

Good morning,

Let me start by thanking IISS, ORF and most importantly Sanjaya Baru for organizing this conference and inviting me. I don't think anyone who seriously thinks about any aspect of the globe can afford to overlook India. And India is certainly not an easy place to comprehend. So I am grateful to our organizers for giving us the opportunity to think more closely about this great country.

Following my exchanges with Sanjaya, I will focus on two commodities today, natural gas and oil.

There is a lot happening on both fronts. I think in both cases, dynamics with different time horizons are superimposed on each other, which makes it difficult to separate the immediate developments from the deeper structural issues. I will try to disentangle those layers of influence to provide a somewhat clearer picture.

Given the time limits, I will have to simplify and overlook many details. We can get to the details in Q&A if the need arises.

Let me start with natural gas.

The Ukraine crisis brought the peculiarities of the gas market into a sharp focus. It is a commodity traded across the globe in large volumes, but it is not a global market. It is still predominantly a fragmented market defined by geographic proximity and pipeline trade.

Because it is a vital commodity for most economies and in many cases, the importer and the exporter are captive to each other, natural gas creates the perfect context for applying economic leverage in the service of political ends. It is a perfect subject matter for geo-economics.

In the bigger global picture, Russian Federation sits at the center of the natural gas geo-economics. In terms of reserves, RF has the largest proven reserves, followed by Iran and Qatar. Iran has about two thirds and Qatar about half of RF's reserves. In terms of exports, RF leads Qatar and Norway by a significant margin. So RF is the critical player in the politically charged gas trade.

RF's key partner in gas exports is Europe especially in terms of revenue, which far exceeds half of its gas revenue.

As for Europe, RF provides over 30% of its imports if you exclude Norway. If you include Norway in Europe, then that ratio goes up to over 50%. And the imports from RF are pipeline traded gas. So we have an almost perfect case of mutual dependence or mutual captivity.

When the Ukrainian crisis erupted, this long-existing interdependence assumed a heightened level of visibility and significance.

In the immediate future, both sides seem to be careful not to disturb their gas trade as neither is capable of finding a substitute for the other. RF needs the income; Europe needs the gas. There is always the possibility of RF leveraging its power, but in the past, it has mainly used its leverage in Ukraine and in Eastern Europe.

Nevertheless, in preparation for such a contingency, Europe has filled up its storage facilities and with the backup of LNG supplies, can withstand a cutoff for some time. This period of resilience varies from country to country.

However, at the moment, the situation looks stable as both sides try not to perturb this tenuous gas trade while trying to punish each other through other means.

The interesting questions about the geo-economics of natural gas trade arise when we look at the implications of the Ukrainian situation in a longer time horizon.

Will the crisis trigger a major shift in the global natural gas game?

Both RF and EU will try to find alternatives to free themselves from the stranglehold of the captive relationship and improve their bargaining position vis-a-vis each other.

For the RF, the best bet is to find alternative clients in the growing Asian markets, mainly China. India still seems difficult because of geographic and political barriers to building pipelines.

As expected, Russia has recently signed a 30-year agreement with China for a 32 bcm/year gas deal worth 400 billion USD. The price was lower than what RF originally asked for, reflecting RF's hasty strategic shift. The actual physical implementation of the transaction will probably take at least 5 years. And the annual planned volume is still much less than the 160bcm exports to Europe, but it can be scaled up.

However, even this arrangement is not perfect for RF because the Chinese gas will flow from separate fields in East Siberia and will not tap into the existing fields that supply to Europe. So, RF won't be able to shift the same gas between Europe and China, which would have given it immense leverage. There is talk of such a possibility, but the costs of such linkage are likely to be very high.

The China deal is the RF side of the attempt to shift the bargaining position.

For this strategy to work for RF in the long-run, the two high-volume importers, namely Europe and China would both have to remain captive to Russian exports.

As it happens, there are two important developments in the global gas trade which jeopardize that strategy. First is the expanding LNG trade which weakens the geographic dependence on pipeline suppliers. Already, globally, about one third of gas is LNG traded. This is an important trend and will probably gain momentum as Europe tries to build alternative sources to strategically weaken the Russian leverage. Similarly, China is about to access LNG supplies from Australia.

The second development relates to shale gas. Although we mainly talk about shale in the US context, the geology of shale is available across the world. And once the technology and infrastructure take hold, we are likely to see national gas supplies emerging in China and even in Europe.

The rise of LNG and the geographically pervasive shale gas can theoretically provide alternative supplies to the two big consumers which would fundamentally weaken RF's bargaining position.

So basically, the Ukrainian crisis has triggered a major shift in the key dormant faultline in the Europe-RF gas relationship with major implications for the geo-economics of gas trade. It seems to be a race against time between RF's attempt to diversify its export markets to Asia on the one hand, and EU and China's access to gas supplies through LNG or shale on the other.

