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Energy Prices and Crisis Risks

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Hearing on Economic and Geopolitical Implications of Low Oil and Gas Prices

Chairman Corker, Ranking Member Cardin, and members of the Committee: thank you for the invitation to testify today. I am honored for the opportunity to discuss the economic and geopolitical implications of low energy prices. I would highlight three takeaways in particular:

- Low oil prices are likely to be persistent. Emerging market oil exporters that drew on fiscal and asset buffers in 2015 to delay adjustment can no longer put off essential reforms.
- The playbook for reform includes moving energy prices to world market levels, strengthening and better targeting the safety net, and putting macroeconomic policy on a sustainable footing. The IMF can play a vital role in support of these efforts, reinforcing U.S. strategic interests.
- Venezuela is an economy on the edge. A default and economic crisis seems to be a question of when, not if. U.S. policymakers need to be planning now for a lead role in resolving the crisis, when Venezuela has a government willing to work with the west.

The sharp decline of oil and natural gas prices has been a rare but significant shock to the global economy. In less than two years, we have seen the price of crude oil dropping from about $100 per barrel to about $30 today. During this period, the prices of natural gas and many other commodities also have decreased sharply. Both demand and supply factors have contributed to this trend. In *Medium-Term Oil Market Report 2016*, the International Energy Agency (IEA) estimates that oil supply exceeded demand by 2 million barrels per day in 2015. Absent a significant production cut, it is hard to imagine prices rising materially till at least 2018. Futures markets also predict low oil prices are likely to persist for some time.

The oil price downturn creates an important windfall for consumers, and has boosted prospects for oil importing countries such as India, China and Japan. But for oil exporting countries, low prices exert heavy financial and fiscal burdens. This comes at a time when the global economy already faces sluggish growth and significant downside risks from slowing Chinese growth, volatile exchange rates and capital flows, and high

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corporate debt. While economic vulnerability is rising, policymakers' ability to respond is not; instead it is becoming more constrained. Many oil exporters are seeing fiscal buffers dissipated, and in some cases weak policies and populist pressures are constraining government's ability to act.

Reflecting this weaker environment, the International Monetary Fund (IMF) in recent years has repeatedly downgraded its growth forecasts, most recently in January when its World Economic Outlook projected global growth of 3.4 percent; further downgrades are likely. Last week, the finance ministers and central bank governors of the Group of Twenty (G20), meeting in Shanghai, China, acknowledged these growth concerns and recognized the need for policymakers to do more—but there was little in the way of specific new policy commitments.

The U.S. economy nonetheless has proven resilient. In 2015, the real GDP grew by 2.4 percent. The unemployment rate is currently 4.9 percent, the lowest level since 2008. Lower oil prices appear to have been a small drag on growth last year, as a 40 percent drop in capital expenditures in the oil and gas sector cancelled out the boost from lower oil to consumer spending. One reason for the muted consumer response to date may be the desire to save and repair balance sheets after the damage caused by the Great Recession. While this is a healthy development, it is possible that consumers could become more willing to spend if oil prices remain low.

Most major forecasters expect similar levels of growth in the United States this year, which would place us above other advanced economies including the eurozone and Japan. Nevertheless, the U.S. economy is not immune to oil-related turbulence. Many of the emerging markets in turmoil share close trade and financial linkages with the United States. Stock market turmoil in recent months has contributed to a tightening of financial conditions, while the appreciation of the dollar along with lower oil prices is imparting a deflationary impulse to the economy. All of this suggests that U.S. policymakers will need to continue to be alert to the risks emanating from abroad.

Assessing Fiscal Sustainability and Risks for Emerging Market Exporters

A starting point for assessing the risks from lower oil to emerging market exporters is the fiscal breakeven price, the level of oil price that balances government budget based on current prices and policies (figure 1)[1]. During much of 2015, oil prices hovered around $50 per barrel, meaning most countries in Figure 1 faced world prices that were below their breakeven prices. With the further fall in oil prices to current levels, it is likely that the gap in 2016 between current prices and the ones that balance the books in most oil exporting countries has grown larger.

