Oil Price Decline: Impact on Europe and Turkey

Oil prices declined by around 60% to US$43 a barrel from June 2014 to January 2015. This ended a four-year period of stability around US$105 per barrel and was the biggest shock to global economy in 2014. This came as a surprise to financial markets and policy makers. This is illustrated by the fact that as late as October, 2014 IMF was concerned about possible spike in oil prices caused by rising geopolitical tensions in the Middle East.

The Cause

The steep decline in the oil prices that defied all expectations can be attributed to the following factors:

- **Supply and Demand Dynamics:** Like any other commodity, the long-term price trend of oil is mainly decided by the underlying supply demand dynamics. The long-term trend of supply exceeding expectations and demand not meeting them has resulted in this situation.

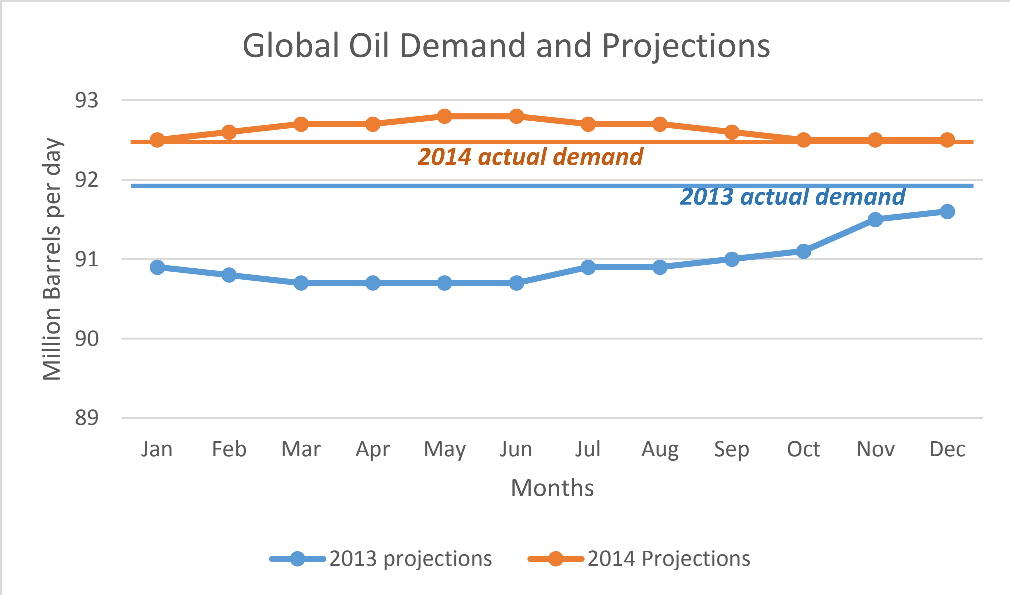

Figure 1: Global Oil Demand and projections *Source: World Bank*

Expectations of oil demand have been revised downwards multiple times a year on the back of disappointing growth data coming in from China and emerging markets. This coincided with consistently higher than expected shale oil production in USA. The shale oil production has beaten production estimates by around 0.9 million barrels per day (mb/d) over 2013 and 2014.

