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Oil Price Impact on Trade Relations Within The West-East Corridor

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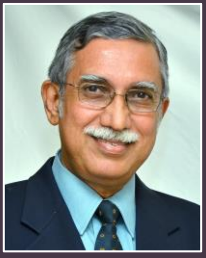

As a strategy consultant, Raj has helped companies across diverse industries in India, USA, Europe, and the Middle East to develop strategies, align strategy to vision, grow in competitive markets, restructure to make companies more customer focused etc.

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Oil Price Impact on Trade Relations Within The West-East Corridor

By **Mr. Raj Nair,** Chairman of Avalon Consulting

The good news is that the drop in oil prices is not going to make the fragile world keel over and sink. The bad news is that a large number of people, businesses and countries which are dependent on high prices of oil are going to get hurt. The real bad news is those who do not anticipate what is in store for them in the latter part of 2015 or may be in 2016, are likely to get caught with their pants down.

On balance, the oil price drop has been good for the world, especially the Super region (Asia minus Japan and the ME) which is becoming the centre of gravity of global commerce. Most countries in this region are oil deficit and therefore stand to gain. What is happening is disruptive but there are winners and losers.

Think of what is happening as an interesting story being told through two sequential movies, starring two different lead actors:

- For Whom The Bell Tolls: The oil price drop, starring Saudi Arabia
- The Dragon Awakens: Other commodities' price drop, starring China

The East West trade will grow in 2015 but it could look somewhat different from you think by 2016 or 2017. Wealth as well as financial flows could get rearranged. Hence you should be watching both movies carefully whether you are a manufacturer, a trader or banker.

The first movie is about oil price drop

I have been telling some of our clients to get prepared for an oil price drop since July 2014 when it became clear that the oil price would start dropping. Many people are not aware that Saudi Arabia, the biggest mover and shaker in the OPEC, had in late 2013 decided that their 2014 budget would be based on the assumption that the average price of oil in 2014 would be $75. If the starting price point was above $100 and the average for the year is 75, it takes no mathematical genius to guess where it would be at the year end. I will not get into details now but I am happy to field questions later. The reason is simple. Shale oil and gas was getting dangerously cheaper to extract due to advances in fracking technology, enough to threaten not just the economics of conventional oil trade but also the political future of OPEC nations. Dropping the price of oil to kill shale oil development had become an imperative. It is a tried and tested old strategy that worked well in the past to slow down the progress of non-conventional energy technologies. This move got a boost because it was a convenient political tool for the US to beat Russia and Iran into submission. Collateral damage would get inflicted on another adversary, Venezuela, and on many hapless oil producing nations. Even poor Egypt is unlikely to escape its impact.

Many commentators are saying that the fragile world economy will become even more fragile because of oil. That is hog wash. The world economy coasted along rather comfortably till 2005 when oil prices were below $50. When it started rising thereafter and even crossing the $100 mark, the oil importing world had to adjust with difficulty. Nearly 62% of the oil produced is traded; therefore the majority of the world suffered. Now it is the turn of those who enjoyed the fruits of high oil price to adjust to the new reality.

Europe may face some deflationary winds, some economies like Russia, Venezuela, Iran, Iraq, Angola, Oman, Bahrain, etc. will suffer badly in the near term because they cannot balance their country's budget at oil below $100. They will have to cut back on expenditure. The richer OPEC nations like Saudi Arabia, Qatar, Abu Dhabi, etc. have sufficient cash reserves to keep going till oil price rises again. You may be right to be concerned if you are an exporter to oil exporting nations.

There will also be a network effect on many parts of the huge East -West trade. For example, Indian exporters of guar gum are in trouble because shale oil producers are badly hit. Those supplying offshore supply vessels to oil exploration companies are seeing order cancellations. The entire tourism industry in Goa is in distress because the Russians are not coming after the rouble crashed because of oil.

The reality is that while Europe will struggle, the US economy in 2015 will provide the boost that the world needs. U.S. is expected to do well this year despite the strong dollar and weakness in partner nations like Canada, the EU, etc. Since the US may grow @ 3 to 3.4% this year, one can expect US imports to rise by 7.5 to 8% in 2015 because import intensity of its GDP is about 2.5 X. That is big. On the whole, we are looking at international trade growth of at least 6 %. Not bad given the gloomy forecasts.

Will low oil prices be short lived?

