



Crude oil, one of the world's most needed commodities, fully earned its title the "Black Gold" due to its non-renewable nature and its ever prevailing quality of initiating global tribulations. In turn, its practicality is used in almost everything: to generate heat, drive machinery, and fuel vehicles and airplanes, and its constituents are used to manufacture plastics, detergents, paints, cements, and medicines, among others.

The recent free fall in oil prices has altered the course of many global economies, leading decision makers to adapt their economic forecasts and change their tools in handling the arising consequences, positive or negative as they turned out to be.

Lebanon was bound to receive the waves of this international shock sooner or later. In saying that, this focus report will assess mainly the impact of declining oil prices on the Lebanese macro level across the major economic sectors, before taking a closer look at the micro level to examine the effects of this decline on the Lebanese oil importers and distributors.

Before delving in the recent fall of oil prices, an examination of the major oil price spikes and downfalls in the last 5 years, attests that these fluctuations in prices are originated from major worldwide events affecting supply/demand mechanisms. The graph below exposes the links between this non-renewable energy prices and the developments affecting its supply.

March 07, 2015

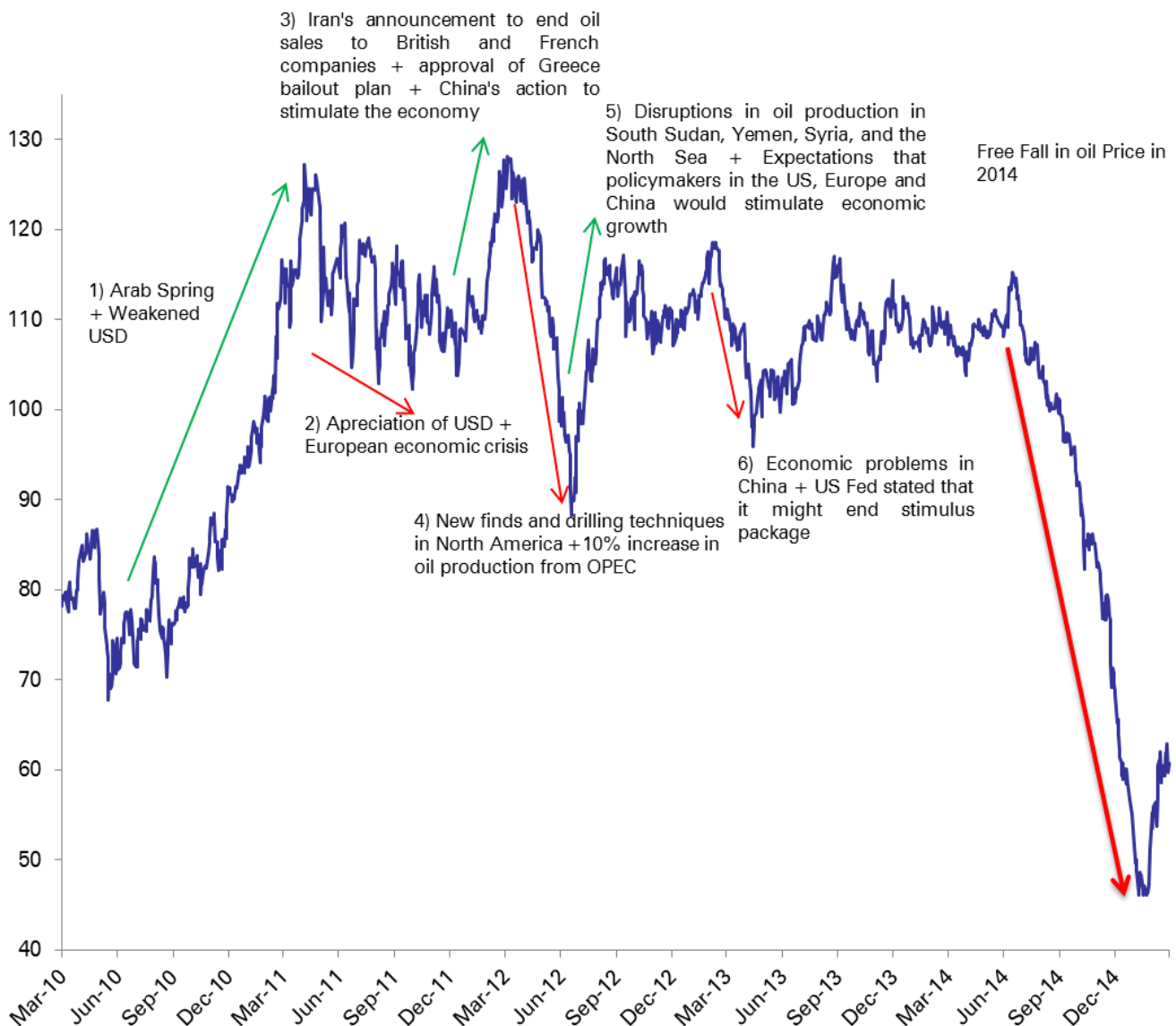
