



Daily Note

OIL PRICE WAR: WHO WILL BLINK?

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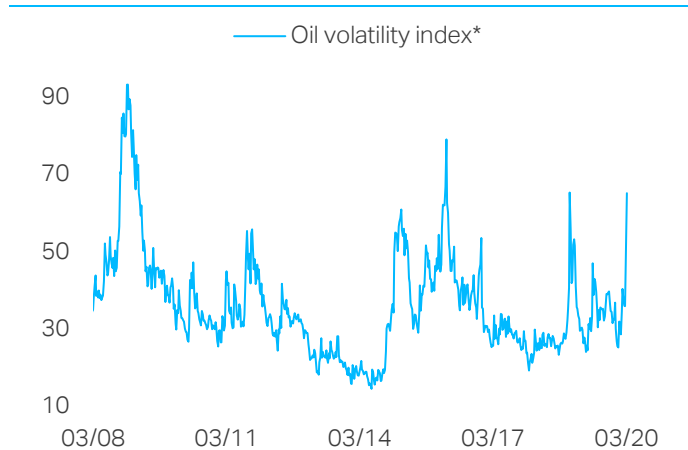
- OPEC+ fiasco a tactical falling-out, repair likely by June
- Saudi Arabia’s need for high oil prices accentuated by political instability
- Russia’s greater short-term resilience belies looming strategic error

The lesson of our [bad call](#) last week about a constructive OPEC+ outcome – when the actual result was a debacle that triggered an oil price war – helps answer the next question: **who will blink first?** We think the answer is Saudi Arabia rather than Russia. But Russia will provide some ‘back-up blinking’ in the sense of making it seem like a joint climb down, with minimal loss of face and hard feelings. The fundamental incentives of both these major petro-states remain aligned: neither can afford a price war – the “unaffordability” applying above all to their respective paramount political agendas.

The tactical falling-out that produced last Friday’s fiasco reflected one key difference between Russia and Saudi Arabia. The difference that matters most here is not the Saudi view of a ‘comfortable’ long-term oil price level – perhaps around \$80/bbl – compared to the \$60/bbl ballpark in the Russian case. The deal-breaker last week was rather that Russia’s macroeconomic policy framework makes it more resilient to temporary storms. Hence the Russian negotiating position that the existing OPEC+ deal on lower output should be prolonged pending greater visibility on what further production cuts may be required.

What seemed like a Russian shift to un-cooperative play is best viewed, therefore, as a recognition that ‘this time is different’ on the demand outlook – consistent [with our view that Covid-19 means a recession and bear market](#). In other words, the type of growth scare engendered by Covid-19 renders additional supply cuts an ineffective tool for supporting oil prices at a time when demand expectations are in freefall. Viewed under this prism, it seems preferable to allow market prices to recalibrate – even at the expense of more violent up-front volatility (left-hand chart below) – before taking the kind of new supply measures on which the Saudi camp was insisting (not only a deep additional production cut – 1.5mbpd – but also, and this was probably the deal-breaker for

Volatility spike Index



Source: Bloomberg, TS Lombard

*CBOE Oil ETF VIX Index

Oil price in ruble terms Rb/bbl



Source: Bloomberg, TS Lombard

Russia, locking in that cut for three full quarters until year-end). The market action of the last couple of days is reminiscent of the 2015 Q4–2016 Q1 period, when Brent overshot to the downside (a 45% correction from the low \$50s/bbl to the high \$20s) – only this time the market has moved faster!

The key to Russia’s preference for riding out volatility until the air clears is the cushion provided by its free floating exchange rate.

The right-hand chart overleaf shows how the ruble depreciation in the present storm has kept the oil price in ruble terms within the same bounds as the previous oil price collapse of January 2016 (compared to the much lower levels in Q4/2008, when the exchange rate remained pegged). This counter-cyclical stabilizer for the budget and the balance of payments is buttressed by the fiscal rule: if the oil price remains below \$42/bbl, current planned expenditure can be financed under the rule by drawing down the ample resources of the sovereign wealth fund (the liquid part of which stands at 7% of GDP) to plug budget revenue shortfalls.

Saudi Arabia, by contrast, displays much higher sensitivity to any sharp oil price dips. This very high sensitivity must have been accentuated by the renewed political instability in the Kingdom ([see the Saudi Arabia section in this week’s EM Watch](#) for analysis of last Friday’s attempted, or pre-empted, palace coup against MBS). At the same time, the Saudi leadership has periodically decided to teach a lesson to other oil producers perceived to be taking market share advantage.

The most powerful evidence of this sensitivity is to be found precisely in the last such occasion that the Kingdom launched an oil price war – in November 2014.

Less than six months later, the Saudis reversed course by announcing output restraint to support the price. The financial pain – and associated socio-political risks – for the Kingdom had proved too acute (and back then, there wasn’t even the organic global demand weakness that is now coming from the coronavirus-driven recession). A year later, the OPEC+ alliance with Russia was sealed. In our view, this time will be no different: after tempers have cooled, OPEC+ will reconvene to try and put a floor under the oil price. The timeline to watch here is the by now traditional OPEC+ consultations in the month of June at ministerial level.

From this, it will be clear that we are sceptical of analysis that assumes that these players are like chess grandmasters thinking several moves ahead.

A popular example of this kind of ‘what-this-is-really-all-about’ theory is that Russia chose this opportunity to avenge US sanctions by striking a blow against US shale oil producers. The ‘evidence’ for this view is the powerful Rosneft CEO Igor Sechin’s well-known dislike for the long-term effect of OPEC+ output restraint in ceding global market share to US shale. That ‘evidence’ has been consistently outweighed by Russia’s wider ‘macro’ interest in strengthening the floor under the oil price.

That ‘Rosneft’ agenda matters in another way, however: alongside Russia’s superior short-term resilience to oil shocks, the country may be committing a long-term strategic blunder.

Russian oil production is now close to plateauing. With present spare capacity of no more than 400kbpd and falling steadily, it makes even less sense for Russia to prioritize the fight for market share against US shale oil than it does for Saudi Arabia, which can easily ramp up production at scale. Nevertheless, Russia plans to develop new greenfield resources (many of which are under the Arctic continental shelf). To be profitable, these projects are going to need an oil price not much below \$70/bbl – which seems highly unrealistic in an environment of terminally declining fossil fuel demand as the world combats global warming. But the Kremlin wants to provide tax subsidies to allow the oil companies (principally its Rosneft champion) to go ahead anyway. The motive is to avoid an up-front hit to GDP from declining oil production and to promote broader industrial development. The reality will be that contrary to diversifying the economy in readiness for the post-fossil fuel age, these oil tax subsidies will transfer resources from the wider economy to a value subtracting oil industry – in the process, undermine the whole macro framework (above all the exchange rate competitiveness that is crucial for broader economic development).