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Investment Publications Highlights

The Economics of Oil: Crude Hope and Complicated Reality

Stephen King, HSBC, December 5, 2014

The plunge in oil prices over the past few months has been dramatic but is by no means unprecedented. While the global economy might benefit from lower prices as it has in prior declines, other factors present today suggest the consequences will be different this time.

King, chief economist at HSBC, examines the well-worn trope that lower oil prices are good and higher, bad. This was most true in the mid-1980s decline, when lower oil prices provided a huge tailwind for industrialized economies. The 1980s decline was primarily a supply-driven decline, and its outcomes gave credence to the idea that lower oil prices boosted aggregate global economic activity as oil consumers would benefit more than oil producers would be hurt. Demand-driven declines in prices, King argues, are more a reflection of economic malaise and less likely to be a positive for the global economy.

King evaluates four popular narratives used to explain the current decline in oil prices. The first, that the United States and Saudi Arabia are allowing prices to fall to bring economic woe upon politically troublesome countries such as Iran and Russia, seems implausible. The other three have more explanatory power. These include (1) that Saudi Arabia is maintaining a high level of production and suffering temporary pain to capture more market share over the long term, (2) that increased US production has far outpaced growth in global demand, and (3) that the drop in oil prices is a response to slowing global growth. This last narrative is a demand-side shock that would suggest the world economy is in danger of losing steam, while the others are supply-side shocks that would be more positive for the global economy.

King notes that the current decline is a combination of both supply and demand dynamics, with the relative weights too difficult to determine as of his early December publication.

Falling oil prices will bring challenges to many nations, from currency declines linked to collapsing energy prices (King cites Kazakhstan, Nigeria, Russia, and Venezuela as examples) to budgetary constraints in Middle Eastern nations if the oil price falls below the country's breakeven price to deliver a balanced budget. Central banks have historically responded to lower oil prices by easing monetary policy, but have little room to maneuver in today's world with rates at zero or near zero in many countries.

Policy confusion is a potential outcome of lower oil prices, King notes, and the likelihood that lower prices bring deflation could undermine progress for central banks determined to remove deflationary pressures. Three mistakes that policymakers could make are (1) using falling oil prices as an excuse not to act, and leaving policy too tight for too long, a dangerous prospect when price declines could be a byproduct of slowing global growth; (2) allowing their currencies to depreciate in a bid to push inflation higher, escalating "currency wars"; or (3) pursuing more radical monetary policies to achieve inflation targets with unknown consequences.

The impact of oil prices is far more complicated than the common view that lower prices are good. The impacts on asset classes in this recent decline are ambiguous at best; some commodity-producing emerging markets could face major export revenue losses, threatening to deteriorate balance of payment positions; and lower oil prices will complicate the message from central banks. Going forward, FX markets could remain volatile as markets react to the dramatic plunge in oil prices, and policy mistakes could occur.

Understanding the Plunge in Oil Prices: Sources and Implications

The World Bank: Global Economic Prospects, January 2015

In the January 2015 volume of their biennial *Global Economic Prospects* report, the World Bank assesses the magnitude, drivers, and implications of the sharp drop in oil prices in the second half of 2014, and the end of a four-year period of oil price stability around $105 per barrel.

The fall in oil prices in the second half of 2014 qualifies as a significant event, a team from the World Bank argues. The past 30 years have seen just five other instances of oil price declines of 30% or more in a six-month period, all of which coincided with major changes in the global economy and oil markets. Parallels can be drawn between the recent episode and the collapse of oil prices in 1985–86, when sharp increases in oil prices in the 1970s were followed by technological developments (offshore fields) and a change in OPEC policy (increased market share) resulting in an oil price decline of 61% and low oil prices prevailing for more than 15 years.

Like any storable commodity, long-run trends in demand and supply conditions and short-run movements in market sentiment and expectations influenced the sharp drop in oil price. The exact contribution of each factor on oil prices is unknown, but the World Bank argues the dominant factor has been changes in supply conditions: US shale oil production has consistently exceeded forecasts; concerns about supply disruptions from geopolitical conflicts have receded; and in late November 2014, OPEC failed to agree on production cuts, signaling a shift in policy from targeting an oil price band to maintaining market share. These changes in supply conditions have coincided with multiple downward revisions in global oil demand as a result of disappointing economic growth. In addition, increasing energy efficiency and declining oil intensity of energy consumption have reduced the oil intensity of global GDP, and estimates suggest the US dollar's 10% appreciation in the second half of 2014 could result in a decline of 3% to 10% in oil prices as demand declines in countries with weakening currencies.

