Oil prices will likely remain low for several quarters

The spectacular correction in oil prices was the standout economic event of the second half of 2014. It caused inflation to fall sharply around the world, and is largely behind the major struggles in the Canadian economy. At the start of the year, we estimated that prices would remain very weak until mid-2015 before gradually rising.

The expected rise in oil prices reflected the notion that low oil prices would trigger a rebalancing of the global market by reigning in the surge in unconventional oil production in North America and by stimulating demand. Overall, these two assumptions have been confirmed in recent months. U.S. crude production has started to plateau, and the sharp drop in investments in the North American oil sector suggests there will be stagnation in the coming quarters. Demand for petroleum products has also accelerated significantly, particularly in the United States.

These developments, favourable for crude prices, were more than offset by a surge in production by members of the Organization of Petroleum Exporting Countries (OPEC), which went from around 30.4 million barrels per day (mbd) at the end of 2014 to over 32 mbd in June. Two countries are responsible for this spectacular increase. Despite clashes with the Islamic State, Iraqi production continued to grow strongly as oil facilities have been spared by the conflict. In addition, contrary to what most analysts forecasted, Saudi Arabia sharply increased its production.

Saudi Arabia’s very aggressive strategy certainly had a hand in the fact that Iran, its main regional rival, will also try to sell more oil next year. An agreement on the Iran nuclear program was concluded in July, which should lead to lifting trade sanctions. With the upcoming return of Iranian oil, Saudi Arabia seems to want to maximize its market share, with little concern about the effect on oil prices.

In this context, OPEC production in the coming quarters should continue to rise to around 33 mbd at the end of 2016. Production at this level will keep the world oil market in a large surplus for many more quarters. Of course, the agreement with Iran could fall apart, or events could affect production in certain countries, such as in Iraq. However, it would take a series of major shocks to rebalance the market and trigger a price rebound.

**Implications:** Oil prices should fluctuate around current levels for at least another year. This will be beneficial for drivers and several large economies, but the situation will continue to be very hard for the Canadian oil industry. Continued low oil prices also suggest that the loonie will stay weak.

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