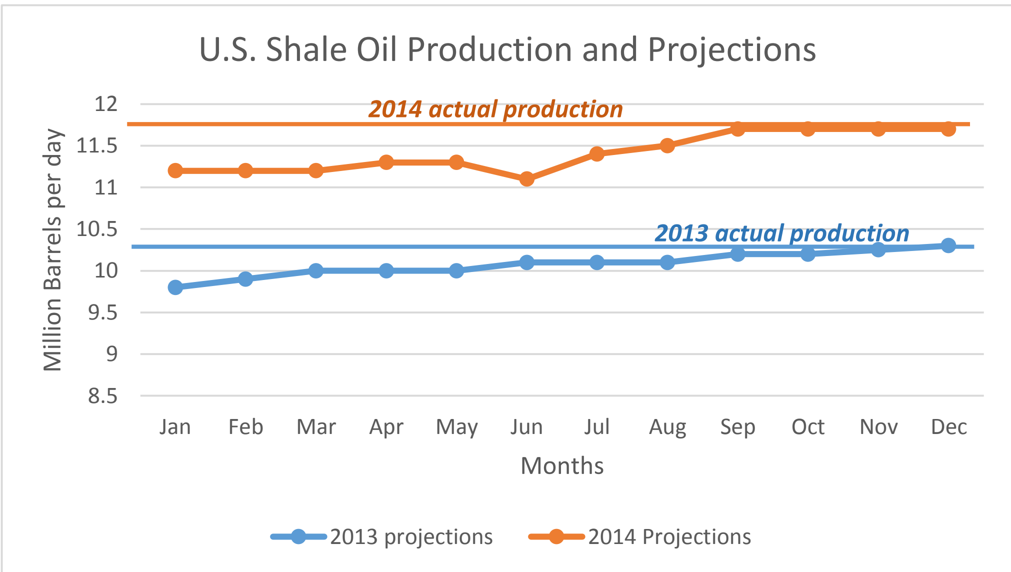

Figure 2: U.S. Shale Oil Production and Projections *Source: World Bank*

- **Change in OPEC Objectives:** OPEC's objective in recent years was to maintain the price of oil in a desired band by increasing or decreasing oil supply. In November, 2014 OPEC changed its objective to maintaining market share in the global oil market and decided to maintain the production level of 30 mb/d. This change in decision effected mainly Saudi Arabia, the cartel's swing producer.
- **Easing of Geopolitical Concerns:** In second half of 2014, it was clear that expected supply disruptions from conflict in the Middle East had not materialized. Production in Libya recovered by 0.5 million barrels a day in third quarter of 2014, advance of ISIS stalled and Iraq's oil output remained steady. Also, sanctions and countersanctions imposed as a consequence of Ukraine conflict, had no material effect on supply from Russia.
- **Appreciation of U.S. Dollar:** In second half of 2014, the U.S. dollar appreciated by 10 percent against world's major currencies. An appreciation in U.S. dollar erodes purchasing power of many oil importing countries like Turkey, India and South Africa causing the oil demand to decline. Empirical estimates suggest that a 10% appreciation in price can cause anywhere between 3% to 10% decline in oil prices.

The effect of each factor is hard to determine but it is clear that supply glut caused by increasing U.S. production and decision of OPEC to maintain market share is the major factor behind the price decline.

Future Outlook

According to World Bank, the oil prices are expected to remain low in 2015 and are expected to increase marginally in 2016. The US Energy Information administration (EIA) projects the Brent crude oil price will average \$59/bbl in 2015 with prices rising from an average of \$56/bbl in the second quarter to an average of \$67/bbl in the fourth quarter. EIA further predicts the average price of Brent Crude for 2016 to increase to US\$75/bbl. The average spread between WTI benchmark and Brent Oil is expected to be between US\$5-US\$7. Experts and analysts do not see Brent Crude crossing the US\$ 75/bbl limit till 2016 as they expect the production from new discoveries of last ten years to last at least for next 3-4 years.

Implications

The oil price decline affects growth and inflation in oil-exporting and oil-importing countries. The effect is often summarised as redistribution of real income from oil-exporting countries to oil-importing ones. The three channels through which the oil price decline has an effect on growth and inflation in the world economy are:

1. **Input Costs:** Lower oil prices reduce energy costs and in turn benefit sectors like petrochemicals, paper and aluminium which use oil as feedstock. Manufacturing, transportation and agricultural sectors are also major beneficiaries because energy costs constitute a high proportion of total costs. Moreover, the price of natural gas, which is increasingly used for electricity generation worldwide, is linked to oil input costs in European and Asian markets. Thus, a decline in oil price has a far reaching impact on input costs of various industry sectors.
2. **Shift in Real Income:** The oil price decline increases the real-income of oil-importing countries and decreases the real-income of the oil exporting countries. If the oil-exporting countries have higher saving rates and the oil-importing ones have higher propensity to consume, this shift in real income can result in an increase in medium term demand. But, if the confidence in importing economies is absent, the higher income can lead to precautionary savings eliminating the prospect of demand boost. Also, if the oil exporting countries do not have high savings rate, the reduction in oil price can force them to reduce government spending and limit imports causing a reduction in growth.
3. **Monetary Policy:** A reduction in oil price can cause drop in inflation in oil-importing countries below target levels of central banks creating room for reduction of interest rates. The

reduction in interest rates coupled with the increase in disposable income can boost growth in such countries.

