Price of crude hits sticky patch

Zafri Zulkeffeli, Research Officer of MIER[1]

Malaysia's exports of petroleum products show sign of pickup recording exports value of RM 5.8 billion in August this year compared to January, RM 4.8 billion. In fact, second quarter performs much better than the first. In line with the movement of world oil price, exports of petroleum products rise in accordance to the price direction.

The average price of oil globally was at USD 35 per barrel in the first quarter and USD 45 in the second quarter of 2016. Slight improved in global demand and slow oil production in Canada and United States are key factors sending oil price up in the second quarter this year.

On 28 September 2016, OPEC members had a meeting in Algeria. Oil ministers of each OPEC members joined the meeting and had agreed on capping oil production in between 32.5 to 33 million barrels per day for the whole OPEC. OPEC contributes roughly about 40 percent of world oil supply. In 2015, OPEC produce 39.2 million barrel per day while non-OPEC contribute almost 57 million barrel per day.

The decision was shocking to the whole world as initially the cartel's members had different interests on oil business especially Saudi Arabia and Iran. Saudi Arabia also seems pressured with the low oil prices and requires more cash to revive the Saudis economy. Oil prices rose by 6 percent right after the decision announced and currently the prices are lingering slightly above USD 50 per barrel.

However, capping the oil production is seen not significant. OPEC is a fragile cartel. Most of OPEC members depend highly on oil revenue as their main economic engine for generating domestic economic activity. Also these countries need more cash to finance their national expenditures and development projects in order to generate economic activity and moving towards less reliance on oil and gas industries.

---

[1] The article is a personal opinion of the writer and does not reflect the view of MIER

Moreover, non-OPEC members will benefit the most such as Russia and United States. Hence, every OPEC members has the tendency to cheat by producing more than the agreed production limit. By that, oil price may rise for very short term waiting pressure from glut of oil supply again to suppress the price down, unless demand-side picking up.

Higher oil price means more revenue to both OPEC and non-OPEC countries. It is like an overloading boat, where few loads including people have to be thrown out in order to keep the boat floating. Some oil producers have to sacrifice to maintain higher oil price. The question is, who is willing to sacrifice?

The price may touch USD 55 per barrel in the fourth quarter but will not last long. According to US Energy Administration, non-OPEC production is in increasing track since June which reflects active respond towards the slight rise of oil price. Therefore, the capped oil production by the OPEC countries will drive non-OPEC to produce more and in the end pressuring OPEC countries to push for higher production volume.

Again the capped production is for the whole OPEC. The latest meeting did not specify how much and limit for each member shall produce. By end of November this year, a small committee among OPEC members will be formed to discuss and find a consensus on a more detailed production limit by each member. It is almost like a mission-impossible for the committee to get all members to agree on each member's production limit.

The main challenge for oil price to rise steadily is weakening global demand. Pessimism global demand is still present partly due to the slowdown of China and emerging economies. Moreover, Brexit impact is starting to spread added with further European banking crisis and possible hike in Fed's rate may add uncertainties in the global market. Together, these factors impede global demand to strengthen.

In addition, geopolitical risks and conflicts in Middle East and Europe contribute towards greater uncertainties in global market. US presidential election is another downside risk factor to suppress global demand if Donald Trump, the protectionist champion wins. Although the ability of Trump to execute his policy is quite shaky but maybe enough to spark pessimistic sentiment around the world.

The prospect of demand side in oil market is dampening due to slow growth of global economy. On the other hand, gradual improvement in production efficiency in the shale gas producers in particular is sponsoring towards strengthening oil supply in the global market. Weak demand side and optimistic supply side are good recipe to suppress the world oil price to stay persistently at low level.

For Malaysia's perspective, OPEC's decision to limit production may not be impactful as oil prices expected to remain at low level. Confirmed by Malaysian Deputy Finance Minister, one dollar drop in oil price will cause RM 300 million lost in government revenue. Crude petroleum dropped by almost 40 percent in terms of exports value in 2015 and contribution share of petroleum products in exports market shrank to 8.8 percent last year from 12 percent in 2014.

Through the introduction of GST last year, the loss in oil-related revenue is partly compensated by revenue generated by GST. Oil-related government revenue shrank by half to 19.7 percent share in 2015 from 41.3 percent in 2009. GST contributed RM 27 billion in 2015 and it is expected to contribute RM 39 billion this year. Despite of Sales and Services Tax, SST charges at higher rate, GST is proven more efficient in generating higher government revenue.

It is time for Malaysia to diversify its economic activity and expand oil and gas downstream activities. Furthermore, the downstream activities shall engage with local SMEs in order to create higher multiplier and spillover effects in the economy. In the long term, Malaysia should set a special oil-revenue sovereign fund such as Norway's oil-sovereign fund. As the oil prices rebound in future, surplus in oil-related revenue shall be saved in the fund and designed as cushion to the economy when economic downturns occur.

Probably the shock in world oil price is a wakeup call to all oil producers and exporters to be less reliance on the industry and having diversified economic activities is more stable, sustainable and resilient. World oil price is less likely to return to USD 100 per barrel. This is due to improved efficiency of oil producers, in particular among the shale gas producers. Plus, substitution effects from oil to non-oil technology is gradually shifting demand side due to technological advancement. For example, the introduction of electric car is a sign of technological advancement that will affect oil and gas industry in the long run. World oil price has entered a new norm and it is time for the oil producers to readjust.

.