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King Abdullah Petroleum Studies and Research Center

Stagflation: Should the Oil Industry Worry?

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About KAPSARC

KAPSARC is an advisory think tank within global energy economics and sustainability providing advisory services to entities and authorities in the Saudi energy sector to advance Saudi Arabia's energy sector and inform global policies through evidence-based advice and applied research.

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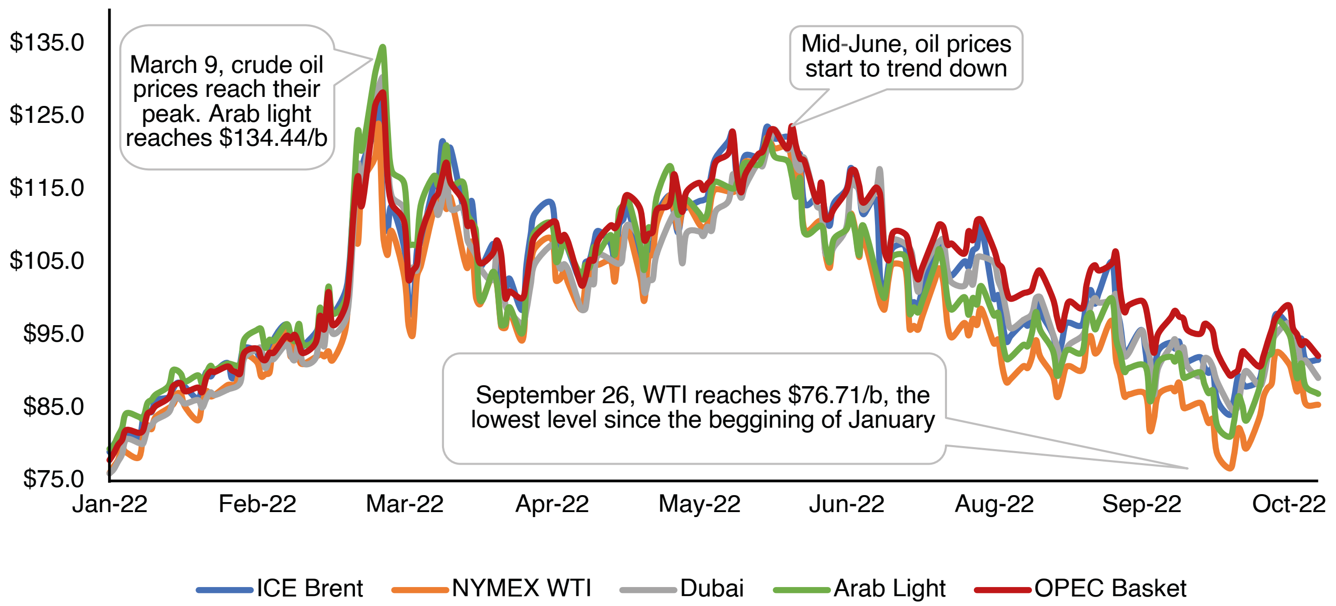
Oil is an essential commodity with an almost perfectly inelastic demand, despite its volatile price. In recent months, fuel prices have declined significantly from approximately $120 per barrel (b) at the beginning of June to less than $85/b at the end of September. Experts and market commentators suggest that this steady decline is symptomatic of the onset of a global economic recession. But what are these recessionary concerns?

Figure 1. Crude daily last price $/b (as of October 17, 2022).



Source: Bloomberg (2022).

Note: WTI = West Texas Intermediate; ICE = Intercontinental Exchange; NYMEX = New York Mercantile Exchange.

To understand better what is going on, recall that the world is still recovering from the effects of the COVID-19 pandemic. The geopolitical crisis in Ukraine is also generating energy and food supply shortages, putting negative pressure on the global economic recovery. Most countries enacted expansionary monetary policies in the post-pandemic era. Interest rates were initially lowered, averaging -0.5%.

