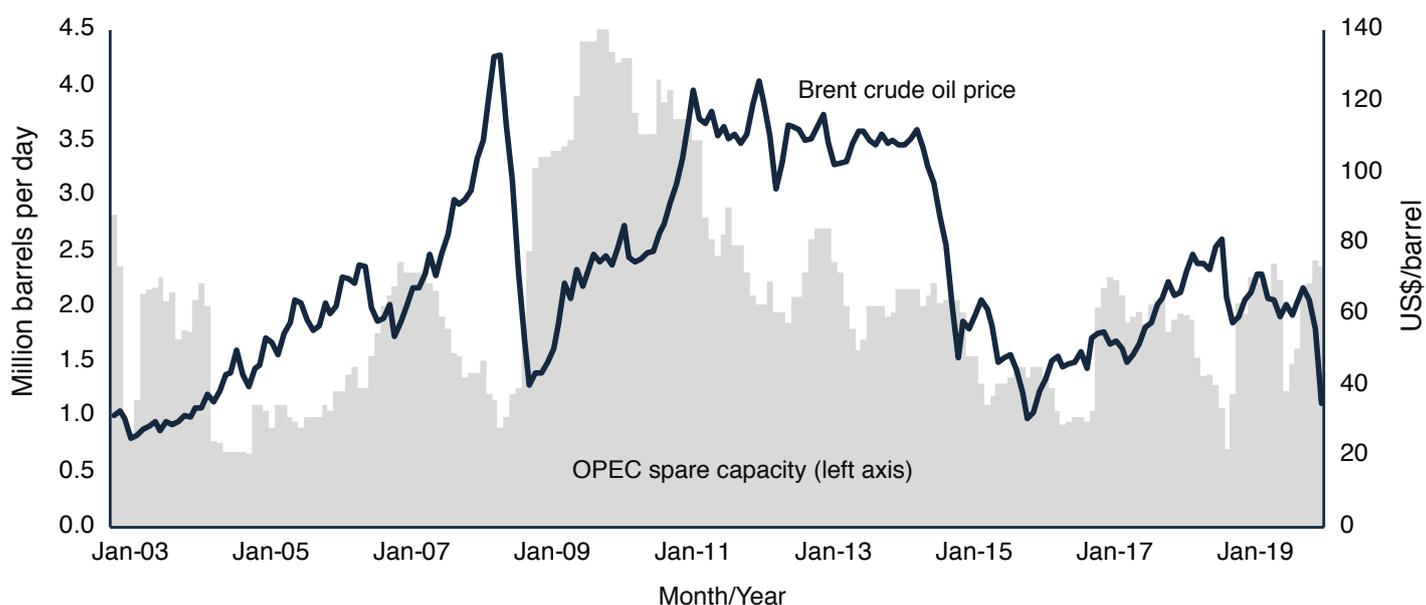
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The global oil market is going through an extraordinary period. The twin shocks of a significant increase in global supply and a remarkable fall in oil demand appear to have no parallel in history. Together, the collapsed OPEC+ agreement and the coronavirus outbreak have put OPEC and the value of its role in the market back into the spotlight. As KAPSARC has previously [studied](#) and [written](#), OPEC’s ability to measure and offset oil market shocks through the use of its spare production capacity has been a substantial stabilizing force, perhaps reducing oil price volatility by as much as half. However, the scale of the current disruption is too big for OPEC to rebalance the market alone.

**Figure 1.** OPEC’s spare capacity typically provides the oil market with a buffer.



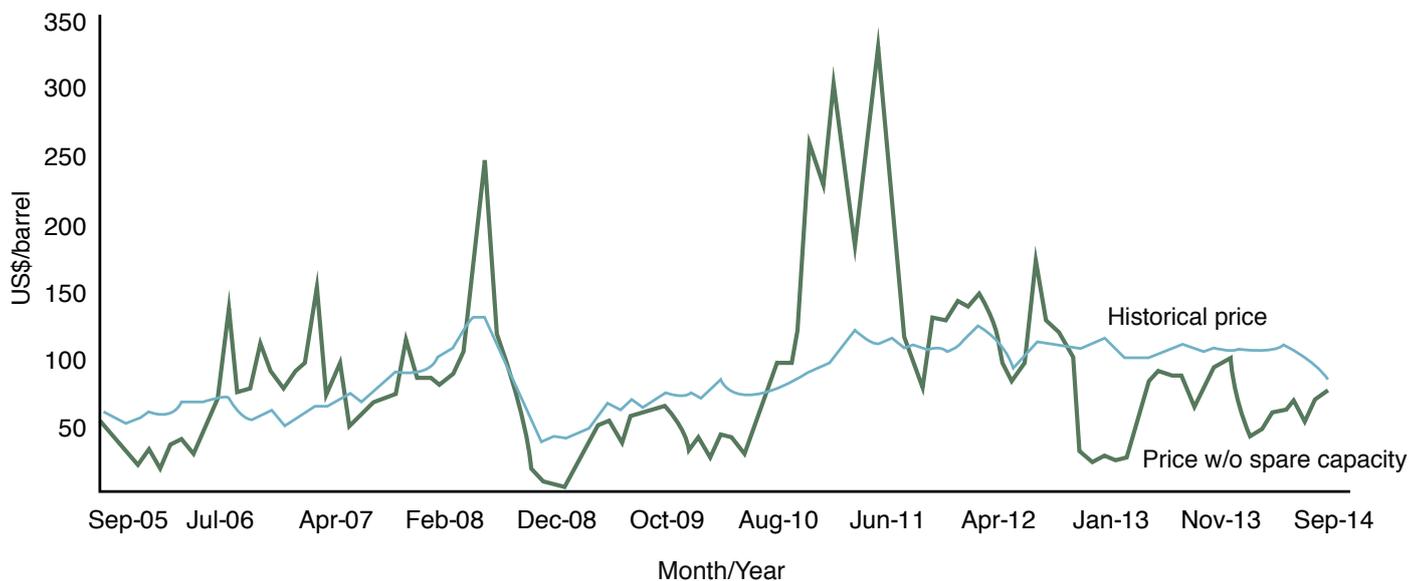
Source: KAPSARC using EIA data.

