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Rising demand for oil could lead to global double-dip recession

Many are forecasting higher oil prices next year, due to increased global consumption and decreased output from Libya and other oil-producing nations. That could threaten global economic recovery.

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When the global economy slows, one of the few bright spots for consumers is a little relief at the pump, with gas prices falling in response to slowing demand. But this time around, oil prices look set to stay firm, and perhaps rise, through a stagnant growth cycle.

Warning bells are sounding from commodities analysts and institutions like the International Energy Agency, which advises industrialized economies.

So far, demand for oil products is slowing in tandem with global economic growth, especially in OECD countries, which explains why the average price for a gallon of gasoline in the United States has fallen 30 cents to $3.67 from three months ago.

But it’s unlikely that they’ll drop much more. In fact, oil prices could rise even as industrial production stagnates in major industrialized countries like the US. That’s because global oil production is not growing fast enough to offset supply cuts – namely from Libya - and consumption is increasing in emerging economies like China.

The IEA in its August oil market report released Wednesday cut its demand outlook for the remainder of 2011 by a measly 60,000 barrels per day. That’s a drop in the bucket compared to 90 million bpd of demand. For 2012, it raised its forecast by 70,000 bpd. Both revisions take into account the latest market turmoil and growth forecasts. Year on year, global oil demand will rise 1.2 million bpd in 2011 and 1.6 million bpd in 2012, according to the IEA.

For industrialized economies, rising demand is coming at the worst time possible, with governments running out of stimulus options and the prospects for economic growth and job creation looking grim.

Diane Munro, senior oil market analyst in the Paris-based IEA, says that oil prices usually fall in a recession – setting the stage for eventual economic recovery by reducing the cost of a major business input. But this time around she thinks that slow economic recovery “will outpace any price relief at the pump. The income effect will outstrip any relief.”

Supply, meanwhile, will increase nowhere near as fast as demand. Non-OPEC oil supply will only rise by 0.4 million bpd in 2011 and by 1 million bpd in 2012, the IEA predicted. OPEC countries don’t appear to have the capacity to meet rising demand, despite Saudi Arabia pumping at the highest level in 30 years.

That indicates oil and pump prices will rise, increasing the risk of a global double-dip recession.

“You’ve had a price correction,” says Harry Tchilinguirian, a London-based senior oil market analyst with BNP Paribas. “However in the end the factors that led to the recent run-up in prices are still with us. The issue is whether we will have enough oil when the time comes. That is not evident. Oil prices will very likely rise again to $100 bpd [from the current $80 bpd].”

“What this means for the average consumer is first and foremost that we’re likely to see gasoline prices contained at their current levels for two or three months, but they will increase again toward the end of year, with a threshold of $4 a gallon,” Mr. Tchilinguirian says.

The bullish oil price trend, amid a sluggish economy, is driven by uncertainty over OPEC production. Non-OPEC output growth 2011 and 2012 was revised downward by 0.1 million bpd each year, mostly due to depleted field production and unplanned outages. That is despite unexpected additional supplies from Canada.

But OPEC production has not been able to recover Libya’s complete loss of 1.5 million bpd. Saudi Arabia production is at its highest in decades, and Angola is pumping more than expected, but that has been insufficient to offset falling production in Iran, Iraq, Ecuador, and Nigeria, or unexpected difficulties for the United Arab Emirates and Kuwait’s efforts to raise production.

The markets are growing more jittery as it becomes clearer that Libya won’t be contributing much production this year or even fully recovering in 2012. If it’s not the stalemate between the rebels and Muammar Qaddafi's forces, it’s infighting within rebel ranks as illustrated by the recent assassination of their top military general under circumstances yet to be explained.

Even if Mr. Qaddafi steps down tomorrow, it will take a long time to get oil output back online because of damage to oil infrastructure, the almost certain need to renegotiate contracts with foreign oil companies, and the loss of pressure in oil fields because of the production shutdown.

“Our take is that it will take longer than what people think,” said the IEA’s Ms. Munro. “You need security on the ground before companies put their people back in. There is a complete shut in production and the crude is clogging pipelines. Infrastructure is cannibalized.”

Just how much prices will rise in the future will thus depend almost entirely on Saudi Arabia, which still holds 70 percent of OPEC’s spare capacity. Munro is optimistic. “I think Saudi Arabia is fully within its capacity. I’m puzzled when people question their capacity,” she said, highlighting that the country has boosted output by 1.1 million bpd since January “without any problem.” Their current spare capacity is a little more than 2 million bpd, of the 3.3 million bpd globally.

But that is precisely the reason investors are betting prices will inevitably rise. Saudi Arabia is already responsible for most production growth, and many question the country’s ability and willingness to increase much more, for both technical and price reasons.

Libya’s “protracted output shortage will clearly challenge Saudi Arabia’s ability to raise production to keep pace with global oil demand growth in 2012,” a recent Bank of America-Merrill Lynch report says. If production out of Libya doesn’t recover until the second quarter of 2012, effective global spare capacity could drop to 2.5 million bpd, the report says.

Munro expects the market to cope with the shrinking spare capacity. Most investors don’t appear to agree.

“I’m not confident that OPEC can deliver,” says Mr. Tchilinguirian. “People can focus on Saudi Arabia, but if others decline you have a shortfall of supply. You still have a gap.”