When we addressed the geopolitical and economic impacts of lower oil prices in our March 2015 article, our analysis focused on the implications for net importers and net exporters of crude oil. As we expected, net oil importers have benefitted from lower prices, while net exporters with large currency reserves and sovereign wealth funds have taken it in stride. But net oil exporters with smaller financial safety nets, notably Nigeria and Venezuela, have been under severe stress.

Nearly 18 months after our initial analysis, oil prices are still near their Q1 2015 lows and fell as low as $26 per barrel during that period, with the probability of supply disruptions on the rise.

OPEC members will meet in September 2016 to discuss the possibility of capping production. In the past few weeks, oil prices have rebounded substantially off their July lows. However, there are a number of reasons to be skeptical of both the recent price rebound, and the OPEC meeting:

1. OPEC has rarely been effective in controlling its output, especially after 1986 when prices collapsed.
2. Saudi Arabia and Iran don’t have diplomatic relations, and Saudi Arabia probably doesn’t trust Iran (or Iraq and most other OPEC members) to cap production.
3. Any cap in Saudi production would likely benefit Iran, Iraq and Russia – all countries with which Saudi Arabia has contentious relationships.
4. Rising oil prices would benefit the U.S. fracking industry to the detriment of Saudi Arabia and other OPEC members. The long-term threat is that if oil prices rise, the technology that powered the 2008-2014 growth in U.S. production could be applied elsewhere.
5. Oil inventories in the U.S. and around the world continue to grow on a seasonally-adjusted basis. This might ultimately put oil under renewed downward pressure.

While the upcoming OPEC meeting might not prove supportive for oil prices, what could impact oil prices and send them on a wild ride is: political risk. In the past, even small disruptions in supply have created outsized moves in oil prices. Although high levels of inventories may buffer upside risks, the greatest risks lie in producer-nations that have the smallest financial reserves relative to GDP (Figure 1). For the most part, these are the smaller producers.
Angola: 1.9% of world production. In power since 1979, 74-year-old President Jose Eduardo dos Santos has indicated that he will run for another term in 2018 but may not serve out a full term. While he has made such statements in the past only to go on serving as president, this potential leadership transition comes at a tumultuous time. Angola’s economy has contracted by nearly 25% in the past two years. The government has slashed its budget by 20%, inflation has soared to over 30%, and the Angolan currency has fallen by over a third against the dollar. Amid the turmoil, Angola’s currency reserve has fallen from nearly $37 billion in 2013 to $23 billion as of May 2016. The country fought a 27-year-long civil war (1975-2002), and has the potential for serious political instability in coming years that could impair oil production.

Algeria: 1.9% of world production. Algeria is also heading for its own leadership transition as 79-year-old President Abdelaziz Bouteflika’s health deteriorates. Bouteflika assumed power in 1999 and helped to reconcile Algeria’s various factions after the 1992-2002 civil war that claimed as many as 150,000 lives. Bouteflika, perhaps stirred by the memories of the civil war, prevented Algeria from descending into the kind of chaos that rocked neighboring Tunisia and Libya in the aftermath of the Arab Spring. However, without a clear succession plan in place, Algeria remains at risk. The collapse in oil prices has cost it dearly, slashing GDP by about 12%, resulting in deep budget cuts. In addition to these woes, Algeria has major problems with drinking water shortages, and is seeing growing tensions with neighboring Morocco.

Iraq: 3.7% of world production. While Iraq never fully stabilized in the aftermath of the U.S. led invasion in 2003, its energy production has grown substantially from 1.3 million barrels per day in 2003 to 4.1 million per day in 2015. Its production is also growing quickly, up 25% in 2015 from 2014. Even so, Iraq is negatively impacted by the collapse in oil prices since oil is the country’s only major source of revenue. The decline in oil prices has meant severe budget cuts. This doesn’t make the government’s already challenging task any easier. Prime Minister Haider al-Abadi not only faces challenges from Islamic State but also has difficulties with elements of his own Shiite majority. In short, the world cannot count on surging Iraqi oil production to keep prices low in the future.

Nigeria: 2.7% of world production. Since 1999, Nigeria has alternated the presidency between candidates from the largely Muslim North and the Christian-majority South. While Nigeria did an excellent job with the presidential transition from Goodluck Jonathan, a Christian, to Muhammadu Buhari, a Muslim, the new president’s administration is beset by problems, many of them exacerbated by the collapse in oil revenues. Many critics see Buhari as relying excessively on advisors from his home region in the North and not sufficiently sharing power with leaders from the South. This situation is made more volatile by the need for steep budget cuts, which threaten Buhari’s ability to deal with a range of problems, including the Niger Delta Avengers militant group whose attacks have already impaired Nigeria’s oil production. Some commentators even wonder if Buhari’s presidency will survive. The potential for supply disruptions is elevated, especially given Nigeria’s long history of instability.

