

## Oil prices: Time for (nasty) second-round effects?

March 4, 2016

Frédéric Andrès, Senior Economist

✉ [frederic.andres@eulerhermes.com](mailto:frederic.andres@eulerhermes.com)

Thomas Cardiel, Junior Economist

✉ [thomas.cardiel@eulerhermes.com](mailto:thomas.cardiel@eulerhermes.com)

Marc Livinec, Sector Advisor

✉ [marc.livinec@eulerhermes.com](mailto:marc.livinec@eulerhermes.com)

Daniela Ordóñez, Economist

✉ [daniela.ordonez@eulerhermes.com](mailto:daniela.ordonez@eulerhermes.com)

### Executive summary

- Oil prices plummeted to a 12-year low in January on the back of large oversupply (60%), sluggish expected demand - especially from China - (30%), and speculation (10%). However, more than the spot price, the problem became the duration of this counter oil shock.
- The gap between winners and losers widened: While India may gain +0.25 GDP point this year, Venezuela is losing -3.4 points. Second-round effects started to kick in: widening current account deficits (-26pps for Saudi Arabia and Venezuela, between 2014 and 2016 for instance); depreciating currencies and declining fiscal space caused higher credit risk; depleting reserves (Equatorial Guinea, Gabon, Angola, Oman and Venezuela) remind the world of the risk of default; and last, the risk of social unrest increased (Venezuela, Russia, Algeria).
- Sector wise, the Energy and Machinery sectors are direct victims of this protracted period of low oil prices (USD200bn of lost CAPEX in the oil sector). Construction and Retail suffer from collateral damage.

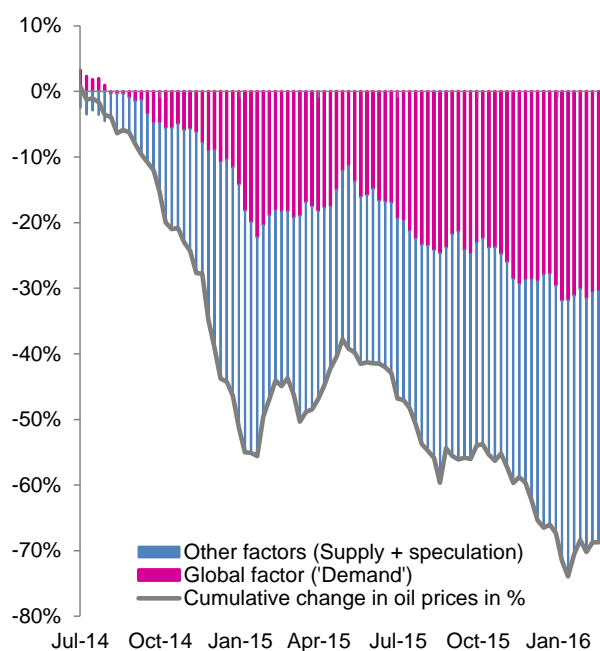
### Oil prices: Low(er) for longer

Oil prices plummeted to a 12-year low on January 20<sup>th</sup>. A combination of factors helps explain this situation. First, the ongoing supply glut. On the one hand, more (Iran, U.S.) and bolder (ready to sell too close to breakeven) oil exporters. On the other hand, decreasing demand mainly due to the Chinese slowdown. As a result, global oil production outpaced consumption by 1.5 to 2 million barrels per day. Speculation has also contributed to the downturn as traders' expectations of a decline created a self-fulfilling spiral.

Estimates show that at least 60% of the fall in oil prices is explained by supply considerations (Figure 1). Still, about 30% of the fall stems from a demand shock and 10% from speculation.

While global demand is set to remain subdued in 2016, oversupply should persist. Oil producers seem unwilling to cut back on production and Iran, a long-time big producer, gets back in the game after the lift of most international sanctions. Though speculation and geopolitics can take the world by surprise – and explain the record low levels, structural factors point to subdued oil prices for an extended period of time. For 2016, we forecast a Brent price of USD38/bbl. on a yearly average.

Figure 1: Breakdown of the fall in oil prices between supply and demand shocks



Sources: Bloomberg, Euler Hermes estimates

Energy importers, notably the Eurozone, the U.S., India, China, and Brazil are benefiting from lower oil prices for longer. Household purchasing power, companies' margins and countries' import bills also reap the rewards. Yet positives may be a bit overstated: preference for saving by households, lack of pass-through to margins, and deflationary pressures are among the limitations of the exercise.