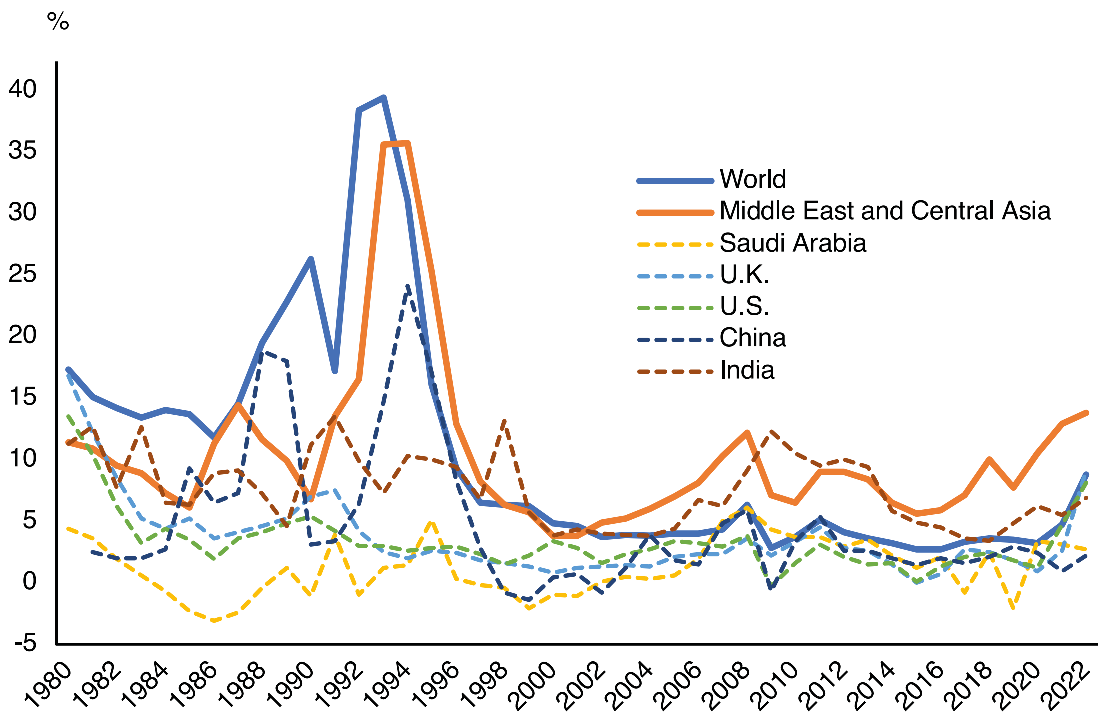
The effects of the Russia-Ukraine geopolitical crisis combined with high inflation raise the risk of stagflation, as the World Bank predicted in June this year (World Bank 2022a). Stagflation is characterized by stalled economic growth, high inflation, and elevated unemployment rates. Economic stagnation implies a dramatic slowdown in economic growth, almost grinding to a halt, accompanied by high unemployment rates, a decline in gross domestic product (GDP), and collapsing wages, among other conditions. A high inflation rate increases the consumer price index, thus lowering purchasing power (Santander 2022). The stagflation caused by the 1970s oil crisis ended with a recession, with emerging markets and developing economies suffering the most. Today, the global economy is facing a rapid economic downturn and high inflation, both symptoms of stagflation.

According to the International Monetary Fund, global growth is expected to slump from 6% in 2021 to 3.2% in 2022 and 2.7% in 2023 — much lower than the 4.4% it anticipated for 2022 in January (IMF 2022b). As a result of the economic damage from the pandemic and the conflict in Ukraine, per capita income in developing economies this year will be nearly 5% below its pre-pandemic levels (World Bank 2022b).

Most nations in the east of the Eurozone experienced a decline in economic growth due to the Russia-Ukraine conflict (IMF 2022b). However, some major economies, including European countries, took timely measures to control the impact of the conflict, avoiding contractions of their economies. Furthermore, the decisions made by the United States (U.S.) Federal Reserve and the European Central Bank to increase interest rates are raising stagflation worries (Boesler and Graffeo 2022). The increases in interest rates, in an attempt to offset the risks of elevated inflation, might trigger an economic downturn similar to that of 1982 (Ha, Kose, and Ohnsorge 2022; Goodfriend 2007).

