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before the

U.S. Senate Committee on Foreign Relations

The Economic Implications of Low Energy Prices

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Honorable Chairman Corker, Ranking Member Cardin and Members of the Senate Foreign Relations Committee, thank you for inviting me today to testify on the impact of low oil prices on oil importing and exporting countries and the potential risks to stability. I am grateful to the Committee for convening this hearing at a critical time for the global economy, given elevated financial market stress, rising risks of a global recession, diminishing effectiveness of macroeconomic policy tools, and the uncertain outlook for the Chinese economy. Emerging markets have been at the epicenter of these developments, amidst below potential economic growth, heavy net capital outflows, reduced boost from China, weak global trade, and growing economic strain among oil exporters. The Institute of International Finance (IIF) conducts research on the global economy and financial markets and assesses key global risks and policy challenges. These themes, including the impact of low oil prices on the global economy, have been at the core of our recent research.

The decline in oil prices by over 70% since mid-2014 has benefitted oil-importing economies by raising household disposable incomes and lowering inflation, such as in Emerging Asia and Emerging Europe where energy accounts for a large share of the consumption basket. Lower oil prices have also helped reduce external vulnerabilities in oil-importing countries with large current account deficits like India, Indonesia, South Africa and Turkey. Policymakers in many oil-importing countries have used this

opportunity to maintain easy monetary policy to support growth and cut back spending on subsidies (such as in India and Indonesia) to free up fiscal resources for capital expenditure, including infrastructure.

On the other hand, oil exporters have come under immense pressure amidst a deterioration in fiscal and current account balances, particularly countries with pegged exchange rates and less diversified economic structures. Countries with substantial assets (such as Saudi Arabia and Qatar) have been able to cushion growth in the near-term by running down reserves and limiting fiscal adjustments. Others with more limited cushions have implemented sharp fiscal, monetary and exchange rate tightening measures (such as Russia and Nigeria) to reduce vulnerabilities from low oil prices, even at the cost of slower growth in the short-term. Meanwhile, countries like Venezuela have delayed the necessary policy adjustment, increasing risks of a sharper downturn ahead.

Looking ahead, if oil prices remain subdued, as we expect, economic vulnerabilities among oil exporters are likely to accentuate. This raises the question of which oil-exporting economies would come under the greatest economic strain under such a scenario. To assess this, we have looked at three types of economic vulnerabilities emanating from low oil prices for oil exporters: 1) *Fiscal vulnerability* from the loss of oil-related revenues, deterioration in fiscal balance, and rise in government debt; 2) *External vulnerability* from the loss of oil export receipts, deterioration in current account balance, decline in foreign exchange reserves, and increase in external debt; and 3) *Macroeconomic vulnerability* from the loss of oil-related economic activity. In our analysis, we have evaluated both the extent of an economy's oil dependence in a flow sense and the resources accumulated by a country from a stock perspective that would help cushion the impact of lower oil prices.

Most Vulnerable Countries

Assessing twenty major oil-exporting countries using this approach, we find five countries to be most economically vulnerable: Venezuela, Iraq, Libya, Angola and Bahrain (See Pages 5 and 6). These countries have significant weaknesses across all three types of economic vulnerabilities. In particular, these countries have heavy reliance on oil as a source of export receipts (especially Iraq and Angola), and as a source of fiscal revenues (particularly Bahrain, Iraq and Libya). Most of these countries also have elevated government debt, high production costs (especially Angola and Venezuela), and limited

cushions in the form of international reserves or sovereign wealth fund resources (particularly Venezuela). More importantly, these countries operate under currency pegs, reducing their economic capacity to adjust to an external shock and making it more likely that the eventual adjustment will be highly disorderly and negative for economic growth. In Venezuela, we are particularly concerned that continued delays in exchange rate and spending adjustments will prolong and deepen the recession, increase the risk of debt default, and threaten social disorder.

In addition to these five most vulnerable countries, an additional group of six countries – Nigeria, Russia, Azerbaijan, Kazakhstan, Oman and Algeria – stand out as economically vulnerable based on our criteria. These countries have shown greater ability to adjust over the past two years to lower oil prices by devaluing (Nigeria and Algeria) or free floating (Russia, Azerbaijan and Kazakhstan) their currency, imposing restrictions on balance of payments, and tightening monetary policy sharply in many cases. Nonetheless, we do still see these countries as being squeezed further in the years ahead, and being pushed towards further fiscal consolidation (for example, in Russia), exchange rate adjustment (Nigeria) and emergency IMF support (Azerbaijan).

