Editor:

Dimitris Malliaropulos:
Economic Research Advisor
dmalliaropoulos@eurobank.gr

Written By:

Maria Prandeka:
Economic Analyst
mprandeka@eurobank.gr

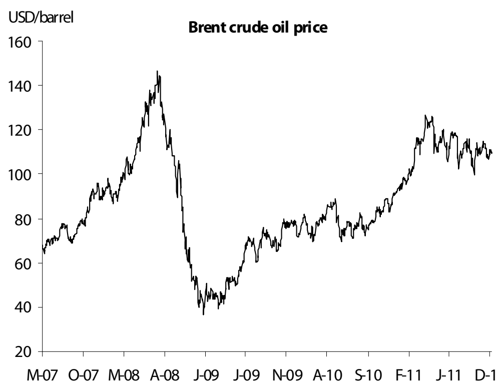
Oil prices to remain high in 2012

- Global crude oil prices continue to remain elevated relative to historical levels.
- Risks of a disruption in global oil supply have increased recently, due to growing international concerns over Iran's nuclear program that have led the European Union to consider banning oil imports from Iran.
- Data from the supply and demand side of the oil market continue to indicate upside risks to crude oil prices for 2012.
- Lack of spare capacity and the low level of oil inventories is leaving the oil market vulnerable to higher than expected demand or to supply disappointments.
- The sharp rise in breakeven oil prices indicates that oil-exporting countries will likely be more willing to cut production to maintain high oil prices, raising the risk of further price spikes.

Global crude oil prices continue to remain elevated relative to historical levels

Since mid-2010, oil prices have risen significantly, mainly on the back of strong gains in global demand and disruptions to global supply. Brent crude oil prices have soared above US$ 125/bl in early April 2011 (Figure 1). Roughly one fourth of this increase (US$ 15/b) constituted a heightened risk premium in the oil market, attributed to the escalation of the turmoil in the Middle East in early February and, consequently, worries about the prospect for more disruptions to global oil supply. The steady increase in oil prices has been followed by a sharp correction in early May (Brent fell by more than US$ 10/b in a one week period) and extreme volatility thereafter. Indeed, since then, oil prices have been navigating between the uncertainty surrounding the global economic environment and rising geopolitical risks along with tight physical oil markets, keeping prices broadly range bound. Relative to historical levels, global crude oil prices continue to remain elevated. The price of Brent crude oil is currently about 20% above its level a year earlier and 35% above its five year average.

Figure 1



Source: Bloomberg

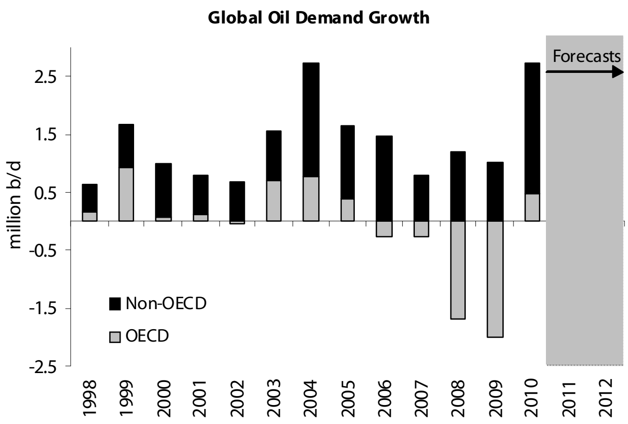
Geopolitical tensions put upside risks to oil prices back in the spotlight

