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Oil, international relations and change

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ON NOVEMBER 27, 2014 the Organization of Petroleum Exporting Countries (OPEC), meeting in Vienna, decided not to cut production: its production ceiling of thirty million barrels per day was thus not lowered. It was a decision influenced by big changes that had taken place in the world oil markets—unexpected changes that came about very rapidly.

Demand and supply

The upward trend in the price of oil that started at the beginning of the present century stemmed largely from the rise in demand from emerging markets, especially China. On the eve of the global recession, the major oil price indexes had reached historical highs. Their price collapse in the wake of the most dramatic economic downturn since the Great Depression was truly impressive: in July 2008 Western Texas Intermediate (WTI) reached a price of \$145 per gallon and by February 2009 it went down to \$34.

The following uptrend, however, seemed to be reassuring for producers, with the WTI index reaching a floor level of around \$80 in October 2009, attaining a peak of \$113 in April 2011, and staying in a range between \$85 and \$110 after that. These price levels gave investors great confidence. As a consequence, a lot of funds were channeled towards the drilling of oil and gas from areas across the globe harder and costlier to reach.

At some point in 2014, however, it became evident that estimates of global growth in demand had been too optimistic. The negative impact was compounded by the weakening of currencies from various Asian countries (India, Indonesia, Malaysia, and Thailand), which led to a decrease therein of gasoline consumption. At the same time supply continued to grow.

The tumultuous realities in Syria, Libya, Iraq, and Nigeria as well as Ukraine (read Russia) did not prevent the price of oil from going down from \$107 WTI in June 2014 to \$80 in October, and to \$73 prior to the OPEC meeting. After the meeting, the price would plummet below \$60 in December and below \$50 in January 2015.

Simply put, the increase in supply and its impact were vastly underestimated. Innovations in extraction technologies proved to be radical.

The biggest game changer was the combination of advances in the technologies of horizontal drilling and hydraulic fracturing (“fracking”). Especially in the United States (and in Canada as well) these ever improving technologies, together with the ongoing upward revisions of estimates on the size of shale gas and tight oil reserves, led to massive investments in production capacity.

As a consequence, global oil and gas supply burgeoned in the second half of 2014. And, in the wake of the mentioned price downfall, some heavy rethinking on expanding productive capacity had to start. And it did, with the relevant analyses necessarily connected to the crucial issue of the identification of those countries benefiting and those being hurt economically and politically by the new realities.

Winners

The lower oil prices seen at the end of 2014 prompted the IMF to cautiously suggest that they should directly contribute to a world GDP increase between 0.3 and 0.7% in 2015.

At the level of individual countries, those which are large energy consumers and importers at the same time will benefit the most. And of those, emerging markets (India stands out in this sense) should benefit more than advanced economies, since in the latter each dollar of GDP is less energy-intensive. Incidentally, in terms of sectors, manufacturing benefits considerably from energy prices declines and agriculture (significantly more energy-intensive than manufacturing) benefits considerably more. The airline industry and shippers are major beneficiaries as well. On the other hand, international oil companies are seeing their cash flows negatively impacted, with the result that investments in high-cost projects such as many in the Canadian oil sands, US shale fields, Brazil’s deep-water areas, and Mexico look truly most dubious at prices below \$60 (which is bad news for oil field services companies).

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The United States, by gaining the top position among producing countries in 2013, has clearly increased its energy independence, importing much less than before the global economic crisis. This could translate into a lesser incentive to play global cop. Also to be noted is that, given that the dollar has increased at approximately the same time that the oil price started to decline, in general the benefits from such decline accrue to other importing countries to a smaller extent than otherwise. A conflict of interests to monitor is that deriving from the existing US ban on crude

