A Different Oil Shock*

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In a curious shift in perception, low and falling crude oil prices are increasingly being viewed as a disadvantage rather than a benefit to the global economy. The spot price of Brent crude has fallen from just above $100 a barrel at the beginning of September 2014 to around $27 a barrel in mid-January 2016—a close to 75 per cent collapse over a 17-month period. The decline is giving rise to jitters on what it would do to an already sluggish global economy.

That marks a shift, since initially the downturn in oil prices, which had been fluctuating in the $100-120 a barrel range for more than three years prior to September 2014, was seen as a benefit. The dominant view earlier was that since in the past (1973, 1979, 1990 and 2008) spikes in oil prices resulted in recessions, a sharp decline in prices should deliver the opposite—a recovery from the recession plaguing the world economy since 2008. In fact, this view is still prevalent among the optimists. An editorial in the Financial Times of January 16, 2016, held, for example, that the slide in oil price to "below $30 a barrel for the first time in more than a decade, reflects a welcome increase in supply rather than a worrying fall in demand. While there are undoubtedly some losers from the fall in the price of crude, notably oil exporting countries and banks exposed to the energy sector, the boost in real incomes in the rest of the world should outweigh them."

The arguments to back this position are many. One for example is that consumers who had to spend less on energy and fuel would divert incomes to demand other commodities and services, leading to buoyancy in demand. Another is that governments faced with lower inflation triggered by the oil price decline would have more headroom to adopt expansionary fiscal and/or monetary policies. The beneficial effects these developments would have on demand would raise economic activity and induce investment. This line of reasoning led to the conclusion that the world was in for a period of "expansionary disinflation" or higher growth with low inflation.

However, with oil prices having declined sharply for much more than a year the opposite seems to be true, with forecasts of global growth turning gloomier by the day. That is not all due to oil price movements. But there is reason to believe that low and falling oil prices have played a role in worsening a bad situation. What is more, there is no indication thus far that the precipitous decline in oil prices will reverse itself. Two factors appear to be principally responsible for the decline. The first is sluggish demand resulting from the prolonged recession. The second is that while US oil and gas output has risen significantly driven by the shale oil and gas boom, OPEC as a group and Saudi Arabia, its main exporter, are unwilling to cut production for fear of losing market share to the US, leading to oversupply. If anything the pressure is to pump out more so as to reduce the revenue loss by expanding the volume of sales.

Initially it was expected that war and political turmoil in West Asia, and the loss of competitiveness of shale production due to the price decline, would lead to an adjustment of supply. However, geopolitics in the region has not made much of a difference to the level of supply from West Asia. In fact, the end of sanctions following the US deal with Iran on the nuclear issue is expected to increase global supply from Iran by as much as 500,000 barrels per day (b/d) immediately and one million b/d in six months. On the other hand, while US crude oil production that peaked at 9.6 million b/d in April 2015 is being cutback, it still remains high by historical standards. Out of the 5 million b/d increase in the net global supply of crude oil between 2009 and 2014, 3.3 million b/d was from the US. The production fall there has been nowhere near required to neutralise the effect of the previous increase, especially since demand has not been soaring. According to the US Energy Information

Agency, crude oil production will fall only by 7 per cent in 2016, which would still leave global production significantly higher than in 2009.

Thus, as of now the reversal of the slump in oil prices does not seem a near-term prospect. This makes the fact that the price fall has not helped recovery but is threatening to intensify the recession a serious concern. If inflation fuelled by the oil shocks of the past led to the adoption of contractionary policies by governments and triggered a recession, the collapse in prices seems to be having effects that would depress investment and spending in many countries, worsening the problem of low global growth.

To start with, there has been significant expenditure contraction in oil exporters dependent on budgetary revenues largely from oil. One extreme example is oil rich Saudi Arabia, which relies on oil exports for 80 per cent of its budgetary revenues. So even though it has boosted production and supply, and has at hand close to $650 billion of foreign reserves, it finds the close to a 100 billion dollars hole in its budget as a result of the oil price decline unsustainable. To reduce the budget deficit it has announced budget cuts for 2016, involving reduced spending and cuts in energy subsidies, besides a privatization drive that would involve sale of equity in state-owned oil major Saudi Aramco. While the sale would not provide rights over reserves, it would not be restricted to just the company's refining and petrochemical units but also exploration and production assets.

Budgetary deficits and spending cuts obviously afflict other oil exporting countries as well, which, besides those in West Asia, include others such as Russia, Nigeria and Venezuela. Russia has announced a 10 per cent cut in budget expenditure, with the total placed at Rbs700 billion ($9 billion). The rouble has depreciated by 15 per cent vis-à-vis the dollar over the first three weeks of the year. But since oil constitutes Russia's major export, this constitutes a problem rather than a benefit since in the short run it can squeeze domestic demand because of inflation rather than raise exports. If a large number of countries that were among the growth poles in their regions fall into a recession pushed by the impact of the oil price fall, the depressive effect on global demand would be considerable.

Elsewhere, in Europe, the effect of the price fall is very different. Europe has been battling deflation with loose monetary policies. It wants inflation to rise from zero to 2 per cent along with increases in demand and output growth. The effort to deal with the problem by injecting more money into the system only seems to yield asset price inflation. This problem is likely to intensify, as the effect of low and falling oil prices add to the deflationary tendency.

To these consequences must be added those likely to result from the huge spending cuts slated to occur in the all-too-important oil industry itself. Petrobras of Brazil, for example, roiled in a corruption controversy in the midst of the price fall, has announced that it will cut its five-year (2015-2019) investment programme by 25 per cent from $130.3 billion to $98.4 billion. The actual cut is likely to be larger. Across the global industry $200 billion of spending has reportedly been cancelled or postponed.

Moreover, oil and gas sector bankruptcies are reportedly at levels last seen in the Great Recession. Nine US oil and gas companies, burdened with more than $2 billion in debt, have filed for bankruptcy in the fourth quarter of 2015. This has its own after effect. Employment in oil and gas extraction in the US fell by 17,000 or 8 per cent from its December 2014 peak. This is even larger than the 12,000 jobs lost at the time of the 2009 (year to December) crisis. In the UK, BP has announced 4,000 job cuts. These too would have multiplier effects that worsen the recession.

Outside the oil sector in the US, the historically observed inverse relationship between the level of oil prices and the strength of the US dollar is proving to be a problem. The trade-weighted exchange rate of the dollar has risen by close to 22 per cent since July 2014. That adversely affects the competitiveness of a beleaguered US industry, and partly explains poor manufacturing performance and the fact that job increases have tapered off in recent months.

Finally, the financial fallout of the oil price decline also promises to be significantly adverse. Exposure of banks in the form of loans to the energy sector and of non-bank financial companies to instruments linked to oil is expected to result in substantial losses. Already major banks like Citigroup and J P Morgan are reporting a sharp rise in non-performing assets and provisioning requirements that have implications for credit availability in the immediate future. Credit may be squeezed precisely when firms need more funding. That too would hold back production and growth.

In sum, rather than expansionary deflation, the world economy seems set for a deflationary crisis given the magnitude of the oil price fall. The world is experiencing a different kind of oil shock—that of falling rather than rising oil prices.

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