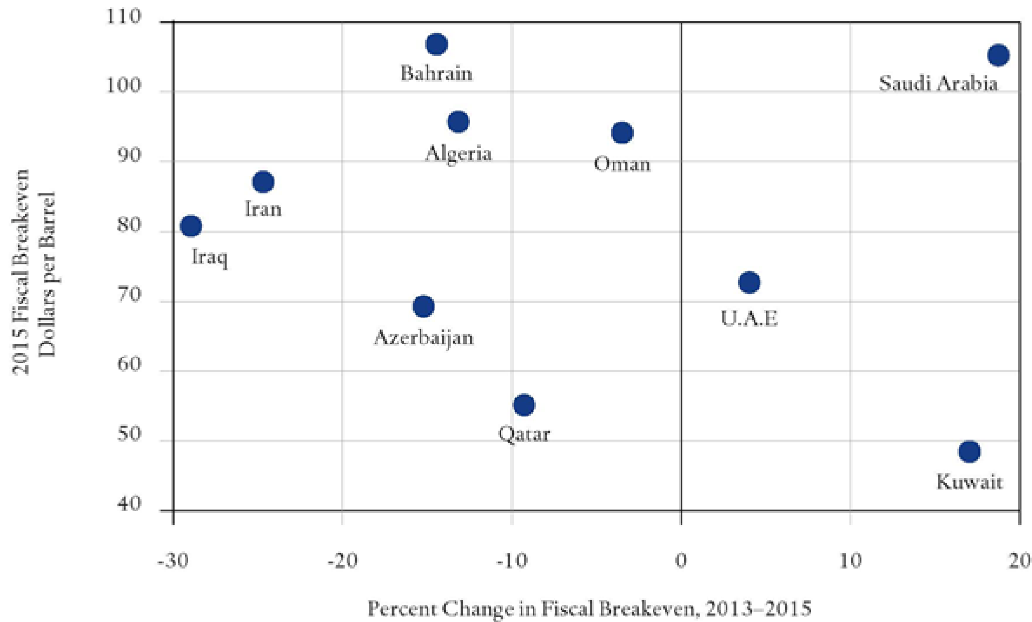
Solely relying on this metric could lead to overconfident predictions of geopolitical risks and future oil prices. What matters is the willingness and ability of countries to adjust to these shortfalls. It was reasonable, through much of 2015, for oil exporting country policymakers to assume that oil prices would rebound, and so to delay adjustment. Fiscal deficits were allowed to increase, exchange rates in some cases were depreciated, and assets (including importantly sovereign wealth fund holdings) were drawn on. It was only later in 2015, following a further oil price decline and as budgets were being prepared for 2016, when many of these countries began to take seriously the need for policy adjustments.

This suggests that the potential for disruptive adjustment is higher in 2016. For now, we are continuing to see sizeable asset drawdowns, with recent reports that countries such as Russia, United Arab Emirates, and Qatar are liquidating their investments, which according to some analysts could result in withdrawal of $400 billion of equities this year. Indeed, some reports suggest that withdrawals from these "rainy day funds" were a major factor behind the stock market turbulence in January of this year.

[1] For a more comprehensive analysis of the insights and pitfalls of using fiscal breakevens, see a report by my CFR colleagues Blake Clayton and Michael A. Levi, from which figure 1 is taken.

How long these countries can continue to drain savings is a difficult question to answer, given the lack of transparency from many of the sovereign wealth funds (SWFs). In a report on the regional economic outlook, the IMF argues that many governments in the Middle East would run out of fiscal buffers in less than five years due to large fiscal deficits (assuming prices in the $50 per barrel range). Meanwhile, countries such as Venezuela are facing unsustainable public debt and possibility of default as soon as 2016. For these countries, "muddling through" is no longer a viable option.

FIGURE 1. IMF FISCAL BREAKEVEN ESTIMATES



Source: Clayton and Levi (2015) "Fiscal Breakeven Oil Prices: Uses, Abuses, and Opportunities for Improvement"

Therefore, sizeable adjustments of fiscal and energy policies are imperative in these oil exporting countries. Some indeed have taken actions. Mexico, for instance, eliminated fuel subsidies in December 2014, which would offset the loss from export-related fiscal revenues. By 2018, the country also plans to fully liberalize domestic energy prices. Saudi Arabia has taken some steps in restoring fiscal sustainability, exemplified by the drastic spending cuts in its 2016 budget and first steps at electricity and fuel price reform.

In the remainder of this testimony, I will touch on Iraq and the Middle East, Russia, Nigeria, and Venezuela, highlighting some challenges faced by these economies as well as policy adjustment options they have.