My view is that it will be challenging for oil to cross $ 80 per barrel because that price will give shale oil extractors a good return on total life cost basis which will lead to oil surplus again. Only a disruption of oil supplies or an OPEC decision to cut back on oil production will push oil price past $ 65-75 per barrel. As long as oil is priced in the region of $65-75 per barrel and not more, the global economy will, in fact, benefit significantly and global trade will grow.

Bears who walked in late for the show, are now crying out rather loud. They talk about gloom and doom, deflation in Europe and more serious concerns about the downward slide of China which sustained the global economy in the past decade. I think they got their script wrong. It is actually the start of the next movie and I will explain why, by using their data-points.

What are scare mongers saying about Oil and China and what is the reality?

China shaped the world trade in the past decade in no uncertain terms. Hence, it scares people when headlines scream about bad things that are happening to China. I will go into some detail about China so that you leave this room understanding why China is not the victim of oil but the key actor in the second movie, *The Dragon Awakens.*

Here are some of the Year-Over-Year data points for January 2015, which economists quote to prove that oil prices have hurt China.

- Imports plunged 19.9% year-over-year vs. economists' expectations of a 3.2% drop.
- Exports fell 3.3% vs. economists' expectations of 5.9% gain.
- Crude oil imports fell 41.8%
- Iron ore imports fell 50.3%
- Coal imports fell 61.8%
- Exports of rare earths down 49 percent from a year earlier

Sounds like disaster written all over world trade in 2015, right?

Now let us look at the same facts more deeply to understand how wrong these convenient conclusions are.

Crude oil import did fall 41.8% in Jan 2015

But

Crude oil imports were 6.59 million barrels per day (bpd) this January, only 0.6 per cent below the levels of January last year and it dropped nearly 8 per cent from December, a month that saw China importing a record 7.15 million bpd to create stockpiles to take advantage of the 50 per cent plunge in oil prices. Jan 2015 imports were still higher than the average for the whole of 2014 (6.17 bpd). Jan was not a bad month after all. Why the 41.8% drop? The import prices were much lower.

Iron ore imports fell 50.3%

But

The Jan 2015 iron ore imports were down 9.5 per cent from the Jan 2014, but higher than the average for 2014. Like crude oil, China stocked up on iron ore when the prices fell in the latter half of the year by 39%!

China's Copper import drops 24% YoY

But

It is the same story as in Iron ore and Oil. Import in Jan 2015 was still 8% higher than the whole year average for 2014 which was a strong year. The prices dropped.

Exports of rare earths down 49 percent from a year earlier

Some people say that China exported only 1457 tons of rare earths in January 2015, down 49 percent from a year earlier- a sure sign of bad times to come. Why is that it is a problem? Almost all modern devices used in the consumer and business world like smart phones, tablets, laptops, etc. need rare earths and China has a near monopoly with 87% of the global supply. Therefore, since the demand for Rare Earths has dropped, it could mean that there is trouble in the digital devices market, and that means there is a recession around the corner. Wrong.

Somewhere around 2009 or 2010 or so, China fixed export quotas and raised prices. In the 2011-13 period it raised export tariffs further to the extent that importers started feeling the pinch. They started to recycle some stuff and searched for cheaper substitutes. That combined with illegal mining in China, created a surplus which dropped prices. In the year 2014 the demand rose cautiously. January 2015 was when China removed export quotas which reduced the pressure on importers to speculatively buy and it was a month of transition. Soon rare earth exports will start rising. I would conclude that the devices market is safe and sound, and that the global economy is very well, thank you.

Coal imports fell 61.8%

China is in the process of going in for clean energy, implementing new air quality laws, etc. Hence the demand for coal will drop. Since China is endowed with a lot of domestic coal, imports will drop drastically. That is no reflection on the economy or trade.

Exports fell in Jan 2015

The dollar value of overall exports from China has dropped because the prices of manufactured goods have fallen in line with drop in raw material prices.

Conclusion

Therefore all these data points are correct but not because China is a victim of global forces. It is enacting a new script. They are building strategic reserves of key raw materials and commodities because they want to wrest control of relevant supply chains from vendor countries so that they can manage unhindered domestic and international growth. See what happened to the Indian cotton yarn industry. The Chinese stocked up heavily for a few years and then cut back on purchases. Prices of cotton yarn collapsed and the Indian exporters are tottering instead of dictating terms. That is now happening to metals and other commodities. China is a big boy now. They are setting the terms for East West trade. The overall volume of global trade will not fall, but as the year progresses, the essential features of the new game will get clear. Global trade in 2016 will look different from that in 2014 and everyone will need to make necessary strategic changes to deal with that difference.

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