In my opinion, although there may be a short window of time where RF enjoys a strong hand in this race, in the medium term, underlying forces of expanding and diversifying gas trade are likely to favor globalised markets and will weaken the power of exporters.

One final wildcard that needs to be mentioned is Iran, which has the second largest gas reserves in the world. If the negotiations on the nuclear issue are successful and Iran joins global gas trade with its ample supply, the era of strong gas exporters and using gas exports as instruments of political power will probably come to an end for good.

Now let me turn to oil and then conclude.

The current surprising news about oil is that its price has dropped precipitously in a very short period of time to around 80 USD/barrel. That one number, the oil price, shapes and is shaped by many economic and political factors around the world.

First, why did it happen and can it go the other way?

The price fell because the US tight oil production increased beyond expectations and disruption fears in Iraq and Libya did not materialize. With that extra supply combined with below-expected demand growth, the price fell.

However, the excess supply is around 1-2mbd and can be reversed due to a variety of disruption scenarios in Iraq, Libya, Nigeria or even Venezuela.

Similarly, unexpected demand pickup around the world, especially in Asia, could have a similar upward effect on oil price. So, just as the price came down, it could easily go up.

Assuming such supply crises or sudden demand shifts do not happen, the next question is how the supplier countries will react to this low price.

It is safe to assume that most OPEC countries are unhappy with a low oil price. But the one country that can potentially cut its supplies in sufficient amounts to raise the prices is Saudi Arabia. And so far, it has not signaled an intent to do so. There will certainly be demands to cut supplies in the OPEC meeting this month but an agreement looks hard to reach.

Another possible supply cut decision can come from the US. If the oil price stays at this level, oil production may become unprofitable at the 80USD breakeven level at some production facilities and may be terminated. Some US shale oil production may be in this category as is deepwater production. It is hard to determine which production sources fall under this category. However, IEA estimates suggest that the susceptible volume is not too high.

If supply crises do not happen, demand does not rapidly pickup and if suppliers do not deliberately cut supplies, then the low oil price may last for a while.

Then the issue is to think about the repercussions because low and high oil prices both have extensive global impact.

The immediate impact looks positive as low oil prices are expected to benefit the global economy which needs a boost as the US quantitative easing comes to its end.

Similarly, low oil prices will hurt some globally assertive economies like Russia and Iran that rely on oil income. The RF reaction is hard to foresee as it will closely interact with Russian domestic politics. It may lead to a conciliatory or a more incendiary tone.

A third short to medium term impact of the low oil price is the prospect of social instability in fragile oil-exporting nations that rely on oil income for their government revenue. This is especially true for countries that do not have accumulated reserves to withstand the low oil income. Nigeria, Venezuela, Iraq are some obvious examples where the financial stress may trigger social unrest. Humanitarian and security consequences would confront the global community.

Of course such disruptions to production in those countries could then lead to the reversal of low oil prices.

However, low oil prices may even survive instability in fragile oil-exporting countries as there are potential new supplies that may flow to the global market in the medium term, ranging from the unconventional oil around the globe (US is estimated to have only 15% of the global light, tight oil (LTO) ) to the Mexican supplies.

Finally, thinking about the possibility of low oil prices for an even longer period of time raises the prospect of large fluctuations in prices. Low oil prices deter investment in new oil production, which leads to long lags in production growth. The supply eventually falls short of the growing demand and causes unduly high oil prices for an extended period of time until new investments, which take time, catch up. The possibility of lagged investment in oil production due to low prices is particularly worrying because the current sanctions on Russia and Iran are already delaying investments in potentially large fields. Similarly, the unstable security environment in Iraq, Libya, and Nigeria is not conducive to expanding current investment in these countries either.

When you combine all these elements, low oil prices for an extended period may well lead to very high prices a few years down the road. This would be similar to the high phase of the familiar oil price cycle which we suffered from in the past decade.

Admittedly, the cycle may be different this time. Newly discovered low cost, light oil supplies around the world or other low cost supplies could sustainably increase supply and preempt such a price cycle. But that is hard to predict at this stage.

And of course, oil price that remains at low levels for too long will make it very hard to fight climate change through efficiency gains or the development of new technologies.

Ideally, oil price should hover around a level that will provide a boost to the global economy while not deterring new investments in oil production. Unfortunately, oil markets rarely strike that perfect balance.

And as the oil price fluctuates through these entangled dynamics, it will impact global politics and will shift and recalibrate economic power around the world.

As long as the world depends on fossil fuels for its core energy needs, we seem to be doomed, at the mercy of this volatile interplay between energy economics and global politics.

I will stop there. Thank you.