OPEC+'s "Reasonable Oil Price Level" Notion and the External Breakeven in Saudi Arabia, Russia and Canada: Accounting for Economic Cycles and Pipeline Politics

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Section 1: Overview and Research Question

The year 2018 was eventful for the oil market, demonstrating that the Organization of the Petroleum Exporting Countries (OPEC) matters and so do other non-OPEC producers. Presently, the largest producers in the market are Saudi Arabia, Russia, and the United States, followed by Canada (EIA, 2019a). In December 2016, OPEC members and 11 non-OPEC countries issued a Declaration of Cooperation to stabilize the global oil market through voluntary production adjustments. These countries, collectively known as OPEC+, seek to create a sustainable, stable oil market and establish a reasonable oil price that benefits all industry stakeholders and the global economy (Fattouh & Economou, 2018; OPEC, 2018). Yet the question is, what is a reasonable oil price? In this paper, we attempt to answer this question for Saudi Arabia and Russia, as well as Canada.

In October 2018, prices for Brent and West Texas Intermediate (WTI) hit approximately 86 USD/barrel and 75 USD/barrel; however, in November 2018, spot oil prices fell below 70 USD/barrel (EIA, 2019b). Oil producers immediately focused on their balance sheets. The estimated fiscal breakeven for Saudi Arabia was approximately 83 USD/barrel in 2018 (IMF, 2019). However, Russia stated that it is comfortable with a 60 USD/barrel oil price, because the government's budget is based on a price of 40 USD/barrel (Blas, 2018). In 2018, West Canadian Select (WCS) was trading at a USD 28.49 discount to WTI by the end of November, crippling the provincial economy of Alberta, Canada's largest oil producer. Alberta's Minister of Finance referred to the situation as a national crisis and called upon the federal government to provide assistance (McNeil, 2018).

In addition to fiscal strain, oil exporters' external balances come under pressure and their current accounts deteriorate when oil prices drop. Although some oil exporters can finance external deficits through their external wealth, other oil exporters face pressure on their reserves. It is important to assess oil exporters' external sustainability. Fiscal and external sustainability are not perfect substitutes unless oil producers are fully owned and operated by the government. Benchmarking would help policymakers determine the magnitude of policy adjustments needed to attain external breakeven (Allegret et al., 2014; Arezki & Hasanov, 2013; Behar & Fouejieu, 2016; Tabeke & York, 2011; Versailles, 2015).

Section 2: Previous Research, Contribution, and Research Objective

Despite the importance of addressing external sustainability in oil producing economies, most research is focused on fiscal sustainability and non-oil primary fiscal balance. Few researchers have investigated external sustainability for oil exporters (Akanbi & Sbia, 2018; Allegret et al., 2014; Behar & Fouejieu, 2016; Gnimassoun et al., 2017; Morsy, 2009; Tabeke & York, 2011). Research on the relationship between the current account and fiscal policy, oil prices, and/or financial development is inadequate. Researchers have not accounted for the impact of pipeline politics or the effect of labour market flexibility. Only Kilian et al. (2009) accounted for global business cycles. Most researchers have used panel data rather than country-specific data. Oil exporters have heterogeneous income and financial development characteristics; thus, relationships among the current account, fiscal balance and oil prices are likely to be country-specific and influenced by the economic environment (Allegret et al., 2014).

We jointly examine the nexus between oil prices, external balance and fiscal policy, and account for cyclical effects, pipeline politics, labour market flexibility and financial development. The objective is to assess the optimal oil price to achieve external and fiscal sustainability in Saudi Arabia, Russia, and Canada. We study Saudi Arabia and Russia because they play leading roles in OPEC+ and the global oil market. Canada is an interesting case because it has close trade links with the United States, is not a member of OPEC+, and has a more diversified oil exporting economy. Zooming in on oil producing provinces, Alberta is heavily oil dependent and hence faces the same economic issues as Saudi Arabia and Russia. All three face pipeline politics; moreover, Alberta is landlocked, Russia has faced international sanctions, and Saudi Arabia's vital East-West pipeline has been attacked. Furthermore, the trade balance exceeds the current account balance in the three jurisdictions.

Section 3: Research Approach, Results, and Outstanding Questions

Building on Gnimassoun et al. (2017), we apply a threshold vector error correction model (VECM) and time-varying VECM. We account for several variables: the current account-to-gross domestic product (GDP) ratio; the overall fiscal balance-to-GDP ratio; the government expenditure-to-GDP ratio; Brent oil price; the differential between Brent and WCS prices, and Russian Urals blend and Saudi Arabian Light prices; foreign exchange reserves; the propensity to spend oil revenues on imports; the labour market flexibility index; the real effective exchange rate (REER); and credit-to-GDP ratios. We use quarterly as well as annual data for various time samples (i.e., the 1980s, 1990s, and 2000s through 2019:Q2). Analyses for Canada are in progress. Our preliminary analysis shows that:

- The oil price threshold effects on the current account-to-GDP ratio are approximately USD 70 and USD 53–55 for Saudi Arabia and Russia, respectively.
- Our estimate for Saudi Arabia is consistent with Setser and Frank's (2017) analysis of the nation's external breakeven around 70 USD/barrel and is approximately equal to the IMF fiscal breakeven estimate (approximately USD 73/barrel in 2019).
- Our estimate for Russia is consistent with the fiscal breakeven of USD 56/barrel for the overall balance (rather than USD 40/barrel for the primary balance) reported by Aris (2018).

Section 4: Conclusion

- It is essential to assess the external breakeven and fiscal breakeven for the overall balance.
- Oil prices below USD 70/barrel and USD 60/barrel may not be good news for Saudi Arabia and Russia.

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