Global

The rise in the price of oil: short term relief, longer term concern?

- **On January 20 this year, Brent oil reached a low of USD 27.88 a barrel (EUR 25.52). Recently it crossed the USD 50 barrier.**
- **The strong rise has reduced the financial stress faced by oil producers. This has been welcomed by equity and corporate bond markets.**
- **In the longer term the observed increase could become a source of concern. It could weigh on consumer spending growth and create ambiguity with respect to central bank policy. In addition, current prices are still well below the budget break-even prices in the producing countries.**

The price of oil has been grabbing headlines this year, initially because of the ongoing decline, subsequently in view of its spectacular recovery (chart 1).

Oil price decline triggered concern

The big drop in the price of oil in 2015 and at the start of this year eventually became a major source of concern for the world economy. Admittedly, lower oil prices give a boost to growth in oil importing countries but the producers suffer, be it at the country level (think of the Gulf region) or at the sector level (e g shale oil producers in the US). Financial stress at the producer level triggers cutbacks in investments and infrastructure projects, an increase in budget deficits as well as a general increase in uncertainty. In addition, given the lacklustre growth of the world economy, declining oil prices ended up being interpreted by some as partly reflecting a shortfall in demand and not only a manifestation of abundant supply, The IMF in its April 2016 World Economic Outlook has estimated that the decline in oil prices in 2015 reflected excess supply whereas the decline of futures prices for the coming years were also partly explained by expected global demand weakness. Liberty Street Economics, the blog of the Federal Reserve of New York, on the other hand argues that the decline since mid-2015 is due to a mix of weak demand and increased supply [1]. To the extent that demand weakness was perceived by market participants as playing a role, the decline of oil prices was even more concerning because it meant that there was a more general weakness in the global economy. This would help to explain that the reaction of the oil importing countries to cheap oil, in particular in terms of household consumption, was weaker than expected [2] according to the IMF.

Price of oil

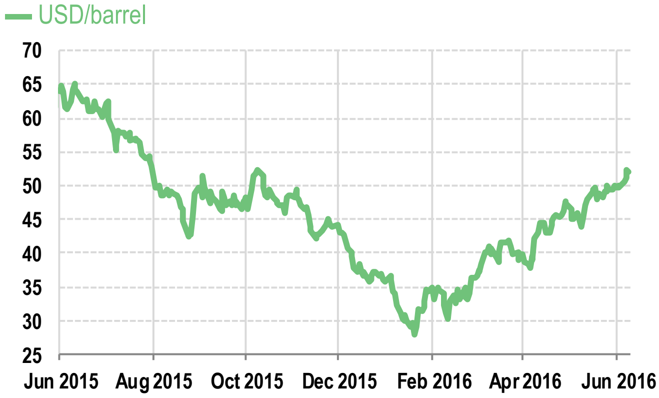

Chart 1 Source: Thomson Reuters

Yield of high yield bonds in the energy sector

Chart 2 Source: Merrill Lynch

Oil price recovery brought relief

Liberty Street Economics [3] is of the view that since early 2016, the "reassessment of global demand expectations has been a slightly more prominent driver of oil price movements than perceived supply conditions". However, supply disruptions in several countries also must have played a role in the oil price rally. Whatever the relative importance, the impact on financial markets has been significant. After a huge increase in the yield of high yield bond issuers of the US energy sector when oil was going down, reflecting an increase in the riskiness of these issuers, the recovery in oil saw as expected a movement in the opposite direction (chart 2).

This was also reflected in the share prices of oil companies which strongly outperformed the market as a whole (chart 3).

[1] Lower oil prices and US economic activity, Liberty Street Economics, 2 May 2016
[2] IMF World Economic Outlook, April 2016
[3] Oil price dynamics report, Liberty Street Economics, 6 June 2016

These strong reactions reflect the sensitivity of company financials to oil prices when the decline of oil had brought them close to or below break-even: any uptick in prices has a disproportionate impact on earnings growth. Moreover swings in investor risk appetite also play a role. Indeed, higher bond and share prices reflect not only renewed interest in the energy sector, but also a more general reassessment of the economic prospects of the oil producing countries and energy companies: the rise in oil prices reduces the probability of tail risk events, which could have had contagion effects on other countries or sectors. The implication is that the correlation between oil and equity prices, which had been positive when oil was declining, has remained positive during the oil price recovery (chart 4).

Concerns to make a comeback?

