Falling Oil Prices and its Implications

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Outline

2

- Introduction
- Importance of Crude Oil
- How and What It Impacts
- Price Trend
- Production and Export Trends
- Implications of Falling Prices
- What Should Be Done
- End Note

Introduction

3

- Earnings from crude oil have played a *crucial role* in the Nigerian economy ever since the Yom Kippur war of 1973 that triggered a massive increase in the international market prices of hydrocarbons.
- The sudden *oil wealth* changed the *structure* of foreign earnings and public expenditure, and even the *lifestyle* of Nigerians.
  - Pay for public servants was increased astronomically and the private sector followed suit in order to remain competitive.
- The largess created an erroneous impression of an *endless flow* that does not warrant conservation, and changed the national values that have been difficult till date to reverse.

Introduction (contd.)

4

- This failed to take into account the reality of the nature of crude oil, as a hydrocarbon that forms over millions of years and therefore, it is *non-renewable*.
- There is even the more worrisome dimension which the government and other stakeholders don't even talk about - extracting crude oil and other solid minerals from beneath the surface and piling the structures there-from on the top, without a thought for the *hollow space* being created below the ground!

Introduction (contd.)

5

- Historically then, Nigeria had being quite *generous in spending* during periods of oil revenue boom and austere whenever oil prices slipped, especially close to or below the budget benchmark.
  - I'm sure that some in this audience will remember the 'belt tightening' policy of the Obasanjo Military Administration of the late 1970s, the 'Stabilization Policy' of the Shagari Civilian Administration in the early 1980's, and subsequent others during the Babangida era and initial years of the Obasanjo Civilian Administration in the late 1990's.
- This attitude is commonly referred to as the '*Dutch Disease*' of depending almost exclusively on a non-renewable natural resource and tailoring governments' fiscal operations as well as economic management accordingly!

Introduction (contd.)

6

- The price of crude oil in the international market has been dampening in the last few weeks and started a *panic* in Nigeria's fiscal operations, which for 2014 was premised on US$77/barrel (bbl).
- This has also caused an agitation for a rethink of the Medium-Term Expenditure Framework (*MTEF*) that is based on oil price and production assumptions that appear unrealistic.
- The scope of supply from *non-OPEC producers* is widening at a time of *intra-OPEC* selfish pursuits.

Introduction (contd.)

7

- All of these became more worrisome because of the *causes* of the downward trend in crude price:
  - Aggressive push of *alternatives* to crude oil - mainly shale oil.
  - *Fragile recovery* in most economies that were affected by the global financial crisis of 2008-2009. on this, the International Monetary Fund (IMF) admitted its unfortunate mistake of advising countries to embark on austerity measures at a time that fiscal stimulus should have continued.
  - The aggressive push of *Saudi Arabia* for market share by lowering the sale price of its crude to USA while raising it for other buyers.
  - Lower projection for crude demand in the medium to long-term (2035).
  - Locally in Nigeria, the systematic *divestment* of International Oil Companies (IOCs) from prospecting and production, limiting the prospects for increase in proven reserves and production.
  - As well, production remains under threat in the Niger Delta region at a time many other African countries have discovered oil in commercial quantities and they are offering better business environment to the IOCs.

