STRATFOR

Falling Fortunes, Rising Hopes and the Price of Oil

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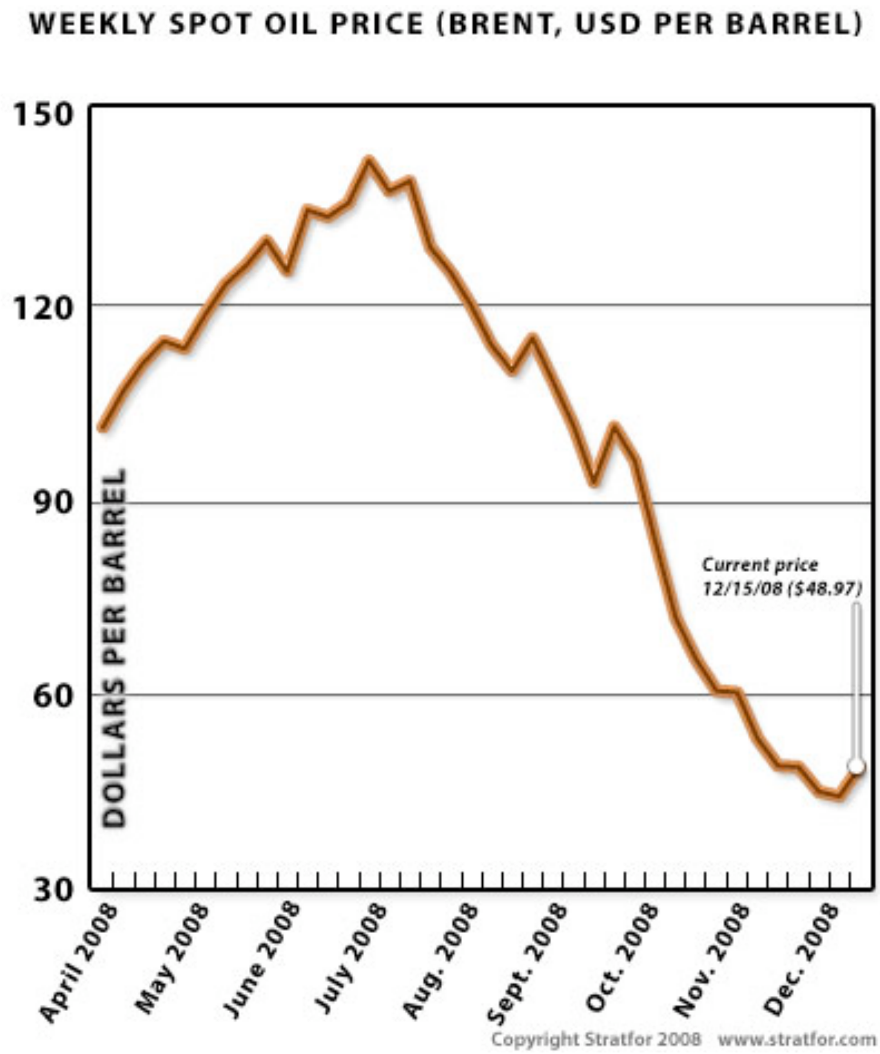
Oil prices have now dipped — albeit only briefly — below US $40 a barrel, a precipitous plunge from their highs of more than $147 a barrel in July. Just as high oil prices reworked the international economic order, low oil prices are now doing the same. Such a sudden onset of low prices impacts the international system just as severely as recent record highs.