The International Monetary Fund also estimates that the global inflation rate stood at 8.8% as of October 2022, with advanced economies at an inflation rate of 7.2% (IMF 2022a). It estimated that emerging markets and developing economies had an inflation rate of 9.9% (IMF 2022a). The United Kingdom's inflation rate reached 9.1 % in October 2022, the U.S. had an 8.1% inflation rate, and the European Union had a rate of 9.2%, levels not seen since the 1980s. Emerging regions such as Latin America and the Caribbean reached rates as high as 14.1%, while Middle East and Central Asia jumped to 13.8%. Saudi Arabia is one of the few economies that has managed to control inflation, keeping it at 2.7%, as the Kingdom's economy has always been small. China also kept its inflation moderate at 2.2%.

Figure 2. Inflation rate, average consumer prices (annual % change).



Source: IMF (2022a).

What Does a Recession/Stagflation Mean for the Oil Industry?

The last time the world faced an economic situation like this was in the late 1970s and early 1980s. It was caused by supply shocks, weak policies, and structural forces, with consequences that lasted for years, and resulting in what we know as the 1980s recession (Kose, Sugawara, and Terrones 2020). OECD inflation levels were above 10%, GDP growth was low, and crude oil prices reached historical records. Beyond these similarities, the 2022 crisis has some distinguishing characteristics. First, all energy commodities are experiencing above average prices, reducing the possibility for substitution with cheaper fuels. Indeed, despite high oil prices, crude oil has been used as the substitute fuel in some cases, as the prices of other energy commodities, such as natural gas, are also at historical highs. The energy intensity of GDP is much lower now than in the 1970s, reducing the consumer's sensitivity to price changes, at least in the short term (World Bank 2022b).

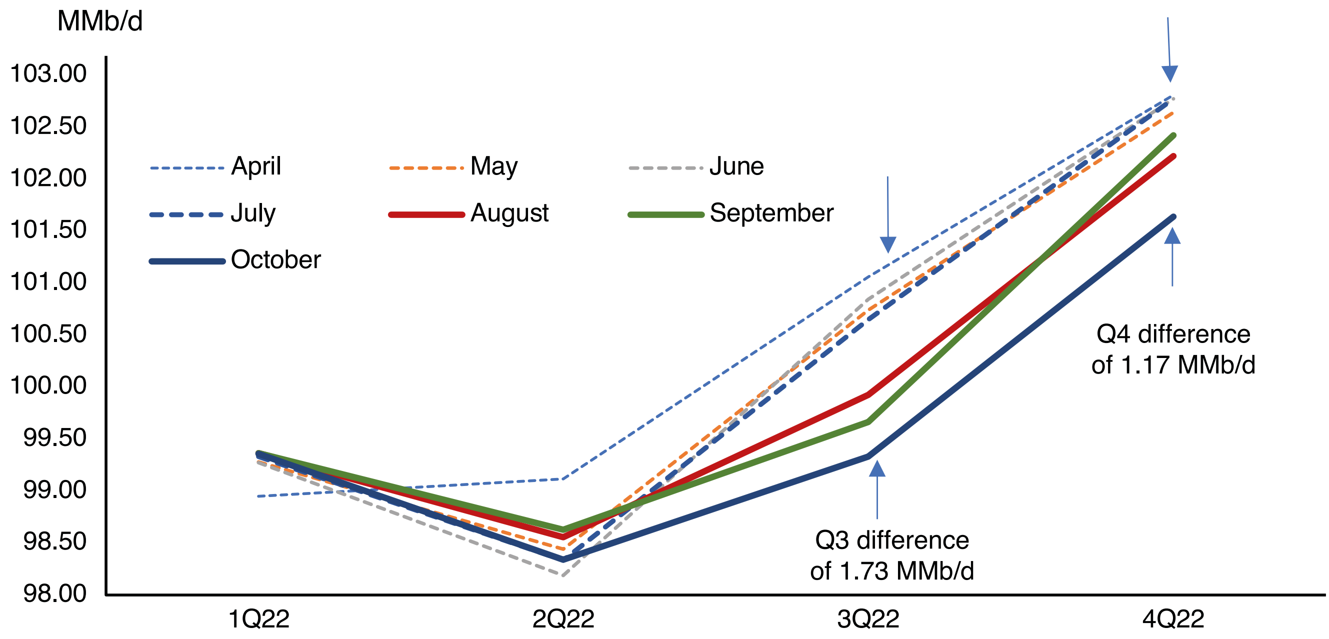
The Bank of America (BofA) forecasts that oil prices will not drop below $75/b if the world falls into a recession (Rosen 2022). Analysts supporting this theory claim that consumer spending on energy, specifically on oil, as a share of total spending is much lower than it was in the 1970s, citing reductions in demand, at least in the short term.

