Oil Shock Reversed*

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The cooperation between the Organisation of Petroleum Exporting Countries (OPEC) and some non-OPEC oil exporters, including oil-major Russia, to limit production and supply of oil and help hold oil prices has collapsed. In a dramatic post-Coronavirus-pandemic turn, discussions to extend this agreement among OPEC-plus countries broke down at the end of the first week of March. The agreement had been arrived at in December 2016, and had been strengthened as recently as December 2019, when production cut commitments were raised from 1.2 to 1.7 million barrels a day.

The trigger for the breakdown of talks was the damaging effect that the Coronavirus shock has had on global growth and consequently the demand for oil. The International Energy Agency's forecast indicates that there would an absolute fall in oil demand in 2020, for the first time since 2009. Falling demand has already resulted in a steep decline in oil prices, with the price of Brent Crude moving from close to $70 per barrel at the beginning of January to around $45 a barrel by the time of the OPEC-plus meet on March 10th. This required additional production cuts to align supply with demand and reverse the price decline, which was what the March discussions sought to secure.

In those discussions, Saudi Arabia's demand was that Russia, the other dominant producer in the post 2016 oil-exporter alliance, should join OPEC in ensuring a further 4 per cent fall in global production. Russia demurred, making it difficult for Saudi Arabia or OPEC to go ahead with production cuts, since increased Russian production could push down prices even further. This would imply that oil revenues of countries enhancing production curbs could be hit by a combination of lower sales and lower prices. Faced with that possibility, Saudi Arabia decided instead to increase sales, so as to offset falling prices with increased production. But the announcement that it too would increase output at a time when demand was falling, only intensified the price collapse with the price of Brent Crude falling from close to $39 a barrel to just above $32 a barrel between 10th and 13 March 2020.

Unless a new agreement helps redress the demand-supply imbalance that is driving down prices, the current situation has two implications. One is that the increase in global oil supplies as a result of the surge in production of shale oil in the United States is likely to see some correction, since shale oil reserves at a number of locations can be competitively exploited only at prices higher than current levels. Lower shale output would moderate the adverse effect on prices of the demand-supply imbalance. The other implication, however, is that even if the oil price decline tapers off, prices of the resource are likely to remain depressed for some time to come.

This turn of events is surprising, given that agreement on a further dose of production cuts had been struck as recently as December 2019. Moreover, in early March the Kremlin had said that following a call from Saudi Arabia's King, Russia and Saudi Arabia were planning "to further co-ordinate their actions" etc stabilise the global oil market. Russia's decision to go back on that commitment seems to have been influenced by recessionary fears and the demands from public and private sector barons close to the Putin administration who rule the oil sector, and who are looking to keep shale production down and increase Russia's market share. The government decision was also spurred by its extreme dependence on oil. Oil and gas account for close to two-fifths of its GDP, pointing to the inadequate diversification of the country's economy which makes it dependent on a range of imports. Oil and gas also account for more than 60 per cent of the country's exports. So, any cutback in oil production not only directly affects GDP and its growth, but also limits the ability of the country to access crucial imports. Clearly, President Putin and his team have calculated that, given the economic threat posed by the Coronavirus pandemic, a price fall will be less damaging than the loss in output and export revenues that production cuts imply. The Financial Times reports that Russia had declared that it can survive with oil at $25-$30 a barrel for a decade, drawing on its national wealth fund for budgetary resources aimed at keeping the economy running.

However, what the Russian authorities may not have taken account of is the Saudi response and the consequent magnitude of the oil price decline their decision could precipitate. A steep decline hurts Russia because its ability to expand production to compensate for lower prices is limited given the production capacity it has in place. Saudi Arabia too is a heavily oil dependent country, perhaps even more than Russia. But it has substantial leeway on the production front, and would not only be in a better position to offset falling prices with enhanced production, but is also better placed in terms of the costs of exploiting its reserves to win back market share by displacing US shale producers. The latter, given their costs, would not be able to stay in production as prices fall below some threshold.

Beyond a point, Russian oil facilities too face a similar cost problem. According to one industry estimate, Saudi Arabia can allow prices to go down to as low as $13 a barrel and still cover cost and turn a profit. Whereas, at exchange rates that prevailed till recently, Russian producers would be looking for price levels closer to $40 a barrel to cover costs, though rouble depreciation can help bring that dollar figure down.

Outside of the OPEC-plus grouping, countries have responded to the consequences of the Russia-Saudi Arabia stand-off very differently. America's position is ambiguous. While that country had earlier always pushed for lower oil prices, the fact that it is now self-sufficient has altered its stance. It still would need to keep prices at the pumps low to appease an automobile-dependent population. But when oil prices trend too low they threaten the viability of the shale industry. That would have repercussions elsewhere in the economy, especially the financial sector, since shale investments were substantially financed with credit, including with junk bonds. Not surprisingly, Donald Trump come to the rescue of beleaguered US oil firms and their financiers with a decision to order purchase of oil ostensibly to shore up the country's strategic reserve. On March 13, he said: "Based on the price of oil, I've also instructed the Secretary of Energy to purchase at a very good price large quantities of crude oil for storage in the U.S. strategic reserve." Oil prices immediately jumped 5 per cent.

The government in oil import-dependent India has decided to garner for itself the benefits from the oil price drop. With the dollar price of an important import falling, the country looks to benefit in the form of a lower import bill and lower trade and current account deficits. That improves the manoeuvrability of a government that has to address an economic recession. But, rather than allow lower oil prices to translate into lower prices paid by consumers, which is what should happen in an ostensibly market-determined pricing system, the government has decided to increase the excise duty levied on petrol and diesel by Rs. 3 a litre. It presumably hopes to make up for revenues lost because of corporate tax concessions doled out to mitigate the effects of the recession on the profits of Indian business and use the money to meet its self-imposed fiscal deficit targets. NDA governments have relied heavily on this source of revenue, with the excise duty per litre levied in the case of petrol rising from Rs. 9.48 in January 2014 to Rs. 22.98 currently, and that in the case of diesel from Rs. 3.56 to Rs. 18.83. So the response to the global oil price seeks to appropriate for the government the benefits that may have accrued to the citizens it governs. That, however, may have been a good idea when the economy was performing well. Raising the price of a universal intermediate that enters into the cost of production of multiple commodities is to court inflation. Rising prices, even of essentials, would depress demand further and intensify the recession. The unintended outcome could be stagflation, in a country that is only beginning to experience the economic effects of the Covid-19 pandemic that, as expected, has crossed its borders as well.

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