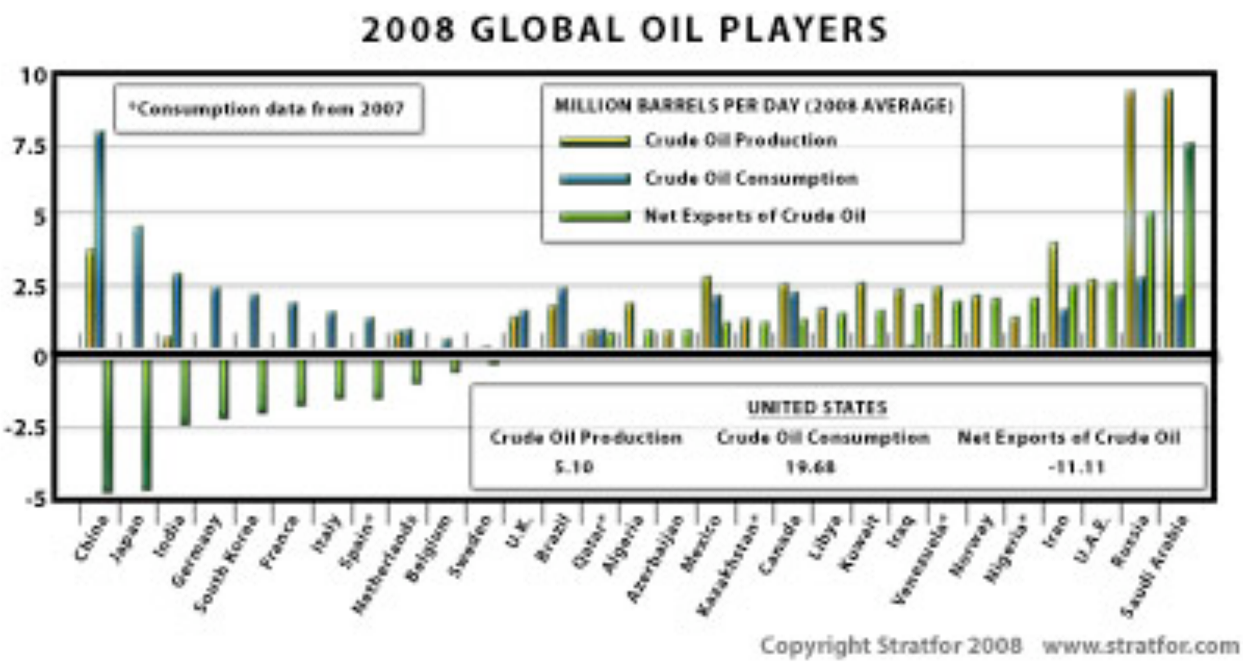
But before we dive into the short-term (that is, up to 12 months) impact of the new price environment, we must state our position in the oil price debate. We have long been perplexed about the onward and upward movement of the oil markets from 2005 to 2008. Certainly, global demand was strong, but a variety of factors such as production figures and growing inventories of crude oil seemed to argue against ever-increasing prices. Some of our friends pointed to the complex world of derivatives and futures trading, which they said had created artificial demand. That may well have been true, but the bottom line is that, based on the fundamentals, the oil numbers did not make a great deal of sense.



Things have clarified a great deal of late. We are now facing an environment in which the United States, Europe and Japan are in recession, while China is, at the very least, expecting to see its growth slow greatly. Demand for crude the world over is sliding sharply even as the Organization of the Petroleum Exporting Countries (OPEC) member states so far seem unable (or, in the case of Saudi Arabia, perhaps unwilling) to make the necessary deep cuts in output that might halt the price slide. The bottom line is that, while the breathtaking speed at which prices have collapsed has caught us somewhat by surprise, the direction and the depth of the plunge has not.

Prices are likely to remain low for some time. Most of the world's storage facilities — such as the U.S. Strategic Petroleum Reserve — are full to the brim, so large cuts are needed simply to prevent massive oversupply. Yet any OPEC production cuts — the cartel meets Dec. 17 and deep cuts are expected — will take months to have a demonstrable impact, especially in a recessionary environment. And there is the simple issue of scale. The global oil market is a beast: Total demand at present is about 86 million barrels per day. This is not a market that can turn on a dime. A firm fact that flies in the face of conventional wisdom is that oil actually falls far faster than it rises when the fundamentals are out of whack. This has happened on multiple occasions, and not that long ago.

