How The Oil Price Crash Is Wrecking Mario Draghi's QE Effect

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2015 will go down as the year when the oil price crash did not result in a swift decline in oil output. At a first glance, this seems a very strange phenomenon. Although the price reduction has been massive (-75% in 18 months) it is certainly not the fastest: in 2008, with the crash of Lehman Brothers, the price cratered from the stellar price of $147 to just $35 in merely six months. However, due to the global recession, output rapidly dropped by almost 1 million bpd and this helped the price to recover in a matter of a few months.

Now, instead, production is showing healthy growth: in 2015 the world extracted 95m bpd against 93m in 2014. The market is flooded with oil. Hundreds of giant oil tankers are parked fully loaded in front of the main global distribution hubs: exporting countries are waiting for a price rebound and are willing to pay the freight costs rather than sell off the oil. This bizarre scenario apparently dismisses rational worries about an inadequate response of oil output to the previously consistent price increases experienced in the past decade.

This phenomenon of apparent hysteresis of growth in oil production can be explained only by understanding the extraordinary mix of coincidences that makes it possible. The rise of US shale oil is the prime cause, since it has completely reshaped market structures and has added 5bn bpd to the global supply. In 2010-2014, prices at over $100 stimulated huge investments in oil reserves subject to difficult extraction: these had been known about since the 1950s but substantially ignored owing to the low chance of producing a profit. US investment funds, fuelled by the zero cost liquidity injected by the Fed into the financial system and starved for yield in a low interest environment, had indiscriminately funded those efforts.

The geopolitical scenario has also played a key role: the OPEC oil cartel has pretty well ceased to exist under the centrifugal interests of the main producing countries that are mainly focused on maintaining their market share. Saudi Arabia, the historical leader in oil production, has actively encouraged a price dumping strategy, with the declared target of forcing the US producers out of the market. While rational, this strategy has not yet brought about the desired result: speculative funds guarantee US drillers a constant flow of low-cost funding, even though the major part of the shale oil industry has been operating at a loss – certainly in the last year.

It's possible that the imminent tightening cycle in US interest rates could prove a decisive step towards the demise of the shale oil experiment. In fact, hedge and mutual funds exposed to the oil sector are experiencing a severe downturn that could stop the required flows of funds towards distressed drilling firms. But nothing can be taken for granted.

All we need is inflation!

What is certain is that the oil price crash has ignited a wave of deflation in all developed countries. Not surprisingly, the Eurozone has been hit more severely than others. Already crippled in an enduring credit crunch, European corporations and small businesses have seen their profit share in a steady decline during the disinflation process. In November 2015 Eurozone inflation slipped again into negative territory, while it appears clear that the December data will not vary significantly after taking into account another 10% drop in the oil price. This deflation has hereby "sabotaged" the strategies of monetary expansion undertaken by central banks, eager to use inflation to ease the burden of OECD countries' enormous public debts. Obviously, this is not a "polite" target in official circles, but it's benignly accepted that more than one Eurozone government debt agency would warmly welcome higher inflation rates to keep financing needs under control.

Here too, a perverse feedback is at work. As seems intuitively to be the case, the drop in energy costs has helped the recovery of private consumption and industrial production both in peripheral and in core countries (German household consumption rose strongly by +0.6% in the third quarter of 2015), but not enough to create pressure on prices. Conversely, the decline in the price of oil and other basic commodities (copper, iron, silver) has compressed inflation expectations in the long term. In other words, the financial sector is basing its trading and hedging strategies on a forecast of persistent, stagnant price levels.

In a similar scenario, the ECB's measures can do very little. Put simply, the ECB and its OECD twin sisters can lend money at zero interest to banks, with the aim of stimulating the growth of loans to the real economy. However, the banks have no incentive to invest outside financial markets, since under deflation the profitability of enterprises is low (and this is hardly surprising: with sliding prices, it's difficult to make any profit). Moreover, the underlying risk of investing in the real economy remains high and global regulatory standards impose the tough requirement to build up capital reserves against bad loans. Consequently, for a bank it's simpler to buy government bonds than lend: not only with its Quantitative Easing is the ECB always ready to purchase them, but EU regulators are overly relaxed about government bonds and do not require the establishment of liquidity reserves. The end-result is simple: the additional liquidity remains entrapped in the financial system, credit fails to recover and inflation remains at a standstill.

After the recent ECB decision of 3 December 2015, markets punished Draghi's QE 2.0, considering it "not enough" to counteract deflation. In reality, even if market expectations were fully met, it's highly improbable that the ECB would obtain little more than the current (poor) results. Like it or not, it's that old black gold that dictates the pace of inflation.