Meanwhile, the fall of Colonel Gadaffi has not removed geopolitical risks from the oil market. After the release of International Atomic Energy Agency's report in mid-November, which warned that Iran has been conducting research and experiments to develop a nuclear weapon, geopolitical risks once again tilt the price balance to the upside. Growing international concerns over Iran's nuclear program have led the European Union to consider banning Iranian oil imports in order to pressure Iran to curtail its suspected nuclear weapons program. Risks of a disruption in global oil supply have increased recently, given that Iran is the world's third largest oil exporter and OPEC's second largest producer. According to BP Plc's annual Statistical Review in June 2011, Iran pumped about 5% of the world's crude in 2010. At the same time, the European Union, which accounts for about 16% of total oil demand, is one of the major importers of Iranian oil. As a result, in the event of an oil embargo, European countries would be particularly hard hit, facing a significant increase in oil prices. In a more extreme scenario, there is a potential of a surprise closure of the Strait of Hormuz by the Iranian military. Under such a scenario global crude oil prices would skyrocket, given that about a fifth (i.e. around 16 million barrels a day) of the world's oil supply is transported through the Strait of Hormuz. Indeed, Iran's foreign ministry spokesman warned oil prices will soar above $250 a barrel, should western nations impose sanctions on their oil exports.

Upside risks from the supply and demand side remain

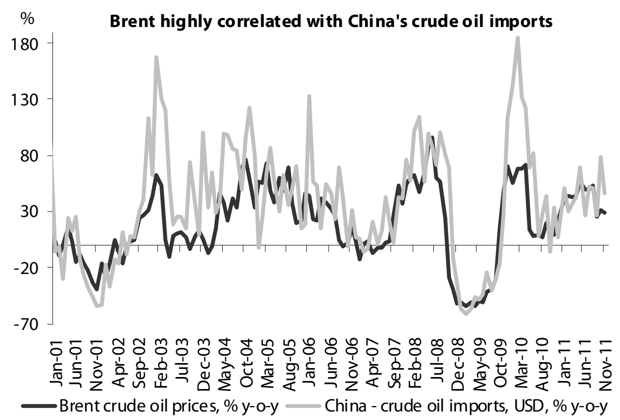
Looking at the supply and demand side of the oil market, balances have softened since the summer, due to a combination of slower demand growth and the partial come back of Libya's oil output. Nonetheless, the data continue to indicate upside risks to crude oil prices for 2012. As far as oil demand is concerned, solid growth in emerging markets economies, which account for more than 50% of global GDP growth and almost half of global oil demand, is expected to continue to provide support to oil prices. In fact, although EMs economies are slowing down, they are expected to remain the leaders of global growth, growing substantially faster than advanced economies over the next few years. According to the latest IMF forecasts[1], in 2011 and 2012, growth in emerging and developing economies is expected to moderate to still buoyant growth rates of 6.4% and 6.1%, respectively, well above the thirty year average of 4.5%. According to the latest US Energy Information Administration's (EIA's) forecasts[2], next year's world oil demand growth is expected to come only from non-OECD countries (Figure 2). Specifically, oil prices have proved particularly correlated with China's crude oil imports (Figure 3). Indeed, China's demand for oil, accounting for more than 10% of world oil demand, continues to surprise to the upside, despite the slowdown in domestic economic activity. In absolute levels, both oil demand and imports were at their second highest level ever in November 2011. Meanwhile, this year's severe drought conditions have resulted in low levels of hydro power, a substantial source of Chinese electric generation, leading to increased demand for diesel in order to fuel electricity shortfalls and a running down of inventories. With Chinese inflation slowing to its lowest level since September 2010, policy focus should shift from managing inflation to supporting growth, underpinning strong inventory restocking and, consequently, China's oil demand growth in 2012. EIA's latest forecasts suggest that China's oil consumption will contribute 40% to global crude oil demand growth in 2012.

