Oil Prices: Why? So? Then What?

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Introduction

In this article, the effect of oil prices on various economies is outlined. In June 2014, the spot price of West Texas Intermediate (WTI) was $105.79; by December 2015, the price was $37.21 (Figure 1). (U.S. Energy Information Administration 2016). This 70 percent drop in oil prices over 18 months has implications for regional and global economies. Oil importing countries, such as the U.S., Japan, China, and India, are set to gain; exporting countries, like Saudi Arabia, Russia, Canada and United Arab Emirates, are set to lose (Brown and Yücel 2013, CIA 2016, U.S. Energy Information Administration 2016).

Figure 1: Monthly Spot Prices for WTI

Why are oil prices low?

There are many answers to this complex question. Supply: when the supply of oil increases, oil prices decrease. There are a number of reasons why oil supply has gone up. The increase of U.S. shale oil production catapulted the U.S. to become the world’s largest oil producer (Figure 2). Subsequently, Saudi Arabian, Nigerian, and Algerian oil that was once sold to the U.S. needed to find another home, forcing producers to cut prices to reduce inventory. In addition, Canadian oil production and exports increased, while Libya and Iraq maintained higher than anticipated production levels, despite their ongoing conflicts. At the same time, demand for oil has declined due to the appreciation of the dollar and increasing energy efficiency, putting additional downward pressure on the price of oil (Krauss 2016).
Effect on Economies

According to Murphy et al. (2015), a 50 percent decline in oil prices causes a 0.3 to 1 percent increase in U.S. GDP, depending on which economic model is used. With low oil prices, overall economic activity in the U.S. is set to gain, although oil producing states will be negatively affected. Today, Alaska, Louisiana and New Mexico are facing distressed budget situations due to the low oil prices, according to a report by Standard & Poor's Ratings Services (Petek and Perry 2016). Outside the U.S., the Russian, Venezuelan and Nigerian economies are facing similarly strained budgets (Tuzova and Qayum 2016).

What about employment?

The drop in oil prices have had a significant effect on employment, regionally and worldwide. Royal Dutch Shell cut 7,500 jobs in 2015, while BP will eliminate 4,000 jobs in addition to the 4,000 it cut in 2015 (Reed 2016). Chevron’s CEO announced plans to cut 6,000 to 7,000 of its employees (Scheyder 2016), while Schlumberger, Baker Hughes and Halliburton slashed 46,000 U.S. jobs (Egan 2015). Overall, an estimated 250,000 jobs have been lost globally since the beginning of the long price decline (Reed 2016). At the state level, a study by Brown and Yucel (2013) reported that a 50 percent drop in oil prices reduces employment in Wyoming, Oklahoma and North Dakota by 4.3, 2.3 and 2.0 percent, respectively. Here in Kern County, the last 18 months have been accompanied by increased farm employment while the oil and gas industry cut jobs. Overall employment, however, increased during this period (Michieka and Gearhart 2016).

Looking ahead

On January 25th, 2016, the spot price of WTI was $30.31. Predicting the direction in which oil prices are headed is a complicated affair, as many factors are involved. Nonetheless, it is important to note the following events set to take place in the short, medium, and long term: (1) There are reports that Russia is willing to work with Saudi Arabia on the possibility of cutting
production of crude oil, which may reduce supply and raise prices; (2) On January 16, 2016, sanctions were lifted on Iran meaning that the country with the fourth largest reserves of crude oil is set to increase oil exports; and (3) A number of African countries have discovered large amounts of crude oil reserves and could start production in the long run and possibly export much more oil, further depressing prices (Essandoh-Yeddu and Yalamova 2016).

References