Venezuela: 3.0% of world production. Bolivarian socialism has been a disaster. Venezuela’s economy is imploding. Highly-qualified urban workers have become so desperate that some of them are even leaving cities to join gold mining operations in swampy rural areas, leading to a resurgence in malaria in a country that had nearly eradicated the disease 50 years ago. President Nicolas Maduro is rapidly losing whatever support he has left. Although Venezuela has enormous oil reserves, mismanagement of state oil company PdVSA has left the country’s energy production stagnant for years. The collapse in oil prices has led to a sharp contraction in GDP and Venezuela has responded by printing money, rather than cut budgets, creating hyperinflation. The Maduro regime is unlikely to last past 2019 when its term ends, but the question is what happens next? Venezuela has the potential for political events that could disrupt oil production.
In contrast, the world’s biggest oil producers look more stable.

**United States: 13% of world production.** Lower prices in the U.S. are impacting supply, which has contracted by 12% from its April 2015 peak. The main risk to supply stability could have to do with the financial health of oil and gas firms.

**Saudi Arabia: 12.8% of world production.** The country, which will probably become the world’s largest producer again in 2016, has sizeable financial reserves valued at 178% of GDP, but down from over 200% at the end of 2014.

While the country can’t continue burning through reserves at this pace, it can raise additional funds through selling a stake in state-run oil firm Aramco. The problem with this strategy is that Aramco’s valuation is very difficult to determine. Some value the firm at up to $2.5 trillion (over 300% of Saudi Arabia’s GDP), but raising capital at other state-run oil firms have often attracted low valuations from investors. From a valuation perspective, state-run firms have a number of problems:

1. The government usually retains majority control, leading to lower valuation. This will certainly be the case in Saudi Arabia, where the country is discussing selling up to 5% of Aramco, leaving the state with the remaining 95%. No control-premium for outside investors here!
2. State-run oil firms usually have to funnel revenue to the government, leaving less revenue for shareholders.
3. Investors may fear that the property rights and the rights of minority stakeholders will not be respected in the event of political change and, as such, may not be willing to pay a high price to own the shares.

In response to the lower price of oil, Saudi Arabia is cutting budgets and has introduced an ambitious plan to transform the country’s economy, making it less oil dependent between now and 2030. Pulling this off could be a challenge. The risks of near-term (pre-2020) instability seem fairly remote, although they cannot be ruled out entirely. After 2020, the country risks running into more severe political and social difficulties if the price of oil doesn’t rebound. As such, instability in the other oil-producing nations might actually benefit Saudi Arabia, if such instability leads to a sustained rise in prices.

**Russia: 12% of world production.** The world’s third largest producer looks fairly stable. Russia’s stability in the face of lower oil prices, budget cuts and a recession may surprise observers but there are good reasons for it. First, Russians have a high pain threshold having lived through numerous catastrophes: two world wars, various communist disasters, the chaos following the collapse of the Soviet Union, and the 1998 Russian debt default. A 4% decline in GDP isn’t likely to send people into the streets. Second, Russia has a fairly elderly population. Revolutions tend to happen in countries with a high proportion of young people, not in a country dominated by the middle-aged and elderly. Third, Russia’s state security apparatus appears to be in firm control.

This isn’t to say that Russia is without risks. Russia’s currency reserves are small compared to the size of its economy. On August 12th, President Vladimir Putin replaced a top aide, Sergei Ivanov, capping off a round of raids, arrests and resignations of Kremlin officials. Despite these events, Russia appears to be busy with its military involvement in Syria, taking its focus off Ukraine. As such, for the moment Russia appears to be a fairly low-risk candidate for political events that would disrupt oil supplies.

**China: 5% of world production.** The world’s fourth largest producer, China is rarely seen as a threat to global supply since it’s a net oil importer. To the extent that China represents geopolitical risks, those risks would be to the downside in demand and price, rather than to supply disruption and higher prices. China has taken an increasingly assertive posture in the South China Sea which does represent some potential for diplomatic tension with the United States and its regional allies. If tensions were to escalate, it could create a great deal of volatility in oil prices but it’s far from clear if prices would rise.

China’s other stability risk stems from its rapidly rising debt levels and slowing economic growth. China’s debt, public plus private, totaled 255% of GDP at the end of 2015, up from 235% a year earlier. This puts it where the United States and much of Western Europe have been since 2007. It’s not too far from where Japan was in 1990 when its economy abruptly faltered and began stagnating. If China suffers a financial crisis and recession, it could send oil prices plunging.
**Iran: 3.7% of world production.** The country has been negatively impacted by lower oil prices but much of the effects have been offset by rising production and the lifting of United Nations’ sanctions. Additionally, Iran’s economy is more diverse and less oil dependent than many outsiders might expect.

Like Saudi Arabia, other Gulf States, including the United Arab Emirates (U.A.E.), have substantial financial reserves and can probably wait out a few more years of low prices. Two smaller producers, Kazakhstan and Azerbaijan, also have stability risks but their production levels are probably too small to have a major impact.

**Bottom line**

- The world’s seven largest producers (United States, Saudi Arabia, Russia, China, Canada, U.A.E. and Iran) for various reasons represent fairly modest risk of supply disruptions.

- A number of smaller producers (Algeria, Angola, Iraq, Nigeria and Venezuela) represent substantial risks of political instability and supply disruption. Taken together, these nations produce 13% of the world’s supply of oil, more than either Saudi Arabia or the United States.

- As the chaos in Libya in 2011 taught us, a supply disruption even in a modest size market can create large moves in oil prices and in spreads between different oil benchmarks.

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