Soaring oil prices pose a growth threat

The constantly rising oil prices and demand-supply gap are indicating tough times ahead for the global economy, as they impact the growth of every sector. The paints and coatings industry is also facing the brunt of this situation, with soaring raw material prices adding to its problems. It remains to be seen how the industry, or the world, for that matter, will tackle the issues revolving around rising oil prices.

■ Dr Mosongo Moukwa

The oil markets for the remainder of 2012 will be driven mainly by fundamentals and, in particular, the supply side: very tight crude oil stocks, very low spare capacity of the Organization of the Petroleum Exporting Countries (OPEC), and significant non-OPEC supply disruptions. In addition, both actual and potential supply disruptions from Iran will be an important factor for the markets. Even before Iran threatened to halt oil shipment to some European countries, the outlook for the global supply of oil was already looking grim.

There are considerable risks to output, which was once confined to the Middle East, but now are spreading to Africa. Inventories are at their lowest point in nearly nine years. Although crude prices are down more than 10 per cent this month, triple-digit soaring oil prices are threatening the growth of the global economy and will affect every sector, including the paints and coatings industry.

Slowing consumption

Many doubts are arising pertaining to the demand for oil. OPEC and the International Energy Agency (IEA) had revised its forecast for oil demand growth in 2012, based on worries about the weak global economy, and in particular, the Euro zone crisis. Steeper declines are expected in the US and the European Organisation for Economic Co-operation and Development (OECD) countries. Oil prices, however, have remained high, despite the renewed threat of recession in Europe. The state of the physical market is reflected in the slope of the oil curve, the price difference among contracts for immediate delivery and those with longer delivery dates. The curve is currently showing a downward slope, known as 'backwardation', with contracts for immediate delivery trading at a significant premium to forward contracts. This indicates that there is some tightness in the market.

Tightness of the supply

Tightness of the supply is mostly a result of supply side issues. For example, South Sudan embroiled in a dispute over transit revenues with Sudan, has either considerably reduced or shut down production, depriving the market of about 3,00,000 barrels a day. Unrest in Yemen is also a concern with a strike halting output at the largest field, Masila. Syrian exports are blocked by international sanctions. Libyan exports, while recovering, are still way off their pre-war levels.

Barclays Capital estimates that the problems in Sudan, Yemen and Syria could together curtail over one million barrels a day output – more than one per cent of global supply. That is now compounded by the looming European ban on Iranian imports, which will deprive the European Union of up to 6,00,000 barrels a day of crude. If this happens, India and Japan will lose tens of thousands of barrels of daily supply and the world will be short of 1.6 million barrels a day.

Pricey oil

The aftermath of the Arab Spring has obliged Middle Eastern governments to boost social expenditures across the region, while renewed unrest has led to increases in military allocations and support of dissident groups (such as outside Arab support for the opposition in Syria). Against these rising obligations, ramping up expenditures for the increased production of oil (upstream allocations) will require almost $ 4 trillion between now and 2035 – on a sliding scale starting at $ 100 billion annually.

The Gulf countries whose production determines OPEC – Saudi Arabia, Kuwait, Iran, and increasingly Iraq – will need an average crude price of $ 80 a barrel now, and more than $ 120 within a few years. This is due to increasing capital outlays to maintain the flow of oil.

Rising prices of crude oil have once again provided a strong incentive to the major global producers towards not diversifying their economies. If they are dependent upon hydrocarbons now, they will be even more so over the next decade. In turn, this will translate into a further straining of budgets. There will be a rise and fall of oil prices moving forward. Nonetheless, the overall trajectory will continue upward. With less supply and constant demand – at a minimum – oil can only go higher. In this case, it could go up so high, and so fast, that some experts, even predict that $ 200 a barrel is a real possibility.

Economic impact

Just as people require food, economies require energy. The relationship is straightforward: economic growth is a function of energy consumption. With national economies around the world once again forced to pay more than $ 100 for every barrel of oil consumed, a critical question must be asked – what happens when the world's most important source of energy becomes unaffordable?

The latest GDP numbers provide the answer. Economic growth has downshifted into a much lower gear nearly everywhere. Europe is struggling to keep its head above water; North America is stagnating; and even the hard-charging economies of the BRIC nations are starting to groan under the weight of high energy prices.

When the price of oil goes up, something has to give. Right now, the European Monetary Union looks to be the most imminent casualty. Without economic growth, Spain and Greece cannot service their debt. Unfortunately, growth is not on the cards for now.

Even China and India, the global economy's principal engines of growth, cannot escape the toll exacted by high energy prices. When policy makers in Beijing tried to sustain double-digit economic growth, food and energy inflation quickly slammed on the brakes. The economies of China and India will soon struggle to grow at half the torrid pace of recent years. When that happens, the rest of the world will need to pay attention.

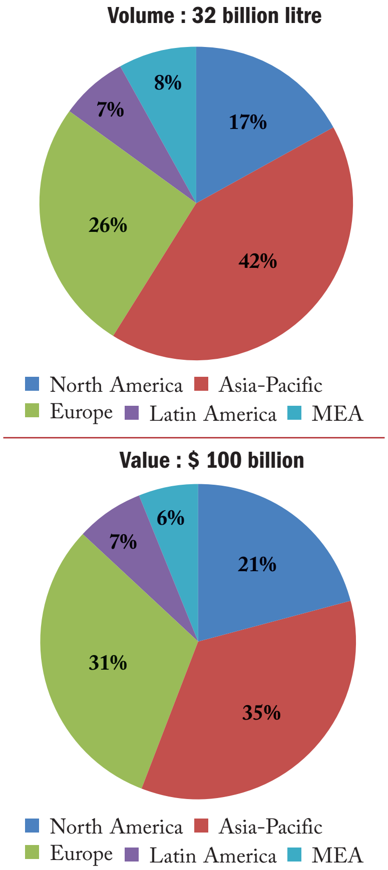
Paints & coatings industry scenario

The demand in the coatings industry is affected by a number of factors. The three most prominent determinants are overall economic activity, construction levels and the quantity of specific end-use products manufactured such as automobiles, furniture and containers. The best measure of overall economic activity is GDP. As a rule of thumb, coatings sales tend to follow overall GDP.

There is no doubt that the global recession has impacted size and growth rate of the coatings industry. Demand for industrial coatings has been severely impacted by the decline in industrial output experienced during recession. Between 2002 and 2007, the global coatings industry grew by more than 30 per cent, a compound annual growth rate of nearly 6 per cent. In contrast, it contracted by about 3 per cent between 2008 and 2009. So, the impact of the global recession has been significant. At the close of 2011, the global coatings industry was estimated to be valued at slightly over $ 100 billion on a volume of a little less than 32 billion litre.

Oil reaching $ 200 a barrel will have several dramatic effects – most of which the world is not prepared for. Today, the prices of raw materials in the coatings industry are at peak levels and the ongoing instability of oil and feedstock prices have already affected the profitability of the industry. But the world, and for that matter,

Figure 1: Global coatings market - 2011



Source: Orr & Boss, Inc., www. american-coatings-show.com, May 2012

the coatings industry, is not prepared for oil at $ 200. Conservative estimates are that, in the current scenario, worldwide demand for paints and coatings will rise 5.4 per cent per year to 45.6 million metric tonne in 2015. These predictions do not take into account turbulences that will be created by oil at a much higher price than what we see today. This possibility forces us to account for a much higher level of uncertainty and revise growth rate predictions much more frequently. ■

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