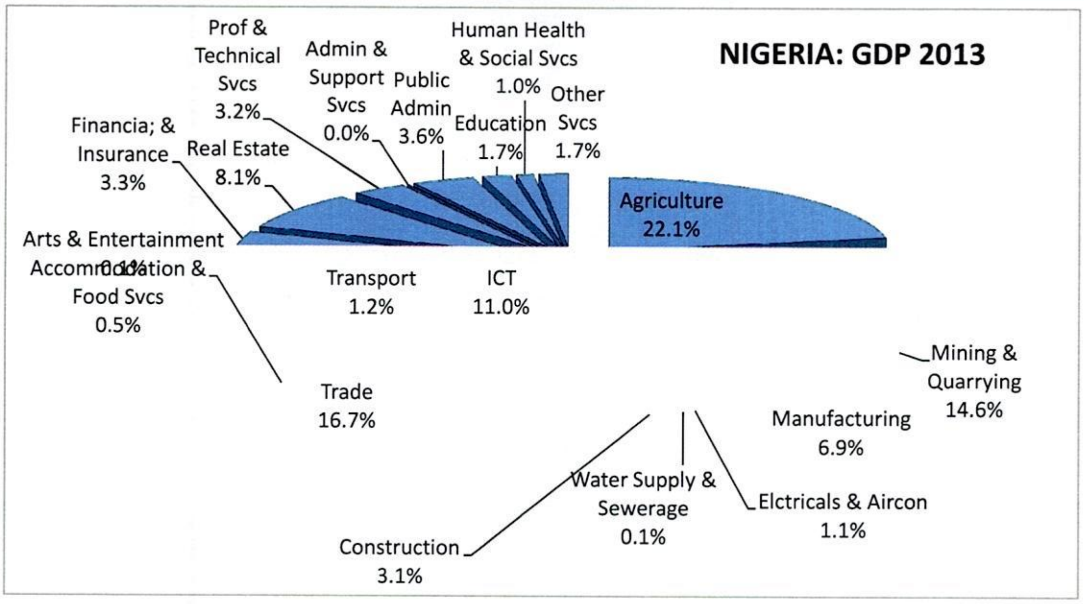
Importance of Crude Oil

8

- The importance of crude oil to the Nigerian economy can be placed in the following *perspectives*:
  - Contribution to GDP, foreign earnings, government revenue (Federal, State and Local), supply of foreign currencies to the FX markets, etc.
- Petroleum oil and natural gas accounted for 14.4% of Nigeria's GDP in 2013 (new series), which suggests value added of about *$73.44 billion*.
- This relative contribution was a drop from between 17% and 18% in the old series, which suggests a *more diversified* national economy and growing importance of the non-oil sector.

Importance of Crude Oil (contd.)

9



Importance of Crude Oil (contd.)

10

- Petroleum oil and gas is the dominant export product and source of *foreign earnings* to Nigeria.
- It accounted for **97.28%** of the total value of *exports* during 2000 to 2013, and **77.8%** of *foreign earnings* over the ten-year period from 2001 to 2010.
- During 2001 to June 2014, its relative share of *government revenue* was **74.4%**.
- This immediately creates a problem of *mismatch*.
  - High revenue profile, of which non-oil is practically unable to match recurrent expenditure.
  - Oil revenue will therefore, finance consumption rather than solely for infrastructure and investment!

Importance of Crude Oil (contd.)

Petroleum oil and gas funds the economy!

How and What It Impacts

- Vagaries of the petroleum oil and gas market/industry affect government's *fiscal operations*.
- Government as the *prime mover* of every economy, either by way of investment in key socio-economic infrastructure or provision of enabling environment for private business and commerce, shape the *business climate*.
  - The global financial crisis of 2008-2009 is a modern-day proof of the critical role of fiscal stimulus (Keynesian approach to economic management) whenever the market system fails to allocate resources efficiently.

How and What It Impacts (contd.)

13

- In Nigeria, the exchange rate management system brings most foreign earnings into the *central bank*, and thus makes the apex bank the cheapest source of foreign exchange ('Forex').
- The blocked portion of *external reserves* (about 2.67%), leaves only the liquid portion available for sale -- $38 billion.
- If the central bank today will choose to *defend the Naira*, it has pocket deep enough only to sustain imports of monthly average of $4.2 billion for only 9 months!

How and What It Impacts (contd.)

14

- The preceding developments have affected adversely *investor confidence*, as already noticeable in the stock market where many foreign investors (especially fund and portfolio managers) have divested heavily and caused the market aggregates to dampen - the ASI from *42,609.75 points* on 2nd July 2014 to **33,967.48 points** on 12th November 2014, while market capitalization (equities only) fell from about *N14.07 trillion* down to **N11.25 trillion.**
  - A custodian recorded outflow of about N6 billion in a matter of 24 hours!

How and What It Impacts (contd.)