Countries with Rising Vulnerabilities

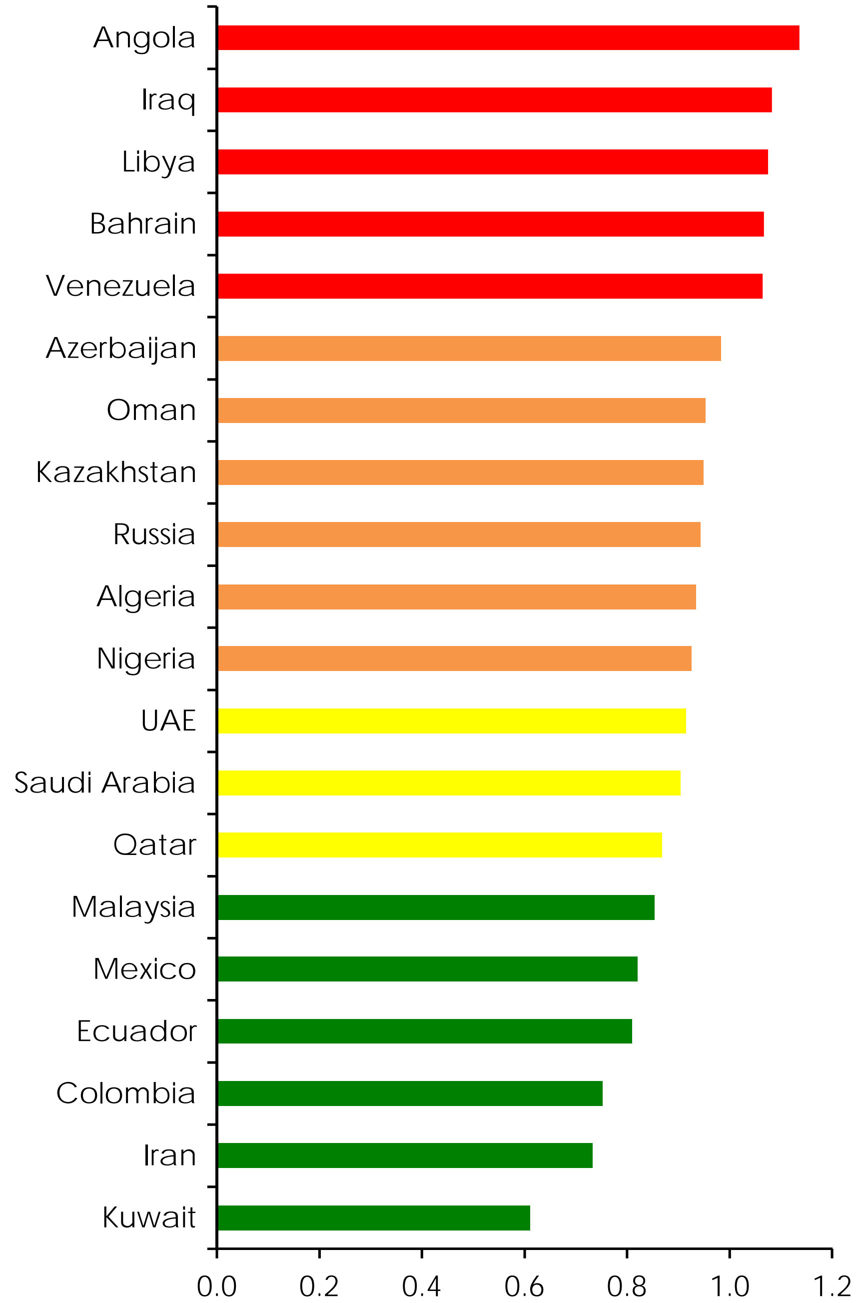
There are a number of other countries, mainly in the Gulf, where we see vulnerabilities contained for now but to rise as the oil price decline prolongs. These economies rely heavily on oil revenues with exchange rates pegged to the dollar – including Saudi Arabia, Kuwait, Qatar and UAE. These countries are less economically vulnerable to a short-term decline in oil prices because they have strong national balance sheets (low government debt and/or high international reserves/sovereign wealth fund assets), substantial current account surpluses, and low oil production costs (helping to protect market share). Continued growth in the nonhydrocarbon sector is cushioning overall economic growth, especially in the UAE which has a diversified economy. These countries have more time to adjust to lower oil prices as they can cushion the short-term impact on their economies by running down accumulated assets and ramping up borrowing. Eventually, however, if low oil prices are extended over time, these economies will need major and sustained economic and fiscal adjustment, especially Saudi Arabia which has a relatively higher fiscal breakeven price for oil. Such adjustments are now starting to get underway – for example by reducing oil subsidy bills and slashing investment projects, but cuts will need to go much deeper.

