Oil Prices

by George Friedman - March 10, 2020

Since before World War I and throughout the 1970s, the people who controlled oil had a lever for controlling others. Since the 1980s, the equation has shifted; oil producers have become dependent on oil consumers. Demand was always there, and then it started to vary and the political stability of oil producers also varied.

Geopolitical Futures' forecast for 2020 was that there would be a global economic slowdown, whose effects would be intensified by dynamics kicked off by the 2008 crisis. We saw the 2008 crisis as being an exporters' crisis, in which countries dependent on exports, particularly China, had been badly hit by the decline of global demand for manufactured goods, and exporters of raw materials, particularly Russia and Saudi Arabia, were hurt by the decline of demand in manufacturing countries like China. Our view of 2020 was that a routine business cycle would resurrect those pressures.

We did not anticipate the coronavirus, nor the global panic, particularly the disruption of the Chinese economy. We predicted that the Chinese economy would be disrupted as a result of a decline in global demand, and this would be followed by a decline in oil prices. The result would be increased global political stress, particularly on oil producers. Energy accounts for 30 percent of Russia's gross domestic product and 60 percent of Russia's exports. It accounts for 50 percent of Saudi Arabia's GDP and 70 percent of its exports.

The political consequences of the global slowdown, according to our forecast, would be most intensely felt by countries most dependent on energy production. The second tier of countries that would be most affected were those most dependent on exports, led by China and Germany, which relies on exports for nearly 50 percent of its GDP. These countries would face internal political turbulence as the decline affected internal economic systems, and social systems as a whole.

European countries have seen contractions in their economies, or declines in growth. China was under heavy economic pressure before the U.S. imposition of tariffs, and was facing instability in Hong Kong and Xinjiang. Russian President Vladimir Putin had imposed a radical new model for Russian governance and was obviously sensitive to weakness in oil prices, which could not return to the high prices that had previously fueled the Russian economy. The United States is the strongest economy in the world, partly because among the major economies it is least dependent on exports, which account for about 13 percent of GDP, with nearly half going to Canada and Mexico. What is happening is in outline what we expected: China is staggering, triggering a decline in oil prices, and the U.S. is slowing but not going into crisis.

The question now is what the effects of the decline of oil prices will be on Saudi Arabia and, most important, Russia. The economic consequence has to be substantial. Russia has reserves, and it has claimed that the Russian system would continue to function well with oil as low as $40 per barrel. At the time of writing, the price is below that level, and reports of serious economic stringency, especially outside of Moscow and St. Petersburg, were rampant even before this crisis. More important, when the Russians speak of reserves, they are speaking of their national budget. That budget is a vital part of their economy but far from all of it. The budget may have some buffering, but the rest of the economy is highly vulnerable to the impact of low oil prices.

Russia is a major power, and as with the Soviet Union, which was difficult to read until it collapsed, economic instability in Russia is significant globally. Many have argued that the Soviet Union collapsed because of low oil prices and high defense spending. I think these were contributing factors but not decisive. We are seeing those forces at work now as well. This also explains why the Russians were not prepared to cut oil production when the Saudis demanded it. The Russians simply could not absorb the cost of stabilizing the price of oil. It is not clear that the Saudis can either, but their global significance, once massive, has declined greatly since the 1970s, and even Saudi Arabia’s regional power is limited. Whether the Saudis miscalculated, acted out of domestic pressures, or now expect the Russians to limit the damage on them by aligning with the Saudis is unknown, but the damage to the global economy is intense and has been inevitable for some time. It is the speed that is unique and damaging.

There have been analyses arguing that the Russians engineered the decline in prices to hurt U.S. shale producers. Given that it was not Russia but Saudi Arabia that engineered the decline (Russia was resisting the Saudi price cut), this would be Russia cutting off an American finger while cutting its own throat. The Russians are enormously more dependent on higher oil prices than the Americans are. Texas oil will be hurt, but that is a fairly small part of the American economy, and nowhere near the 30 percent of Russia’s economy.

The economic and political question surrounding the coronavirus is how long it will take to normalize its presence. The virus is new and frightening. It is likely not going to disappear. If it does not, it will be integrated into expectations around the world. As with other diseases, some people will get it and some will die. Shutting down the movement of people and goods and slashing economic output will likely produce net negative results greater than the coronavirus. Unless it appears that it has the characteristics of the Black Death, it will become part of the panoply of diseases like tuberculosis, Lyme disease or malaria that the world lives with. The arrival of treatments and vaccines will of course speed this up.

The question then is what the economic damage will be, and therefore what the political damage will be. China is the fulcrum of the issue, and its problems go beyond the coronavirus. It is also the largest importer of oil in the world. As its economy weakens, oil prices will decline. And with the decline of oil prices, oil exporters will face serious economic problems, and political tension as their economies weaken. The coronavirus did not cause this. It did, however, intensify the time frame dramatically.

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