Figure 2



Source: Ecowin

Figure 3



Source: Bloomberg, Ecowin

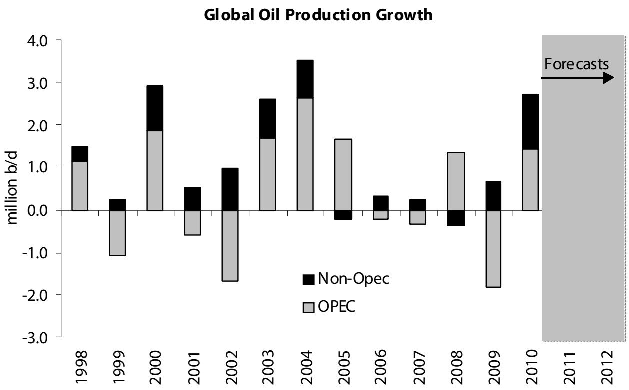
On the supply side, this year's non-OPEC oil production, which accounts for about 60% of world oil supply, has proved disappointing since the beginning of the year. In 2011 as a whole, non-OPEC oil supply is projected to increase by 410 thousand barrels a day (0.8% y-o-y) (Figure 4). This represents the lowest annual increase since 2008 in terms of both absolute and percentage change. The greatest declines in non-OPEC oil production during 2011 compared to 2010 are expected to occur in the North Sea (due to problems in a number of oil fields), and the Middle East (due to geopolitical backdrop in Syria and Yemen). As far as OPEC's production is concerned, Libyan crude oil production has already started to recover, after halting completely in April-August this year, reaching recently about US$ 350 thousand barrels a day, according to the International Energy

[1] *IMF, World Economic Outlook, September 2011*

[2] *EIA, Short-Term Energy Outlook, December 2011*

Agency (IEA). By early November, this figure was an even higher US$ 500 thousand b/d. IEA forecasts that almost 80% of Libya's pre-disruption production will resume by the end of 2012. Despite the return of Libyan supplies, we believe that a steady output level from OPEC should not taken for granted, given the new geopolitical problems currently brewing in the market.

Figure 4

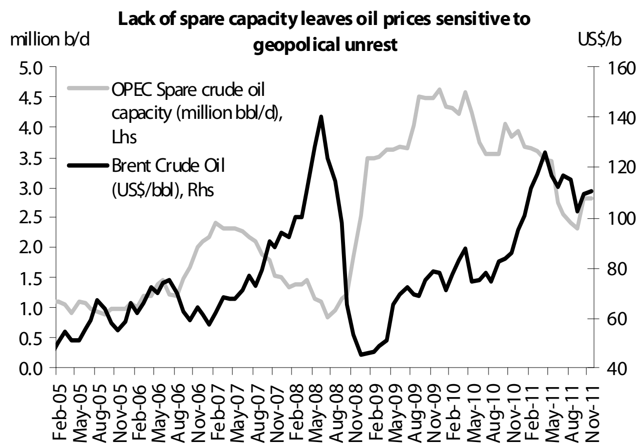


Source: Ecowin

Lack of spare capacity and the low level of oil inventories is leaving the oil market vulnerable to higher than expected demand or to supply disappointments

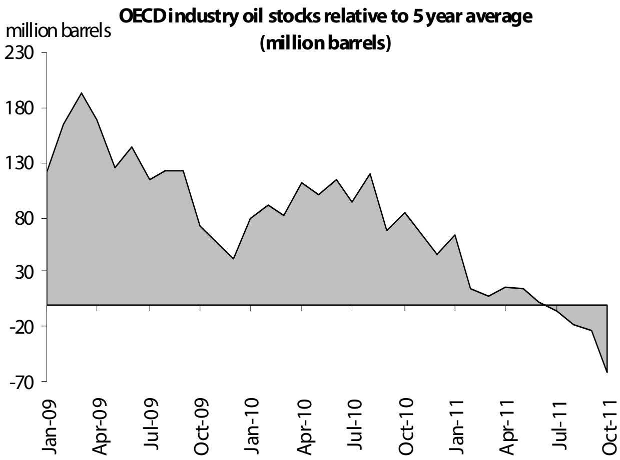
With global economic activity supporting oil demand so far in 2011, and global oil production lagging behind, the oil market has been operating with a significant deficit (the worst deficit since 2007), which is expected to ease only slightly in 2012. As a result, inventories and OPEC spare capacity fall. The emergence of new geopolitical risks has served to focus the market's attention once again on OPEC's spare capacity, since the lower the spare capacity, the more susceptible the market is to geopolitical turmoil. As Figure 5 depicts, OPEC's surplus production capacity has historically been a good indicator for oil prices. Currently, the lack of spare capacity in crude oil generates upside risks to oil prices as it intensifies the potential price impact of future supply disruptions. Meanwhile, OECD industry oil inventories declined by 36.3 million barrels to 2630mb in October 2011. Inventory levels stood below the five year average for the fourth consecutive month (Figure 6), for the first time since 2004. Year-to-October OECD industry oil inventories drew by 38 million barrels, a period when they typically build by 80.9 million barrels on average. Consequently, upside risks to oil prices have also increased as tight inventories is leaving the oil market rather sensitive to potential supply disruptions from geopolitical or other kinds of risks.

