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Implications of the recent drop in world oil prices

<u>What has happened?</u>

Over the past 6 months the oil price has effectively halved, moving from around $110 per barrel in June 2014 to around $55 a barrel by the end of December 2014.

<u>Why has this happened?</u>

The underlying reasons for this shift revolve around the supply of and demand for this basic commodity.

Demand is lower than expected due to the prospect of continued low world economic growth, or in the case of China, slowing growth. At the same time, the supply of oil remains relatively high. This surplus of supply has arisen because of the increases seen in US production from shale deposits, with no offsetting reductions, planned or unplanned, to supply from the OPEC countries area, something that has often occurred in previous periods of oversupply.

While these demand and supply trends are consistent with a falling price they do not explain the timing or the depth of the fall seen over the last 6 months. However, such shifts in the price of basic commodities like oil are not uncommon.

For example, back in 2008, the price of oil lurched from over $140 in June to $33 in December. This was followed by a slow climb back to over $120 by April 2011. Prior to the current fall, the oil price had remained unusually steady, at around $110.

It is worth noting that, in £ terms, the fall in the price has been slightly less dramatic, as sterling has depreciated by around 10% against the dollar over the same period.

<u>What will happen now?</u>

Just as forecasters were not expecting the big fall seen in the last 6 months, it is difficult to predict what will happen in the next 6 months. Some believe a prolonged period of low oil prices while others expect more of a bounce back.

In the longer term there is greater consensus that a degree of bounce back will occur as this has tended to be the outcome in previous cases of such price adjustment. Typically a low price reduces investment in future production which tends, over time, to reduce output and so raise prices. For example, Goldman Sachs have warned that around $1 trillion of investment in future oil projects is at risk with a price of around $60 a barrel, while Wood Mackenzie have suggested that the industry could cut a quarter of its capital expenditure over the next five years.

According to the IMF in late December, the futures market for oil suggested that prices would recover to $73 a barrel by 2019, although the range of future prices for 2019 extended from $38 to $115. As this suggests, the degree and the timing of any such upward adjustment in oil prices is highly uncertain.

One of the difficulties in estimating such a rebound is due to the influence of shale oil producers in the US. The US shale industry is relatively new, and although it is high cost, it can open and close wells quickly (unlike oil production in other high cost areas like the North Sea). As a result, we are in new territory when estimating how they will react to the low price now in place.

It is also worth noting that the oil price seen in recent years has been relatively high. In sterling terms, the annual average (real terms) price in the last 3 years (2011- 2013) has been around £70 a barrel. This appears atypical, given there has been only one year, 2008, where the average real price was higher and even in the early 1980s the annual average price was close to £50 a barrel. Hence, while the price may well bounce back, it is unclear whether such a bounce back will reach the relatively high price levels experienced prior to the current collapse and, even if it does, if it will remain that high in the long run (see Chart 1).

Winners and losers?

In general terms it can be assumed that large oil importers will be the main winners and large oil exporters will be the main losers.

Overall, the IMF estimate that for every \$10 fall in oil prices world economic growth improves by around 0.2%. The latest IMF simulations (from late December 2014) suggest a gain for world GDP of between 0.3 and 0.7% in 2015.

However, not all effects will be beneficial to non-oil exporters. For example, there are concerns that with such a low oil price in place some oil producing countries which are dependent on a high oil price to balance the books may default and that related banking systems may also be vulnerable. In terms of scale, Russia in particular stands out and any such problems could spill over into other financial systems. Furthermore, falling energy prices could push more countries towards deflation and the problems that can bring.

The impact on the UK is different to most countries as it is both an oil producer but also an oil importer. On balance most analysts think that growth will receive a small boost as a result of the price fall. The impact on public finances however, is likely to be negative, at least in the short term, as North Sea oil tax revenues fall by more than other (non-oil activity based) tax revenues rise.

