SPECIAL BRIEFING

Low Oil Prices, Part I: Economic Implications

MARCH 2016

OVERVIEW

The importance of oil prices to businesses cannot be understated, and neither can the planning difficulties created by their volatility: as recently as June 2014 the Brent spot price for a barrel of oil was more than USD115, but throughout 2016 it regularly flirted with the USD30 per barrel (/b) mark. For governments, meanwhile, volatile oil prices mean unpredictable budget outcomes and potentially untenable current accounts. This briefing paper highlights the impact of continued low oil prices on the business environment and identifies the economic winners and losers in this context. (The geopolitical and socio-political implications for businesses are covered in our accompanying paper "Low Oil Prices, Part II: Geopolitical and Socio-Political Impacts".)

At the global level, the traditional rule of thumb has been that an oil price fall of USD10/b would add 0.2 percentage points (pp) to global growth. If the rule were true, oil-price changes should have generated almost 1pp of extra growth in 2015. However, most macroeconomic models suggest the actual effect of oil-price shifts was around 0.5pp of additional growth: so while there has been an overall benefit from low oil prices, it is smaller than conventional economic wisdom would have predicted, and global demand has remained muted. Moreover, while this overall benefit means there have been a number of winners in economic terms, there have also been many losers.

WINNERS AND LOSERS

The main winners will be oil-importing countries – as diverse as Bulgaria and South Korea – which should see real GDP growth increase as their import bill is reduced, or, for the likes of India, as the subsidy bill falls. Turkey, for instance, has already seen its current account improve. Lower energy prices should also feed through into lower inflationary pressures for the oil importers. However, this particular aspect is creating problems for central bankers in the euro zone and Japan, where inflation remains stubbornly below comfortable levels.

Meanwhile, at the losing end of the spectrum, the oil exporters are suffering as lower oil revenues affect both the current account and fiscal position, in turn threatening exchange rates. Russia, Kazakhstan and Azerbaijan have all moved to more flexible exchange rate systems rather than exhaust their reserves, and the devaluation of their currencies has increased the cost of servicing their foreign debts and acted to import inflation. Even the likes of Saudi Arabia, which has pegged its currency to the US dollar since 1986, has faced market pressure, suggesting the possibility of a de-linking or a devaluation in the short term.

Some nations are better placed to weather the storm in the short to medium term. These include countries that have built up significant FX reserves (such as Algeria), transferred excesses to a sovereign wealth fund (SWF, such as Kuwait), have small populations (such as Qatar), or have attempted to diversify from oil dependency (such as the UAE). However, the repatriation of huge sums by the SWFs is adding further volatility to already spooked global capital markets. In addition, asset prices, such as housing in London, are being hit as demand from oil-producing countries dries up.

Importantly, countries that do not have these advantages are facing (or will face) considerable challenges in the short to medium term. Countries are having to resort to borrowing on the capital markets at a time when sovereign risk agencies are downgrading their ratings (for example, Bahrain, Brazil, Kazakhstan and Oman), reducing the number of investors able to purchase the bonds, as well as raising the servicing costs. In addition, the IMF has already been called in to Azerbaijan to provide a bailout, with Nigeria, Brazil, Ecuador, Venezuela, Russia, Kazakhstan, Angola and Gabon also potentially requiring support. IMF involvement would involve adopting painful restructuring policies, which would impact negatively on the short-term risk outlook (but be supportive of longer-term risk rating upgrades).

Finally, the oil-rich countries are cutting back both current and capital spending (inhibiting growth and pressurising businesses that are reliant on government contracts) and raising taxes (thus undermining one of the major advantages of doing business in the low-taxation GCC countries, Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the UAE). However, they are also finally implementing programmes that roll back the state's involvement in the economy. This includes reinvigorating moribund privatisation programmes, which should result in significant cross-border investment and trade opportunities. Saudi Arabia has even suggested privatising parts of ARAMCO; arguably the highest valued company in the world.

COMMERCIAL IMPLICATIONS

- Capital markets are being undermined by the repatriation of SWF funds.
- FX and transfer risk in relation to oil-producing countries will remain elevated well into the medium term.
- Certain asset prices are being hit as demand from investors from the oil-producing countries falls.
- Where countries need IMF assistance, there will be a sharp cut in government expenditure, which will feed through to lower demand in the economy in the short term.
- Weak oil prices will ensure inflation remains low in the euro zone over the next two years; even as base effects dissipate.
- Barring major geopolitical changes, energy inputs and transport costs will remain low for at least the next five years, cutting business costs.
- Companies in the energy sector will experience cash flow problems, profit warnings and increased bankruptcy rates in the next few years: in January, Moody's put 175 energy companies on downgrade watch.
- Banks exposed to energy company loans will experience an increase in non-performing loans, undermining their capital base and ensuring that risk related to the banking sector remains high over the next few years.
- There will be a pronounced move towards a more market-oriented economy in the oil-exporting countries, including reduced subsidies, increased PPPs (public-private partnerships), and fresh privatisation efforts.
- In the short term, companies that are reliant on state contracts in oil-rich states will face difficult trading conditions, while payments from these governments can be expected to slow.
- There will be increased consumer spending power in oil-importing countries: car-buying in the US increased in 2015, partly due to lower fuel prices.

