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New 'Oil Shock' – Impact on South Asia

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In the 1970s, the oil-producing and exporting countries of the Middle East delivered a shock to the global economic system that had many unexpected consequences. The then-quadrupling of the price of oil hastened a process that came to be called "globalisation". It deeply affected the structure of the global economy and also produced a number of political consequences. The oil-importing developing countries were the most-affected group. Some of those who could borrow from the world's capital markets did so to pay the oil import bill. This created indebtedness and moved some of the countries which had borrowed massively towards default on their external obligations. Many of them turned to the International Monetary Fund for help. The Washington-based institution responded with aid-and-policy-reform packages that were unprecedented in its history. The Fund received additional funding from the world's rich nations to follow through with these programmes. Now, in November 2014, the Organization of the Petroleum Exporting

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Countries (OPEC) has administered another shock to the global system but of a kind very different from the one 40 years earlier. Its consequences will be equally far-reaching – globally and in South Asia.

Swift technological changes and quick transmission of market signals were behind the oil shock of November 2014. Unlike the 1970s shock, this time, it is a sharp decline in oil price that has produced a number of unexpected changes in the working of the global economic system. The price of Brent Crude dropped 40 percent between mid-June and end-November to around US$72 a barrel. It was the result of relentless output from US shale oil fields. The United States produced a million barrels a day of additional oil from the freshly commissioned production centres in the country. The same amount will be added in 2015. Additional production by Iraq and Iran further increased global supply. These additions to output came while the economic downturn in Europe and Japan reduced demand.

The OPEC ministers meeting in Vienna in the final week of November shook the markets by choosing not to cut output. "OPEC is not alone in producing oil", said Suhail Mohammed Al Mazrouei, Energy Minister of the United Arab Emirates. "There is oversupply but that is not an OPEC problem. In 1970, the US shale-oil industry started as a humble producer and is now a major contributor to world supply. The new-comers need to work with the fundamentals".

Mark Wittner, the oil analyst at Societe Generale, said the move showed that the cartel led by Saudi Arabia would "no longer be the mechanism to balance the market from the supply side. They have relinquished that role. Instead, the market itself – prices, in other words – will be the mechanism to rebalance the market. We cannot overstate what a dramatic and fundamental change this is for the oil market". The most obvious reason for delivering this shock was to cut the ground from under the shale industry which would not be able to compete with the low-cost producers in the Persian Gulf.

Politics must have also played a part in the OPEC decision. The cut in prices put pressure on Iran which needs high oil prices to meet the challenge it faces because of the sanctions imposed by the West and the United Nations. The Iranians were adding 100,000 barrels a day to their stocks, most of that on tankers looking for markets. The oil price shock may persuade Tehran to agree with the West and give up its nuclear ambitions. The price cut will also hurt the Islamic State in

Iraq and Syria (ISIS) which was generating significant revenues for running the fledgling 'state' by exporting oil from the fields it had captured in the summer of 2014. Saudi Arabia and the UAE had joined the United States in fighting the 'Islamic State'. The price of oil was one more weapon in their arsenal.

Also hurt will be Japan which will find it even harder to fight against deflation, the major economic challenge faced by the government of Prime Minister Shinzo Abe. Japanese core inflation rate in October fell to 0.9 percent, a 13-month low. China is also grappling with low inflation. Fears of deflation were one of the motivations behind the surprise cut in the central bank rate on 21 November. Chinese inflation is 1.6 percent compared with the government target of 3.5 percent. Beijing cannot afford to have a Japanese-type of deflation to hit the economy.

For Asian energy companies, the impact of the drop in the price of oil varies according to their place in the supply chain. It also depends on the level of government involvement in setting energy prices. In China, the country's three largest energy producers – all working under the control of the state – saw Hong-Kong traded shares fall between 4.8 percent and 6.8 percent on 28 November, a day after the OPEC decision. However, the shares in Chinese shipping and aviation companies, heavy users of petroleum products, rose sharply on the OPEC news. Indian oil marketing companies benefitted as well with the price of their shares increasing sharply on 27 November.

The fall in the price of oil will bring political rewards to a number of Asian governments led by populist leaders who had promised that their elections would result in benefits for those who had supported them. However, this will depend on how successful they are in selling their message to their constituents. India, Indonesia, and Pakistan have already seized the opportunity of price declines by reducing fiscally damaging subsidies on oil products. Narendra Modi was being called the lucky prime minister by some business people; he was elected in May 2014 with a mandate to revive the economy. The economic landscape he had inherited is being transformed by the oil price decline. He will be in a position to meet the target of fiscal deficit and improve the country's balance of payments deficit with a significant decline in the import bill. Lower annual inflation, already down to 5.5 percent in mid-October, is likely to decline further. This in turn is likely to result in a growth-boosting interest rate cut by the Reserve Bank of India, the country's central bank.

However, there will be some negative results for the labour-exporting South Asian nations. There are more than 15 million people from South Asian countries working in the Middle East, mostly in those that are large oil exporters. The sharp drop in the price of oil will slow down their economies, reducing their demand for foreign workers. Also, the demand for the services of those who are already there may reduce the incomes of low-skilled South Asian workers. This will have an impact on the amount of funds the workers remit back home. Savings on the oil import bill by South Asian nations will be cut by the very likely decline in the flow of remittances.

The November 2014 decision by the OPEC nations is already rippling through the global economy. If the organisation maintains its new stance – it is set to meet again in six months' time – the consequences for the global economic and political systems will be profound. Some analysts believe that the price of oil will settle down at about US$60 a barrel, a further reduction of 16 percent. This will have enormous distributional consequences with a sharp decline in capital transfers from the oil-importing to oil-exporting countries.

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