## Contact Information

Research Assistant: Lana Saadeh  
[lane.saadeh@blominvestbank.com](mailto:lane.saadeh@blominvestbank.com)

Head of Research: Marwan Mikhael  
[marwan.mikhael@blominvestbank.com](mailto:marwan.mikhael@blominvestbank.com)

Research Department  
Tel: +961 1 991 784

## 5 Year Daily Brent Crude Spot Price (\$/barrel) Trend and Timeline of Major Events



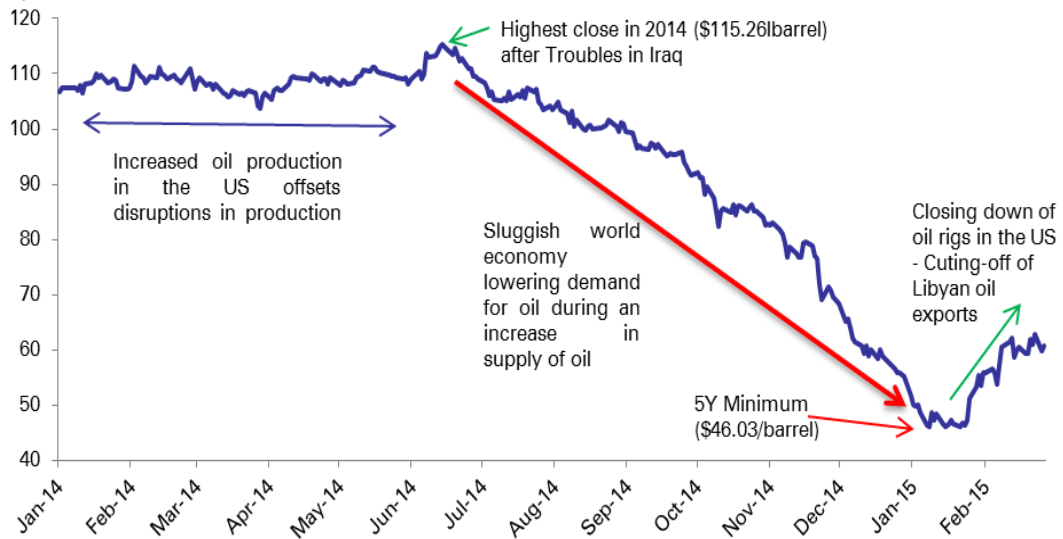
Source: Thomson Reuters

Zooming back to the most recent decline in the price of oil that started in the second half of 2014, the unexpected free fall was no exception to the opposite market dynamics of supply and demand. (Refer to the graph below)

On the demand-side, frail economic activity, higher efficiency, and an increased substitution away from oil to other fuels decreased the demand for oil causing its price to fall. Moreover, Japan's decision to restart some of its nuclear reactors also reduced forward demand for oil as a source of energy.

On the other hand, oil supply has also increased recently. The return of many oil-producing countries to the market, such as Iraq, Libya, Nigeria, South Sudan, and Venezuela, and the appearance of new major producers in Africa like Angola are the main reasons behind the surge in the supply of oil. In addition, North America saw a rise in shale oil production after finding a new technology, fracking, which led to a fall in the cost of a typical project from \$70/barrel to \$57/barrel.

