Oil: Hope of respite?*

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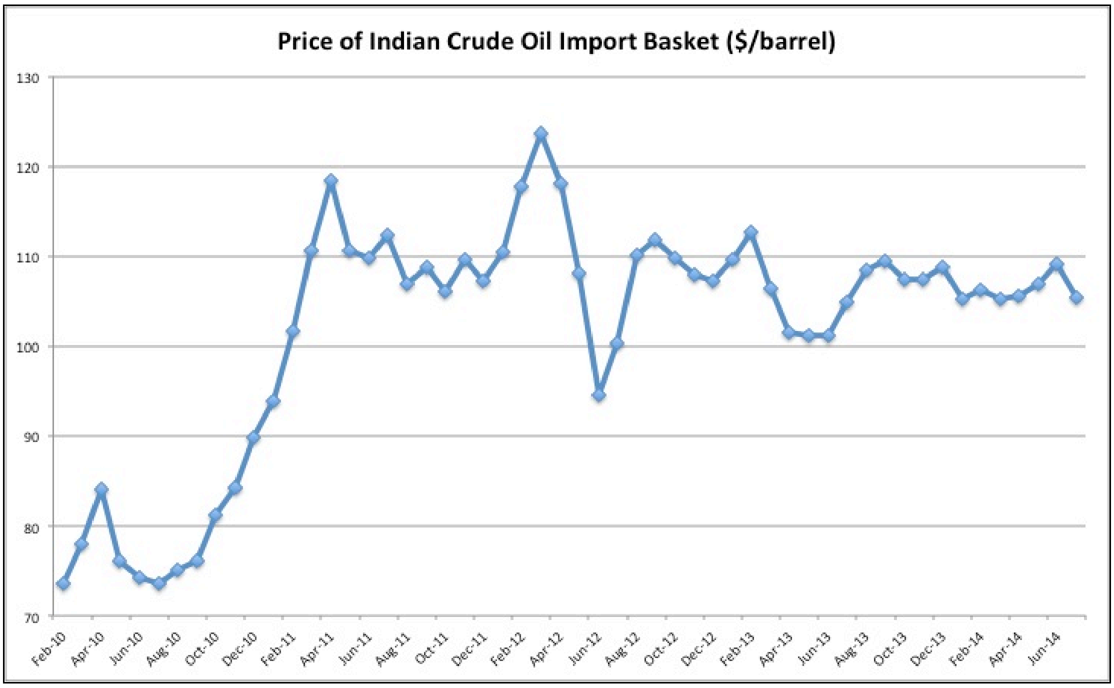

For the Indian government, which has to address high inflation and persisting trade and current account deficits, the news from global oil markets is heartening. The import price of India's crude oil basket fell from $105.44 a barrel over the pricing fortnight for August 1 (July 12-July 29) to $101.67 on August 13. The short-term trend is downwards and has been noted by oil price analysts. While war and conflict rage in West Asia and other regions (such as Ukraine) relevant for the world's energy supplies, the International Energy Agency of the US has come out with a projection that global oil prices have peaked and are likely to slide. This is surprising, given past experience. In 2008, for example, the stand-off over Iran's nuclear programme send oil prices spiralling to touch $147 a barrel. Yet, in it August Oil Market Report, the IEA notes that despite these conflicts, rising supply and weakening demand have brought oil prices to a 13-month low. It expects that this trend is more likely to continue than not. But there is a case for caution, before the celebrations begin.

Two factors have been principally responsible for the enhancement of supply: a decision by Saudi Arabia to raise production beyond 10 million barrels a day to address shortfalls due to the conflict in Ukraine; and the persistent rise in production of non-conventional gas and oil in the US, and the consequent increase in US exports. The shale boom has allowed the US to add as much as three million barrels a day to global supply. Combined with slack demand because of slower than expected international growth, these factors have triggered a minor slide in oil prices, when geopolitical factors threaten a spike in prices.

Signs of respite in the oil market are of significance because the real price of crude oil, adjusted for inflation, is currently close to its historical high. According to the BP Statistical Review of World Energy that "real price", measured in 2012 dollars, has fluctuated between $10 and $120 a barrel in the years since 1861. That real price now is close to it peak value. With oil price at a historical high, economies dependent on crude imports are already under stress. Further increases would be difficult to bear. A decline in nominal prices is what they need.

Take India, for example. Petroleum crude and oil products (P&O) accounted for 31.7 per cent of its import bill in 2011-12 and 36.7 per cent in 2013-14. The country has been able to bring down its trade deficit by 28 per cent from $190.3 billion in 2012-13 to $137.5 billion in 2013-14, largely as a result of duty hikes and restrictive policies that ensured a 46 per cent reduction in the value of gold imports. But the deficit still remains uncomfortably high, despite the recession induced reduction of the non-oil, non-gold trade deficit to $12.3 billion from $39.8 billion in 2012-13.

But within the current trade regime, any further adjustment, especially if the economy revives and increases non-oil imports, will have to be on account of oil. And that adjustment is unlikely to be realised through a reduction in the volume of imports, anytime in the near future. In 2013-14, for example, the P&O import bill registered a low 0.7 per cent increase relative to the previous year largely on account of a 2.3 per cent fall in the average price of India's crude import basket. So the oil price scenario is quite crucial.

In June this year, the IEA in its annual medium term report had suggested that the spread of the shale revolution beyond the US could increase the weight in total supply of non-conventional sources that have already transformed the energy landscape. According to one extremely tentative estimate, the US may account for just 15 per cent of the world's shale and light tight oil resources. If non-US sources begin to be even partially exploited, the demand-supply balance can change dramatically.

But while that scenario waits to unfold, there are signs of concern. The most important of these is the uncertainty over supplies from the OPEC. According to the IEA, "OPEC production in 2013 was 850 kb/d lower than it had been a year earlier, partly offsetting record growth of 1.35 mb/d in North American supply." And while OPEC's capacity is projected to rise by 2.08 mb/d over 2013-2019, almost all of this is expected from Iraq, where matters have got worse than better.

In addition, shale sceptics say that the projected shale oil and gas boom has been overstated, with fracking costs and environmental concerns affecting the spread of the revolution. So, as yet, the expectations of excess supply in the coming years may be exaggerated. University of California Professor, James Hamilton, a respected oil analyst, is sceptical of such projections. According to a July 2014 analysis by him, production has in the recent past fallen short of potential increases in demand. "One factor holding back production in a number of locations today is geopolitical unrest," he argues. "The biggest single contributor over the last three years has been Libya. ... Sanctions continue to reduce Iran's production, and attacks on oil infrastructure keep Nigeria's production below its potential. About 400,000 b/d is currently lost as a result of open conflict in Sudan and Syria. All told, the EIA estimates that these and other unplanned disruptions reduced world oil production by 3.3 mb/d in June 2014."

So, according to him: "The story behind the doubling of real oil prices since 2005 is thus quite simple—if prices had not risen, growth in demand, particularly that coming from the emerging economies, would have outstripped production. A big price increase was necessary to reverse the trend of growing consumption in the developed economies.” Geopolitical disruptions do not seem temporary any longer. In addition, in the near future, production increases are likely to be constrained by geological limitations that physically restrain increments in output or make them too costly to generate. So given the increase in demand for oil from emerging economies, oil prices in this view are unlikely to fall, or, if they do, the experience would be short-lived. That may necessitate other routes to limiting or financing India’s still large import bill.

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