

## Slide in Oil Prices

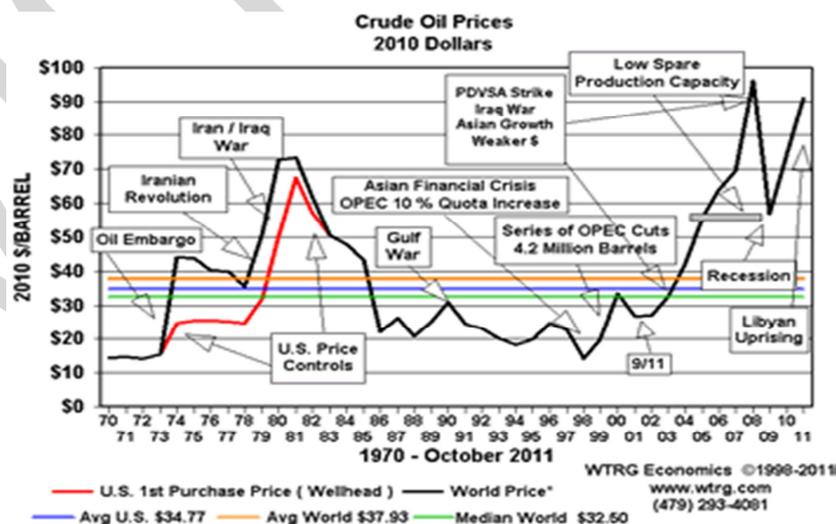
### 1. Introduction

One of the most unexpected stories since the start of 2015 has been the continuous decline in worldwide oil prices. In June 2014, oil prices were hovering around \$110 a barrel. Six months later, prices have plummeted by over 50 percent to as little as \$47 a barrel. The remarkable fall in global oil prices is continuing because of a mismatch in demand and supply. While the benefit of low oil prices is already evident to consumers of oil importing nations, there is a pervasive fear that continually declining prices can ultimately have a negative impact on the world economy.

### 2. Oil Price Fluctuations in the Last Decade

During 1999-mid 2008, the price of oil rose significantly. It was explained by the rising oil demand in countries like China and India. In the middle of the financial crisis of 2007–08, the price of oil underwent a significant decrease after the record peak of US\$145 it reached in July 2008.

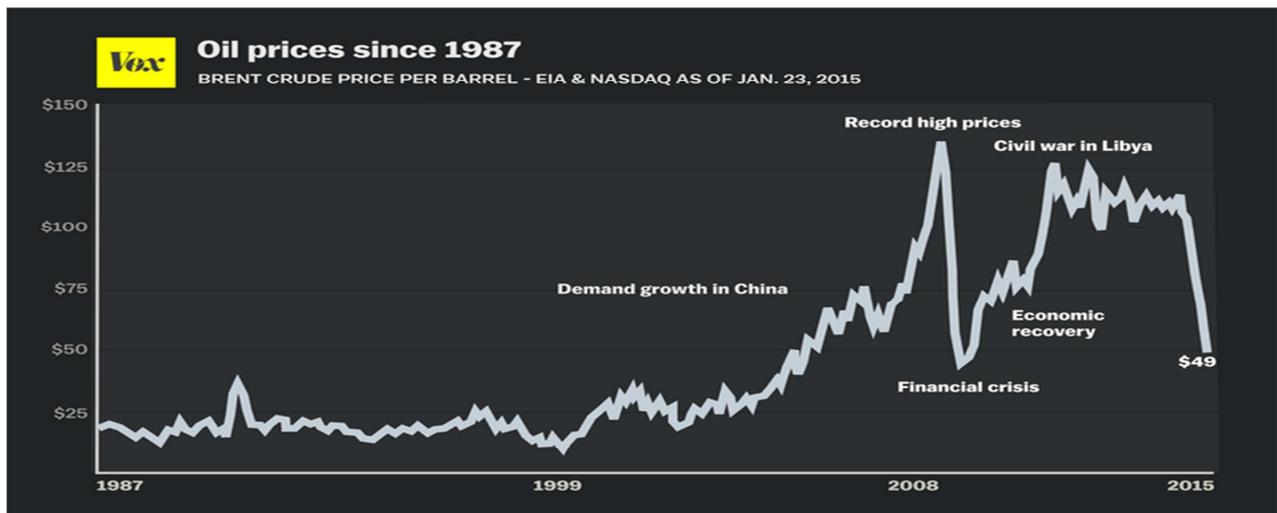
The price sharply rebounded after the crisis and rose to US\$82 a barrel in 2009. On 31 January 2011, the Brent price hit \$100 a barrel for the first time since October 2008, on concerns about the political unrest in Egypt. For about three and a half years, the price largely remained in the \$90–\$120 range. In the middle of 2014, the price started declining due to a significant increase in oil production in USA, and declining demand in the emerging countries.