Falls occurred both in the aftermath of the 1990-1991 Persian Gulf War and as a result of the 1997-1998 Asian financial crises that were similar in percentage terms to the present drop. Until the balance between supply and demand is restruck — something not likely until a global economic recovery is well under way — there is no reason to expect a significant price recovery. The journey, of course, is not necessarily a one-way trip. Quirks in everything from weather to shipping to Nigerian riots and Russian military movements can set prices gyrating, but the fundamentals are clearly bearish. It will most likely take several months for the core features of the new reality to change much at all.



Low oil prices create both winners and losers on the international scene. First, the winners' list.

Far and away the biggest winner from drastically lower prices is the world's largest consumer and importer of oil: the United States. The last two years of high prices have spawned a sustained American consumer effort to get by with less oil via a mix of conservation and a shift to better-mileage vehicles. Whether this purchase pattern in automobiles lasts is not at issue. The point is that it has already happened: Many Americans have already shifted to more fuel-efficient vehicles. Just as the 1990s obsession with sport utility vehicles artificially boosted American gasoline demand so long as those automobiles were on the road, so the new fleet of hybrids and smart cars will push demand in the opposite direction for a sustained period.

Overall U.S. oil consumption has plummeted by nearly 9 percent from its peak in August 2007 to November 2008, according to the U.S. Department of Energy. Combining this with the drop in prices since July translates into U.S. energy savings of approximately $1.95 billion at a price of $50 a barrel and $2.1 billion at a price of $40 a barrel. And that is daily cost savings. In recessionary times, that cash will go a long way to building confidence and stanching the recession.

Next on the list are the major European importers of crude: Germany, Italy and Spain. As a rule, European economies are less energy-intensive than the United States, but by dint of fuel mix and lack of domestic production these three major states are forced to rely on substantial amounts of imported oil. We exclude the other major European economies from this list as they are either major oil producers themselves (the United Kingdom and the Netherlands) or their economies are extremely oil efficient (France, Belgium and Sweden). Don't get us wrong — the EU states are all quite pleased that oil prices have dialed back. Nevertheless, in terms of relative gain, Germany, Italy and Spain are the real winners.

And with Europe facing a recession much deeper and likely longer than that in the United States, the Europeans need every advantage they can get.

India, far removed from Europe culturally and geographically, sports a somewhat similar economic structure in that it boasts (or suffers from, based on your perspective) an industrializing base that is highly dependent on oil imports. Broadly, the Indians are in the same basket as Spain in that they are voracious energy consumers who have seen their demand skyrocket in recent years. Between the Nov. 26 Mumbai attack, upcoming federal elections and the energy price pain from earlier in the year, the government is desperate to pass on the cost savings to the population to shore up its support.

Then there are the East Asian states of South Korea, China and Japan (listed in descending order of how much each one benefits from the price drop). All import massive amounts of crude oil, but we put them at the end of the list of winners because of their financial systems. In East Asia — and particularly in China and Japan — money is not allocated on the basis of rate of return or profitability as it is in the West. Instead, the concern is maximizing employment. It does not matter much in East Asia if one's business plan is sound; the government will provide cheap loans so long one employs hordes of people. One side effect of this strategy is that firms can get loans for anything, including raw materials they otherwise could not afford — such as oil at $147 a barrel.

Therefore, high oil prices just do not affect East Asia as badly as they affect the West. Just as the East Asian financial system mutes the impact of high prices, the converse is true as well. In the West, energy consumers are not shielded from high prices, so lower prices immediately translate into more purchasing power, and thus more economic activity. Not so in East Asia, where the same financial shielding that blunts the impact of high prices lessens the benefits of low prices.

