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MACRO ADVISER: Life in Russia with $80 oil

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From late 2010 until the middle of August this year, the price of Brent crude has traded within a relatively narrow range and averaged close to $110 per barrel. Over the past two months the price has collapsed from a high of $115 per barrel to just over $80. For commentators with more of a political than energy bias, the explanation for the sudden price collapse is because of collusion between the US and Saudi Arabia to damage their respective enemies, Russia and Iran. It has also led a spate of headlines suggesting that weaker oil will collapse the Russian economy and bring about the demise of Putin’s rule. Both are very wide of the mark.

The weaker oil price certainly suits the US administration’s geopolitical position and, as the US is still the world’s biggest importer of oil, it also acts as a further stimulus to the economy. But the idea that the White House is leaning on the government in Riyadh to keep supply high in order to kill the price is ridiculous. Relations between the two countries have become very strained in recent years as a result of the US support for Qatar and, most recently, the plan to cooperate with Iran in the battle against ISIL. Qatar has been a very open supporter of the Muslim Brotherhood and gave substantial financial aid to Mohamed Morsi’s government in Egypt. The Saudis have always had a huge fear of a Muslim Brotherhood revival and the threat it posses to the region. The Riyadh government, and others amongst the Gulf Cooperation Council states, were very suspicious of the Morsi government and were relieved to see it replaced. Beyond that, the Saudi-US relationship has deteriorated in recent years as the US weans itself off Middle East oil and pursues its strategy of winding down its military presence in Afghanistan. The need for the previously close mutually beneficial relationship is no longer there.

Fed's fault
There are several reasons for the oil price fall, but the catalyst came not from the political machinations of the US President but from the actions of the 68-year-old, silver-haired, mild-mannered chairman of the US Federal Reserve, Janet Yellen. Her comments about Fed policy resulted in a strong rally in the US dollar which, in turn, undermined confidence in emerging market economies and hit the oil price. Historically there is a very close correlation between the value of the dollar and the price of crude, because all of the major Opec producers have currencies pegged to the dollar. Once the decline started it was easy to pile on other reasons, such as the Internationa Energy Agency's demand forecast cut and the partial resumption of Libyan exports.

Saudi Arabian Oil Minister Ali Naimi has always said that the Kingdom views $100 per barrel (Brent) as the correct price for both producers and consumers. But he has also very clearly stated that Saudi Arabia will not revert to its previous role as swing-producer within Opec. Specifically, the Kingdom will not unilaterally cut production in order to support the price of oil for all other producers. It wants all Opec producers to share in any cuts required to support the price.

A major part of the reason for that stance is because of the big increase in budget spending by the Arab producers since the Arab Spring. They have all had to substantially raise both social and defence spending in a sort of carrot-and-stick response. At its current volume of production, close to 9.5m barrels per day, Saudi will need between $85 and $90 per barrel to balance its budget in 2015, depending on spending plans. But not before trying to secure a new deal within Opec to ensure that any price-support cuts are spread amongst all member states.

The next policy meeting will take place in Vienna on November 27 and that is likely to bring the showdown between the Saudi, UAE, Kuwait faction on the one side and the Iran, Venezuela led faction on the other. The former group can live with a lower oil average for longer than the latter, eg. Iran now requires $130 per barrel to balance its budget because of the lost export volumes, but will eventually have to try and rally the price back towards $100 per barrel.

A period of weak oil seems inevitable ahead of that meeting and until the moderate Arab producers get an agreement on production cut sharing. Only then may we see the market return to balance and the price rally. In the meantime, of course, the risk of a price-supporting event remains reasonably high. Libya has managed to raise daily exports to close to 500,000 barrels, but the civil war there is worsening rather than easing and that supply remains vulnerable. For now the US-led coalition appears to be containing Islamic State (IS), but one successful attack on a southern oil pipeline or refinery would certainly spook oil traders. Boko Haram has raised its threats against Nigeria’s oil industry in recent weeks and Venezuela’s ability to sustain current output is questionable. On top of that, the cost of maintaining much of the US shale oil production has been rising very steadily as the easy oil is depleted and extraction becomes more difficult. Below an $80 per barrel average, a lot of the oil added over the past two years becomes uneconomic. So while a recovery towards $100 per barrel is dependent on complex Opec politics, traders are more likely to see $80 per barrel as a support level because of the evident risks.

What $80/b means for Russia

For Russia, $80 oil would mean a ruble-dollar exchange rate of approx RUB41.50. However, the Central Bank of Russia (CBR) may reduce that to RUB40.0 if it raises its Key Rate by at least 100 basis points later in October. At that oil price and ruble exchange rate, the federal budget would likely run a deficit of approximately 2.5% of GDP. Hardly the sort of scenario which would crash the economy or kill public support for the president.

The reason for the relatively benign scenario is because of the CBR’s changed stance on the ruble since it last spent over $200bn in a futile attempt to defend the currency in 2008-09. Now it allows the ruble to free float against the oil price. In the year to date, the ruble has dropped 25% against the dollar and that is exactly the same price decline for Urals crude. The CBR’s currency flexibility, which is not available to the major Opec producers, makes a huge difference this time around and places Russia in a better position to ride out a period of lower oil. It also has the added advantage of providing a boost to the competitiveness of domestic producers and to efforts to promote import substitution. But it is also only a survivalist strategy and cannot lead to a recovery in growth. Continuing capital flight, negligible foreign investment flows, high inflation and an excessively high cost of capital are more likely to lead to prolonged stagnation. Russia needs reforms and an improved investment climate in order to attract the much-needed boost to inward investment which President Putin clearly identified in his state of the nation address last December as an essential condition for long-term growth.

In early 2009, when oil traded below $40 per barrel and the economy was in recession, we saw a greater emphasis on reforms and efficiency initiatives within government and the big state enterprises than ever seen previously. Regrettably the price of oil rallied too quickly in the second half of 2009 and most of the reform plans were placed back in the pending tray. Different this time? One big difference is that Janet Yellen and Elvira Nabiullina are much more important than many of the emotion-charged politicians. For that at least we should be thankful.

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