### 3. Current Situation

Down nearly 50 per cent since June, international crude prices are close to levels last seen in 2009, when the global economy was gripped by its worst slump since the 1930s. It might have devastating impacts on economies

of oil produce countries like Russia, Venezuela, Iran while it is a good news for consumers in oil importing countries.



#### 4. Why are Crude Oil Prices Declining since June 2014?

The oil price is partly determined by actual **supply and demand**, and partly by expectation. **OPEC's decisions** shape expectations; if it curbs supply sharply, it can send prices spiking.

The remarkable fall in global oil prices is continuing because of a mismatch in demand and supply. Demand is down because of **Eurozone's economic stagnation, Japan slipping into recession and China's slowdown**. Output, on the other hand, is rising on account of the **U.S. shale boom, revival of Libya's oil production, and continuous increase in production in Iraq and OPEC's decision of not cutting down the production**.

1. **Increase in US Shale gas production:** As oil prices increased in 2011 (because of surging global demand, especially China), many energy companies found it profitable to begin extracting oil from difficult-to-drill places. In the United States, companies began using techniques like fracking and horizontal drilling to extract oil from shale formations in North Dakota and Texas.

This caused increase in supply by US, where a **surge in fracking is driving an oil boom**. The rapid increase in shale oil production in the last few years brought America's oil output from five million barrels per day in 2008 to an astonishing average of 9 million (bpd) in 2014.

**Why US Shale boom had very less effect on oil prices earlier?** Until very recently, however, the US oil boom had surprisingly little effect on global prices. That's because, at the exact same time, **geopolitical conflicts** were flaring up in key oil regions. There was a **civil war in Libya**. Iraq was facing threats from ISIS. The EU and US slapped oil sanctions on Iran and pinched its oil exports. These conflicts took more than 3 million barrels per day off the market.

2. **Present turmoil in Iraq and Libya** has not affected their output. These are two big oil producers with nearly 4m barrels a day combined. Production is rising even in both of these countries.
3. **OPEC unwilling to cut the production**

**Why OPEC is not curbing oil production to check the falling oil prices?** OPEC members are caught in a difficult spot, as cutting down production will mean a **loss of revenue**. They are also conscious about holding on to their **market shares**; cutting output will mean a loss of market share to other OPEC members or to U.S.

The decision of not reducing the supply signifies a willingness to bring prices lower in an **effort to curtail the increase in supply from non-OPEC producers**, particularly the U.S.

**Why is Saudi Arabia not willing to curb production?** After the first global oil shock following the 1973 Middle East War, Saudi Arabia, has influenced geopolitics at will by changing the oil production.

**Saudi Arabia** is best suited to weather a long price war. The government holds **currency reserves** over \$700 billion, government deposits of \$450 billion, and **no national debt**, placing it in the best strategic position. Also, Saudi Arabia is the **ultra-low-cost** (\$5 -\$10 per barrel) producer of oil.

It is again playing politics with oil to force down the price. It has **4 objectives**: of hurting Iran and Russia's oil incomes, establishing complete dominance in OPEC, forcing smaller producers out of the market (therefore allowing Saudi Arabia's market share to increase), and pushing back against U.S. shale production.

Saudi Arabia is gambling that **shale oil will become economically unviable** to produce — if it already has not — as prices head below the \$50 a barrel mark. First signs of that gamble paying off are just beginning to appear on the horizon. Drilling activity for shale oil is beginning to slow down as producers begin to feel the pinch of unremunerative prices.

4. **Fed tapering:** The **oil market** was **funded** in a major way in the **last few years** by **cheap dollars** flowing out of the Federal Reserve's quantitative easing programme. With interest rates at near zero, surplus funds flowed into the commodity markets, notably crude oil, driving their prices upwards.

With the Fed winding up its stimulus programme and an interest rate hike in the U.S. possibly just round the corner, **funds are now flowing out of commodities, driving their prices down**. It is not a coincidence that oil prices started falling at around the same time that the Fed first indicated the possibility of a rate hike in the near term.