Iraq and Middle East

In Iraq, the drop in oil prices coupled with supply disruptions due to Islamic State (ISIS) attacks have had a profound effect on an economy that is heavily reliant on oil for government financing. In 2014, oil accounted for over 94 percent of the central government's revenue. Worse yet, the ISIS attacks are hindering the development of non-oil sectors by disrupting trade and destroying infrastructure. The government deficit increased from 5.6 percent of GDP in 2014 to over 15 percent in 2015. Under a non-financing IMF program, the government is attempting fiscal consolidation, but firm policy implementation will be required to sustain the adjustment effort and preserve domestic stability.

Iraq's plight is not uncommon in the region. In CFR's recently released 2016 Preventive Priorities Survey, eight of the eleven most critical contingencies are related to events unfolding or ongoing in the Middle East. Whether the concern is Syria, rising tensions between Saudi Arabia and Iran, or a weakening of state control

elsewhere in the region, it is hard to discount the Middle East as the leading source of geopolitical risks, "new thirty years' war."[2] The instability in the region could continue to impede many governments' efforts to diversify economic structures and promote private sector growth, which are crucial for the region's economic future.

Russia

The recession in Russia is deepening, due to a combination of factors: poor economic policies, low energy prices, and sanctions imposed by the United States and the European Union (EU). The economy contracted by 3.7 percent in 2015 and will likely shrink by more than 1 percent this year. With nearly half of government revenue from oil and gas, prospects for energy markets are critical to economic results. The 2016 budget assumes oil price to be $50 per barrel, which would produce a fiscal deficit of 3 percent of GDP. But this assumption is looking badly outdated. With the current oil price, Russia could see a deficit of 7 percent, putting more pressure on the currency. Similar to many energy-exporting countries, Russia's revenue shortfall exposes its difficulty in generating non-energy incomes and subsequently structural weaknesses.

In response to these pressures, the government has chosen to run down wealth funds and allow a sharp depreciation of the rouble. That depreciation has provided support for the budget (by raising the rouble value of oil revenue) but at a significant cost to the broader economy. Inflation has risen well above target, a tax on all Russians and especially painful for those on fixed incomes. Real incomes have fallen sharply. On its current trajectory, the government's fiscal buffers will be exhausted by end 2016, which could put additional pressure on the government. Demographic change and decades of distorted prices and poor investment are further undermining the long-term health of the economy. The risk of a crisis will rise over time unless the government adopts more fundamental reforms.

Nigeria

Despite efforts of diversification, the Nigerian economy is struggling to come to grips with low oil prices. Non-oil sectors are the main drivers of the country's growth, but in absolute terms oil revenues remain significant, and the shortfall to the budget is causing stress. The country's GDP growth was 2.8 percent in 2015, a significant drop from the 6.3 percent in 2014. Moreover, the general government deficit was 3.3 percent GDP in 2015, almost doubling the figure of 2014 despite a sharp drop in public investment. Foreign exchange restrictions introduced by the central bank have caused credit problems for the private sector and contributed to broader shortages in the economy.

In view of the worsening conditions, the country is seeking emergency loans of $3.5 billion from the World Bank and the African Development Bank (AfDB). If granted, these funds could help cover the government's financing needs but may not be sufficient. Further, financing alone cannot solve Nigeria's fundamental problems. The country's external balance has been deteriorating. The currency naira is fixed but under pressure, and the Nigerian central bank has had to deplete foreign exchange reserves to defend the peg. While reserves remain ample ($28 billion at the end of 2015), there would look to be a compelling argument that Nigeria should liberalize (devaluate) naira and/or loosen capital controls, as part of a broader strategy to promote exports, further diversify from oil, and relieve external pressures.

Venezuela

The economy is descending into a deep and profound crisis—reflected in severe shortages, hyperinflation, and a collapse in economic activity. It faces a widening financing gap, and has imposed highly distortive foreign exchange controls. Debt service far outstrips dwindling international reserves. Recent policy measures by the

[2] Richard Haass (2014) "The New Thirty Years' War"

government, including a rise in gasoline prices, fail to meaningfully address the imbalances. The Venezuelan government made a $2.3 billion debt payment on February 26. But the debt of state oil company Petroleos de Venezuela, S.A. (PDVSA) due this year is more worrisome. A default increasingly appears to be a question not of "if," but "when."

