INSS Insight No. 1276, March 18, 2020

The Economic-Political Struggle behind the Energy Market Crash

Daniel Rakov, Yoel Guzansky, and Tomer Fadlon

Russia's decision to break its alliance with OPEC was motivated by the desire to change the dynamics of the energy market – in which the cartel provided a "safety net" for American production while Russian corporations were a target of sanctions from Washington – and to demonstrate its ability to influence the global and the Middle East economy. Yet notwithstanding the heated rhetoric and price competition, it appears that both Russia and Saudi Arabia have an interest in resuming cooperation in the framework of an "updated cartel" within the next few weeks or months. Relevant factors are uncertainties due to the coronavirus crisis, fundamental problems in the economies of both countries, and internal political sensitivity in both countries. At the same time, the loss of trust between the two capitals, the tactics of other key actors, and the volatility in the markets are liable to lead to low energy prices in the long term, which will contribute to a recession in the global economy and in many Middle East countries. A crisis in the energy market will have a dual impact on Israel: reduced energy costs to industry and to consumers; and potential changes in the regional balance of power, which will constrain Israel's political and military room to maneuver.

The price of a barrel of Brent crude oil plummeted on March 9, 2020 by more than 26 percent, which brought the price drop to a total of 50 percent since the beginning of the year. This nosedive, the sharpest since 1991, coupled with the impact of the spread of the coronavirus, caused the steepest plunges in stock markets worldwide since the global economic crisis in 2008. It prompted a downturn in the share prices of the giant energy companies by dozens of percentage points, and brought high volatility in the markets since then.

The drop in the markets was a reaction to the recent breakup of the OPEC+ cartel (comprising OPEC countries, Russia, and nine other oil producers). The energy ministers of the expanded cartel convened on March 5 in Vienna to discuss an additional cut in production in order to stop the downturn in oil prices since the beginning of the year, which was caused by the drop in demand as a result of the coronavirus. They were caught off guard by Russia's adamant refusal to take part and cut in its own oil output. Following the breakup of the cartel, price competition arose between Russia and Saudi Arabia, supported by other OPEC members.

In 2014, Saudi Arabia, the unofficial leader of the OPEC cartel, had already increased output, and the price of oil plummeted (from more than $100 per barrel to less than $30). Riyadh's aim was to push American companies out of the market, which had invested in expensive shale oil technology, and to weaken Iran. Since 2016, OPEC+ – a platform for cooperation led by Russia and Saudi Arabia comprising 24 oil producers – drove the price up $50-70 per barrel, generating tens of billions of dollars in profits to both countries.

Why did Russia obstruct its continued alliance with OPEC? Official Russian spokespeople and commentators presented a variety of plausible explanations:

a. The desire to change the dynamics in the global oil market: The Russians explained that they would have continued their alliance with the cartel, but the Saudi insistence that the Russian companies participate in slashing output was unacceptable. In their view, the cooperation with OPEC generated short term achievements, but from a long range perspective adversely affected Russia's standing in the energy market. The cuts in production and the hikes in oil prices caused the American producers, to increase their share of the market and to benefit from the OPEC+ safety net. The United States not only benefited from the cartel's price stabilization, but also persisted in its unfair competition by imposing sanctions on Russian producers. Russian spokesmen have stressed repeatedly that Russia's macro-economic robustness will enable it to cope for several years with the current price level (around $30 per barrel) thanks to its large cash reserves, even if it will have to incur a budget deficit (at a price of less than $42 per barrel).
b. To exploit the uncertainties in the global environment during the coronavirus crisis in order to crush the American shale oil industry: Due to the high production costs, the American oil industry needs a price level of $50 per barrel in order to continue production. The Russians have exploited the low demands in order to undermine the American goal to achieve energy independence. This course of action derived, inter alia, from Russia's desire to retaliate for recent American sanctions undermining Nord Stream 2, Russia's leading gas pipeline project.
c. To demonstrate Russia's importance in the global economy: The tactic is designed as a power ploy to present Russia's ability to damage the global economy and oil exporters, and to strive shortly thereafter to reach a compromise and a new status quo under improved conditions for Russia. Other motives are to refute claims that Russia is incapable of designing economic processes at a global level, to prove its centrality in the Middle East, to extract more significant waivers from OPEC partners (more lenient production cut requirements from Russia or promises to

invest in the Russian economy), and perhaps even to form a wider cartel than OPEC+.

d. To divert public attention from Russian President Vladimir Putin's move, which he revealed explicitly on March 10, to change the constitution to enable him to hold the reins of government until 2036. At the same time, Russian economy experts believe that low oil prices over time will thwart any chances of realizing civilian welfare improvement programs designed to make it easier for the public to accept the new constitution.