The order in which we listed the three Asian giants relates to how much progress they have made in reforming their financial practices. South Korea's financial system is much closer to the Western model than the Asian model: South Korea hurts more as prices rise, and so will be more relieved as prices fall. China is in the middle in terms of financial practices, but it is also attempting to unwind its system of energy price-fixing as oil costs drop; due to subsidies being reduced, Chinese consumers actually may not be seeing much of a change in retail prices. Finally, Japan will benefit the least because its system is already highly efficient compared to the other two, so the price impact was less in the first place. One barrel of oil consumed in Japan generates approximately $2,610 of Japanese gross domestic product (GDP), while the comparative figures for Korea and China are $1,270 and $1,130 respectively.

In short, the heavily industrialized Asians still benefit, but the impact isn't as much as one might think at first glance. In fact, the biggest benefit to these states from cheaper energy is indirect — lower prices spur consumption in the West, and then the West purchases more Asian products.

And now, the losers.

Venezuela and Iran top this list by far. Both are led by politicians who have lavished vast amounts of oil income on their populations to secure their respective political positions. But that public approval has come at its own price in terms of economic dislocation (why diversify the economy if strong oil prices bring in loads of cash?), low employment (the energy sector may be capital-intensive, but it certainly is not labor-intensive), and high inflation (high government spending has led to massive consumption and spurred rampant import of foreign goods to satiate that demand).

Of the two states, Venezuela is certainly in the worse position. By some estimates, Venezuela requires oil prices in the vicinity of $120 a barrel to maintain the social spending to which its population has become accustomed. Iran's number may be only somewhat lower, but President Mahmoud Ahmadinejad is in the process of at least beginning to bow to economic reality. On Dec. 5, he announced massive cuts in subsidy outlays with the intent of reforging the budget based on a price of only $30 a barrel.

It is an open question whether the Iranian government — and especially the increasingly unpopular Ahmadinejad — can survive such cuts (if they are indeed made), but at least there is a public realization of the depth of the crisis at the top level of government. In Venezuela, by contrast, the mitigation process has barely begun, and for political reasons it cannot truly be implemented until after a referendum in early 2009 on term limits that could allow Chavez to run for president indefinitely.

Next is Nigeria. In terms of seeing an increase in human misery, Nigeria should probably be at the top of the losers' list. But the harsh reality is that Nigerians are used to corrupt government, inadequate infrastructure, spotty power supply and all-around poor conditions. Some of the perks of high energy prices undoubtedly will disappear, but none of those perks succeeded in changing Nigeria in the first place.

The real impact on Nigeria will be that the government will have drastically less money available to grease the political wheels that allow it to keep competing regional and personal interest in check. Those funds have been particularly crucial for funneling cash to the country's oil-rich Niger Delta region, giving local bosses reason not to hire and/or arm militant groups like the Movement for the Emancipation of the Niger Delta to attack oil and natural gas sites. With Abuja having less cash, the oil regions will see a surge in extortion, kidnapping and oil bunkering (i.e., theft). We already have seen attacks ramp up against the country's natural gas industry: Within the last few days, attacks against supply points have forced operators to take the Bonny Island liquefied natural gas export facility offline. And since Nigeria's militants never really differentiate between the country's various forms of energy export, oil disruptions are probably just around the corner.

Russia is also in the crosshairs, but not nearly to the same degree as Venezuela, Iran and Nigeria. Russia has four things going for it that the others lack. First, it exports massive amounts of natural gas and metals, giving it additional income streams. (Venezuela and Iran actually import natural gas and have no real alternative to oil income.) Second, Russia never spent its money on its population. Thus, Russians have not become used to massive government support, so there will be no sharp cuts in public spending that will be missed by the populace. Third, Russia has saved nearly every nickel it made in the past eight years, giving it cash reserves worth some $750 billion. The financial crisis is hitting Russia hard, so at least $200 billion of that buffer already has been spent, but Russia still remains in a far better position than most oil exporters. Fourth and last, the Russians can rely on Deputy Prime Minister and Finance Minister Alexei Kudrin to (somewhat forcefully) keep the books firmly in balance. At his insistence, the government is in the process of refabricating its three-year budget on the basis of oil prices of below $35 a barrel, down from the original estimate of $95.