These effects led to steady growth rates in oil-importing economies and series of interest rate cuts in USA after the oil price decline of 1985-86. The current scenario differs in a two ways. First, the oil intensity of global economy has fallen drastically, weakening the correlation between oil prices and economic activity. Second, all the major economies in the developed world are already having expansionary economic policies eliminating the possibility of additional monetary stimulus.

In the light of above discussion, the subsequent sections discuss the potential impact of oil price decline on the economies of Europe and Turkey.

Europe

- The European Union imports 88% of its oil requirements and natural gas prices (long-term contracts) in the union are linked to oil prices. The decline would hence, have a huge positive impact on the energy bill of the economic union.
- Traditionally, the softening of oil prices have resulted in lower consumer prices and ECB is of the view that this decline would also lead to a reduction in consumer prices. A reduction in consumer prices would lead to higher disposable income for individuals.
- The decline would also help European companies to compete with US companies who enjoy lower energy costs mainly due to lower costs since the shale oil boom.
- The inflation is alarmingly low at the moment and the oil price decline could veer the economy towards deflation. This would exacerbate the debt burden which is restraining the spending power in the economy.
- Deflationary concerns can lead to precautionary savings by households and companies leading to lower consumption and investments. This can limit the potential positive effects of oil price decline.
- The decline of Euro combined with the decline in energy costs outweighs the concerns related to deflation according to European companies. Industry confidence has been boosted because of these developments and according to Munich-based Ifo Institute, the GDP of Germany, leading economy of the EU, is expected to grow at a rate of 1.5% in 2015. Ifo Institute attributes 0.25% points of the 1.5% growth to decline in oil prices. IMF has forecasted a 1.5% growth in 2015 for Euro Area and 1.6% growth for Germany during the same period.
- Oil imports constitute a mere 0.6% of the GDP of UK. Hence, even though investment has slowed down in the North Sea, the overall economy is expected to grow by 2.7% in 2015 according to IMF.
- In UK, the inflation has come down to 1% on account of lower fuel prices and the higher economic growth is expected mainly on the account of increased company budgets and higher household spending.

To sum up, the European economy is going to benefit from low inflation and higher growth because of oil price decline but the deflationary pressures in the economy can reduce the potential benefits through precautionary savings.

	Net Imports of Oil	Net Oil Imports as % of GDP	GDP growth forecast 2015	GDP growth forecast 2016
European Union	406	3.00%	1.50%	1.60%
Turkey	50	6.20%	3.10%	3.60%
UK	17	0.60%	2.70%	2.30%

Table 1: Oil imports and GDP forecasts for EU, Turkey and UK. *Source: IMF, Financial Times*

Turkey

- In 2013, Turkey's total liquids fuel consumption averaged 734,800 bbl/d. More than 90% of Turkey's crude oil consumption came from imports. In 2014, Turkey's total oil import bill was US$50 billion, 6.2% of its GDP.
- A decline in oil price would help Turkey reduce its import bill and in turn narrow the current account deficit which has been a major area of concern for the Turkish economy. According to BNP Paribas, every US$10 drop in oil prices improves the current account deficit by US$4.5 billion. Turkey's current account deficit is expected to narrow to 5% in 2015 from 8% this year according to Citi Global Research.
- The direct benefit to consumers would be less pronounced as Turkey has some of the highest petroleum taxes in the world. Still, inflation is expected to fall from above 9% to around 7% by the end of 2015. This would be another boost to the Turkish economy.
- The reduced inflation would create the appropriate conditions for reduction in interest rates which were increased from 4.5% to 10% last year to stem the fall of Lira. This reduction in interest rate would boost economic activity in the country.
- Turkey's currency is already trading at a discount when compared to similar current account deficit countries namely, South Africa, Indonesia and Brazil. According to BNP, a hike in interest rates by Federal Reserve would not cause the currency to underperform and hence, the benefits of cheap oil would not be eroded by depreciation in currency.
- Turkey also stands to benefit from growth in European economies as it has strong trade relations with them.

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