However, the BofA's hypothesis is not shared by all. Citigroup, for example, thinks that in a recession, oil prices would drop to $65/b by the end of this year and to $45/b by the end of 2023 (Arab News 2022). However, this scenario assumes declining investment and no intervention from OPEC and its allies (OPEC+). Citigroup's assumptions seem unrealistic, as one of OPEC's primary goals is "ensuring the stabilization of prices in international oil markets with a view to eliminating harmful and unnecessary fluctuations" (OPEC 2021). Such a drop in prices would generate unnecessary fluctuations, causing OPEC to act immediately.

Another reason that supports the theory that the impact of stagflation/recession on oil demand will be limited is the recent policy reaction of many nations, providing compensatory measures to reduce the impact of high retail prices on their consumers. Tax breaks and subsidies have been implemented to mitigate the impact of high fuel prices for consumers, such as at the pump, domestic electricity costs, etc.

However, despite the global energy economy being better prepared than in the 1970s, stagflation will cause some reduction in oil demand. Between 1979 and 1983, global oil demand fell by 11%, or 6 million barrels per day (MMb/d) (World Bank 2022a). We are far from experiencing a similar drop today. The energy crisis in the 2000s, as well as the crises in the 2010s, have shown that an economic crisis now has much less impact on oil demand than it did in the 1970s. OPEC's monthly oil market report has adjusted its short-term outlook for the third and fourth quarters (Q3 and Q4) of this year, reducing its estimates from its July forecast by more than 1.73 million barrels per day (MMb/d) for Q3 and 1.17 MMb/d for Q4 (OPEC 2022). This reduction shows the impact that stagflation is having on OPEC's assessments, and those numbers could fall further if the world enters recession territory.

Figure 3. The difference in OPEC monthly oil market reports for 2022.



Source: OPEC (2022).

Aside from oil price and demand, another major concern among analysts is capital spending. The oil and gas sectors are already suffering from low investment, and they could be further impacted by higher production costs and lower investment attractiveness, as a recession would restrict financial conditions. The industry has an urgent need to increase capital expenditures (capex). However, a recession would make this already challenging task more difficult, harming every stakeholder in the industry. Small competitors would find it difficult to attract funds. Central banks in many OECD countries have already increased their interest rates on the back of high inflation rates. This reduces the activities of small competitors in the oil industry, who, in most cases, use financial support to develop their projects. Large oil and gas competitors do not rely on financial loans, but they are less motivated to invest as production costs have also been impacted by inflation, resulting in higher capex and operating expenditure values.

Future Projections

Although a global recession may not happen, some OECD countries have already experienced slow economic growth and high inflation, producing more than four months of stagflation. Several measures are being taken by governments to avoid further economic dislocation and high inflation, such as the U.S. Federal Reserve increasing its interest rate, and several EU countries introducing compensatory measures for consumers to mitigate their high energy bills. However, it is hard for the global economy to escape from this crisis without further ramifications for energy demand.

Weakening demand is not the critical point in the current crisis. Investment in the oil and gas sector, which was already weak, is the concern. It will face another challenge if the current economic downturn does not recover fast, with the risk that private investment may not reach the levels needed. In such a circumstance, national oil companies may have to reconsider their production targets, which most probably will have to increase faster than expected to secure supply in the next three years (Arboleda and Al Sadoon 2022).

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