At the end of the losers' list we have two states that most people would not think of: Mexico and Canada. Both have other sources of economic activity. Canada is a modern service-based economy with a heavy presence of many commodity industries, while Mexico has become a major manufacturing hub. But both are major oil exporters, and have been leading suppliers to the American economy for decades. So both are exposed, but their concerns are more about unforeseen complications rather than the "simple" quantitative impact of lower prices.

Mexico has purchased derivatives contracts that, in essence, insure the price of all its oil exports for 2009. So should prices remain low, Mexico's actual income will be unchanged. We only include Mexico on the list of losers, therefore, because it's quite rare in geopolitics that such planning actually works out as planned. Hurricanes and strikes happen. (Mexico also faces the problem of insufficient funds, expertise and technology to counter rapidly declining output, something that will leave it with a lack of oil to sell in the first place — but that is an issue more for 2012 than 2009.)

As for Canada, most of the oil it produces comes from Alberta province, the seat of power of the ruling Conservative Party. Right now, the Canadian government is wobbling like a slowing top. Seeing the Conservatives' power base take a massive economic hit due to oil prices is not the sort of complication the government needs right now. In the longer term, Alberta recently increased taxes on oil sands projects. Oil sands extraction is among the more capital-intensive and technologically challenging sorts of oil production currently possible. Combine the tax changes with the nature of the subindustry and the recent price drops and there is likely to be precious little investment interest in oil during — at a minimum — 2009.

Most readers will take note of the countries we have chosen not to include on the list of vulnerable states. These include the bulk of the OPEC states — specifically Angola, Iraq, Kuwait, Saudi Arabia, the United Arab Emirates, Qatar and Libya. All of these states count oil as their only meaningful export (except the United Arab Emirates and Qatar, which also export natural gas), so why do we feel such countries are not in the danger zone?

For its part, Angola only became a major producer recently. Nearly all of Angolan oil output is from offshore projects controlled by foreigners — shutting in such production is a very tricky affair for a country that is utterly reliant on foreign technology to operate its only meaningful industry. But the primary reason Angola is not feeling the heat is that most of its income has not been spent but instead has been stashed away due to a lack of the necessary physical and personnel infrastructure needed to leverage the income.

Iraq is in a somewhat similar position as far as finances are concerned. While Iraq has been producing crude for decades, its current government is only a few years old, and its institutions simply cannot allocate the monies involved. Despite massive outlays by both Iraq and Angola, their respective governments simply lack the capacity to spend, and so have stored up cash accounts worth $26 billion and $54 billion respectively.

The rest of the Arab oil producers warrant a much simpler explanation: They've been fiscally conservative. While all have shared the wealth with their somewhat restive populations, none of them has repeated the mistakes of the 1970s, when they overspent on gaudy buildings and overcommitted themselves to expensive social programs. All have been saving vast amounts of cash, with the Saudis alone probably having more than $1 trillion socked away. Tiny Kuwait officially has a wealth fund worth more than $250 billion.

So while none of the Arab oil states are particularly thrilled with the direction — and in particular the speed — oil prices have gone, none of these governments faces a mortal danger at this time. What they are now missing is the ability to make a substantial impact on the world around them. At oil's height the Gulf Arab oil producers were taking in $2 billion a day in revenues — far more cash than they could ever hope to metabolize themselves. Bribes are powerful tools of foreign policy, and their income allowed them — particularly Saudi Arabia — to wield outsized influence in Iraq, Syria, Lebanon, and even in Beijing, London and Washington. So while none of these states faces a meltdown from falling prices, there are certainly some hangovers in store for them. It is just that they are more political than economic in nature, at least for now.