The economic significance of efforts to stabilize the price of oil requires little explanation. The market is exposed to substantial shocks. The impact of these shocks is magnified because even small changes in demand and supply can cause sharp price movements in the short term, at least until the market has had time to adjust production and consumption levels. These sharp movements and the financial risk premium associated with volatility impose costs on the global economy. A KAPSARC [study](#) finds that the reduction in oil price volatility caused by OPEC’s spare capacity generates between \$170 and \$200 billion of annual economic benefits for the world economy.

OPEC’s mission to stabilize the oil market by balancing supply is but one part of a larger set of remedies that exist in the market to help manage oil price risks. These include both private and public mechanisms such as precautionary inventories, hedging offered through the financial markets, longer-term contracts, and government stockpiles. However, OPEC’s role is unique because it aspires to reduce price volatility directly, by acting as a swing producer to offset physical shocks to supply and demand, rather than simply mitigating the cost of price shocks after they have occurred. In addition, when faced with a huge negative shock to demand, such as the current one, there are very few effective remedies available

beyond physically restricting global supply. The consequence of not restoring market equilibrium without supply interventions is sharp negative price movements and, eventually, demand growth and/or a fall in supply.

**Figure 2.** OPEC’s spare capacity reduces oil price volatility.



Source: Estimates from authors: OPEC’s Impact on Oil Price Volatility: The Role of Spare Capacity; The Energy Journal, Vol. 39, No. 2, April 2018; Axel Pierru, James L. Smith, and Tamim Zamrik.

Note: Price with no spare capacity policy based on -1% monthly price elasticity for global demand.

The rigidity of demand and supply means that restoring equilibrium without market intervention can take a long time and may lead to significant overcorrections. The current scenario is unprecedented. While prices have fallen drastically, there is little scope in the short term for a pick-up in demand due to the necessary measures that countries have introduced to restrict the movement of people to contain the spread of the virus. Further, in recent years, as the size of the oil market has expanded, market stabilization efforts have necessitated greater collaboration between OPEC and non-OPEC countries, together forming OPEC+. However, in the face of this particular disruption, reaching a consensus on further and additional supply restrictions proved out of reach for this expanded group.

The result of the no-deal was another blow to market sentiment, which was already turning increasingly bearish in the face of the growing COVID-19 outbreak. Spot prices fell dramatically, and the futures curve flipped into contango, which, along with the emerging fundamental imbalance between supply and demand, has caused inventories to rapidly surge. Oil market volatility is now at an all-time high, with the turmoil in the global financial system further exacerbating the situation and making it more difficult for OPEC and its supporting countries to attempt to stabilize the market.

The recent emergence of shale oil in the United States (U.S.), the world's marginal producer, with a development lead time measured in months, has contributed to market stability by capturing a share of the historical value of global spare capacity. However, shale oil cannot rapidly offset unanticipated shocks of such a magnitude as the present one. Given the greater elasticity of U.S. shale than that of conventional supply, and the prevailing headwinds that shale producers were already facing before prices crashed, these producers will be hit first and hardest under the current scenario. However, despite shale's greater reactivity to price, overall supply is still relatively rigid in the short term. So it will take time and a lot of pain for many producers around the world before the market can begin to rebalance without some form of intervention.

The market has become accustomed to OPEC, and more recently OPEC+, balancing supply and demand, the value of which is at times perhaps overlooked. KAPSARC's research has highlighted the benefits that market stabilization efforts provide for the world economy. However, the magnitude of the current disruption is far beyond what OPEC can deal with alone, leading to the current situation which is in no one's best interest. Greater international cooperation is needed.



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