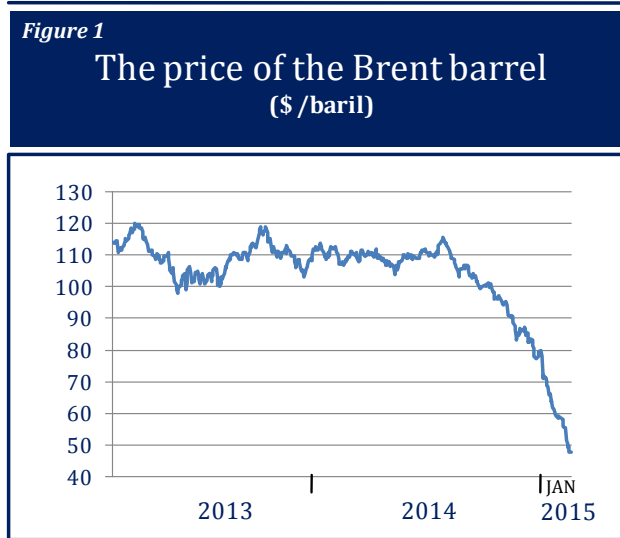


THE FALLING PRICES OF OIL

THE ILLUSION OF ABUNDANCE

The price of oil at the end of 2014 was marked by a precipitous decline, not seen since the financial crisis of 2008. At \$60 per barrel, the Brent price fell by more than \$40 compared with the summer of 2014 [Figure 1]. Today, the \$50 mark was reached for the first time in almost six years (\$48.01 in 2009). Is this a symptom of sluggish growth or a positive shock to the world economy? The latest oil counter shock merits further observation, especially as it coincides with rising tensions in the Middle East, the civil war in Libya and the sanctions against Russia. Tension in the petroleum market can only fuel soaring oil prices!



Source : US. Energy Information Administration

We propose in this note to analyze the challenges of the collapse of the oil market. First, we track down the reasons that reside behind the sharp drop in oil prices in recent months. Then, we identify the impact of this fall on the main parties (importers and exporters). Finally, our focus is drawn to the impact of this larger shock on the Tunisian economy.

THE FALL IN OIL PRICES: ENDOGENOUS SHOCK VS EXOGENOUS SHOCK

The positive effects of the sharp fall in the price of petroleum products tend to make us forget the underlying reasons behind the fall in the price per barrel of oil. Worsening perceptions of the world economic growth outlook have negatively impacted oil demand and explain today the fall in prices.

US monetary policy: an expected markets normalization

The recent direction of US monetary policy impacts oil prices by means of two economic mechanisms: the negative correlation between the dollar and oil prices, and the negative correlation between real interest rates and the price of a barrel.

On the one hand, the signs of recovery are confirmed in the United States pushing the dollar higher. So, the negative correlation between dollar and the price of oil explains the lower barrel prices. We are reminded that this negative correlation is justified by the oil revenue diversification strategy adopted by all major producers. The rise in oil prices pushes them to diversify their assets by limiting their exposure to the dollar, and taking long positions in other major currencies. This behavior severely penalizes the dollar. Today, we find ourselves in the opposite situation that justifies the purchase of US dollars, especially as US growth prospects argue for its continuing growth in value.

On the other hand, the prospects for monetary tightening in the US are starting to emerge from the upward growth investment in US long real rates. The rise in long rates calls for a more abundant supply of oil on the market and partly explains the lower prices. Recall that historically low real interest rates discourage sales and promote storage, which is likely to fuel the rise in oil prices (*Hotteling rule*). Producers avoid placing their oil revenues at very low real interest rates, and then the oil price will increase. Recently, the bullish trend observed on the US long term rates discourages this storage and pushes oil prices down.

The emerging world: The new locomotive broke down

The first signs of the downward trend of the oil price can be detected in the spot market. On the demand side, all attention is focused currently on the emerging world. Today, China has become the largest oil consuming country. This accounts for almost 40% of the increase in global demand. With an average of 7million barrels per day in 2014, China attained first place in the top ten importing countries in the world, exceeding for the first time the United States. The decline in China's growth rate (capped at 7% in 2015) explains its transition to a new growth model. Thus, it plays a key role in the fall in the price of a barrel of oil.

The shale revolution : a profitability war

Another geostrategic dimension also explains the fall in oil prices. Since 2008, the US increased its production of gas and crude oil by 55% through the exploitation of shale gas, thus exceeding Saudi Arabia. Over the last three years, US production has increased by one million barrels/day. This new configuration of the oil market is beginning to worry some oil producing countries, including Saudi Arabia. The Saudis do not hesitate to put pressure on the oil market in order to maintain lower prices. as evidenced by their decision to keep production quotas unchanged at the last meeting of the OPEC countries.