On the other side of the spectrum, oil-dependent countries are paying a high price. Figure 2 summarizes the impact on GDP for selected economies. India is the big winner with +0.25 point of GDP while Venezuela is the main loser (-3.4 points). Bigger concerns stem from the duration of the counter oil shock, triggering negative second-round effects, including wrong policy-making.

### Painful– but not to the same intensity

Figure 3 shows how deep a country's business model can be affected by low-for-longer prices. First, the degradation of the current account is often massive. Some net exporting countries became net debtors, as balances deteriorated by as much as 20 points of GDP since 2014.

With our current oil price forecast, the total current account deterioration for 2014-2016 would amount to -31pps for Equatorial Guinea, -28pps for Kuwait, -27pps for Angola, -26pps for Saudi Arabia and Venezuela (see Figure 4). A rapid sensitivity analysis shows the impact of a deeper fall in Brent prices to USD30/bbl for 2016 amounts to additional 5pps of current account deficit on average.

Secondly, the impact of a widening current account deficit depends on the exchange-rate regime. If the currency is pegged to the dollar, inflation will be contained but the fiscal burden will be important. On the contrary, if the currency is free-floating, the country will experience a depreciation with possible inflationary pressures down the road but less austerity needed.

As a result, companies will be impacted differently depending of previous and current policy choices. Some will have a hard time paying their international suppliers because of depreciations; others will see aggressive taxes put in place to offset the lack of fiscal space; and a third group will have to bear the brunt of a recession as consumption plummets.

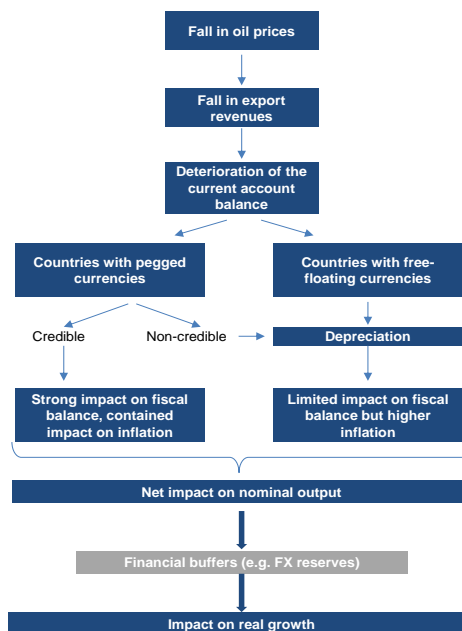
Thirdly, the severity with which policies can become counterproductive will depend on whether countries consider they have enough buffers, such as foreign reserves, to cushion this long-lasting shock. Even if most oil-dependent countries – and their companies – are at risk today (delays in payments, non-payments, defaults), we identified those who may be pushed to the wall using their import cover.

Figure 5 shows the most vulnerable countries. Equatorial Guinea, Gabon, Angola, Oman and Venezuela take the podium. The negative positioning of Kuwait and, to a lesser extent, the UAE, needs to be put into perspective. Indeed,

Figure 2: Impact on GDP growth after 1 year from a permanent decline in oil price of -10USD/bbl

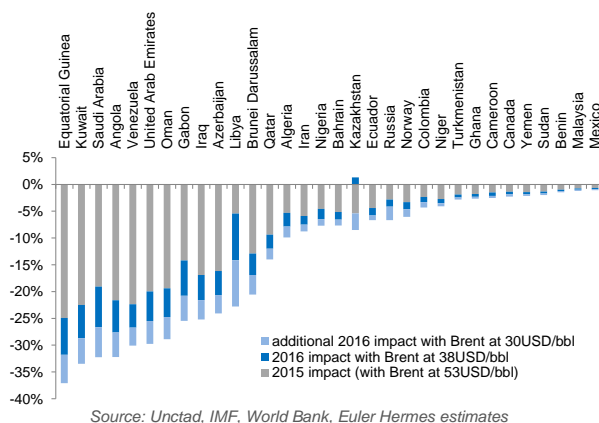


Figure 3: Low oil prices, policy-making and growth



Note: Credible pegged countries are those with sufficient FX reserves to support their currency; Non-credible ones are those with too few reserves to prevent currency free-falling.

