Box 2

Understanding the Recent Decline in Oil Prices

Despite intensified geopolitical tension in major oil-producing countries, oil prices have declined noticeably in recent months. After trading at above USD 100 per barrel for about two years, Brent crude oil prices have declined by almost 25% since early July to reach a four-year low of around USD 86 per barrel at the end of October (see Chart A). When the recent decline is expressed in euro instead of US dollars, it is less pronounced (around 18%). This box describes the main drivers behind this decline in oil prices.

In general, oil prices are determined by the interplay of oil demand and supply developments. For example, with the onset of the financial crisis in 2008 a steep fall in oil demand together with increasing oil supply caused oil prices to drop substantially (see Chart B), whereas a strong recovery in global oil demand combined with slower growth in supply pushed oil prices above USD 100 per barrel again in 2010. From 2011 to mid-2014 oil prices were broadly stable, reflecting the well-balanced oil market. Demand was recovering gradually from the crisis, and supply grew on the back of strong gains in North American shale oil production. At the same time oil prices were supported by oil production outages in OPEC countries triggered by geopolitical tension. More specifically, political instability in Libya caused domestic oil production to drop to levels close to zero in 2011 and again in 2013, and the western embargo imposed on Iranian oil exports from 2012 led to a drop in Iranian oil production by almost a third. More recently, the ISIS invasion of northern Iraq and geopolitical uncertainties related to

Chart A Brent crude oil prices

(USD and EUR per barrel)

Source: Bloomberg. Notes: Daily data; the last observation refers to 29 October 2014.

Chart B Oil prices and growth in oil demand and supply

(percentages (left-hand scale); USD per barrel (right-hand scale))

Source: International Energy Agency. Notes: Annual data. 2014 data for supply are calculated as the average of the first three quarters and 2014 data for demand are based on IEA estimates. The average demand and supply growth are calculated over the period 1986-2013.
the Ukraine-Russia conflict maintained oil prices well above USD 100 per barrel owing to the fear of potential negative supply effects.

The decline in oil prices observed since early July has also been driven by a combination of supply and demand factors. Plentiful oil supply against a backdrop of continued weak oil demand is mainly responsible for the observed drop in prices (see Chart B), reinforced by receding concerns over potential supply-side disruptions related to geopolitical tension.

On the supply side, growth in global oil production has remained strong for two reasons. First, growth in North American shale oil production continues to increase at a steady pace, which leads to reduced oil imports by the United States and frees up oil production elsewhere, creating a glut in oil supply in the European Brent oil market. Second, in contrast to market expectations, global oil production has remained robust so far despite heightened geopolitical uncertainty in Russia, Iraq and Libya. Consequently, concerns related to potential short-term supply disruptions owing to geopolitical instability have been receding overall. Specifically, increases in production capacity in southern Iraq have compensated for supply losses in the occupied northern part of the country, and Russian oil exports have remained on track. In Libya, despite increased levels of domestic unrest, oil production increased noticeably following the lifting of a year-long blockade of its export terminals.

On the demand side, global oil demand growth is showing signs of softening, driven in particular by weaker projections for Chinese and European oil demand. This has caused the International Energy Agency (IEA) to lower its global oil demand forecast for 2014 and 2015 in recent months. In turn, ample supply combined with weak demand growth is causing oil inventories to rise, creating a buffer to absorb potential future short-lived shocks.

Falling oil prices will lead to lower energy prices in the euro area, implying a positive stimulus to household real disposable income and reducing input costs for companies. These developments may dampen inflation in the near term, while supporting growth in the euro area.