Macroeconomic impact series

Oil price slip

Price decline a continuing risk

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Key messages

- Oil prices are expected to rise. And yet, US energy self-sufficiency, China's growth transition and a divided Organization of the Petroleum Exporting Countries (OPEC) could prevent this.
- Oil exporting countries that have experienced deterioration in their terms-of-trade since 2014 must halt the decline in foreign exchange reserves and restore competitiveness.
- Authorities should maximise oil sector investment returns. Oil companies' privatisation revenues could help rebuild foreign exchange reserves and diversify into non-oil sectors.

A restrained recovery

Weak oil prices have been beneficial for some economies, reducing fuel import costs and inflation, particularly for oil importers such as the Eurozone and Japan. However, the oil price downturn has also been a negative export shock for some.[1] Sub-Saharan Africa's net loss could be as large as $63 billion, or 5% of its gross domestic product.[2] The transmission of oil price changes can be diffuse in that oil is not mainly a developing country commodity.

A moderate recovery in oil prices is expected. From around $40 per barrel, financial market analysts expect $57 in the West Texas Intermediate (WTI) measure by end-2017.[3] Even with such a recovery, this would still be well below 2014's peak of $107. The continued revenue and investment loss will hurt oil exporters. Undiversified economies, and those that have failed to successfully invest past oil revenues, are vulnerable to financial sector fragility and weaker growth.[4]

Several factors are likely to restrain the oil price recovery. The oil price drop has been largely demand driven. As such, continued weakness in demand, particularly from the US and to a lesser degree, from China, will curb price rises. On the supply side, OPEC production cuts are unlikely to support oil prices. And, incremental rises in US shale production, in response to profit opportunities, will limit price rises.

Fragile demand and a fragile OPEC?

The 50% drop in WTI oil prices, between mid-2014 and mid-2015, was largely demand-driven. This is not uncommon: oil price shocks are typically associated with unanticipated shifts in oil market-specific demand and with shifts in global demand.[5] Although emerging market energy demand is expected to support oil prices in the next two decades, near-term global growth will be anaemic.

US energy self-sufficiency will limit oil price rises. Petroleum imports have declined, and will continue to fall, because domestic production of natural gas, largely from shale resources, is rising.[6] Despite bankruptcies, US shale production has not fallen as significantly as oil prices.[7] Companies now plan to boost output,[8] which would limit any price rises.

China's energy demand is a source of debate. Its long-term demand and oil dependence are expected to grow robustly to 2035 given its infrastructure plans.[9] However, in the next few years, China's less energy-intensive growth, away from investment spending towards consumption-led growth, suggests weaker energy demand.[10]

OPEC exports 60% of total petroleum traded internationally.[11] And yet, even with its new Secretary General calling for unity, any production freezes are unlikely to succeed in stemming price declines, given its members' divergent strategies. Saudi Arabia, its largest producer, is increasing production,[12] while other members have typically looked to curb output.[13]

Limiting the growth fallout

As ever, risk aversion is the wild card. Flare-ups in financial market volatility typically trigger oil price declines, as seen in the aftermath of June's 'Brexit' vote. The US presidential election in November could have the same effect. On the other hand, geopolitical tension, perhaps in one of OPEC's 'fragile five' – Algeria, Libya, Nigeria, Venezuela and Iraq – or in the broader Middle East, could push up prices. Geopolitical tensions would increase precautionary demand, and the oil price, amid fears about oil supply shortfalls.

Oil exporting emerging economies could engage in a number of reforms to counter the impact of lower oil revenues. Countries with a high share of oil in their exports, that have seen a dramatic decline in their terms-of-trade since 2014, will have to rebuild their foreign exchange reserves and restore competitiveness.[14] In order to do this, to start with, freely floating exchange rates should function as shock-absorbing mechanisms to support export growth, similar to Nigeria's abandonment of its US dollar peg.

Oil sector investment returns should be maximised. Revenues from full or partial privatisation of state-owned oil companies could be used to rebuild foreign exchange reserves and invested in non-oil sectors. The latter would offset oil-related investment losses and ensure future revenue rather than a one-off privatisation windfall. Even reserve-rich countries are taking steps; Saudi Arabia plans to use privatisation revenues from its state-owned oil company, ARAMCO, to make long-term investments in its non-oil industries.[15]

Endnotes

1 https://www.odi.org/publications/10364-triple-transition-slowing-china-lower-oil-prices-and-higher-us-dollar
2 https://www.odi.org/comment/9458-low-oil-prices-africas-winners-losers
3 http://www.bloomberg.com/news/articles/2016-08-01/looking-beyond-a-bear-market-analysts-see-57-crude-next-year
4 https://www.imf.org/external/pubs/cat/longres.aspx?sk=43658.0
5 https://www.aeaweb.org/articles?id=10.1257/aer.99.3.1053
6 http://belfercenter.hks.harvard.edu/publication/23191/shale_oil_boom.html
7 https://www.federalreserve.gov/econresdata/notes/feds-notes/2016/unraveling-the-oil-conundrum-productivity-improvements-and-cost-declines-in-the-us-shale-oil-industry-20160322.html
8 http://www.reuters.com/article/us-usa-oil-shale-idUSKCN0W20JH
9 'Conference notes', T20 International Financial Forum, Shenzhen, 27-28 January.
10 http://www.imf.org/external/pubs/ft/weo/2015/02/
11 https://www.eia.gov/finance/markets/supply-opec.cfm
12 http://www.saudiaramco.com/en/home/news-media/news/AR2015.html
13 OPEC is comprised of Iran, Iraq, Kuwait, Saudi Arabia, Venezuela, Qatar, Indonesia, Libya, the United Arab Emirates, Algeria, Nigeria, Ecuador, Gabon and Angola: http://www.opec.org/opec_web/en/about_us/25.htm.
14 A country's terms-of-trade is broadly defined as the ratio of export prices to import prices.
15 http://www.reuters.com/article/us-saudi-aramco-idUSKCN0Y10XL

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