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SPECIAL BRIEFING

Low Oil Prices, Part II: Geopolitical and Socio-political Impacts

MARCH 2016

OVERVIEW

The importance of oil prices to businesses cannot be understated, and neither can the planning difficulties created by their volatility: as recently as June 2014 the Brent spot price for a barrel of oil was more than USD115, but throughout 2016 flirted regularly with the USD30 per barrel (/b) mark. For governments, meanwhile, volatile oil prices mean unpredictable budget outcomes and potentially untenable current accounts. This briefing highlights the potential impact of continued weak oil prices on the global business operating environment in relation to geopolitical and socio-political risks. (The economic implications are covered in our accompanying paper "Low Oil Prices, Part I: Economic Implications".)

'Resource Curse' is a well-recognised phenomenon. Academic studies link high levels of wealth generated from commodities, such as oil, to poor governance and a corrupted political system, citing countries such as Russia, Venezuela, Iraq, and Saudi Arabia. Based on this argument, lower oil revenues should see a restructuring of the political system with better governance in the longer term. However, there is liable to an intermediate period of chaos which can have far-reaching unintended consequences. For example, the civil wars in Iraq and Syria have resulted in the refugee crisis in Europe, which is polarising political debate, thereby boosting support for extremist parties, as well as having a direct (albeit at present limited) impact on supply chains.

In the oil-rich countries of the GCC (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the UAE) the authoritarian regimes have been underpinned by an informal contract which essentially states that, in return for supporting the regime, the populace expects high standards of living. In the past five decades this has been made possible by the government recycling the huge inflows of oil revenues accruing to the national oil companies. Thus, well-paid public-sector jobs were virtually guaranteed for all citizens, subsidies of basic necessities kept a lid on the cost of living, and huge infrastructure projects resulted in GDP per capita exploding. Indeed, Qatar's GDP per capita is one of the highest in the world, at over USD93,000.

However, this social contract is being undermined by the current bout of weak oil prices. The GCC governments are being forced to recognise that the present budget structure is no longer sustainable, and are cutting back on spending through reductions or freezes in public sector employment, phasing out expensive subsidy systems, and cutting back on capital expenditure. The impact will be to increase the cost of living, while reducing employment prospects. It was these very factors, allied to high levels of perceived corruption, that were the key drivers behind the outbreak of the Arab Spring in late 2010 and early 2011.

We expect the GCC governments to attempt to offset the employment problem by reinvigorating their plans to increase hiring of locals at the expense of foreign nationals in the private sector: at present, 90% of Saudis work in the public sector, while 90% of jobs in the private sector are filled by expatriates. However, previous attempts have only resulted in higher costs for private sector companies, with the result that companies, voluntarily or through bankruptcy, exit the market.

In addition, the GCC governments are going to introduce a VAT system in 2018; this comes after years of pressure from the IMF. Although there will be a number of exemptions and the rate, at 5%, is low by international standards, this is liable to be the start of a concerted effort by the GCC governments to widen and deepen the tax base. The move will, however, raise socio-political tensions as the informal contract of 'no taxation; no representation' is broken.

The move will also provide a platform for more radical groups to recruit and to launch terrorist attacks against government and foreign business targets. In addition, it is highly likely that groups, such as Islamic State (IS), will take advantage of escalating violence to destabilise the country though sectarian violence against the Shi'a population and implement economic jihad. The aim of economic jihad is to target the economic infrastructure of a country, such as oil rigs and pipelines, in order to further upset the status quo and boost support for IS.

Other oil-exporting countries, in which the democracy deficit is high, can be expected to face increased political and security risks to various degrees as oil prices remain weak. Falling standards of living, and rising unemployment and poverty levels – particularly among recently empowered middle classes – is set to trigger rising discontent with the government. These countries include Algeria, Angola, Azerbaijan, Colombia, Iran, Iraq, Kazakhstan, Mexico, Nigeria, Russia, and Venezuela. Countries where democracy is more embedded, such as Australia, Canada, Norway, the UK and the US, are far less vulnerable to these risks.

COMMERCIAL IMPLICATIONS

- Budget austerity in oil-exporting countries will reduce household spending power, curtailing demand for imports (especially of high-end quality brands), and reduce inputs into infrastructure development.
- The introduction of taxation in the GCC countries will put further pressure on the informal social contract, raising political and possibly security risks.
- Local and regional supply chains will face challenges in the event of rising political and security tensions.
- Refugee flows into the advanced countries raise government spending, encourage support for extremist nationalist parties and disrupt supply chains; all undermine the commercial environment in the countries impacted.
- Localisation of the workforce in GCC is liable to add costs for domestic businesses, negatively impacting cash flows, payment performance and the viability of companies.
- Increased taxation will not only impact directly on business costs and consumer spending, but it is also liable to meet with increased political action against the authoritarian regimes.

RECOMMENDATIONS

- When dealing with counterparties in oil-producing countries, closely monitor the country risk environment, which is set to worsen over the next few years.
- Take out political risk insurance where possible.
- If businesses have a presence in authoritarian oil-exporting countries, have a staff evacuation plan in place (which should be continually updated) in the event that the security situation deteriorates quickly.
- Ensure plans are in place to take account of short- and long-term supply chain disruption because of anti-government demonstrations and/or violence.
- Monitor GGC government policies on the localisation of the workforce as this is liable to add to the costs for local businesses, raising risks for doing cross-border business.
- Take into account that increased domestic taxation is likely to raise socio-political tensions.