15

- The response of the CBN so far is to return to *demand management* by restricting access to forex through outright exclusion of certain transactions from the official market as well as limits to how much can be taken out per day -- $2,000.
- This is more or less pushing Nigeria to the experience of the second half of 2008, when oil price slip coincided with waned investor confidence. The Naira had to be devalued by the central bank by about 20%.
  - Such correction is inevitable for the Naira, as the exchange rate premium now hovers around 10.82%, which is more than double the recommended benchmark maximum 5%.

How and What It Impacts (contd.)

16

Dampened oil earnings vitiates the capacity of the central bank to defend the Naira, and makes devaluation inevitable.

Price Trend

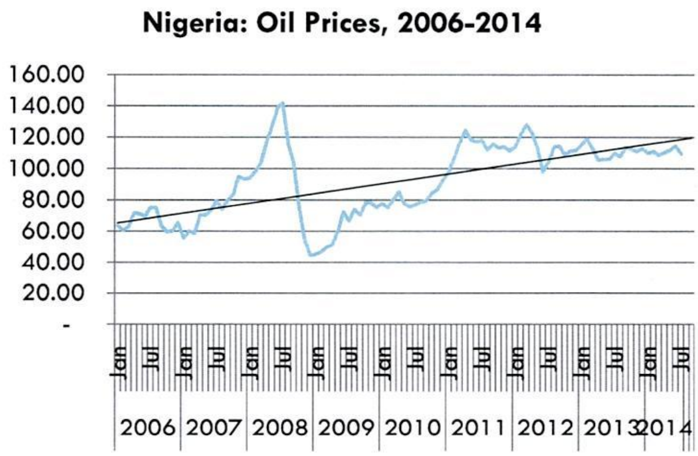
17

- The *historical* oil price trend is upward sloping, as shown in the data/chart in slide 18 -- the black trend line in the chart.
- The *trajectory* however, portends a different outcome in the light of projected weak demand to 2035, strengthening non-OPEC producers and desperate moves by OPEC members.
- In recent history, Nigeria had experienced crude oil price dampening and responded appropriately by adopting fiscal prudence on the one hand, and dipping into reserves to fund the deficit occasioned.
  - Fiscal discipline was necessitated in 1999 to 2001, while historical peak of about $64 billion in external reserves came in handy in 2008.

Price Trend (contd.)

18

Year	Price ($/bbl)
2006	66.51
2007	74.48
2008	101.14
2009	63.90
2010	80.92
2011	113.78
2012	113.47
2013	110.99
2014_1/	110.91
Average	92.90



- Source: Central Bank of Nigeria Note: _1/ Up to July 2014.

Price Trend (contd.)

19

There is high risk of further price dampening.