Daily Brent Crude Spot Price in 2014-Present (\$/barrel)



Source: Thomson Reuters

*Brent Crude Oil price hovered at an average of \$108.96/barrel in the first half of 2014, where increased oil production in U.S offset outages in the Libyan oil production. ISIS attacks on Iraq threatened the oil market, as Iraq produces 3.3M barrels per day (bpd), causing the price to reach its highest value during the year at \$115.26/barrel, on the 19<sup>th</sup> of June, 2014. From then on, price of oil followed a bearish trend, going down 60.06% to close at its 5Y minimum of \$46.03/barrel, on the 26<sup>th</sup> of January 2015. Oil underwent a correction, after the low price triggered around 400 oil rigs in the U.S to idle. In addition, the continued conflict in Libya, the largest oil producer in Africa, caused its oil exports to drop.*

## But why isn't OPEC limiting the free fall of oil price?

The answer may lie in OPEC's past experience with petroleum shocks. Back then, when oil prices diverted from their sustainable levels, OPEC countries, and mostly the cartel's swing-producer, Saudi Arabia, would change supply to defend prices.

For instance, in the 1980s, global recession, along with other factors, caused a reduction in demand for oil. Concomitantly, increased exploration and production outside OPEC caused supply to increase. This in turn led to lower crude prices. Hence, OPEC attempted to set production quotas low enough to stabilize prices. During most of this period, Saudi Arabia acted as the swing producer cutting its production in an attempt to stem the free fall in prices. The Saudi Kingdom slashed its own output from more than 10M bpd in 1980 to less than 2.5M bpd in 1985-1986 in an attempt to prop up prices. Seeing that other countries (OPEC and non-OPEC) did not restrain supply keeping oil price on its downtrend, Saudi Arabia shifted its strategy, by increasing production. This pushed oil prices further down, shutting out higher-cost oil producers and paving the way for a gradual recovery.

Today, the Kingdom's aim is to defend its market share instead of price, and stop unconventional oil production. Many geopolitical reasons may be behind Saudi Arabia's decision for not defending oil price by restricting supply, and instead flooding the market. Saudi Arabia might want to push oil prices down in order to hurt its adversaries, Iran and Iraq, to squeeze Russia's ability to fund the Assad Regime in Syria, and/or to combat the Islamic State, as the latter relies heavily on seized energy

assets to support burgeoning population and intensifying war effort. Other countries of course may have coinciding interests as well.

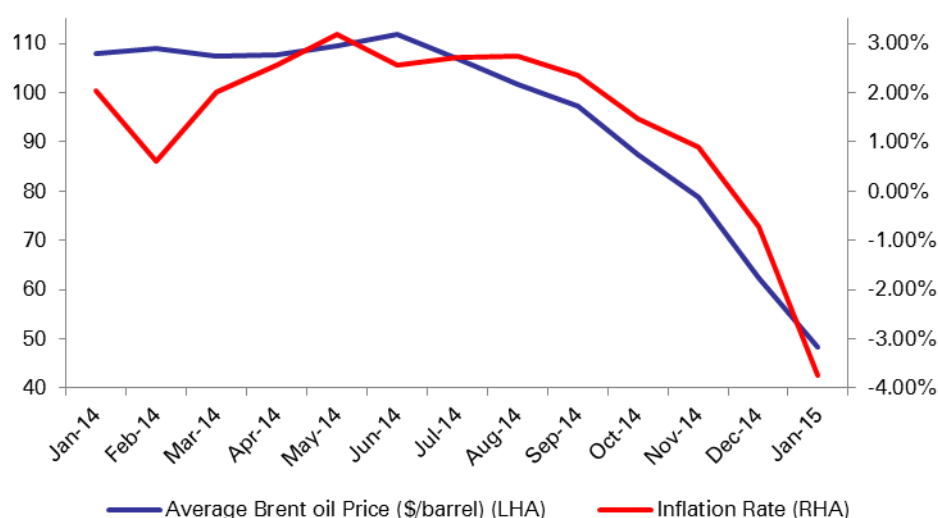
The outlook for oil prices shows that they are expected to gain some momentum in the coming two years, but to remain below their previous averages, as supply is expected to continue to exceed demand, however at a slower rate. The U.S Energy Information Administration (EIA) predicts Brent crude oil prices to average at \$58/bbl in 2015 and \$75/bbl in 2016, on the back of accelerating economic growth forecasts raising hopes for improving demand.

