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Positive and Negative Impacts of Rapid Oil Price Drops

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Crude oil prices have been in free fall. On December 10, the benchmark West Texas Intermediate futures price lost $2.88/barrel from the previous day to $60.94/barrel. The Brent futures also fell $2.60/barrel to $64.24/barrel. They are about to slip below $60/barrel. In the current market environment, oil prices are likely to continue testing lower ground. As in the downward trend for oil prices after the Lehman Shock, we do not see where oil prices would discontinue falling or what would lead oil prices to discontinue falling. While some people expect that oil prices will have "floor levels" equivalent to costs for U.S. shale oil and other high-cost oil fields, oil prices are likely to drop further over a short term.

Oil prices are unlikely to turn upward unless (1) the Organization of the Petroleum Exporting Countries decides on an emergency production cut in response to an excessive price fall, (2) excessive oil price drops cause social and economic destabilization in major oil producing countries to disrupt oil supply, or (3) unexpected accidents or geopolitical risks bring about oil supply disruptions. Anyway, crude oil price fluctuations will continue to attract global attention. At the same time, impacts of low oil prices will become a matter of great concern. In this report, I would like to analyze positive and negative impacts of low oil prices.

Positive impacts include those on the world economy. Oil price drops cause an income transfer from oil producing countries to consuming countries with higher propensity to consume, becoming a factor to invigorate the world economy. In oil consuming countries, oil price drops bring about an increase in disposable income to raise consumption (from levels under higher oil prices). In Japan and other countries that heavily depend on oil imports, positive impacts will be more remarkable.

For Japan, crude oil price drops lead to falls in liquefied natural gas prices linked to crude oil prices (though with some time lags). Crude oil price drops will bring about windfall profit for Japan that has increased dependence on LNG and oil thermal power generation in the absence of nuclear power generation after the March 2011 Great East Japan Earthquake. If crude oil prices remain weak for a certain period of time, LNG import prices may fall to around $10 per million British thermal units. Crude oil price drops will hold down a trade deficit (national wealth outflow), reduce electricity and gas costs and cut petroleum product prices. Coupled with the expected restart of nuclear power plants next year, weak crude oil prices are expected to produce positive impacts on macroeconomic performance and civil life in Japan.

Among oil consuming/importing countries are major oil producing countries such as the United States and China. Weak crude oil prices' impacts on these countries will be patchy as falling oil prices deteriorate earnings in the oil/gas upstream sector. As far as these countries are net oil importers, however, weak oil prices will have net positive effects on them. Major economies including the United States, China, the European Union and Japan will basically benefit from oil price drops to the advantage of the world economy.

But oil price drops will have clearly negatives impacts on some areas. First, weakening oil prices will seriously affect oil producing countries (net oil exporters) that heavily depend on oil revenues and lack economic capability to resist low oil prices. Depending on future developments, falling oil prices may destabilize their governments, economies and societies. In this sense, we may have to closely watch future economic conditions in such countries as Venezuela, Nigeria and Russia. Serious destabilization and subsequent oil supply disruptions could become risks for the world economy.

Second, weak oil prices will deteriorate companies and industries involved in the oil/gas upstream sector, exerting adverse economic effects. In many oil consuming countries as well as net oil exporters, the oil/gas industry is a major economic player. In the United States, the industry has played a major role in supporting economic growth over recent years under the shale boom. The sharp oil price drops will lead the oil/gas upstream sector to substantially reduce profits so that the sector may fail to drive economic growth. Such negative impacts could partially be offset by earnings improvements in other economic sectors. Given that negative impacts on the oil/gas upstream sector are expected to spill over to relevant sectors, however, such impacts may not be negligible.

Third, weak oil prices will exert negative impacts on oil and gas investment plans and future production capacity in line with such impacts on the oil/gas upstream sector. As noted recently, falling oil prices are destined to adversely affect investment in the costly development of shale and other unconventional oil/gas resources, and deep-water and frontier oil/gas fields. Oil price drops will also affect the profitability of high-cost LNG projects with higher breakeven prices reflecting cost hikes in recent years, which include those for the Asian market where LNG prices are linked to crude oil prices, and those projects may have to be subject to be reviewed or revised comprehensively. Such review/revision will prevent oil, gas and LNG production capacity from being maintained or expanded over a medium to long term.

Lastly, falling oil prices will affect relative energy prices and make business conditions more uncertain and complicated for future investment and energy choice decisions, given that crude oil prices have played a role as a benchmark for various prices in the international energy market. Typically, oil price drops may influence the issue of Asia's LNG pricing formula. As noted above, the steep oil price declines may result in a substantial drop in LNG prices linked to JCC (Japan Crude Cocktail: average crude oil import price in Japan) next year, lowering LNG prices to $10/MBtu in Japan. In such a case, JCC linked LNG prices could slip below future U.S. LNG import prices based on U.S. Henry Hub prices. Such change in the relative relationship between pricing formulas linked to crude oil prices and Henry Hub gas prices may affect negotiations between LNG

sellers and buyers over the LNG pricing formula for the Asian market. In this way, oil price drops have produced complicated and uncertain factors affecting the future course, making business decisions more difficult and complicated.

All things may have both positive and negative impacts. While oil price drops are expected to have net positive impacts, we may have to pay attention to negative impacts including those on the future course.

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