Surging Oil, Tanking Prices Although oil prices will rebound, a permanent return to $100 a barrel is unlikely.

ECONOMIC OUTLOOK

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From February 2011 until June 2014, a barrel of Brent traded below $90 on exactly three days. This past July, only two of 49 forecasters polled by *The Wall Street Journal* expected oil to fall below $90 by the end of the year. An ever-growing population, plus ever-shrinking oil reserves, meant that $50 oil was mere nostalgia, like $1 movie tickets. Or so we thought. In the last trimester of 2014, the price sank to $55. Where did that come from? Is this a temporary or a permanent fall? What are the consequences?

Congratulations, You're a Winner! (Restrictions Apply)

If you're reading this, I bet you benefit from cheaper oil. In the short term, lower prices benefit oil-importing countries, a category that happens to include the five largest economies in the world: United States, European Union, China, Japan, and India. Altogether, they account for two thirds of the world's gross domestic product (in nominal terms, at market exchange rates), and half the population.

A $10 fall in the price of oil transfers $325 billion a year from oil producers to consumers. If the average price in 2015 were $70, $30 lower than in 2014, the gift would amount to 1.2% of world GDP.

When oil prices change, one minus one doesn't equal zero. The winners are, largely, households in rich countries. They are many and spendthrift. The losers are few: the governments of oily countries and producing companies. They're both also less constrained by current income than consumers, so it'll be a while before they cut investment, dividends, etc. Overall, then, cheaper oil lifts global spending—for now.

The crude rule of thumb is that U.S. demand increases 0.1% for every $10 drop in the price of oil. European consumers hurting from high unemployment get a much-needed lift. But there's a catch. Consumer prices track the cost of black gold in the short term. Persistently low oil prices could mean that U.S. inflation will fall below zero. The eurozone in December was already in technical deflation.

The D-word gives central banks the jitters. If consumers expect prices will keep falling, they will put off spending. If nominal incomes fall, debtors will have a harder time paying back their loans. Expectations of deflation will cement, making it hard to break the destructive loop. Real interest rates will rise, sucking the life out of asset prices and investment. And having hit the zero lower bound, conventional monetary policy is impotent. While I think the fabled debt-deflation spiral is unlikely (even Japan's experience was more like a malaise than deadly spiral), our central bankers don't want to take the chance.

For oil exporters, the effects of cheaper oil are (no surprise) negative. Income, profits, and fiscal revenue will all go down, but to different degrees, depending on how hooked the economy is on oil. For example, energy makes up 70% of Russia's exports, 25% of its output, and 50% of government revenue. Cheap oil, consequently, is wreaking havoc there. By contrast, Norway's net exports of oil and gas amount to just 10% of GDP, and 29% of the government's receipts. Its massive sovereign wealth fund (almost $1 trillion) should help soften the blow.

According to data from the International Monetary Fund and the *Financial Times*, most major producers outside North America run a fiscal deficit if the price goes below $100 (see chart). Cheaper oil will mean less revenue, tighter budgets, and currency depreciation—wherever the exchange rate is not fixed. And if inflation expectations are not well-anchored, higher inflation is likely.

Supply, Supply, Supply

Why are prices falling? The most important reason is plentiful supply.

As oil prices increased in the mid-2000s, energy companies found it profitable to extract oil from shale formations. Crude production in the United States alone jumped from about 5 million barrels per day in 2008 to 9 million now, out of a worldwide total of 75 million. The United States is on track to overtake Saudi Arabia as the world's top producer. Including ethanol and other liquid fuels, the United States is already number one. Crude production in Canada has increased by about 700,000 barrels per day since 2008, thanks to tar sands.

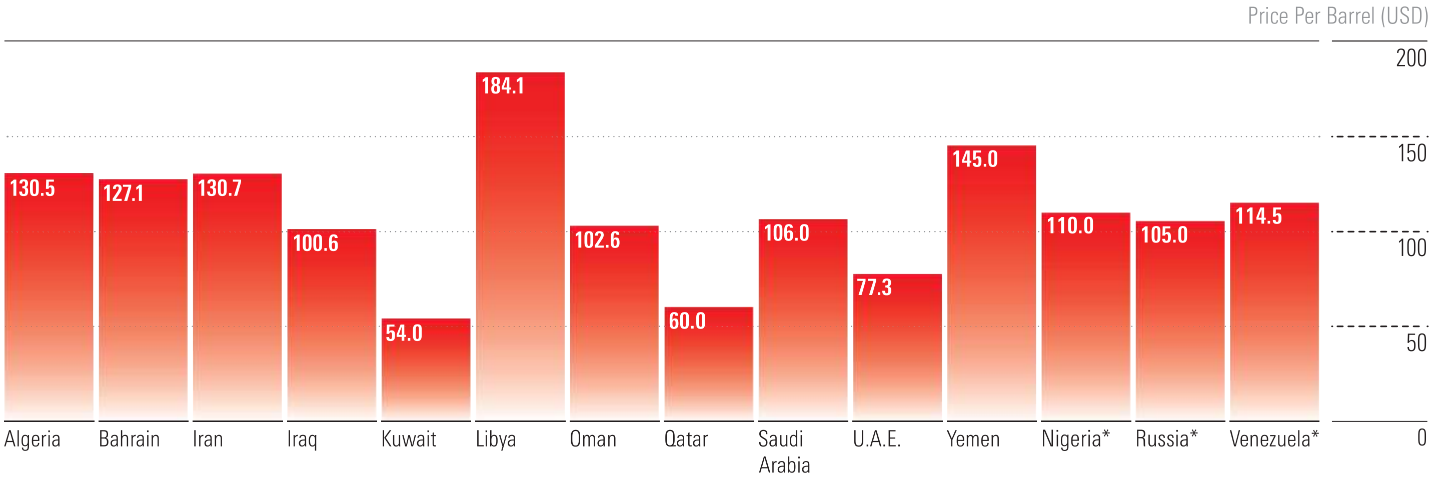
Until recently, the extra oil from North America had a muted effect. The boom coincided with disruptions in the supply from Libya, Iraq, and Iran. That took about 3 million barrels of daily production off the market. But in 2014, things changed. Libya's output, for instance, according to OPEC's Monthly Oil Market Report, increased by 400,000 barrels per day since the summer. That led to OPEC's total production rising to 30.3 million barrels per day in the third quarter of 2014 from 29.8 million in the first quarter.