## The Case for Lebanon

As stated in the beginning, a change in the price of oil has an impact on the whole world: oil exporting countries as well as importers. Lebanon, an oil-importer, already began to feel the effects of these changes, across all its economic sectors.

On the real sector, both consumers and producers benefit from lower oil prices. Slashing oil prices already led to a yearly deflation rate of 3.75% in January 2015. "Water, electricity, gas and other fuel" sub-index experienced an annual drop of 18.10%, while "transportation" sub-index was tailing by a 14.07% yearly decline. In fact, as seen in the graph below, inflation somewhat tracks the trend in oil prices, though with a slight lag. Faced with lower prices, consumers' real incomes would be higher, which would bring about a higher propensity to save and consume.

## Monthly Inflation Rate and Average Monthly Price of Brent Crude Oil



Source: CAS – Thomson Reuters

As for producers, especially those in capital-intensive industries, the lower costs of production might translate to an increase in supply and growth in profits. One example would be the cement sector where the prices go hand in hand with energy costs, given that cement production is one of the most energy-intensive industries. To produce one ton of cement, requires 60 to 130 kilograms of fuel oil or its equivalent, depending on the cement variety and the process used, and about 110 KWH of electricity. Therefore, any variation in the prices of energy products will be highly reflected in the upcoming trends of cement prices.

On the monetary scale, low inflation expectations for an extended period of time, might trigger the Lebanese Central Bank to respond with additional monetary policy loosening, which in turn, can support economic growth. Recently, BDL planned another economic stimulus package for 2015 for an amount of \$1B, expected to reflect in an economic growth of 2.5%.

On the fiscal front, government deficit is expected to narrow, thanks to the fall in oil prices, as transfers to Electricite du Liban (EdL) covering the majority of its oil bill, represent the second largest component of the government's primary expenditures, with a share of 22.4%. According to the World Bank, transfers to EdL and oil prices are positively correlated, with a correlation coefficient of 0.4. Hence, a lower price of oil will reduce these subsidies, which in turn will narrow the fiscal deficit, however with a 6-9 month lag taking into consideration the structure of outstanding contracts with fuel oil and gas oil providers.

Transfers to EdL for the first ten months of 2014 already showed a 9.33% year-on-year drop to \$1.63B. This was the primary reason to the 1.50% decline in total expenditure to \$11.27B. Consequently, public deficit narrowed 30.71% y-o-y to \$2.44B in October 2014, with a primary balance displaying a surplus of \$1.13B, compared to a deficit of \$313M during the same time the previous year.

If oil prices continue to decline, the smaller EdL bill might release more funds for the government to be used in investments and capital expenditures, electricity being one of them. Worth mentioning, EdL's generating capacity of 2,019MW is far lower than the peak demand of 3,195MW, leading to power outages.

As for the external sector, and since Lebanon is an oil-importer, a lower oil price would necessarily narrow the trade deficit. As a matter of fact, Lebanon's trade deficit for 2014 contracted by 0.64% y-o-y to stand at \$17.19B as imports during the year displayed a 3.48% decrease to \$20.49B. This was mainly due to the 4.36% decline in the mineral products imported to Lebanon, which represent the largest share of 23.86%. Nevertheless, the volume of mineral products imported increased from 7,047 tons in 2013 to 7,375 tons in 2014.

While this has a positive impact on Lebanon's balance of payments, there is a downside for lower oil prices stemming from the possibility of lower remittances. The effect of a decline in oil prices on remittances from expats in Gulf countries remains contested, noting that they represent 60% of total transfers to Lebanon. The World Bank expects a decrease in remittances from GCC countries, but sustains that the overall effect on Lebanon's balance of payments will remain positive. According to the World Bank estimates, the relative elasticity of energy imports apropos oil prices is 0.25, higher than the 0.12 of income receipts. This implies that a 1% decline in oil prices would decrease energy imports by 0.25% and remittances by 0.12%. Furthermore, energy imports to Lebanon are larger than income receipts, which means that the positive impact on the balance of payments resulting from the decline in imports would more than offset the shortfall arising from lower remittances.