Considering the substantial rebound from the low point in January, one wonders when the sentiment about its consequences will change. Chart 4 is a reminder that the oil-equity correlation isn't always positive. When prices are sufficiently high (USD75 or more), the correlation becomes random: it is nearly as often positive as negative. Clearly, in the current environment, this price seems unrealistic, if for no other reason than that it would trigger a significant increase in oil supply from fracking in the United States, which would likely cap the upturn in oil prices. Even so, the dynamics of the correlation reminds us that any future increases in oil would give rise to less favourable alternative analyses.

One factor is that oil exporting countries are still faced with huge challenges. Table 1 presents our estimates of the price of oil allowing to balance the state budget ('break-even price'). In many countries, the break-even price is well above current prices. Although demanding a balanced budget may be too much of a stretch, because after all a stable debt/GDP ratio would be sufficient, the table is a reminder that in many countries the recent concerns about public finances have not gone away, despite the increase in oil prices.

A second factor is the impact on inflation and central bank policy. Janet Yellen mentioned in a recent speech[4] that compared to the labour market objective less progress has been made toward the FOMC's inflation objective, adding however that she remains optimistic because the effective exchange rate of the dollar has now stabilised, i.e. is no longer appreciating and because oil prices have stopped declining. This would seem to indicate that Fed policy looks at headline inflation as well and hence is influenced by the evolution of oil prices. The question of whether the central bank looks at core or headline inflation is very much relevant for the Eurozone as well, where we estimate that for each USD10 increase in oil prices, headline inflation increases by about 0.4 percentage points. In ECB research and statements this matter has been discussed under the heading 'second round effects', i.e. to what extent could the decline in oil prices until January 2016 influence the evolution of wages? In case of second round effects this would imply that declining oil prices cause slower wage growth and trigger self-reinforcing disinflationary dynamics. When oil prices are rising, as has been the case since the end of January, the opposite would occur. On several occasions in the recent past Mario Draghi has addressed this point. In January

Stock index

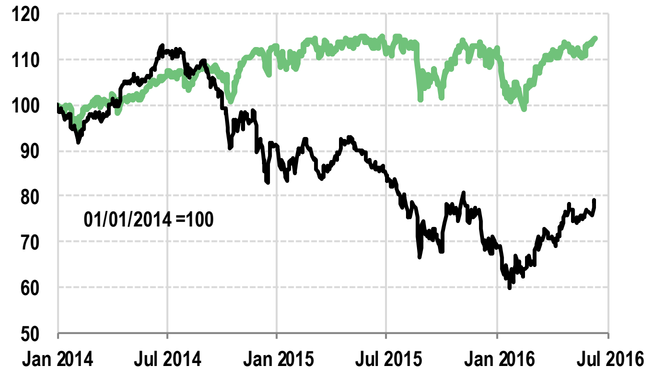

Chart 3 Source: Thomson Reuters

Daily S&P500 Returns, Oil (Brent,$/bbl), rolling 60-Day

Since 01/01/2014, 606 observations

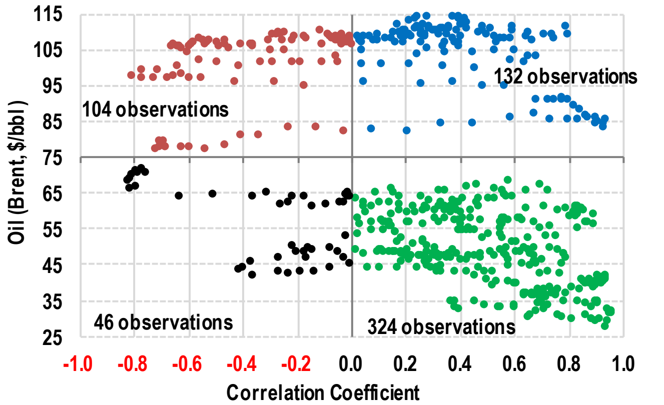

Chart 4 Sources: Bloomberg, BNP Paribas

Break-even prices of oil in Brent terms in USD for budget balance in 2016

Bahrain	107
Algeria	96
Nigeria	93
Oman	78
UAE	73
Saudi Arabia	72
Angola	70
Russia	58
Kuwait	55
Qatar	52

Table 1 Source: BNP Paribas estimate

[4] Janet Yellen, Current conditions and the outlook for the US economy, 6 June 2016

2016 he said "We look at second-round effects, namely whether low oil prices and low commodity prices do feed into other prices, and then that could generate exactly what we want to avoid, namely a spiralling downward phenomenon"[5] and later in February "While the most recent wave of disinflation is mainly due to the renewed sharp fall in oil prices, weaker than anticipated growth in wages together with declining inflation expectations call for careful analysis of the channels by which surprises to realised inflation may influence future price and wage-setting in our economy"[6]. Research conducted by the ECB in 2010 showed that the indirect and second round effects of a 10% oil price increase was estimated to range from 0.20% to 0.29%, adding that these effects had declined since the mid-1980s due to structural changes including changes in wage and price-setting behaviour[7].