Figure 5



Source: Bloomberg

Figure 6



Source: Bloomberg

Higher breakeven oil prices: an important factor in the formation of future oil prices

The 2008-2009 recession affected the revenues of oil-exporting countries, particularly in the Middle East, since oil prices dropped sharply after their peak in 2008. As a result, these countries increased massively government spending in order to mitigate the effects of the global crisis on economic activity. To cover the cost from rising fiscal expenditure, energy producers have to squeeze more money from their oil fields. That means raising their breakeven oil prices, namely the price needed per barrel of oil to cover government spending and avoid fiscal deficits. According to the Institute of International Finance (IIF), for example, the breakeven price of Brent oil that balances Saudi

Arabia's, the world's largest oil producer, budget is expected to rise from about $50/b in 2008 to $85/b in 2011 and to $90/b in 2012. The increase in breakeven oil prices may indicates that oil-exporting countries will likely be more willing to cut production to maintain high oil prices, raising the risk of further price spikes. That said, it seems that breakeven oil prices will become an increasingly important factor in the formation of future oil prices.

Overall, with oil inventories remaining tight and spare capacity still low, the rising geopolitical risks will continue to pose upside risks to prices in 2012. In fact, another abrupt increase in oil prices triggered by an additional shock to the global economy would have a severe impact on the global economy, as there is not much room for economic policy to accommodate an oil shock. The fiscal stance in several economies is already overstretched, while monetary policies still loose. Meanwhile, the 2008-2009 recession along with the current financial meltdown impaired research and development in new technologies, reducing capacity expansion and, thus, supply growth. This is likely to continue to contribute in reducing the pace of supply growth over the coming years, adding to upside risks to oil prices. We believe that softer European demand will not constitute a major downside risk to oil prices as long as the US economy, the world's largest oil consumer, keeps on strengthening, and growth in China, the world's second largest oil consumer, remains fairly robust.

Research Team

Financial Markets Research Division

Platon Monokroussos, *Head of Financial Markets Research Division*
Paraskevi Petropoulou, *G10 Markets Analyst*
Galatia Phoka, *Emerging Markets Analyst*

Sales Team

Nikos Laios, *Head of Sales*
Vassilis Gioulbaxiotis, *Head of International Sales*
Yiannis Seimenis, Ioannis Maggel, *Corporate Sales*
Stogioglou Achilleas, *Private Banking Sales*
Alexandra Papathanasiou, *Institutional Sales*

Economic Research & Forecasting Division

Dimitris Malliaropulos, *Economic Research Advisor*
Tasos Anastasatos, *Senior Economist*
Ioannis Gkionis, *Research Economist*
Vasilis Zarkos, *Economic Analyst*
Stella Kanellopoulou, *Research Economist*
Olga Kosma, *Economic Analyst*
Maria Prandeka, *Economic Analyst*
Theodosios Sampaniotis, *Senior Economic Analyst*
Theodoros Stamatiou, *Research Economist*

Eurobank EFG, 20 Amalias Av & 5 Souri Str, 10557 Athens, tel: +30.210.333 .7365, fax: +30.210.333.7687, contact email: Research@eurobank.gr

Eurobank EFG Economic Research

More research editions available at http://www.eurobank.gr/research

- **New Europe**: Economics & Strategy Monthly edition on the economies and the markets of New Europe
- **Economy & Markets**: Monthly economic research edition
- **Global Economic & Market Outlook**: Quarterly review of the international economy and financial markets

Subscribe electronically at http://www.eurobank.gr/research