5. **Decrease in Demand:** Demand is low because of **weak economic activity, increased efficiency**, and a growing **switch away from oil to other fuels like nuclear, solar, wind**. Oil demand in Asia and Europe suddenly **began weakening** — because of slowdown in China and Germany and focus of Germany on solar energy.

More broadly, oil demand has been flatlining in lots of places around the world. In many countries gasoline consumption stagnate as cars became more fuel-efficient. At the same time, countries like **Indonesia** and **Iran** have been **cutting back on subsidies** for fuel users.

## 5. Global Implications

Falling oil prices is good news for oil importers, such as Western Europe, China, India and Japan; however, it is bad news for oil exporters, such as Venezuela, Kuwait, Iraq and Nigeria.

### 5.1 Positive Impacts

**Impact on Global economy:** A recent IMF study says that every \$10 fall in oil price adds 0.2 percentage points to global GDP growth. And that should mean a boost of over 1.2 percentage points to global GDP growth given that oil has dropped from around \$115 a barrel six months ago to less than \$50 a barrel now.

**Impact on Nations that import oil:** crude oil price decline will support industrial output in oil-importing nations of the Asia Pacific and Europe (**European countries, China, Japan, India etc.**). Also demand in the retail sector will increase as costs fall for consumers, which will stimulate the economy further.

Decrease in oil prices should also result in **improving demand for discretionary goods** and will support retail and e-commerce spending. **Logistics markets** will also benefit from falling transportation costs. Oil related transport costs would directly fall, leading to lower cost of living and a lower inflation rate.

**Impact on ISIS:** Since expanding its territorial control over the summer 2014, ISIS has built several small refineries to extract oil to use as fuel for vehicles and to fund its operations. **Falling oil prices is reducing its revenue**, which will negatively affect its functioning as terror operations and war requires huge resources.

But falling oil prices **might reduce the capacity of Iraq govt. to fight against ISIS**, as it is also dependent on oil revenues to fund operations against ISIS. So, other nations should support the efforts of the Iraq government, both financially and materially, by providing weapons, training, food and logistics.

## 5.2 Negative Impacts

**Impact on Eurozone:** Lower oil prices, which would normally be seen as producing **disinflation** in oil-importing countries, **could accentuate the general deflationary tendency** in Europe -- one that could be quite detrimental to the continent's immediate and longer-term economic well-being.

**Effect on America's shale boom:** American shale gas producing companies, western oil companies which are involved in drilling in deep sea water or in Arctic, are facing difficulties because of falling oil prices. **Many projects become unprofitable** because of falling oil prices.

Fracking wells tend to deplete quickly — with output falling about 65 percent after the first year — so new wells have to be drilled constantly. Already, **firms are pulling out of places like Texas' Permian Basin**, and the number of US rigs has fallen 15 percent from December to January. **Drilling activity for shale oil is beginning to slow down** as producers begin to feel the pinch of unremunerative prices.

**Impact on Oil exporting Countries:** The economic impact on Russia, Iran, Venezuela and maybe Iraq, Algeria, Nigeria and Libya could be ruinous. **Russia** is hugely dependent on oil and gas production — with oil revenues making up **45 percent of the government budget**. The plunging price of oil has also caused the **Ruble's value to collapse** — which is leading to panic inside Russia and a rise in **inflation**, as imports become drastically more expensive.

The sharp decline in oil revenues could force **both Russia and Iran** to review and maybe **reduce their financial and material support for the Assad regime in Syria**.

Some optimists speculated that the crude reality brought about by the changing energy landscape may **force Iran to show more flexibility** in its nuclear negotiations with the **P5+1** in return for a quicker process of sanction relief.

The foreign currency reserves that **Saudi Arabia, the United Arab Emirates and Kuwait** have accumulated will help them navigate the turbulent markets in the immediate future, but even these economies will be forced to adjust their balance payments and maybe cut back on subsidies and social programs.