For Scotland, as North Sea related taxes have not been devolved as part of the Smith Commission recommended package, then the fall in the oil price will not impact directly on Scottish funding levels. However, falls in indirect oil related activity could impact on Scottish funding. This could happen as a result of lower income tax due to lower employment and/or lower wages of those workers involved in the oil industry who are Scottish residents.

It is estimated that around 450,000 people in the UK have jobs connected with the North Sea and that around half of them are in Scotland. Sir Ian Wood has estimated that around 10% of all jobs could be lost over the next five years as a result of the lower oil price.

It is very difficult to estimate how much of an impact this would have on Scottish government tax revenues but it may well be something that the Scottish and UK governments spend some resource exploring as part of the post Smith Commission negotiations.

Reflections on the 2014 UK Autumn Statement

Fiscal Affairs Scotland released a brief commentary on the 2014 UK Autumn Statement (and the associated Economic and Fiscal Outlook by the Office for Budget Responsibility (OBR)) at the time of publication. However, since then a number of issues have arisen in relation to it that are worthy of further comment.

Back to the 1930s?

At the time of the Autumn Statement the OBR stated that, based on current plans, total public spending in 2019-20, as a share of GDP, "*would probably be (at) its lowest level in 80 years*" i.e. since 1939.

While this statement is true it needs to be put in context to be properly understood.

The first thing to note is that public sector spending, in both current and real terms (i.e. after adjusting for inflation), is far higher now than it ever was in the 1930s. For example, real terms public spending in 2019-20 is expected to be well over double what it was even forty years ago, in 1979-80 (equivalent to well over seven times higher in cash terms). However, as the economy (measured in terms of Gross Domestic Product) has also grown by a similar amount then the recent downturn in public sector spending means that such spending, when measured as a <u>share</u> of output has dropped back to the levels seen in the late 1930s.

The OBR chart for this measure only goes back to 1948, but shows that, post WWII, the level of public spending as a share of GDP has only twice fallen to the 36% level projected for 2018-19. The first time was in 1957-58 and the second as recently as 1999-2000.

In terms of adjustment, the 10% cut in public spending as a share of GDP currently planned for 2009-10 to 2019-20 (from 45% to 35%) has only been matched once post WWII, but over a shorter period, from 1983-84 to 1988-89 (from 47% to 37%). The crucial difference between these two periods is that the former was a period of rapid growth, while the latter has been a period of very slow growth.

Furthermore a general terms comparison with the 1930s also hides what public sector money was being spent on. In the 1930s the two largest components were debt repayments (in relation to the First World War) and military/defence spending, which together accounted for around 40-50% of the budget. Back then health accounted for only around 5%. Now the position is reversed with health accounting for around 20% and other budgets, such as pensions, having also grown in importance, while the combined defence budget and debt interest payments now account for only around 10% of overall public spending.

As a result, when comparing public spending now with the 1930s, or any other historical period, it is important to be clear what the comparator relates to, especially in terms of levels or shares, and on the composition of such spending.

<u>Autumn Statement fiscal projections vs those of the main UK political parties?</u>

The Autumn Statement projections for public sector spending up to 2019-20 suggest that significant real terms cuts to Departmental budgets will continue for the next 5 years.

However, the latest UK public finance projections are noticeably tighter than those implied by the new fiscal rules outlined by the coalition UK government.

These new rules, from December 2014, are:

(i) to achieve a cyclically adjusted current budget balance by the end of the third year of a rolling five year forecast period. Currently, this effectively means balancing day to day spending (i.e. excluding investment spending) and tax revenues by 2017-18.

(ii) for public sector net debt as a share of national income to fall between 2015-16 and 2016-17, (as well as thereafter).

As a result, all political parties have some leeway in reducing the degree of austerity that is currently in place in the OBR's public spending forecasts post 2015-16, should they retain these rules after winning the 2015 UK general election. Of course the knock on effect of such a move would be that debt levels, and the associated debt interest payments, come down more slowly.

