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DECEMBER
2014

THE SHOCK OF COLLAPSING OIL AND GAS PRICES

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The consequences of the near halving of oil and natural gas liquids prices since last summer depend on whether you are a country highly dependent on such exports or a major importer. Why this decline has happened and how long it might last help to explain what this decline spells for the world economy. Much uncertainty remains over how low prices will go, and for how long, but to the extent that they reflect strong supply rather than lower demand, they offer a welcome boost to the world economy. For many in the West, they also represent a welcome transfer from petro-despotic countries, not least Russia.

If the downshift in prices is lasting, the consequences will be many. Let us simply mention four. Falling oil and natural gas liquids prices will make economies more carbon intensive and less energy efficient but they would afford the opportunity to cut wasteful subsidies to consumption, maybe permanently. Governments should seize the opportunity but will they? The answer is probably that very few will.

A fall in prices will redistribute income from net exporters to net importers among which are the European Union, Japan, China and India. Net exporters heavily dependant of the revenues of oil and natural gas liquids include Iran, Algeria, Venezuela and Russia. Few will be upset that they find themselves in a tight corner but, where Russia is concerned, it is best to remember that despots can be even more dangerous when they are in a corner.

Russia is facing the perfect storm: a collapsing economy, a collapsing currency and very high interest rates. Oil and gas represent two thirds of Russia's exports of \$530bn and without them, the country could ill afford its massive deficits in the public and trade sectors. Capital outflows this years amount to \$100bn. The government might be tempted to impose stringent capital controls but this would inflict considerable long term damage on foreign capital inflows and trust in the country - hence on Gazprom and its foreign partners investment in new oil and gas fields. Russia's cancellation of the \$50bn the South Stream gas plan is the most important casualty so far of plunging oil prices. Others could follow.

Another country which is going to have to tighten its belt is Algeria. Handing out ever more subsidies, not least in energy – the domestic gas price is one of the lowest in the world, to keep the peace may not be available in the months ahead. Will this force to government into making bold economic, nay political reforms,

as happened in 1988-1992 after riots broke the back of the single ruling party. That is anybody's guess, especially at a time when a fierce battle is under way for the succession, whenever it occurs, of the ailing head of state. One thing is sure: it is only when oil prices collapse that there is a real chance of economic reforms in Algeria.

Another consequence is that declining oil and natural gas liquids prices shift the price of assets. The exchange rate of energy-producing countries will be under tremendous downward pressure – the precipitous fall in the Russian rouble illustrates the point perfectly. Share prices in companies which benefit from lower prices will have gains, directly or indirectly. Hence the impact of stock exchanges and market valuation will be complex and unpredictable. A further consideration is that already-low headline inflation could entrench expectations of ultra-low inflation and could bring about deflation.

A \$40 fall in the price of oil amounts to a shift of roughly \$1.3tn – close to 2% of world gross output, from producers to consumers. As things stand, the fall today has gone beyond \$40. Consumers are more than likely to spend more than producers so that this should give the world economy a small and welcome boost.

History is always worth recalling on such occasions. In a little over 12 months to the summer of 1986, the price of oil fell ever further than it has this year, an event which not coincidentally preceded the collapse of the Soviet Union. The fall can be traced to the reduction of energy intensity of consumption and production caused by the two oil shocks of the 1970s and the emergence of significant production in non-Opec countries,

not least Mexico and the UK. The story this time round is not so different as 64% of the increase in supply between 2014 and 2010 is expected to come from non-Opec oil and natural gas liquids, mostly from North America's fast growing production of unconventional oil.

Those who argue that the decline in prices will prove temporary believe that Saudi Arabia's desire to cripple the production of unconventional oil, which requires high capital expenditure will succeed quickly. Lower oil prices, a faster than anticipated recovery and fast rising demand for oil in emerging economies could boost demand for oil. As global capacity remains very tight by historical standards and concentrated in Saudi Arabia, the Saudis might see fit, in a few months time and once they have made their point, to cut production. But Saudi Arabia is also very happy to make life more difficult for its arch foe across the Gulf, Iran. Both the US and Saudi Arabia can only draw comfort from the difficulties Russia is facing. Both countries were well aware that, following Western sanctions on Russia earlier this year, the country's economy was very vulnerable to a further shock. How far political calculations played out in the fall of prices is impossible to know. It depends, to a degree, on whether you believe in, or enjoy, conspiracy theories.