The positive effect extends to Lebanon's current account balance, as the Institute of International Finance (IIF) expects the declining imports to narrow its deficit by 25% to reach 15% of GDP, compared to an equivalent of 21.5% of GDP in 2014.

Another drawback from falling oil prices is lower Arab investments in Lebanon. However, due to the spill-overs of the Syrian war on Lebanon and the unstable political and security occurrences that Lebanon has been facing, capital-holders have been reluctant to invest in Lebanon. This means that Investment in Lebanon is already at a really low point, and would not be affected greatly by oil prices.

### The Effect on Lebanese Oil Importers and Distributor

On the micro level, oil importers and distributors in Lebanon had a different take on the falling oil prices.

There are 13 oil importing and distributing companies in Lebanon constituting the Association of Petroleum Importing Companies (APIC), a non-governmental association founded in 2007. The market is almost shared between the 13 companies, each having around 9-10% of the total. Worth mentioning that there is an arrangement between three companies: Total, Wardieh and IPT, where Total imports oil and sells it to Wardieh and IPT. Most of these operating companies import oil from the Mediterranean and Black Sea countries, especially Russia, Romania, Greece, Italy, Turkey, and sometimes Libya. Some also import oil from France.

Several sources at the Lebanese oil importing and distributing companies confirmed that the recent decline in oil prices had a deleterious impact on their operations. The lag between their purchasing dates and actual selling time exposed them to the negative price fluctuation. Distributors usually seal their contracts beforehand at a fixed price. Typically, this price is the average 3-week price. The oil vessels need almost a month to arrive to Lebanon. By that time prices had decreased, which caused the oil distributors to sell the oil at a lower price, incurring heavy losses.

Besides, some of the companies buy almost half of their inventory in October. Those are the companies that have sufficient silos to store their oil purchases. When prices went down, the latter took advantage of the low prices and increased their oil imports, storing them in their own tanks and in those of sister companies. Others simply bore immediate losses as they had no storage facilities. Oil producers are exposed to price risks, and may choose to hedge against its fluctuations or bare gains/losses along the way.

Oil importers, complaining that demand for oil is inelastic, did not face a higher demand when oil prices declined. However, demand increased due to the harsh winter weather that Lebanon faced, which coincided with the declining oil prices reaching to the 5-year minimum. Yet, by that time, a ship importing oil to Lebanon couldn't dock at the port, and hence, the country faced a shortage.

Excluding the seasonal effect, long-term behavioral changes in consumption that could lead to a higher demand have not yet materialized. Moreover, there were no major signs of consumer stocking oil in anticipation of future price rises.

Oil market in Lebanon has no barriers to entry. Any company can distribute oil. However, there are certain legal procedures that should be done in order to import oil. For instance, they should have an importing permit, a terminal on the port, and the necessary infrastructure for oil importing. The legal procedures are somehow halted as there is no president in Lebanon.

The oil industry in Lebanon seems saturated, according to one source. So if more companies open in this market, they would take away shares from the already existing importers and distributors. However, increased capital expenditures and investments in the country could lead to a growing demand for fuel, an unlikely scenario under the continuing crisis in neighboring Syria.

To conclude, on a macro level, Lebanon is drilling into the benefits of falling oil prices: higher real income, narrower trade balance, tighter fiscal deficit, and higher expected economic growth. Certainly, an economic plan attempting to decrease oil subsidies at this stage and improve government finances would be interesting to examine. On the other hand, the business players will probably need to put in place hedging strategies to protect them in hardships. The outcomes of the OPEC meeting scheduled in June of this year or any emergency meeting held beforehand will play a significant role in the alteration of the expectations mentioned.

**For your Queries:**

**BLOMINVEST BANK** s.a.l.

Research Department  
Bab Idriss, Weygand Str.  
POBOX 11-1540 Riad El Soloh  
Beirut 1107 2080 Lebanon

Lana Saadeh  
Tel: +961 1 991 784  
[lane.saadeh@blominvestbank.com](mailto:lane.saadeh@blominvestbank.com)

Marwan Mikhael, Head of Research  
[marwan.mikhael@blominvestbank.com](mailto:marwan.mikhael@blominvestbank.com)  
+961 1 991 782

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