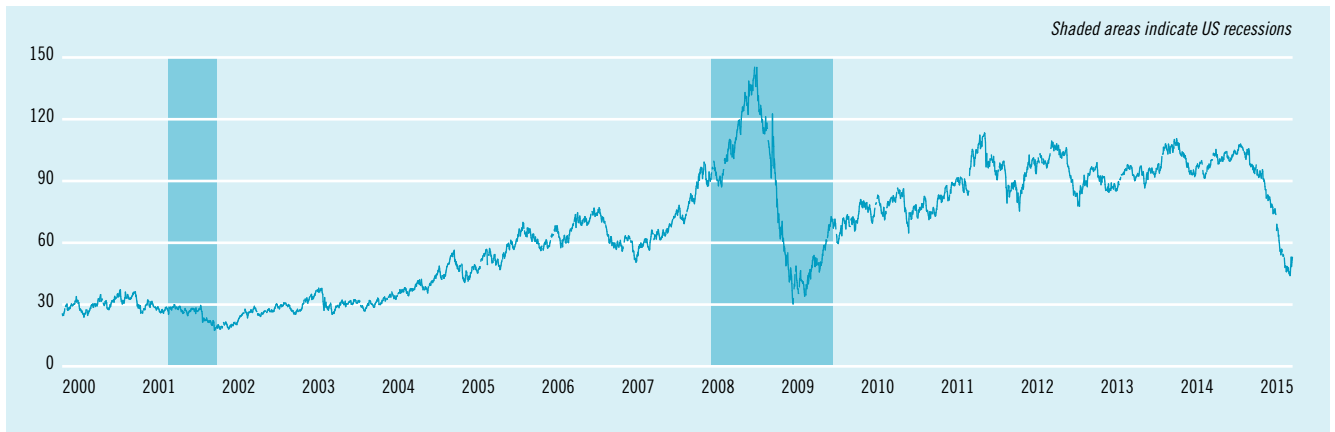
oil exports, which is supported by US refiners and opposed by US shale producers. Moreover, for these latter, sales of their fields to major oil companies would take place at severe discounts. Further, the much politically intense debate on the Keystone pipeline linking the Canadian tar sands with the US Gulf Coast refineries will have to factor in what now appear as too-high break-even costs of extraction.

The European Union, Japan, and China all benefit from the windfall. For instance, for Japan, a consumption tax to narrow its budget deficit has been basically financed by the lower energy bill. But there are some downsides as well. One key issue for the Eurozone and Japan is that of the deflationary impact of the oil price decline. Increases in consumption cannot be taken for granted and that makes the task of the respective central banks much more challenging. For the EU, lower oil prices may also mean that some major projects in Britain’s North Sea may be stopped and that the appeal of costly renewables is lessened, especially in a world where EU’s competitors move less aggressively on the environmental front. China, as the world’s largest oil importer, benefits from lower prices but as the world’s fourth largest producer after the United States, Saudi Arabia, and Russia it also has to live with some downsides. For instance, while its eastern manufacturers enjoy lower input costs, the energy producing regions of the interior experience significant deflationary pressures. Thus, these regional governments are experiencing serious budgetary difficulties, compounded by the fact that coal, of which China is by far the largest producer and consumer in the world, is trading at a five-year low. In terms of a broader picture still, the fact that the economies of Western Europe, China, and Japan are, in the opinion of many analysts, weakening at the end of 2014 may bode poorly for oil demand.

Losers

Major exporters are clearly experiencing problems. Several indicators of vulnerability exist, estimates of some which often vary broadly across sources. A few general considerations can be offered here on some key countries.

Venezuela appears particularly vulnerable. About 95% of its foreign income derives from oil sales, its foreign currency reserves are near a ten-year low, oil accounts for about 40% of its fiscal revenues, and its fiscal break-even price (the oil price at which an oil producing country balances its budget) is about \$120. With the 60% bolivar’s depreciation against the dollar in the black market observed in 2014, the highest inflation rate in the Americas, food and goods shortages,



Crude oil prices: West Texas Intermediate (WTI) – Cushing, Oklahoma (Dollars p/barrel).

Source: FRED - Federal Reserve Economic Data, [accessed: <http://research.stlouisfed.org/fred2/series/DCOILWTIC0#>].

and unaffordable foreign aid policies, it is little wonder that President Nicolás Maduro's popularity is extremely low. Measures to attempt to reverse the tide should include a further devaluation of the currency and, most importantly, sizeable budget cuts. The unpopularity of implementing such measures cannot be underestimated, especially in light of the violent social unrest observed in 2014.