In November, as excess oil kept piling up, Saudi Arabia announced it wouldn't scale back production. As the only major producer with spare capacity, it can steer world prices, while everybody else acts as a price-taker.

The Saudis might be trying to defend their market share. A recent interview with the Saudi oil minister supports this view: "It is not in the interest of OPEC producers to cut their production, whatever the price is," said Ali al-Naimi in a recent interview with *Middle East Economic Survey.* "Whether it goes down to $20, $40, $50, $60, it is irrelevant." He added that we may never see a $100 price again. For now, he's certainly crushing it.

Wall Street estimates that most shale projects in the United States turn a profit at $60 a barrel. That means many wells are losing money as I write this column. Companies should look hard at where they pump and put off production in the

Fiscal Break-Even Point The chart shows the per-barrel price in 2015 at which some nations would start to run a fiscal deficit (if the price remains under that dollar amount). It's no wonder that Russia's economy is hurting.



*2014. All other data refers to 2015 estimates.
Source: IMF's Regional Economic Outlook (Middle East and Central Asia), *Financial Times*.

least-profitable fields, reducing output and putting a floor under oil prices, at least in theory.

Not the case, though, in practice. Oil companies sign contracts that give them the right to drill on a plot of land for a certain period. If they don't drill, they must compensate the lessor, and the right to drill expires. In the short term, after the contract is awarded, drilling makes sense even below the "break-even price."

Production, then, won't necessarily slow down in the coming weeks. Canadian oil sand projects can turn a profit for years. Tar sands are more like mining than oil drilling: They require large initial investments, after which they can keep producing oil at low marginal cost.

Even over the long run, prices might not recover all the way to $100 a barrel, for several reasons. First, technology is lowering the cost of squeezing tight oil out of the ground. Second, disruptions in the Middle East will return, eventually. In fact, one could argue that low oil prices might lead to more disruptions, if OPEC producers have to cut public expenditures and trigger social unrest. Third, at $60 a barrel Saudi Arabia would run a fiscal deficit of 14% in 2015, according to Moody's. How long can Riyadh afford it?

Pessimism Sells

The supply surge is one story. But on the other (proverbial) hand, analysts worry that the price of oil has fallen because of weaker demand. Instead of raising disposable income for consumers, cheaper oil is a harbinger of slower growth. But where's the evidence of this slowdown?

Copper, nickel, and iron ore have all dropped over the past six months. The same is true of wheat, sugar, cotton, and soybeans. That price declines are so widespread strongly suggests that global forces, not just commodity-specific effects, are at play.

A different explanation, however, for decreasing commodities prices is that U.S. real interest rates are expected to go up. The Fed is now patiently awaiting the right time to start tightening. Past bouts of rising real rates have coincided with sinking commodities prices.

Others point at forecast surveys to explain lower oil prices. Forecasters have been marking down GDP projections, bringing down the world's expected growth 0.3 points in 2015. In particular, economists have in mind the structural slowdown in China, the lackluster recovery in the eurozone, a Russian rumble, and the failure that is Abenomics. Pessimism is further amplified because negative scenarios get a lot of press.

But real-time gauges of activity, such as the composite Purchasing Managers Index, don't show a major decline. The problem with the demand hypothesis is that it's mostly in the realm of the "expected," not the "actual." Oil supply has actually gone up, but whether China will slow down in 2015 remains to be seen. Pin your global outlook, if you wish, to the herd's. But remember: Mr. Consensus forecast that oil would now be trading at $100.

To be sure, the supply and demand interpretations are not at odds. Oil prices may be responding to a recent surge in supply. Cheaper oil is raising growth now, but it's not enough to offset macroeconomic forces that are expected to depress demand in the medium term. If the pessimism is overdone, plus oil supply stays up, prices will recover—although not all the way to $100. M

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