RECOMMENDATIONS

- Closely monitor the country risk environment in any oil-producing countries where you deal with counterparties (particularly those with close links to the state).
- Be prepared for sharp increases in FX risk in many oil-producing countries: hedge where appropriate.
- Consider tightening terms with counterparties in oil-producing countries, if market conditions permit.
- Be prepared for delays in payments from governments or state-owned/-operated enterprises in oil-producing countries.
- Plan for slower payments and the increased likelihood of bankruptcies when dealing with companies that are reliant on government contracts.
- Factor lower transportation costs into business plans for the medium term; but be prepared for increased taxation on fuels in the short to medium term, as well as a rapid increase in fuel costs into the long term.
- Plan for lower demand, particularly for branded products, in oil-producing countries.
- Look for trade and investment opportunities as oil-rich governments reduce their involvement in the economy.
- Take advantage of increased consumer spending power in the oil-importing countries.
- When making business plans, assume weak inflation in many oil-importing countries over the next two years.

OUTLINE SCENARIOS

SCENARIO A

Our baseline scenario is that supply continues to outpace demand over the next five years, but that global growth conditions improve in parallel, narrowing the gap. As a result the annual average price climbs slowly until 2020 (while remaining below the level seen in 2014). After 2020 there should be a strong rebound in oil prices as a consequence of supply shortages; the current weak oil price is causing investment to plummet.

WE ASSIGN A 70% PROBABILITY TO THIS SCENARIO.

SCENARIO B

Geopolitical or socio-political events relating to a significant oil-exporting country curtail oil supplies into the medium term, pushing oil prices back above the USD75/b level more rapidly than in Scenario A, thus attracting further investment into the sector and leading to a milder longer-term rebound in oil prices in the 2020s.

WE ASSIGN A 15% PROBABILITY TO THIS SCENARIO.

SCENARIO C

Global growth remains sluggish well into the 2020s, curtailing demand for oil. The cost of extracting unconventional supplies declines sufficiently to allow supply growth to outstrip demand growth, ensuring oil prices remain weak for at least the next decade. Oil prices will not rebound to 2014 levels until at least 2030.

WE ASSIGN A 15% PROBABILITY TO THIS SCENARIO.

BACKGROUND AND CONTEXT

This century has seen extreme volatility in oil prices (ranging from under USD18/b to over USD145/b) as the market adjusts to a number of a fundamental changes. These changes include:

– The rise of ‘unconventional’ supplies (US shale oil and Canadian tar sands), putting downward pressure on prices.

– The rise of renewables, which accounted for 81% of the increase in energy supply in 2013, exerting downward pressure on prices.

– The global financial crisis has affected demand growth (depressing short-term prices) and investment in new supplies (putting upward pressure on long-term prices).

– Increased insecurity in the Middle East (and other oil-rich countries) threatening supplies, putting upward pressure on prices.

– Increased politicisation of supply (e.g. Russia-Ukraine), putting upward pressure on prices.

– The commitments made at the COP21 climate change conference in Paris in November 2015 have called into question the long-term sustainability of fossil fuels.

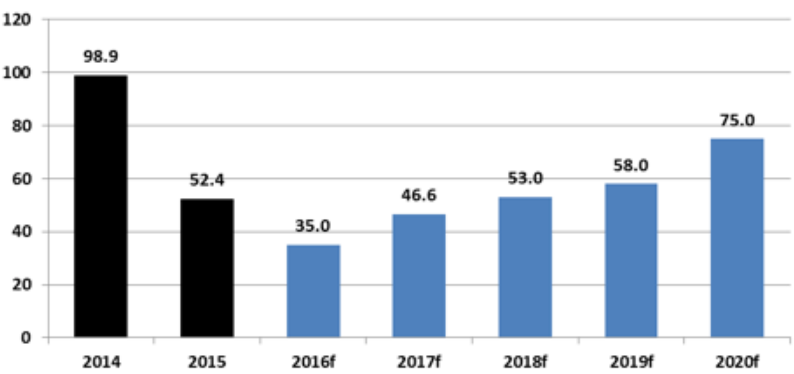
Against this background, a number of factors are currently combining to ensure oil prices remain weak by recent standards. These include the fundamentals of supply and demand being out of kilter (with supply outstripping demand), the strong US dollar (the dollar and oil price have an inverse relationship), and high levels of stocks. Thus, the International Energy Agency (IEA) reports that ‘the markets are already awash in oil’.

Despite calls for agreement between OPEC and non-members to put a lid on production and limit supply, this is unlikely to happen. Two OPEC members, Iraq and Iran, are both attempting to rebuild their output levels. Indeed, the IEA states that Iraqi output in January reached a new record, with further increases still to come. Meanwhile, the lifting of international sanctions has seen Iranian output start to increase; although it will be into the medium term before more substantial output is achieved. Furthermore, Saudi Arabia shows no signs of decreasing its output.

According to the IEA, OPEC production as a whole increased in January 2016 by 280,000 barrels per day (b/d) in month-on-month (m/m) terms, to 32.6m b/d; up 1.7m b/d year on year. However, non-OPEC supply, which includes US shale output, fell by 500,000 b/d m/m, taking non-OPEC supply to around the same level as in January 2015. The expected slump in US shale production will lead to non-OPEC production falling by a further 600,000 b/d in 2016. Against this, demand growth is set to slow in 2016. The IEA is currently forecasting demand growth of 1.2m b/d in 2016, as against the five-year high of 1.6m b/d in 2015.

Our baseline scenario is that supply will continue to outstrip demand into the medium term, keeping a lid on prices (see Chart 1). However, upward pressure will resume as the US dollar eventually weakens and stocks fall. The risks to our forecast are on the downside over 2016-18, but on the upside in the latter part of the forecast. Meanwhile, the weak oil price is resulting in investment being cut back, which will curtail supply growth into the long term and set the scene for a sharp rebound in oil prices.

CHART 1: ANNUAL AVERAGE OIL PRICES (USD/B)



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