

Cheap oil, QE and Greece – what does it all mean?



At a glance...

A low oil price could boost output in the Eurozone, Japan and the US

Our main scenario assumption is that the oil price will average around \$55 per barrel in 2015, which is around 50% lower than in June 2014. This is expected to have a positive impact on the output of net oil importing economies like the Eurozone, Japan and the US.

But, the effects of a low oil price will not be felt evenly across different sectors of the economy. Some large corporations may not feel the benefits straight away due to having hedged against higher oil prices or being bound by long-term contracts with their suppliers. Households may also have to wait for oil price cuts to be passed on down the supply chain to consumers.

What is the sectoral impact of a low oil price?

We have estimated the direct first-order benefit of a low oil price for the industrial, residential, transport and services sectors in the US and key Eurozone economies.

Our analysis shows that:

- the US transport and industrial sectors could benefit in total by nearly \$300 billion in 2015;
- the transport sector should also be the big winner in the Eurozone, but the full effects could take time to feed through; and

- due to its lower energy efficiency, Greece could benefit relatively more than Germany from lower oil prices.

QE in the Eurozone could provide a modest boost to short term growth....

The European Central Bank (ECB) has announced a quantitative easing (QE) programme of more than €1 trillion to try to stimulate economic growth and push inflation back towards its target of below, but close to, 2%.

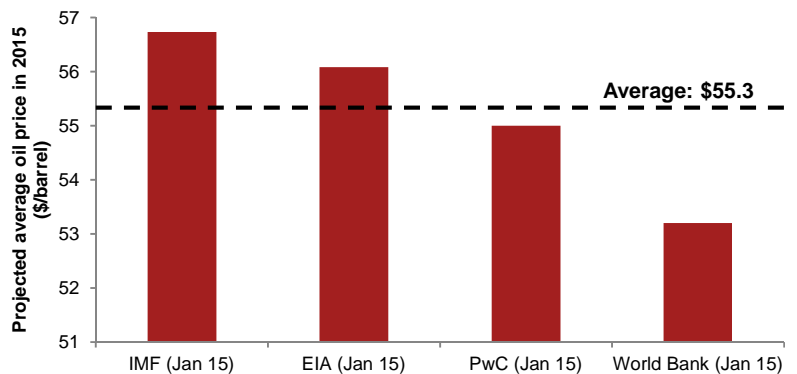
QE could lead to a further depreciation in the euro against the dollar. Uncertainty about Greece's future in the Eurozone could also put downward pressure on the single currency. This should provide a boost to Eurozone exporters, but it would also increase import prices faced by domestic businesses and consumers, offsetting in part the benefit from a lower oil price in US dollar terms.

...but it's not a substitute for structural reforms

We expect QE to provide a short-term boost to the Eurozone economy through increased borrowing, confidence and net exports. But structural reforms to labour and product markets remain the key requirement for improving the long-term potential growth rate of the Eurozone.

QE may be able to offset some of the initial pain of these structural reforms, but it should not be seen as a substitute for such reforms or a reason to delay them.

Fig 1: The price of oil is projected to be around \$55 on average in 2015, more than 40% lower than last year



Note: The oil price here is defined as the average of Brent and WTI except for the IMF and World Bank numbers which are for the average of Brent, Dubai and WTI
Sources: PwC analysis, IMF, US Energy Information Administration (EIA), World Bank

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Economic update: It's QE for the ECB!

European Central Bank takes action to combat low inflation

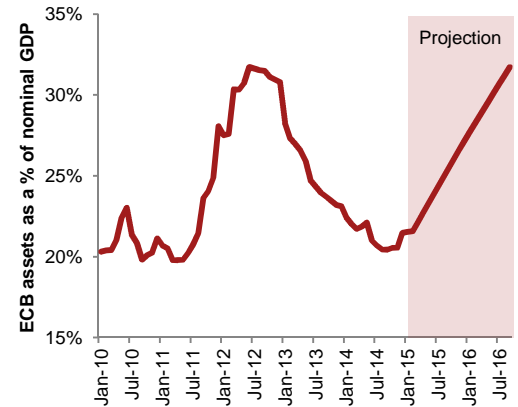
The European Central Bank (ECB) has announced plans to carry out an expanded quantitative easing (QE) programme, involving the purchase of government bonds. Specifically, the ECB is expected to boost its balance sheet by €60 billion per month beginning in March 2015 and lasting until at least September 2016. If the programme finishes in September 2016, it will have increased the ECB's balance sheet by over €1 trillion. This is expected to increase the ECB's assets as a percentage of GDP back towards the level it reached in mid-2012 (see Figure 2), as a result of bond purchases through the Securities Markets Programme (SMP) and the longer-term refinancing operations (LTROs).

