Global Economic Prospects

HIGHLIGHTS from Chapter 4:

Adding Fuel to the Fire: Cheap Oil in the Pandemic

Key Points

- *The outbreak of COVID-19 and the wide-ranging measures needed to slow its advance have precipitated an unprecedented collapse in oil demand, a surge in oil inventories, and, in March, the steepest one-month decline in oil prices on record.*
- *In the context of the current restrictions on a broad swath of economic activity, low oil prices are unlikely to do much to buffer the effects of the pandemic. Still, they may provide some initial support for a recovery as restrictions begin to be lifted.*
- *Energy-exporting emerging market and developing economies (EMDEs) face both an unprecedented public health crisis and a collapse in oil revenues, at a time when fiscal positions were already strained.*

The steepest oil price drop on record. The collapse in oil prices in March 2020 was the steepest on record, and prices slid further in April before recovering in May (Figure 1). As of end-May, oil prices are around half their end-2019 levels. A precipitous decline in oil consumption in the context of still-robust production has led to a rapid buildup in oil inventories. Inventories are expected to attain near-full capacity in June.

Predominantly demand-driven oil price decline. The oil price plunge since late January has mainly reflected a collapse in demand arising from the pandemic and the restrictions that have been needed to stem its spread. Besides triggering a global recession, these restrictions severely disrupted travel and transport, which account for around two-thirds of oil demand. Oil demand is expected to decline by an unprecedented 9 percent in 2020.

Output losses in energy-exporting EMDEs. This latest oil price plunge is preceded by six previous plunges over the past half-century, some of which left a legacy of lasting output losses. During past *demand-driven* oil price plunges, energy exporters and importers suffered similar initial output losses (about 0.5 percent) that were unwound within three years. In contrast, in past *supply-driven* oil price plunges, similar initial output losses in energy exporters were much longer-lasting, being only one-third unwound three years later. In these plunges, energy-exporting EMDEs with lower debt, more flexible exchange rates, and more diversified export bases suffered smaller short-term output losses.

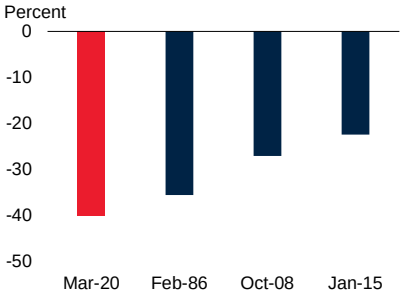
Potential support for global growth early in a recovery. As long as widespread restrictions continue to constrain activity across the global economy, low oil prices are unlikely to provide meaningful support to global growth. If anything, the current episode of low oil prices holds less promise for boosting global growth than past episodes since energy exporters entered it with weaker fiscal positions and foreign exchange buffers, after having drawn on them to weather the previous oil price plunge of 2014-16. That said, when restrictions ease and excess inventories remain high, low oil prices could provide some initial support for reviving global activity.

Need for policy action. For energy exporters, this most recent oil price decline is yet another reminder of the urgency to continue with reforms to diversify their economies. These include measures to foster competition, broaden fiscal revenue bases, and enhance fiscal and monetary policy frameworks. Current low oil prices are also an opportunity to review energy pricing policies, including remaining energy subsidies. A carefully calibrated design, phasing, and communication of such reforms is critical for their success.

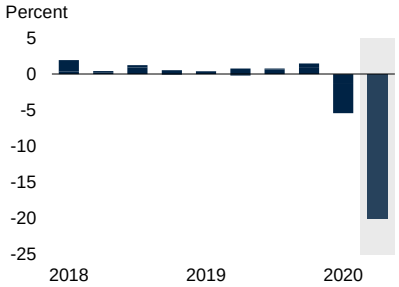
Figure 1. Oil market developments and implications for the global economy

In March 2020, oil prices suffered their steepest one-month drop on record. The fall was predominantly demand-driven, reflecting collapsing oil demand that was accompanied by rapidly rising inventories. Past demand-driven oil price plunges have not been associated with significantly higher growth in the near or medium term; past supply-driven oil price plunges have been associated with persistent output losses in energy exporters and no significant output gains in energy importers.

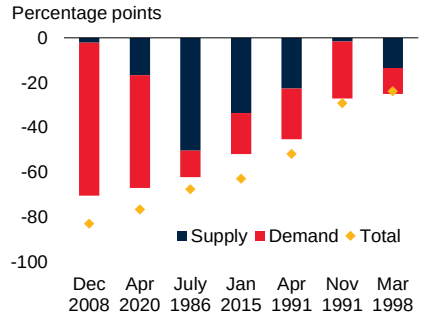
A. Largest one-month declines in oil prices since 1970



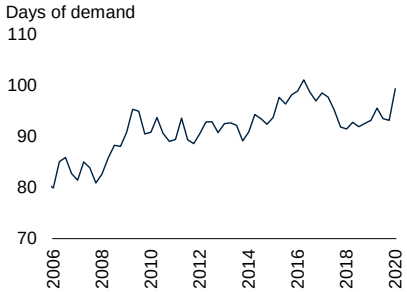
D. Global oil demand growth



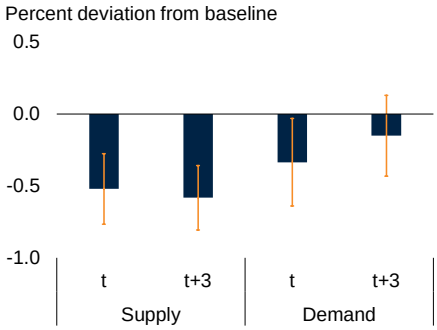
C. Contribution to largest oil price declines since 1970



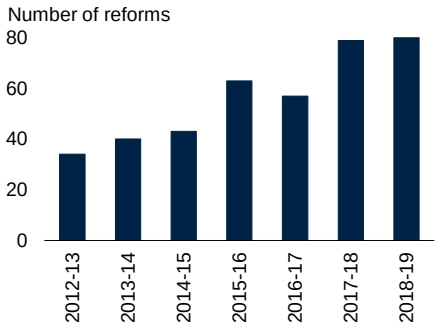
D. OECD oil inventories



E. Cumulative impulse response of EMDE output, by type of oil price plunge



F. Reforms in energy-exporting EMDEs



Source: Bloomberg; EIA; Haver Analytics; IEA; OPEC; Thomson Reuters; World Bank.

A. Figure shows the largest declines in Brent oil prices since 1970. Dates on the horizontal axis indicate the date in which the decline occurred. Months with consecutive declines are omitted.

B. Shaded area shows IEA estimates for year-on-year demand growth in 2020Q2.

C. Chart shows the contribution to explained six-month log changes in oil prices. Decomposition based on structural vector autoregression estimation. For each of the seven episodes, only the month with the deepest six-month oil price plunge is shown, consecutive months are not shown. The gap between the total price decline and the contributions of demand and supply represents speculative demand factor.

D. Days of demand represents the level of OECD oil inventories at the end of the quarter (government and industry) divided by average daily OECD oil demand. Last observation is March 2020.

E. Cumulative impulse responses of real output in EMDEs in response to an oil price plunge, based on a local projections model estimated for 155 EMDEs, of which 36 are energy exporters, for 1970-2018. Numbers on the x-axis indicate years since the oil price plunge, which occurs at t=0. Oil price plunges of more than 30 percent over seven months occurred in 1985-86 (supply-

driven), 1990-91 (demand-driven), 1998 (demand-driven), 2001 (demand-driven), 2008-09 (demand-driven), and 2014-16 (supply-driven).
F. Sample includes 35 energy-exporting EMDEs.