The Saudi objective is to return oil prices to a level which will maintain the profitability of exploitation of unconventional hydrocarbons. However, the definition of the threshold at which this becomes an unprofitable operation remains unclear. Some experts say \$60, others argue\$55. The question is even more complex because production costs differ from one deposit to another. If we limit our reference to the United States case, the threshold switches below \$60 on the Bakken oil field in North Dakota, and nearly \$85 per barrel on the Woodford Basin, between Texas and Oklahoma.

THE FALL IN OIL PRICES: WINNERS AND LOSERS

The fall in the price of a barrel of oil limits the field of budgetary manoeuvre of oil producing countries and gives to oil-importing countries room for manoeuvre. Several effects can be identified.

First, a fall in oil prices to \$50 results in a transfer of income from producers to consumers, and from net exporting countries (OPEC, Russia, ...) to the net importing countries (Japan, Euro area, China, India, ...).

Second, the fall in energy prices reinforces expectations of an ultra-low inflation rate which exercises an important deflationary pressures in some countries.

Third, the fall in the price of oil could affect the profitability of oil projects, impacting negatively in this sense, banks strongly involved in financing this sector.

Fourth, the decline in energy prices also impacted negatively the exchange rate in the exporting countries. It should be noted that a downward pressure on some currencies has been observed in recent months (Russian rouble).

Fifth, the stock market may be affected by the fall in oil prices. Companies taking advantage of the drop in oil prices will see their price rise, as oil stocks show a sharp decline.

Finally, at the public finance level, we should expect an increase in taxes on oil to make up for the loss of earnings, and a possible removal of subsidies on hydrocarbons in some developing countries.

Exporting countries: a negative and unfair balance

The rub is on the side of the producer countries. Countries with large reserves which may be able to face the current shock with a minimum damage. Saudi Arabia appears to be among the best placed to adapt its economy to the new situation. Since the last decade, Saudi Arabia saves annually 25% of its oil revenues, while the figure did not exceed 7% in the seventies. This is far from the case of Russia and Venezuela, where the outlook is bleaker.

Public expenditures are so important in these countries, that it would be very difficult, especially politically, to reduce them. The high dependence on oil revenues remains a key element to explain the magnitude of the oil counter shock. The situation is critical for Venezuela as long as oil revenues account for 95% of current revenues. This is far from the case of another oil country like Mexico where its oil revenues do not exceed 10%.

Russia will likely sink into a deep recession. The drop in oil prices arrived at the wrong time. Some analysts have argued that by the willingness of Western countries to suffocate the Russian economy in response to its military intervention in Ukraine. Today, the flight of capital and the depreciation of the rouble further complicate the situation and aggravate tensions.

In the Gulf, the shock is less burdensome, but the fiscal imbalances are alarming. Public expenditure programs, established on the basis of a price per barrel around \$100, have been revised downwards. For Saudi Arabia, Moody's expects a budget deficit of 14% of GDP at the end of 2015. The strike force of sovereign wealth funds from these countries in international financial markets was also heavily weakened.

Eurozone: A profitable counter shock at different degrees

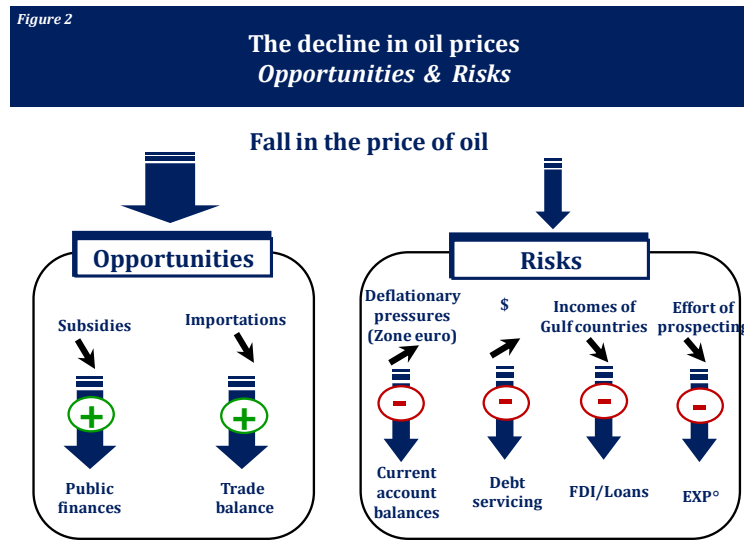
The simulation exercises for the eurozone are unanimous to indicate a positive impact of lower oil prices on European growth. The macroeconomic model (QUEST model) developed by the European Commission argue that a 30% drop in the oil prices may increase, after one year, more than 0.3 percentage points of GDP in the euro area. The OECD model (Interlink model) suggests an increase of 0.25 percentage points of GDP. The simulations of the British National Institute for Economic and Social Research (NiGEM model) retain +0.46 percentage points of GDP for the eurozone.