OUTLINE SCENARIOS

SCENARIO A

Our baseline scenario is that supply continues to outpace demand over the next five years, but that global growth conditions improve in parallel, narrowing the gap. As a result the annual average price climbs slowly until 2020 (while remaining below the level seen in 2014). After 2020 there should be a strong rebound in oil prices as a consequence of supply shortages; the current weak oil price is causing investment to plummet.

WE ASSIGN A 70% PROBABILITY TO THIS SCENARIO.

SCENARIO B

Geopolitical or socio-political events relating to a significant oil-exporting country curtail oil supplies into the medium term, pushing oil prices back above the USD75/b level more rapidly than in Scenario A, thus attracting further investment into the sector and leading to a milder longer-term rebound in oil prices in the 2020s.

WE ASSIGN A 15% PROBABILITY TO THIS SCENARIO.

SCENARIO C

Global growth remains sluggish well into the 2020s, curtailing demand for oil. The cost of extracting unconventional supplies declines sufficiently to allow supply growth to outstrip demand growth, ensuring oil prices remain weak for at least the next decade. Oil prices will not rebound to 2014 levels until at least 2030.

WE ASSIGN A 15% PROBABILITY TO THIS SCENARIO.

BACKGROUND AND CONTEXT

This century has seen extreme volatility in oil prices (ranging from under USD18/b to over USD145/b) as the market adjusts to a number of a fundamental changes. These changes include:

- The rise of ‘unconventional’ supplies (US shale oil and Canadian tar sands), putting downward pressure on prices.
- The rise of renewables, which accounted for 81% of the increase in energy supply in 2013, exerting downward pressure on prices.
- The global financial crisis has affected demand growth (depressing short-term prices) and investment in new supplies (putting upward pressure on long-term prices).
- Increased insecurity in the Middle East (and other oil-rich countries) threatening supplies, putting upward pressure on prices.
- Increased politicisation of supply (e.g. Russia-Ukraine), putting upward pressure on prices.
- The commitments made at the COP21 climate change conference in Paris in November 2015 have called into question the long-term sustainability of fossil fuels.

Against this background, a number of factors are currently combining to ensure oil prices remain weak by recent standards. These include the fundamentals of supply and demand being out of kilter (with supply outstripping demand), the strong US dollar (the dollar and oil price have an inverse relationship), and high levels of stocks. Thus, the International Energy Agency (IEA) reports that ‘the markets are already awash in oil’.

Despite calls for agreement between OPEC and non-members to put a lid on production and limit supply, this is unlikely to happen. Two OPEC members, Iraq and Iran, are both attempting to rebuild their output levels. Indeed, the IEA states that Iraqi output in January reached a new record, with further increases still to come. Meanwhile, the lifting of international sanctions has seen Iranian output start to increase; although it will be into the medium term before more substantial output is achieved. Furthermore, Saudi Arabia shows no signs of decreasing its output.

According to the IEA, OPEC production as a whole increased in January 2016 by 280,000 barrels per day (b/d) in month-on-month (m/m) terms, to 32.6m b/d; up 1.7m b/d year on year. However, non-OPEC supply, which includes US shale output, fell by 500,000 b/d m/m, taking non-OPEC supply to around the same level as in January 2015. The expected slump in US shale production will lead to non-OPEC production falling by a further 600,000 b/d in 2016. Against this, demand growth is set to slow in 2016. The IEA is currently forecasting demand growth of 1.2m b/d in 2016, as against the five-year high of 1.6m b/d in 2015.

Our baseline scenario is that supply will continue to outstrip demand into the medium term, keeping a lid on prices (see Chart 1). However, upward pressure will resume as the US dollar eventually weakens and stocks fall. The risks to our forecast are on the downside over 2016-18, but on the upside in the latter part of the forecast. Meanwhile, the weak oil price is resulting in investment being cut back, which will curtail supply growth into the long term and set the scene for a sharp rebound in oil prices.

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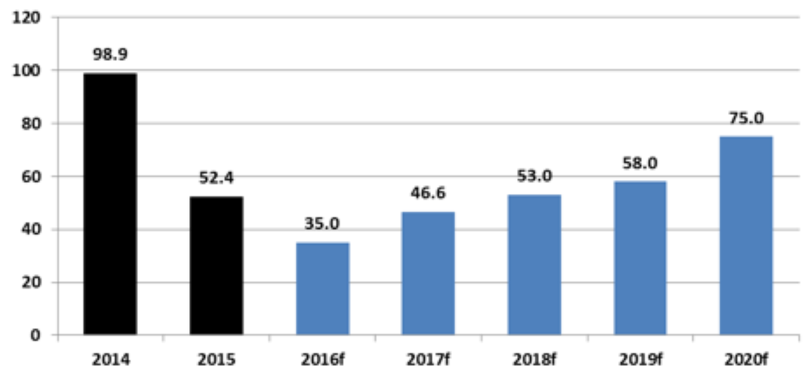
CHART 1: ANNUAL AVERAGE OIL PRICES (USD/B)



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