Least Vulnerable Countries

The last group of countries lying at the lower end of the economic vulnerability spectrum are Malaysia, Mexico, Colombia, Ecuador and Iran. These countries combine significant oil exports with more diversified economies. Countries like Colombia, Mexico and Malaysia have come under heavy market pressure due to their oil exposure but these economies are less exposed to the negative impact of low oil prices on growth and balance of payments, as flexible exchange rates and track records of good policy management make them better equipped to weather pressures through a combination of fiscal and/or monetary policy adjustment and exchange rate depreciation. In Iran, the lifting of sanctions is likely to boost oil exports and private investment, providing support for growth.

To conclude, the past two years have forced oil-exporting countries to start adjusting their economies. Exchange rates have been allowed to depreciate, monetary policy has been tightened, and most commonly, fiscal policy measures have reduced capital expenditures, cut back subsidies and expanded tax and non-tax revenue tools. However, low oil prices are likely to be sustained, implying that pressures on fiscal balances and public debt will escalate, calling for even more aggressive fiscal consolidation and other policy actions going forward. A number of countries that are most vulnerable will come under heavy pressure over the next few years. Countries already facing political risk (Venezuela) or conflicts (Iraq, Libya) will be particularly vulnerable. Many GCC countries which have been cushioned by depleting assets accumulated over many years will need to make more meaningful adjustments. This is likely to weigh on economic growth for a prolonged period and increase risks of social tensions amidst high inflation and unemployment, and cut backs in social spending, transfers and government wages. Managing growth and social stability under such circumstances would therefore call for accelerating reforms beyond fiscal policy in order to rebalance their economies towards non-oil sectors. This would include improving the business climate, continuing with financial sector development, reforming the SOEs, strengthening institutions, investing in human capital, and attracting private investment and FDI, especially in non-oil sectors.

Mr. Chairman, Mr. Ranking Member and Members of the Committee, thank you again for giving the opportunity to testify before the Committee. I look forward to answering any questions that you may have.


Oil Exporters: Economic Vulnerability Score
2015 or latest
Angola
Iraq
Libya
Bahrain
Venezuela
Azerbaijan
Oman
Kazakhstan
Russia
Algeria
Nigeria
UAE
Saudi Arabia
Qatar
Malaysia
Mexico
Ecuador
Colombia
Iran
Kuwait
0.0
0.2
0.4
0.6
0.8
1.0
1.2
Source: IIF.

Individual Vulnerabilities

	Oil Revenues/ Total Govt Revenues	Fiscal balance/ GDP	Govt Debt /GDP	Net Oil Exports/ GDP	Current Account Balance/ GDP	FX Reserves/ GDP	External Debt/GDP	Exchange Rate Regime	Hydrocarbon Sector/GDP	Cost of Oil Production
Angola										
Algeria										
Azerbaijan										
Bahrain										
Colombia										
Ecuador										
Iran										
Iraq										
Kazakhstan										
Kuwait										
Libya										
Malaysia										
Mexico										
Nigeria										
Oman										
Qatar										
Russia										
Saudi Arabia										
UAE										
Venezuela										

Aggregate Vulnerabilities

	FISCAL VULNERABILITY	EXTERNAL VULNERABILITY	ECONOMIC VULNERABILITY	OVERALL VULNERABILITY
Angola				
Algeria				
Azerbaijan				
Bahrain				
Colombia				
Ecuador				
Iran				
Iraq				
Kazakhstan				
Kuwait				
Libya				
Malaysia				
Mexico				
Nigeria				
Oman				
Qatar				
Russia				
Saudi Arabia				
UAE				
Venezuela				

Source: IIF.