# The Return of the Oil Threat*

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On the morning of April 24, the price of Brent crude, the global benchmark for oil prices, rose above $75 a barrel, touching its highest level since 2014 and signalling the return of an era of high oil prices. That is a $30 per barrel or 66 per cent rise from the previous low of around 10 months ago. As expected, this has made oil importers nervous. But, despite the benefits it would bring US shale producers, even President Donald Trump is rattled. In one more of his infamous early morning tweets he declared: "Looks like OPEC is at it again. With record amounts of Oil all over the place, including the fully loaded ships at sea, Oil prices are artificially Very High! No good and will not be accepted!"

The sharp rise in the price of oil does raise a host of questions. What explains the reversal of the late-2014 price collapse? Would the price recovery be sustained and where would it taper off? What would be the implications for economic performance of a global economy still burdened with the effect of the recession. And, why, if there is need for a sensible reason, is President Trump rattled?

Among the many factors that were seen as driving the collapse in prices after September 2014 was the huge increase in supply relative to demand, intensified by the boom in shale oil and gas production in the US, consequent to the earlier price. From its post-crisis low in early 2009, the spot price of Brent crude had risen above $120 a barrel. This cycle where a rise in prices leads to excess supply and then a price fall, suggests that this fall too would be self-limiting. Lower prices would drive many shale fields, especially potential ones, out of the market and limited supply would dampen speculator expectations. In the event, price declines would moderate, leading to stability and even a partial reversal.

In practice these drivers took time to take effect. Besides the fact that geopolitical shifts increased production and supply from Iran and did not limit to the expected extent supplies from elsewhere, the economics of shale also underwent a change. Those producers who had made large investments decided to get as much as they could from their fields, so production cuts were not sharp. On the other hand, technology improvements reduced costs of extraction of shale oil and gas, keeping investments going even when prices fell. The net result was that the low oil price scenario proved far more resilient than many expected.

That said, given the strong dependence of viable shale production on the level of oil prices and the fact that increased production would require migrating to costlier fields, the excess supply created by the shale revolution had to unwind as demand rose. This would have moderated, stalled and eventually reversed the price decline. But, in practice other factors have intervened to affect the demand supply balance in the volatile world of oil and gas.

One was the ability of the principal exporting countries to limit supplies far more than OPEC had managed in recent times. Besides greater discipline among OPEC producers overall, which has helped implement quotas and restrict production, Saudi Arabia has changed its position on the oil price question. In late 2014, the traditional "swing producer" Saudi Arabia, which accounted for nearly a third of OPEC production, when OPEC accounted for around two-fifths of total supply, declined to cut production, for fearing of losing market share to new producers, especially the shale industry in North America. The argument was that by holding back production in the interests of keeping prices high, Saudi Arabia would gradually lost market share. On those grounds a supplier with major influence on the global supply-demand balance weighed in favour of a decline in prices, so as to keep shale producers at bay.

That, however, had a major impact on Saudi Arabia's public finances, given the government's dependence on oil for revenues. Sustaining the implicit and explicit subsidies that it provided its population has proved difficult and Saudi Arabia's debt has increased, especially as it seeks to shift away on extreme oil dependence. One way in which it seeks to neutralise these effects is by selling a five per cent stake in publicly owned Saudi Aramco. But the price it garners for equity in these enterprises and therefore the volume of receipts from disinvestment depends on the price of oil. According to an estimate from Financial Times (April 13, 2018), Saudi Aramco's valuation would rise from $1.1 trillion to $1.5 trillion, as the oil price rises from $64 a barely to $93 a barrel. The result of these circumstances has been a change in the Saudi view on the preferred international price for oil, which analysts say now goes as high as $100 for a barrel.

To attain this goal, Saudi Arabia decided in November 2016 to tie up with Russia, another major producer and global supplier. Oil producers meeting in Vienna in December 2016 had struck a deal that would hold back 558,000 barrels a day of crude from the market. A major chunk of that output reduction, amounting to as much as 300,000 barrels a day, had been promised by Russia. The rest was to come from 10 other non-OPEC countries. These production cuts were to be additional to the 1.2 million barrels a day in cuts already agreed to by OPEC member. In total this amounted to a reduction equal to almost 2 per cent of the then global oil supply. Most analysts were sceptical, given OPECs past record with sticking to declared production cuts and quotas, that these cuts would be realised in practice. However, not only have the countries concerned collectively ensured the cut, but Russia and OPEC have indicated that they would continue with their cuts in 2018 and possibly through 2019.

The result of this has been a sharp fall in available oil inventories. According to the International Energy Agency, commercial stock in the industrial countries was at 2.8 billion barrels only marginally above the figure's five year average, pointing to an end to excessive stockholding. This encouraged it to say: "It is not for us to declare on behalf of the Vienna agreement countries that it is 'mission accomplished', but if our outlook is accurate, it certainly looks very much like it." The promised reduction in supply seems to have been ensured.

In the midst of this, two developments have aggravated the supply shortfall. The first is political unrest in Venezuela and the effect that this has on its oil production. According to reports, that country's oil production has fallen from around 2.2 million barrels a day two years ago to 1.54 million barrels per day by February this year. Secondly, threats from Donald Trump that he would lead the US's walk out of the Iran nuclear agreement and impose sanctions once again. The deal he recently declared was "ridiculous" and "insane" and "should have never, ever been made." Since re-imposition of sanctions on trade will shrink Iran's contribution to global supply, the threat has heighted uncertainty in markets and brought speculators to their feet once again.

These developments would have resulted in an even steeper increase in oil prices, but for the US shale factor. Recent higher prices have meant that fields that were unviable have turned viable and investments that had to be stalled could be revived. But for this moderating influence, prices would have risen even further. What is unclear is whether this moderating influence would gain the upper hand, more than neutralising the other factors. But geopolitical uncertainty is at a level where as of now, bets on $80 to the barrel are the norm, and others predict that Saudi Arabia's ostensible target of $100 per barrel is within reach.

Oil importers, including the two fast growing giants, India and China are bound to be hit, with inflation that may force cuts in public spending, and in India's case balance of payments vulnerability and currency weakness. But the rise in prices need not be all bad, since oil exporters, many of whom depend on oil revenues for budgetary resources, may ramp up spending. Overall, however, since commodity prices are known to move in tandem with oil prices, global inflation may revive. That could hasten the retreat from the easy money and low interest rate policies adopted by central banks across the globe. This, in turn, could subvert the almost invisible recovery from the recession that optimistic analysts have been celebrating.

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