OPEC Agrees to Lower Production

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Organization of Petroleum Exporting Countries (OPEC) oil ministers meeting in Algeria on December 17 agreed to reduce oil production by an additional 2.2 million barrels per day beginning in January 2009. This is the third output cut agreed on by OPEC since September 2008 in an attempt to raise oil prices that have fallen by more than $100/barrel since July. Individual OPEC member production quotas were not specified.

Q1: How will OPEC's agreement affect oil prices?

A1: Global oil demand is falling in response to the economic downturn. OPEC's goal of raising prices will be made more difficult the longer the downturn persists and the deeper economies contract. Oil inventories are building and additional supplies from outside the OPEC quota system are projected to increase in 2009. The combination of lower demand and increasing non-OPEC supplies indicates sharply lower demand for OPEC crude oil in the coming months. This suggests that OPEC members will be required to comply strictly with output restrictions in order to keep prices from falling further. The ambiguity in the most recent agreement would appear to further complicate the prospects for strict compliance.

Q2: What will be the impact on the global economy?

A2: Lower oil prices are providing a stimulus to the economy. Lower energy costs are expected to bolster consumer confidence and increase spending on durable goods. Lower commodity costs should therefore improve the pace of economic recovery and complement fiscal and monetary policy efforts such the U.S. Federal Reserve's most recent action to reduce interest rates. In the longer run, however, higher economic growth could lead to higher oil prices.

Q3: What are the factors that would lead to a rebound in oil prices?

A3: The oil industry will require high front-end capital investments with long lead times in order to meet growing demand projected for the emerging economies and to keep pace with the declining output from mature oilfields. The International Energy Agency projects investment requirements in the oil and gas sector at $6 trillion during the next two decades. A prolonged period of relatively low oil prices will stimulate economic growth and oil demand growth and may lead to a slowdown in the investment needed to develop new productive capacity. Thus, we may be setting the stage for the next spike in oil prices in the next 3 to 5 years.

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