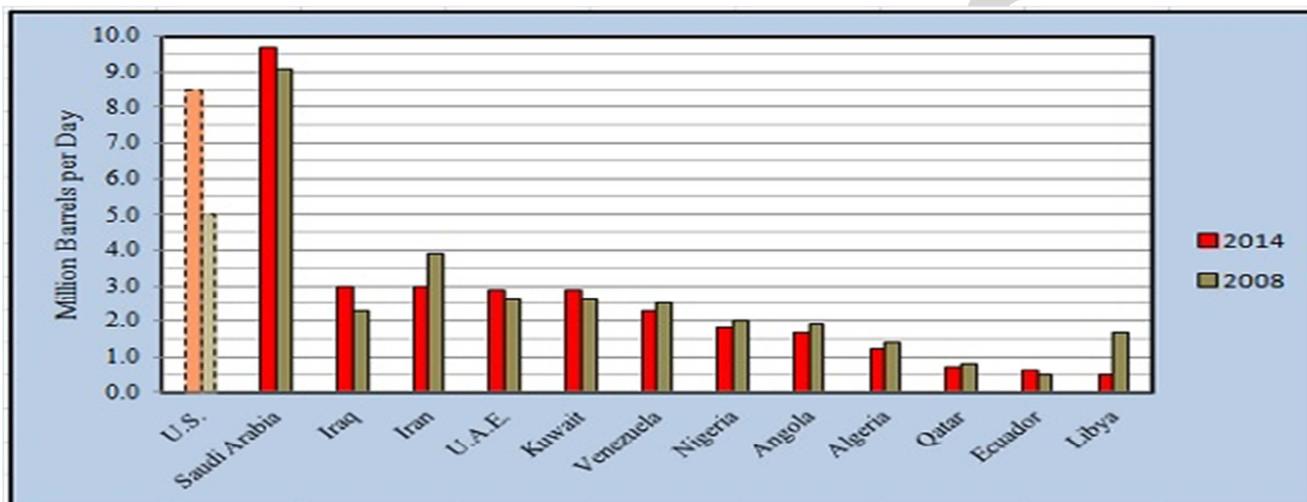
There is a **growing concern** that **the oil crash could cause Venezuela**, another major oil producer, **to default**. The nation's economy — heavily dependent on oil revenue — is set to shrink some 3 percent this year and inflation is rampant.

In **Iraq, Libya and Yemen**, very low oil prices could plunge these countries deeper into violence. It will also affect **fight against ISIS, terrorism**.

**Impact on Global financial stability:** Such a devastating impact on the oil producer countries will have global consequences. **Venezuela, Russia and Iran** are facing the biggest challenges because of fall in oil prices. It is causing huge instability in these regions, which can lead to global instability as economies and banks of many other countries are linked to these countries.

It will lead to **immediate cuts in energy companies' investment budgets**, both in the traditional sector and among promising alternative technologies. It will lead to reduction in new oil explorations.

**Environmental Implications:** Falling oil prices could delay investment into alternative 'greener' forms of energy, such as electric cars. Falling oil prices could reverse the recent decline in car use, leading to a steady increase in traffic congestion and environmental costs of petrol use.



Major Oil producer countries and their share in world oil production

## 6. Domestic Implications

### 6.1 Positive Impacts

For an energy-intensive economy such as India, which also depends on **imported oil for meeting four-fifths** of its needs, a fall in oil price will help in improving **trade balances**. Thus, current account deficit (CAD) will decrease. Huge **foreign exchange** will be saved.

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Improvement in macro fundamentals [**inflation and the fiscal deficit and the current account balance**] will, at the margin, **increase the space for macro [monetary and fiscal] policies** for RBI to boost growth.

The spare cash from fuel cost **savings**, howsoever small, should increase consumer discretionary spending. **Higher consumption** adds to **corporate incomes**. Abating input costs too will widen **profit margins** for businesses. As balance sheets start improving, companies will be better placed to **start new projects or revive stalled ones, generate new jobs and growth**.

Diesel prices have a direct bearing on prices of essential commodities, as it is the preferred fuel for the transport sector. So **inflation** will also **reduce**. Also, as the cost of production decreases, the **exports will become more competitive**, which will help in raising the exports.

The direct impact of this fall will be on **upstream oil companies such as ONGC and Oil India** that will now see their share of the subsidy burden going down.

Companies that use crude or crude derivatives as inputs, such as manufacturers of **plastic products, synthetic textiles, tyres and paints**, will see profit margins expanding due to lower input costs.

## 6.2 Negative Impacts

**Indian investors** and companies hold a lot of stakes **in countries like Nigeria, Russia** and the **Gulf**, which are facing the downside of this oil price decrease. Indian investment in these countries would be at risk.

Also, the inward **remittances** from these countries to India are adversely affected as the Gulf countries may downsize their foreign labor force. Further **investment (FDI, FII)** coming from these countries will also reduce, as there is huge fall in oil revenue earned by these countries.