This mismatch was highlighted in a recent paper by the Institute for Fiscal Studies (IFS), who found that the existing 14.1% of further real terms cuts to departmental spending up to

2019-20 could be reduced to under 2% without breaking the new fiscal rules.

This is in fact in line with the proposals made thus far by the Labour Party and the Liberal Democrats. Even under the Conservatives proposals of a balanced overall budget, the cuts could be reduced to around 9%.

All of this suggests that the departmental cuts profile currently being projected by the UK coalition government and the OBR up to 2019-20 is very much at the high end of likely outcomes and that the final position may be less dramatic.

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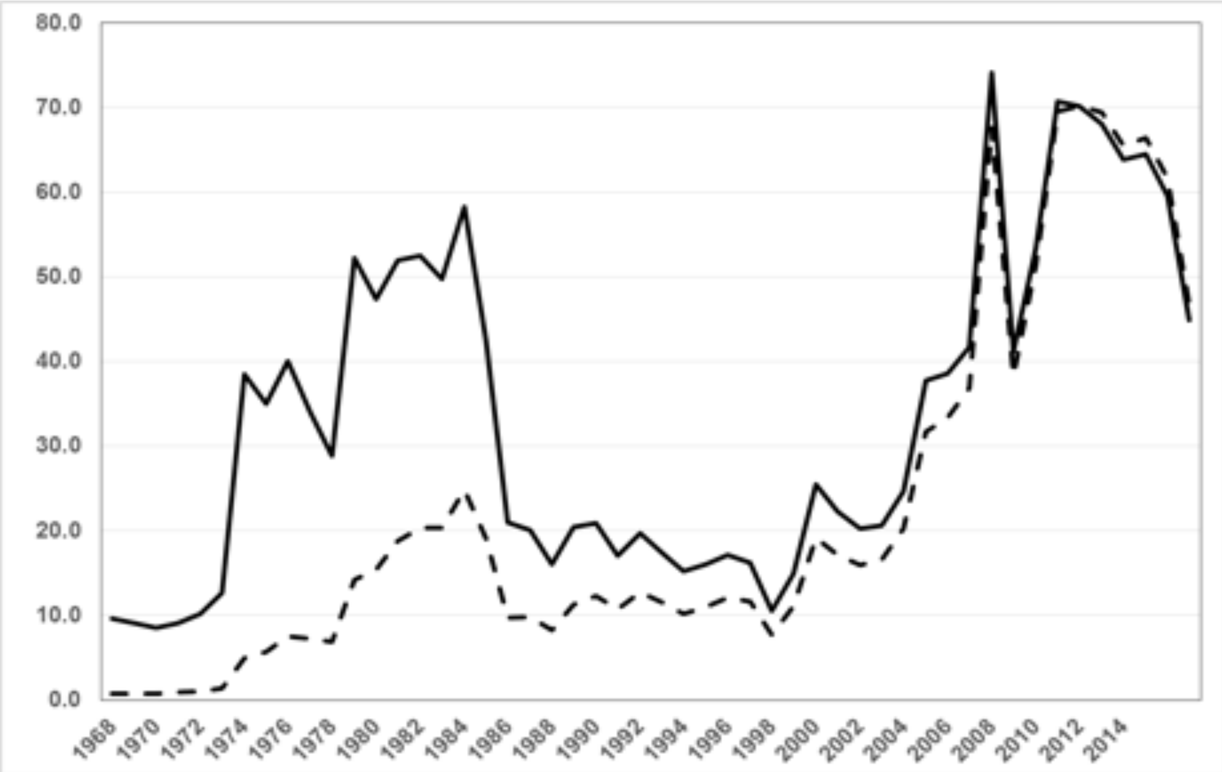
Chart 1: Historical price of Brent oil, £ per barrel, real (solid line) and cash (dashed line) terms



Source: EIA database, ONS

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