Figure 4: Impact on current account balances (% of GDP)



despite relatively low FX reserves, both have a stronger financing position as they have accumulated substantial hard currency assets in Sovereign wealth funds (SWF).

These SWF were estimated in 2014 at USD970bn (240% of GDP) for the UAE and USD355bn (200%) for Kuwait. Azerbaijan's assets in its SWF are also relatively large, amounting to about USD34bn, equivalent to 50% of GDP or 23 months of imports.

With huge FX reserves and financial assets, Saudi Arabia, Algeria, Iran and Iraq look better suited to coping with low oil prices over a long period of time.

Last, inflation and degraded fiscal balances could translate into higher risk of social unrest in countries where lavishing money from oil has been a way to buy social peace. Thus, countries most exposed to social tensions are those that registered both fiscal consolidation in the form of fewer transfers (fewer subsidies) and higher inflation (see Figure 6). Countries plagued by soaring inflation (Venezuela) or where the social compact is fragile (African States, Russia and Algeria) are exposed to heightened risk of social unrest due to the consequences of lower oil prices. On the other hand, the financial cushion of Gulf States should help prevent (or delay) social troubles from arising shortly.

### Sectors: Winners and losers

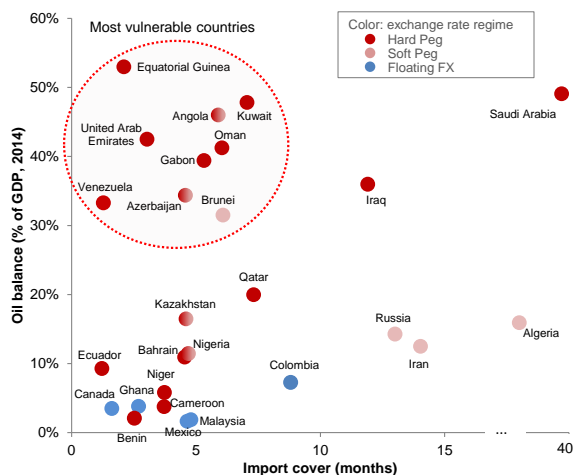
If the Transportation sector – especially air transport – is the main beneficiary of prolonged low oil prices, Euler Hermes has identified several sectors set to suffer from this situation.

First, the Energy and Machinery (and equipment) sectors could be even more at risk in 2016. The plunge in oil price has hit the revenues of every oil company, private-owned or state-owned. In the US, where the number of rigs has been halved since 2014, 2016 could be a defining moment.

Under intense pressure to axe costs amidst uncertainty about future profitability, companies have had to cut their exploration and production expenditures, which resulted in a significant CAPEX decrease in 2015. This is likely to continue over 2016 (see Figure 7). More than 40 listed shale companies have filed for bankruptcy since last summer. The delay or cancellation of E&P expenditures have also strongly affected oil-related companies dealing with geophysics, fracking or drilling. Likewise, oil related machinery and equipment manufacturers have been strongly hit by this downturn. One number to keep in mind: Total CAPEX in the oil sector could be down by USD200bn between 2014 and 2016 affecting the entire industrial equipment sector.

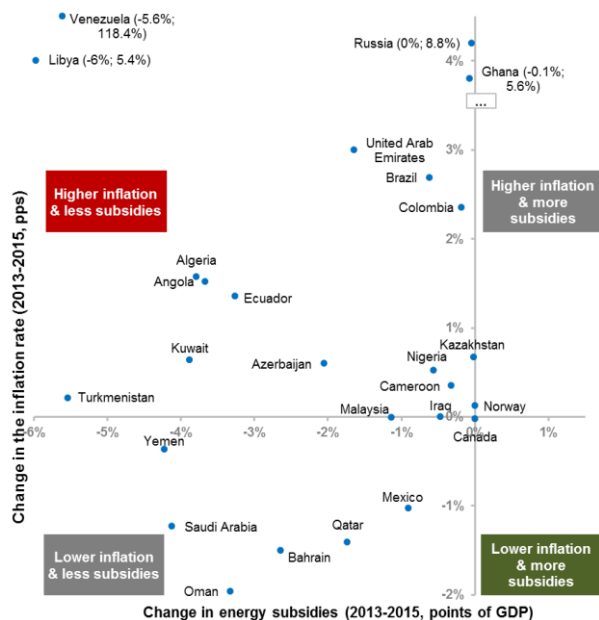
Collateral damage includes Construction and Retail. The fall in oil revenues leads to fiscal consolidation and the cancelation or delay of many state investments, notably in the Construction sector. This is particularly relevant for oil countries