Decreasing oil prices will adversely impact the oil economies like Saudi Arabia, Iran, Qatar, and Russia resulting in decreasing exports to such countries. Being the **sixth largest exporter of petroleum products, India's revenue from this sector will also decrease**. E.g. the recent decline in share prices of Bharti Airtel and Bajaj Auto.

Govt. is hoping to give new licenses for oil and gas explorations. Now, it will be increasingly **difficult to attract risk capital into oil and gas exploration**. This is because most oil companies have pared down their exploration budgets.

**Environmental Impacts:** Lower price of fuel **shifts focus away from renewable green technologies**. Due to this, purchase of vehicles as well as use of vehicles will increase which will create environmental, health problems such as increased pollution, environmental degradation, global warming and wastage of resources.

**Why the prices of petroleum and diesel in India have not been reduced proportionately to that of reduced global crude prices?**

In spite of decrease in crude oil price more than 50%, the prices of petroleum and diesel have not been reduced proportionally because of following reasons.

- 1) Indian government raised **excise duty 4 times** to reduce its fiscal deficit. This extra raised money will be utilized for funding welfare schemes, infrastructure projects.
- 2) **Subsidies** were reduced to zero on Diesel and Diesel is deregulated like petrol.

**What more should be done by the Indian government?**

Government should use the chance to **clean up its subsidy act** once and for all, mainly in **cooking gas and fertilizers**. It should push for **transparency in pricing of fuel** by the oil companies, something that is now absent.

The government should also ensure market prices for the oil producing PSUs — ONGC and OIL — so that they can invest in exploration and production.

According to one view, it should **resist the temptation to raise taxes** — excise duty has gone up 4 times in the last three months depriving consumers of the benefit of lower prices. To the contrary, the government should pass on the benefit to consumers who can then either spend the surplus elsewhere or save. This will help in boosting growth.

## 7. Possible Future of Oil Prices

This is very hard to predict. If oil demand remains weak and production stays high, prices might not bounce back for some time. Earlier in history also **oil prices fell (2008, 1996) and rose again**; so if history is an indication then oil prices **will eventually rise again, though it could take some time**.

RBI Governor, Raghuram Rajan, became one of the first, worldwide, to caution against the **possibility of a reversal in the downward trend** in global crude prices rising on the back of geopolitical risks.

The current downturn in oil prices underlines the cyclic nature of commodity trade and illustrates **OPEC's reduced regulatory capacity consequent to it supplying only 40% of global demand**. While **Shale Revolution** may be a new and price-sensitive factor, it is unlikely to vanish with time or with lower prices. **During past oil price fall in 1986, 1993-99 and 2008, the lower prices invariably spurred consumption and the prices bounced back**. There is no reason to believe that the oil prices shall not rise again.

## 8. Conclusion

The **implications for India are**, of course, on balance **hugely positive**. It has saved approximately \$40 billion in **reduced import costs**; inflationary pressures have eased; the **subsidy outgo has reduced** and **growth** has got a boost. RBI deputy governor said that the **dramatic fall in global oil prices are a boon for the Indian economy**, as it would increase disposable incomes, reduce input cost of businesses and bring down energy subsidy burden.

But there is a flipside. Indian companies are having substantive investment, trading and financial interests in Venezuela, Russia, Nigeria and the Gulf, which would be at risk. Also, **Indian diaspora** and **remittances** from Middle East would be negatively affected. Also, there is a possibility of **decrease in stability of global financial system** if this decrease continues for long. So, the Indian government should use this opportunity by taking appropriate steps to boost the economy but it should also be prepared for future rise in oil prices, as this may be a temporary phenomenon.

## Possible Questions in Interview from this Topic

1. Name the members of OPEC and its role?
2. Is the fall in oil prices good for India?
3. How is the current geopolitical situation in Middle East contributing towards fall in oil prices?
4. Why have the prices of petroleum and diesel in India not been reduced proportionately to
5. That of reduced global crude prices?
6. How can the Govt. of India best utilize the opportunity generated from a fall in oil prices?
7. How will this affect Indian diaspora and relation of India with middle-east countries?
8. Would the Eurozone crisis be enhanced by this fall in price of oil?
9. Why is it not such good news for many countries in the Eurozone?
10. Why is Saudi Arabia not willing to curb production?
11. How will the slide in Oil prices affect shale gas boom of USA?

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