Inflation expectations could also influence how the ECB deals with the rise in oil prices in setting its monetary policy. Looking at market-based inflation expectations, chart 5 shows that the 5 year 5 year forward inflation swap is sometimes driven by Brent oil and sometimes by the exchange rate. After an increase early May, inflation expectations stabilised despite an increase in oil prices because the euro was appreciating against the dollar. Difficult to draw clear conclusions under these circumstances.

All this implies that for the coming months, ECB statements on second round effects will be particularly important because a market perception that it might be tempted not to consider further measures because of headline inflation evolution might trigger a rise in the euro. All in all we think however that with core inflation still way below the ECB inflation target and considering that it remains to be seen whether the rise in oil prices is temporary or permanent, the ECB will keep its current monetary policy stance and guidance.

A third factor concerns the impact on growth. Given recent oil price trends, a net increase in headline inflation seems inevitable. Chart 6 shows our forecasts for core and headline inflation based on an assumption of an initially weaker oil price (USD45), subsequently moving back up to USD50 by the end of this year and USD55 by the end of 2017. In this scenario, HICP inflation in December 2017 would reach 1.5%. In a stress scenario with oil moving linearly to USD70 by the end of next year, HICP inflation in December 2017 would be 2.1%.

Even with the ongoing improvements in the labour market, wage increases should fall short of headline inflation, implying slower growth in real wages and hence slower growth of consumer spending. In addition to this headwind, we must also add the impact of the price increase on oil imports (increase in value) and consequently on the trade balance as well as on the profitability of companies which are big users of oil. All this should lead to somewhat slower growth in the Euro area in 2017 compared to this year.

Inflation expectations

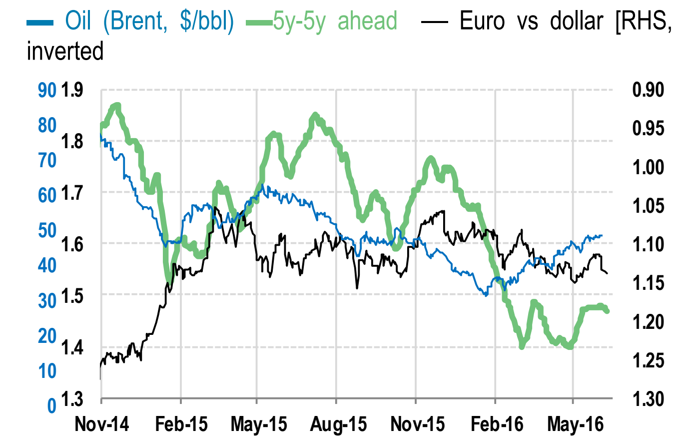

Chart 5 Sources: Bloomberg, BNP Paribas

Inflation

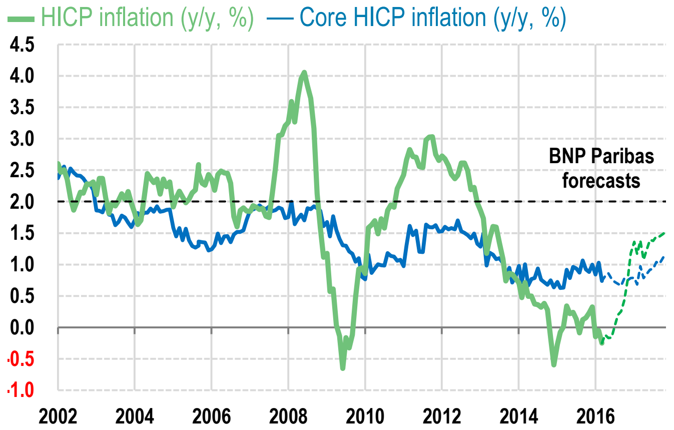

Chart 6 Source: Macrobond, BNP Paribas

[5] Introductory statement to the press conference, 21 January 2016
[6] Introductory statement to the European Parliament, 1 February 2016
[7] Oil prices – their determinants and impact on Euro area inflation and the macroeconomy, ECB Monthly bulletin, August 2010