Figure 5: Sensitivity to long-lasting low oil prices



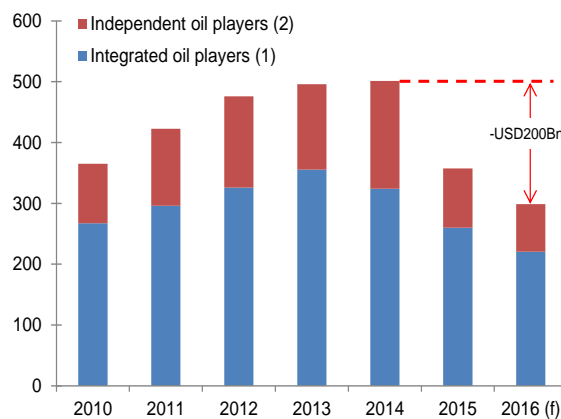
Source: IHS, IMF, Unctad, National sources, Euler Hermes

Figure 6: Exposure to negative outcomes of low oil prices



Sources: IMF, Euler Hermes

Figure 7: Global oil CAPEX - E&P spending (USD bn)



(1): panel of 18 companies (BP, EXXONMOBIL e.g.)  
 (2): panel of 60 companies about which most of them are North American and independent (APACHE, ANADARKO e.g.)

Sources: Bloomberg, Euler Hermes estimates

that had used their oil revenues to fund extensive construction projects. The cut in state investment has hurt the sector which was downgraded in all six GCC countries (see latest Economic Outlook for a full analysis of the pass-through: [Let the Sector Games begin](#)).

Similarly to Construction, the Retail sector in net oil exporter countries has been strongly affected. Raising gasoline prices and reduced subsidies in response to fiscal pressures are the norm. Saudi Arabia announced last December a 5-year plan to raise prices of fuels including natural gas, gasoline, diesel, and electricity, e.g., +133% for ethane, +79% for transport

diesel, and +67% for natural gas or low-grade gasoline. Electricity prices will rise by varying amounts, except for households with low consumption levels.

As a result, rises in energy prices - traditionally kept low by governments - reduce household welfare and purchasing power and increase input costs for companies. It clearly hits the Retail sector across oil-producing countries even if governments started to adopt mitigation policies such as compensation for households, especially those with low incomes, and technical assistance and loans to help industries adjust. ■

**Figure 8: Losers of long-lasting low oil prices**

| <b>Segment at-risk<br/>(by decreasing level of importance)</b>                 | <b>Negative impacts<br/>(how the risk becomes a reality)</b>  |
|--|---|
| <b>Oil sector</b> (majors and upstream actors)                                 | <ul style="list-style-type: none"> <li>- Lowering revenues</li> <li>- New E&amp;P projects put on ice</li> <li>- Lower share price for listed companies</li> <li>- Tightening of credit for high-indebted oil producers (i.e. United States independent shale oil players)</li> </ul> |
| <b>Oil-related sectors</b> (downstream)  | <ul style="list-style-type: none"> <li>- Falling revenues short of new E&amp;P investments</li> <li>- Production running with a loss</li> <li>- Ongoing layoffs</li> </ul>  |
| <b>Machinery &amp; equipment</b>   | <ul style="list-style-type: none"> <li>- Plummeting revenues short of orders from the oil-related players</li> <li>- Insufficient activity to make a profit</li> <li>- Potential prey for a hostile takeover bid</li> </ul>   |
| <b>Construction</b> , in net oil exporter countries                            | <ul style="list-style-type: none"> <li>- Plummeting budget revenues of net oil exporting countries</li> <li>- Construction work halted whenever they deal with lavish new property programs</li> </ul>  |
| Consumer-related sectors: mainly <b>Retail</b> , in net oil exporter countries | <ul style="list-style-type: none"> <li>- Slowdown in consumers' demand of net oil exporting countries</li> <li>- Savings not passed on to the final consumer</li> </ul>   |
| <b>Financial services</b>  | <ul style="list-style-type: none"> <li>- Heavy potential losses on oil-related loans</li> <li>- Possible losses on hedging oil products</li> </ul>  |

Source: Euler Hermes

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