Prices on the carousel

With a fiscal break-even price widely estimated at being above \$130, Iran is another country deeply damaged by lower oil prices. Even more than Venezuela (with its high risk of expropriations) foreign investors are afraid to plunge money into Iran to increase production capacity. This is so, not just because of the low oil prices but, more importantly, of the sanctions levied by the West. The latter's impact on the economy is not made much lighter by the economic interaction with China, Russia, or India nor by the interim deal reached with the five permanent members of the Security Council plus Germany, unfreezing in 2014 some Iranian oil revenues held in foreign banks. Since taking office in August 2013, President Hassan Rowhani has confronted reasonably well high inflation and a recession, lowering the former and coming out of the latter. The lower oil prices have made his job more difficult though, and are pushing him towards necessary but politically unpalatable spending cuts and tax increases. The costs of Iran's foreign policy, with the support of Syria's Assad government standing out, add to the challenges. Further, in such a climate, the challenges for the central bank increase considerably.

Energy plays a big role in the Russian economy. With oil and gas accounting for 25% of its GDP, about 70% of its exports, and 50% of federal revenues, President Putin has benefited substantially from the high energy prices that have prevailed throughout his 15-year-long stay at the top of Russia's politics. For the same reason, the recent great price declines have been rather painful and the economic picture at the end of 2014 shows an unpleasant fiscal break-even oil price hovering around \$105, a high inflation rate, and a ruble that has lost 40% of its value against

the dollar in the second half of the year. All of which are unlikely to change soon. The sanctions enacted by the West over Ukraine (on capital markets, on dual-use goods and technologies, and on products and services for oil exploration and production) clearly have compounded substantially the challenges that Russian economic authorities have to face. One element of strength that they are increasingly relying on is their sizeable foreign currency reserves. Estimated to exceed \$400bn, they can buy a lot of time and perhaps succeed in stabilizing the ruble. Needless to say, an agreement in 2015 putting an end to the sanctions would be most beneficial to the country and possibly steer it toward a different balance between statist and liberal economic forces.

With an estimated fiscal break-even price of around \$90, oil receipts accounting for about 90% of fiscal revenues and of its exports, Saudi Arabia would seem to be in a most vulnerable position. However, the world's largest exporter and longstanding leader of the OPEC cartel has low debt levels and sits on top of foreign exchange reserves in excess of \$700bn. Thus, with its ability to act as a swing producer (as it has done on multiple occasions since the 1970s) apparently undiminished, the November 27, 2014 decision to do nothing has triggered much speculation over the kingdom's motivations. Some argue that by maintaining its current production levels (with the help of its main allies, cash-rich Kuwait and the United Arab Emirates), Saudi Arabia is assisting the United States against Venezuela, Iran, and Russia, supporters of a geopolitical agenda much adverse to Washington and Riyadh. With regard to Venezuela, proponents of this view may point to the Saudi monarchy's desire to demonstrate that, in spite of significant data showing that Caracas has the largest energy reserves in the world, Riyadh still is in control of the energy markets. With regard to Russia, its support of Assad's regime in Syria is certainly a source of great resentment in Riyadh. As to Iran, the sources of attrition and conflict are numerous and include different interpretations of Islamic doctrine, the vying for leadership in the Islamic world, different positioning with regard to the West, and the backing of opposing forces in multiple areas of conflict in North Africa and

the Middle East. Most notably, Saudi Arabia views the West as too tame in its response to Iran's nuclear program and its aggressive foreign policy. In this sense, a lower oil price could be informed by the same "anti-nuclear" logic that was employed in 1977 against the Shah of Iran, which contributed in no small measure to his ousting. Another view, not necessarily incompatible with those just mentioned, is that Saudi Arabia wants to make life most difficult for US-based energy producers, given that they must confront much higher extraction costs. Unless innovation comes to their rescue by lowering such costs and increasing their ability to react effectively to price fluctuations. Incidentally, innovation's role in conservation and renewables' conversion, transmission, and storage could at one point become game-changing. Be it as it may, short-term and long-term political, economic, and technological factors will continue their complicated and hard to anticipate interaction. ■

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