Historical estimates suggest that a 30% oil price decline driven by a supply shock would be associated with an increase in world GDP of about 0.5% in the medium term. The World Bank team identifies five cyclical and structural developments that will affect the growth impact in 2015 and 2016. These include weak global growth; limited room for additional monetary policy easing; a decline in the impact of oil prices on overall activity; reduced investment in new exploration and development; and the potential for households and corporations to save, as opposed to consume and invest, real income gains from falling oil prices.

Falling oil prices affect importers and exporters differently. The authors cite studies suggesting that a 10% decline in the annual average oil price could cause growth in some oil-importing economies to expand by 0.1 ppt to 0.5 ppt; conversely, such a move could cause oil-exporting economies to contract by 0.8 ppt to 2.5 ppts. Oil importers could see substantial improvements in their fiscal and current accounts, but fragile oil exporters may face fiscal and external adjustments (import compression or depreciation). The shift in real income from oil-exporting to oil-importing countries will impact individual countries differently depending on the amount of oil in their exports or imports, their cyclical positions, and the policy room they have to react. As investors reevaluate growth prospects in oil-exporting economies, many countries are seeing significant volatility in their currency and equity markets that is contributing to capital outflows, reserve losses, sharp depreciations, and rising CDS spreads.

Policy implications from a sharp decline in oil prices will vary across regions and countries.

Developing countries with large fuel subsidies have an opportunity to implement subsidy reform with limited impact on the oil prices paid by consumers. The authors suggest that the impact of oil prices on inflation is likely to be temporary, meaning central banks will not need to respond unless inflation expectations become de-anchored. This could be the case in parts of Europe, which the World Bank notes has already experienced several months of outright deflation. In oil-exporting countries with flexible exchange rates, central banks will need to support growth while simultaneously maintaining stable inflation and investor confidence in the currency. A sharp decline in oil prices is also a reminder for oil exporters to diversify and implement reforms aimed at reducing their dependency on oil exports.

How Low Can Oil Go?

Francisco Blanch et al., BofA Merrill Lynch, January 6, 2015

With supply still outpacing demand, the stage is set for lower oil prices in the first quarter of 2015. For prices to finally find a floor, supply needs to be reduced and/or demand needs to increase, neither of which is likely in the near term. The authors see supply cuts in non-OPEC countries taking some time, and OPEC policy on reducing supply has shifted. On the demand side, lags in response time mean demand will take at least six months to improve.

In the near term, BofA Merrill Lynch strategists suggest oil prices could go as low as $35 per barrel for WTI and $40/bbl for Brent as markets try to find a floor. To stop falling prices, the oil market needs supply to come down—the authors estimate a cut of at least 1 million bbls/day is needed—and/or demand to return. Both of these face challenges.

On the supply side, factors worth watching include floating storage, operating cash costs for non-shale production, and cash flow break-evens for marginal producers. Land-based storage in a number of regions is filling up given rapidly building inventories. For non-shale crude producers outside of OPEC, the authors estimate that much of the production is not price sensitive, meaning there will be no immediate output cuts at current prices, and that prices would have to move below operating cash costs before meaningful drops in output would occur. US shale production, in contrast, appears very sensitive to prices, though the industry has never yet been tested in this way.

On the demand side, given lags in response time to lower prices, the authors project a meaningful increase in demand in the second half of 2015 and into 2016, driven primarily by China and India. Demand may increase somewhat in developed countries, but fuel efficiency and demographics mean increases will not be large. For oil-producing countries, the authors note their concern that demand could slow as lower prices negatively impact their economies, and that this poses a meaningful downside risk to prices.

The authors note that future investments will be hurt the most by current falling prices, which also lends support to prices over the long term. Prices could start to recover toward $77/bbl in the latter half of 2015, heavily dependent on what Saudi Arabia decides to do with its production. The country has nearly 3 million bbls/day of spare capacity, and if the kingdom decides to put this capacity to work, that could keep prices lower for longer. ■

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