There is no doubt that the dramatic decline in oil prices has hit Venezuela hard. At $30 per barrel, oil exports will be around $26 billion this year, down about three-quarters from 2012. The net export revenue is inadequate to meet debt service this year of nearly $20 billion on $125 billion of debt. Altogether, market commenters have estimated a financing gap of around $30 billion. Meanwhile, reported reserves are only $15 billion, and there are serious questions as to whether all of those reserves (especially the gold) are freely useable. In sum, it will take extraordinary measures to make it through the year without a default. And if the government responds by further compressing imports, popular support for the government could collapse. Change could come quickly, not because of a debt payment due but rather because of domestic conditions.

Meanwhile, the economy likely declined by around 10 percent last year, and according to the IMF is expected to decline by an additional 8 percent this year. Inflation was officially 180 percent in 2015, though the actual number was probably closer to 250 percent, and accelerating rapidly this year. In response, the government has invoked emergency powers through mid-March, devalued the primary official exchange rate by 37 percent, and adjusted some domestic prices—but this has done little to address widening imbalances and shortages.

China has been the primary provider of financing to the government in recent years, and while there is low transparency to these deals, it is thought that net claims are on the order of $30 billion. Many of the contracts require payment in oil, but the decline in the price has dramatically increased the quantity that needs to be provided. Venezuela needs continuing relief from the required amount, but at the same time it is not in China's interest to be seen as providing loans under the guise of commerce that serve solely to extend the life of the current government. Even today, China's message needs to be that it will be a critical player in a rescue package, and to that end cannot be too closely associated with the current government or policies.

The current government of Venezuela is unlikely to seek help from international financial institutions. It will also refuse cooperation with Western governments. Indeed, the IMF is operating largely in the dark. The last IMF review of the economy was in 2004, and Venezuela ceased all cooperation with the Fund in 2007. But it is not too early to begin planning for a time when a future Venezuelan government is willing to take the hard measures that warrant strong and broad international support.

When conditions warrant, international policymakers should move fast rather than let the crisis fester. A bold adjustment program will need to include the following items

- A rapid move to unify the exchange rate regime
- Move domestic energy prices to the world levels
- A strengthened and better targeted social safety net system that protects those most in need from the dislocations caused by the adjustment effort
- A sustainable budget (including a broadening of the revenue base) and well-anchored monetary policy.
- A comprehensive program to recapitalize the banks.

Short-term bridge financing, perhaps linked to oil, may be needed once agreement is reached on a comprehensive adjustment program. Given the likely financing needs, any future IMF package will need to include at a minimum a debt reprofiling (an extension of maturities with limited net present value loss) to provide breathing space. Whether the IMF goes further, and demands a deep restructuring because the debt is unsustainable, is hard to know given the current uncertainties. However, extraordinarily high debt as a share

of exports suggests the need for restructuring, as would the ratio of debt to GDP (the Fund's preferred metric) if a unified exchange rate settles near the black market rate.

China will need to contribute, through transparency about its claims on the government and a willingness to provide relief through a negotiation that leaves other official and private creditors with a sense that there is fair burden sharing. That will be a change in how China has been operating in emerging markets, but would go a long way toward becoming a responsible part of the global rescue architecture. The IMF is uniquely placed to develop a bold program that contains these elements, and mobilize support to ensure adequate financing for the adjustment. U.S. government support will be essential to putting such a package together.

Conclusion: Policy Adjustments to Prevent Crises

While the experience of oil exporters vary significantly in terms of the scale of the imbalances, the assets that can be drawn on to deal with the shock, and the ability of policy to adjust, there are common elements. Policy adjustments need to be made, ideally ahead of a crisis. Failure to address these imbalances could translate into crises of much larger scale and spillover into the United States in unexpected fashions. Commenting on the 1994 Mexican peso crisis, Rudi Dornbusch stated that "the crisis takes a much longer time coming than you think, and then it happens much faster than you would have thought, and that's sort of exactly the Mexican story. It took forever and then it took a night." Where there is a willingness to take tough measures, there are important benefits to IMF-led international support in terms of policy advice, strong reform packages, and financial support where needed. Low energy prices are generating global risks, and U.S. policymakers need to be vigilant and ready to act. Thank you.