

# WHEN CHINA SNEEZES: OPEC'S STRUGGLE TO COUNTER THE OIL DEMAND IMPACT OF CORONAVIRUS

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As OPEC ministers this week mull their response to the coronavirus and the corresponding fall in oil prices, the challenge facing the producer group couldn't be more daunting. Oil prices have tumbled in recent weeks due to concerns about the demand impact of coronavirus, especially from China, which has been hardest hit by the virus. Aside from the uncertainties associated with the virus itself, no oil importing country looms larger in the oil market today than China. In the last 20 years, China's economic surge has made it the engine of global oil demand growth. It is now the world's largest oil importer and a towering oil storage capacity holder. Given the importance of China, it would be difficult to overstate the potential oil-market impact and ripple effects of Covid-19. While considerable uncertainty remains about the duration of the epidemic, the short-term depth and scope of the disruption are such that OPEC's traditional toolkit might not be of much help. By deepening supply cuts, OPEC and its allies might manage to soften the blow to oil prices but they will not dodge it.

Analysts and market participants have struggled to find an analog from which to attempt to map out the oil impact of the coronavirus. When news of the outbreak first broke in January, analysts reached back to the SARS epidemic of 2003 as a guide. It is now clear that SARS is not the right reference to think through the effect of Covid-19, and not only because the latter is a different type of virus. China's economy has grown beyond recognition since 2003, both in absolute numbers and relative to other economies. Its oil consumption has more than doubled from an estimated 5.8 million barrels per day (bpd) to 13.7 million bpd last year, second only to that of the United States. China accounted for 14 percent of global demand in 2019, up from 7 percent in 2003. Its share of oil imports grew even faster, tripling from 5.5 percent to 15.5 percent by 2018.

But initial back-of-the-envelope calculations of the impact of Covid-19 using 2003 as a baseline and adjusting for the intervening growth in Chinese demand miss the point. It's not just the growth in China's oil use since SARS that matters but the fact that no other economy has come close to matching that growth. What matters is not just the scope of China's oil demand loss and the dip in economic activity caused by the coronavirus but the sheer lack of a countervailing factor in the oil market. There is not another market capable of making up for China's demand drop.

However dramatic the initial hit on crude prices due to Covid-19 may have seemed, initial projections of its impact on oil markets were likely an understatement. In its mid-February



monthly Oil Market Report, the International Energy Agency put the coronavirus at the center of its analysis and reckoned global oil demand would contract year-on-year in the first quarter of 2020 for the first time in more than 10 years, leading to the slowest average annual demand growth since 2011. Yet the projected demand contraction for the first quarter averaged less than half a million barrels per day, and annual demand growth was expected to rebound to well over 1 million bpd for the remainder of the year.

Satellite imaging showed that the initial impact of the coronavirus on global crude oil balances, and particularly on Chinese crude oil inventories, was surprisingly subdued until early February. China refineries kept humming—along with other strategic industries such as steel mills and power plant—including in and around Wuhan, the epicenter of the epidemic, even as activity in more labor-intensive sectors such as car manufacturing and services ground to a halt. While air, rail, and road traffic were sharply curtailed and caused end-user oil-product demand to plummet, crude oil demand from Chinese refineries did not immediately follow suit. China's crude demand and its pull on international supplies took a hit, but not nearly as much as domestic product demand, and the decline was offset by the loss of Libyan supply due to domestic strife at about the same time.

Just as the Covid-19 outbreak has entered Stage 2 in epidemiological terms, however, so has its oil-market effect. By early February, crude markets reached a turning point as the impact of the coronavirus spread from domestic product markets to crude markets and from China to the world. From February 22 to March 1, radar imaging of more than 90% of China's crude storage tanks indicated a 32-million-barrel surge in the nation's crude oil inventories, or 4 million bpd, according to data analytics firm Kayrros.\* From early January to March 1, Chinese crude stocks swelled by an estimated 47 million barrels, and since mid-December by 56 million barrels. Most of those gains came in the last 10 days. The lagged effect of the reduction in end-user consumption is now being felt with full force in crude balances, lifting Chinese crude oil inventories to levels last seen in June 2019.

Global crude oil balances had not been initially affected by Covid-19 as long as Chinese builds remained relatively subdued, as those were offset by draws elsewhere due in part to the Libyan disruption. As uncertainty spreads to the rest of the world, however, crude oil inventories outside of the United States seem to be rising. For example, five trading houses reportedly leased a total of 50 million barrels of underground storage capacity from state-owned Korea National Oil Company (KNOC), out of 106 million barrels of total underground storage capacity.

Indeed, the full economic impact of the coronavirus is subject to many lags: first within China itself, from labor-intensive industries to strategic and less labor-dependent sectors of economic activity and from end-user product markets to domestic crude markets and the refining industry. And globally it will be felt in the international transmission of the coronavirus, in the propagation of its economic aftershocks from Chinese manufacturers to their counterparts along the global supply chain, in the reductions in air travel and international conferences, and in the expansion of oil demand declines from Chinese domestic markets to other emerging markets and OECD economies.

Shortly after the SARS outbreak, Chinese demand recovered with a vengeance in the second half of 2003 from its dip earlier in the year. A shortfall in Chinese power generation capacity



emerged in the summer of 2003, pushing diesel demand for backup generators through the roof and launching Chinese oil demand on an ascent that would eventually send oil prices to record highs in July 2008. The global integration of the Chinese economy since 2003 and the lags in the diffusion of the effects of the Coronavirus make such a V shape recovery much less likely this time around. Even in the event of a recovery in Chinese and global oil demand, it will take a long time to draw down the crude stock overhang accumulated in recent weeks.

This makes any attempt by OPEC and its Russian allies to counter China's downturn and balance the oil market difficult if not impossible. By some estimates, current oversupply may exceed 2 million bpd. For Riyadh to singlehandedly offset the effect of Covid-19 would mean dropping production below 8 million barrels per day, something it has not done in three decades. Riyadh's prospects of getting other producers to join in the effort seem somewhat bleak. Rather than provide only a partial offset to the demand loss and thus blunt the price drop, it might make sense for OPEC's low-cost producers to let prices drop further and let their higher-cost competitors deal with the consequences. While a further price decline would hurt all producers, Gulf petrostates would be in a better position to withstand the effects than any other and would benefit in the longer term from reduced investment in higher-cost non-OPEC production capacity.

In the last 20 years, emerging markets, and China in particular, have been the engine of oil demand growth and the main support of oil prices. The takeoff in Chinese and emerging-market consumption that fueled the 2003-08 oil price rally sparked fears of oil scarcity and inspired a whole library of books on the seemingly inevitable "resource wars" between oil-thirsty emerging countries and industrialized consumers over finite oil reserves. The US shale revolution has since put these supply worries to rest, sparking the fastest production growth in oil history and replacing worries over "peak oil supply" with a feeling of endless abundance. With the coronavirus outbreak, the tide has turned. China's impact on oil prices no longer seems one-directional.

When China sneezes, the world catches a cold. The coronavirus may put world oil demand into cardiac arrest. Chinese and Asian demand growth had long put a floor under oil prices and had been seen as a major upside price risk. Precisely because of its growth, emerging Asia has now become a mammoth downside risk to the oil market, at least for some time. Rather than fight it, low-cost producers might find it preferable to surf the dip and leverage it to weed out their higher-cost competitors.

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