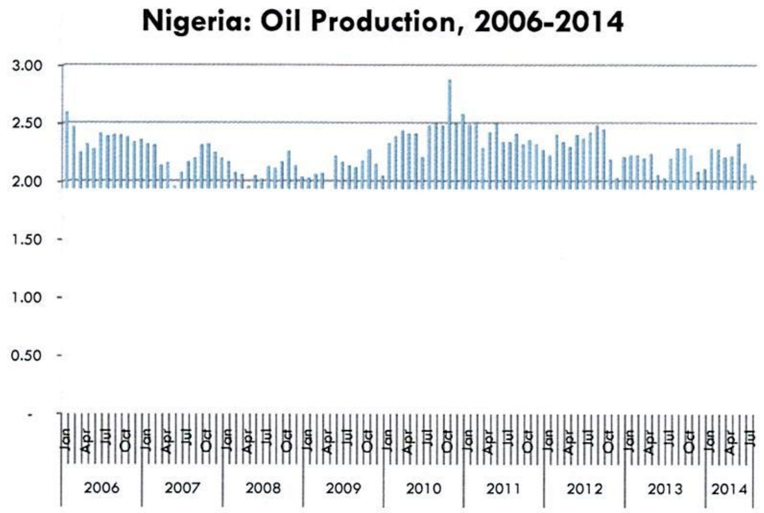
Production and Export Trend

20

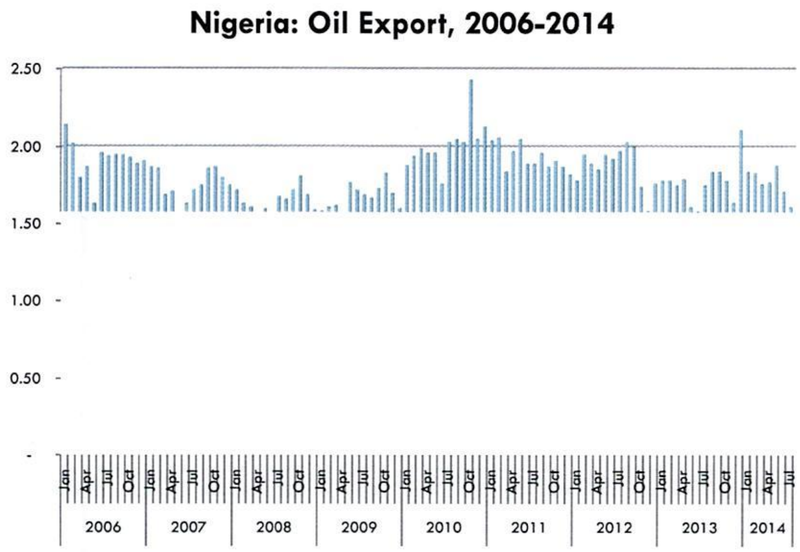
- The *production* and *export* figures for the same period of 2006 to July 2014 averaged **2.26** million barrels per day (mbd) and **1.82 mbd** respectively.
- The government's *projection* that production will rise to *2.4 mbd* and further to 2.8 mbd is obviously at variance with current reality - alternatives in shale oil and increasing production in African countries that offer more conducive business environment.

Year	Production	Export
2006	2.38	1.92
2007	2.20	1.75
2008	2.10	1.65
2009	2.11	1.66
2010	2.47	2.02
2011	2.38	1.93
2012	2.32	1.87
2013	2.18	1.77
2014	2.22	1.77
Average	2.26	1.82

Production and Export Trend (contd.)



Production and Export Trend (contd.)



Production and Export Trend (contd.)

23

The key to stable and growing petroleum oil earnings is <u>robust production</u> that grows and can boost export!

Implications of Falling Prices

24

- Decrease in ***foreign earnings*** and ***government revenue***.
  - This has been manifest since the 2nd quarter of 2014.
- Depletion of buffer purse – ***Excess Crude Account*** (ECA).
  - The ECA had depleted to $2 billion upon persistent pressures for sharing it when the opportunity for accretion existed. As at 27th October 2014, it was $4.1 billion.
- Depleting ***external reserves***, now at $37.7 billion as at 11th November 2014.
  - The CBN Governor's target of growing it to $50 billion in the medium term remains a mirage (as I had stated when he announced this as one of his cardinal objectives), because he has no exclusive control over external reserves.
  - A conspiracy of factors, as we at present are witnessing, can throw it to less than $30 billion in a matter of one to two weeks!

Implications of Falling Prices (contd.)

- Pressure on the ***Naira exchange value***, which officially now stands at N155.85/$, which is a slight adjustment from a sustained rate of N155.73 for some time.
  - This implies premium of *11.65%* -- more than double the benchmark maximum of 5% that will preclude round tripping.
- Dampened ***investor confidence***, which usually results in profit taking on the stock market and dip in market indices.
  - For a market whose recovery is still fragile, there is a high possibility of reversals of the gains that were laboriously made in the last four years.
- These all together have ***inflationary implications*** also.

Implications of Falling Prices (contd.)

The current falling oil prices is not like any of the ones experienced in the past. Nigeria cannot 'wade through it' as posited by the Minister of Trade and Investment!

What Should Be Done

- Rein in ***expenditure*** - get serious about dealing with bloated recurrent expenditure and truly plug the loopholes in fiscal operations.

- Get the ***Petroleum Industry Bill*** (PIB) quickly through legislative processing and sign it into law. Robust production as focus is more enduring than price.

End Note

- Do the *obvious*!

- *Match* non-oil revenue to recurrent expenditure over a well-defined period of time.

- At the end of the day, it is *the economy* that matters!

Thank you

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God bless