However, the decline of oil prices benefits mainly countries such as Spain, Portugal, the Netherlands and Ireland. While for the core countries, the beneficial effect has been shown to be limited. For France, it is mainly the weight of nuclear (76% of electricity generation), and for Germany it is the development of renewable energy and the intensive use of coal, which limit the positive impact against the last oil counter shock.

The oil price profits from the decoupling between the US monetary policy favorable to the dollar and the ultra-accommodating policy adopted by European and Japanese monetary policy, is disadvantageous for the euro and the yen. Thus, the recovery of the economy in the eurozone will be decisive for the direction of oil prices. On the one hand, it could boost global growth and especially in the emerging world; and on the other, it would support the euro exchange rate against the dollar. These two factors plead in favor of increasing oil prices. However, such a scenario is not likely to emerge before the

TUNISIAN ECONOMY AND THE FALL IN OIL PRICES : OPPORTUNITIES AND RISKS

The sharp drop in oil prices has been hailed by all observers of the Tunisian economy. This is a boon for public finances in a country where the burden of energy subsidies limits the margins of manoeuvre of the fiscal authorities. This means that the oil price decline offers to the Tunisian government, an opportunity to reform the subsidy system if the political audacity exists. However, the decline in the energy prices is not without risks [Figure 2].



First, the fall of the barrel is timely. It is an opportunity for the **public finances**. The 2015 budget was established on the basis on an oil price of \$ 95 a barrel. The state of public finances remains alarming, especially in light of the huge amounts allocated to energy subsidies. Subsidies allocated to oil and electricity are an estimated \$1,826 MD in 2015. However, the operation actually becomes profitable only if current prices remain for a longer period. Nevertheless, these budgetary savings will be curtailed by a lack of taxes on petroleum products.

Second, the decline in oil price to \$50 is an opportunity for the Tunisian authorities. This opportunity should not be missed to advance **the reform of the subsidy system**. This is an opportunity not to be missed to advance the reform of the subsidy policy, and especially to establish the indexation of the fuel prices at the pump in the price of crude on the world market. Not far from us, our Moroccan neighbors have already taken a step in this direction. Tunisian authorities would gain credibility by introducing this mechanism, which provides greater clarity to economic policy. And Tunisian households could benefit to a greater extent from the decline in the inflation rate.

Third, it is not excluded that this dramatic drop could also fuel concerns about the economic prospects. The populist movement can exploit this fall to demand better wages and conditions which raises the risk of delaying the most serious reforms.

Fourth, lower barrel price often coincides with the **rising dollar**, as is the case today. On the one hand, the rise of the dollar erodes expected gains of the lower barrel price. And on the other hand, it increases the debt service in an economy stifled by a debt ratio above 50% of GDP.

Fifth, in a favorable economic environment, a collapse in oil prices could be a great benefit to the European economy. But with the recession currently affecting several European countries, the abrupt decline in the price of crude oil, in recent months, could only raise the **deflationary pressures in the euro area**.

The downward cycle in oil prices may reduce the rate of inflation in the euro area (as measured against the HICP index) into negative territory which could widen the Tunisian current account deficit.

Sixth, the sharp decline in the oil prices is also inhibiting **investment in the hydrocarbon sector**. The situation is already worrying from the perspective of the energy imbalance. In 2014, no petroleum exploration permit was granted. The fall of energy prices discourages prospecting operations and further hampers FDI inflows, which remain dominated by investments in the hydrocarbon sector. So, in this context the potential of Tunisian oil exports is further limited.

Finally, the negative impact of the fall in oil prices on the ability of Tunisia authorities to mobilize external funding should not be underestimated. Tunisia cannot expect consistent **financial support from the Gulf countries**. The deterioration of public finances in these countries would be very damaging for both FDI, and for lending flows from these countries.

The fall in oil prices should boost the pace of reform rather than slowing it down. The hour of truth has come. There is now an urgent need to reform the subsidies system. Tunisia should not be seduced by the apparent ease of fiscal solutions (higher taxes and resort to foreign lending), but it is forced to foster vital reforms. However, a concern for social justice to equitably allocate the costs of reforms, must accompany this dynamic. In other words, a policy of efficiency and not simply austerity must be sought. Spending cuts, which came more rapidly than the structural reforms can become counter productive. If so, they may disrupt the reform process for several years. Only by thinking long term that we will solve the most immediate problems.

Moez LABIDI

Professor at the Faculty of Economic Sciences and Management of Mahdia

Economic Advisor to MAC SA