In response to the Russian course of action, Saudi Arabia announced its intention to increase the pace of production in April 2020 to 12.3 million barrels of oil per day (about 30 percent higher than in January) and to lower prices by $6-8 per barrel to its principal customers. Its reasons:

a. Saudi Arabia is attempting to prevent Russian dominance in the cartel and to demonstrate to Moscow the Saudi power and positioning in the oil market and its ability to "pain" Russia's economy – in an effort to force Russia back to the bargaining table.
b. In Riyadh, the assessment is that the Saudi economy can cope with this drop in prices due to its large foreign currency reserves totaling about $500 billion, and because it enjoys the lowest oil production cost in the world – $2.8 per barrel. However, this is a gamble, and Riyadh needs to restore the confidence of foreign investment. Riyadh needs a price of about $80 per barrel to balance its budget, and, at the current price level, it will need to utilize a chunk of its currency reserves or sell bonds: if it does not do so, the deficit in 2020 will climb to about 15 percent of the GDP.
c. The Saudi decision can be attributed to the nature and management style of Crown Prince Mohammed bin Salman, but it could be that there is long range strategy underlying the Saudi recklessness and risk-taking, centering on the desire to weaken American oil producers.
d. The timing of the Saudi decision – immediately following a wave of arrests of numerous princes and key military officers from the ranks of the opposition to Crown Prince bin Salman – was chosen apparently to prevent criticism of bin Salman's decision on the part of those arrested.
e. Eighty percent of Saudi revenues are generated from oil, and the most significant implications for the Saudi economy concern impediments to its ability to implement essential economic reforms within the framework of the 2030 Vision program.

Following the OPEC+ breakup, the Goldman Sachs investment bank assessed that the oil prices might plummet to $20-25 per barrel. Russia's declarations regarding its ability to endure for years in a low oil price environment given its large foreign currency reserves may constrain its ability to develop the Russian economy, including energy projects, and adversely affect social projects. This is also true with regard to Moscow's threats to increase oil output to compensate for the price drop: the Russian capacity to increase oil output is very limited compared to Gulf members of OPEC that can afford to absorb the decrease in oil revenues.

Reducing the competition by severely harming the American shale oil industry is also a challenging objective – American technological improvements reduce their production costs and the sector is too important for the United States to allow it to collapse. Even if companies do go bankrupt, this will only serve to improve the competitiveness of the American energy giants.

The future scenarios in the global markets depend on a combination of the repercussions of the coronavirus crisis and the ability of oil producers to reach agreement between them. If the corona crisis continues for many months, oil strategists at Goldman Sachs assess that low demand in an environment of surplus supply will cause oil prices to remain low. If the coronavirus crisis is overcome in the coming months and the demands for oil revert to their previous levels, prices might stabilize around the price needed to balance the budget in Russia ($42 a barrel). Therefore, the range of scenarios fall between the following:

a. Within the coming weeks or months, Russia and Saudi Arabia will reach a new arrangement that will rehabilitate OPEC+ – perhaps in a different and expanded format – and will try to drive the prices up. This could mitigate the complex negative repercussions of the current crisis on these two countries and on the global economy. Recent statements from both countries signal that they are leaving the door open for the dialogue. The realization of this scenario is liable to strengthen Russia's huge sway over oil producers and strengthen the perception that the American position in the Middle East is weakening.
b. On the other hand, the dynamics of the price war and the erosion of confidence might cause the parties to miscalculate and cause continued instability in the energy sector, which will deepen the trends that are pushing the global economy into a period of recession.

The crisis in the energy market has a dual impact on Israel. First, it is a key shaper of Israel's macro-economic environment. A low oil price environment is very good for manufacturers, which will benefit from lower costs, and is very good for consumers, who will benefit from lower prices.

However, the crisis is also liable to affect the balance of power in the region. Israel's political and military room to maneuver might be negatively affected – if the Russian regional posture becomes stronger, if the American economy and the United States position in the region are weakened, or if the economies of Gulf states, Israel's main partners in the campaign against Iran, are seriously damaged.