Will QE have the desired effect in the Eurozone?

QE works by the central bank buying government bonds, which pushes up the price of bonds and lowers the interest rate, making borrowing cheaper and potentially boosting other asset prices. These direct monetary effects should encourage borrowing and increase credit in the economy. This is expected to spur consumer spending and investment, thereby stimulating economic growth. As well as this, QE could also lead to increased optimism amongst consumers and businesses, encouraging them to spend even more, as well as boosting net exports through a weaker euro.

We expect QE to provide some boost to economic growth prospects in the short-term, but without structural reforms it will not raise the longer-term growth potential of the Eurozone economy. It is buying time for such reforms, but this opportunity cannot afford to be wasted.

Fig 2: After QE, the ECB's balance sheet is projected to be equivalent to nearly a third of Eurozone GDP



Note: Assumes a €1.1trn increase in the ECB's balance sheet and our latest projections for real GDP growth and inflation. Sources: PwC analysis, ECB, Eurostat

Interview with Andreas Riris, PwC Greece Partner (3rd February 2015)



Andreas Riris is the Financial Services Leader and an Assurance Partner in PwC Greece. He joined the firm in 1995 and has been a UK qualified chartered accountant since 1996.

One silver lining in 2014 was the sustained increase in economic output in most peripheral Eurozone countries, including Greece. Do you think this trend will continue?

Greece's new government was elected on the promise of adopting a different strategy to deal with the country's economic problems and its relations with its creditors. But they don't have the luxury of time.

Greece's bailout programme expires at the end of February. This means that unless an agreement is reached, around €43 billion of ECB liquidity could be withdrawn from the local banking system.

In view of this a potential extension to the bailout programme until around May-June would be helpful. This would give enough time for the new government to agree on a new set of reform measures followed by an agreement on the new terms of the bailout.

However, even if a "new deal" is struck, the short-term uncertainty could adversely impact consumer spending and investment growth. In this context, Greece's originally planned GDP growth rate of 2.9% in 2015 (as per the Troika model) looks more challenging than a few months ago.

2015 is shaping up to be an important year in Greece's economic recovery. What do you think are the main risks and opportunities to Greece's economic outlook?

A sustained increase in economic output would firmly signal the end of recession in Greece. However, recent economic conditions have become less favourable, driven in part by the recent political developments.

In our view Greece's economic prospects could improve if the following key issues are tackled:

- An effective work-out of non-performing loans, which now stand at around 40% of local banks' loan portfolios;
- Investment and exports increase on a sustained basis; and
- An agreement is reached on some form of sovereign debt restructuring, possibly through the extension of the maturities of the bailout loans and a further reduction in the interest rates rather than an outright write off of some of the debt. Along these lines, the new Greek Finance Minister, Yiannis Varoufakis, revealed yesterday that he intends to propose a "menu of debt swaps" to ease the debt burden, including bonds indexed to economic growth to replace the ca. €200bn European bailout loans and perpetual bonds to replace the €27bn PSI exempt Greek bonds held by the ECB.

The final point will be the key focus of negotiations in the next few weeks and months and will set the tone for Greece's growth outlook in the longer term.

On the plus side a number of structural reforms have already been implemented, particularly in the labour market. However, it is important that the new government maintains the momentum of structural reforms, including measures to make tax collection more effective and boost government receipts.

The current account balance has also improved, but this has been driven primarily by a reduction of imports. This shows that Greece needs to focus even more on improving its external competitiveness.

What are the main issues facing Greek banks preventing them from extending credit to Greek businesses?

Since the crisis began, Greek banks have been generally unwilling to lend because of solvency and liquidity pressures, but also due to a lack of healthy credit demand.

However, even though lending volumes are declining, production seems to be slowly picking up and bankers are trying to channel capital from the consumer-driven sectors towards the more productive export-oriented sectors like tourism, energy and shipping.

The restructuring plans that local banks have implemented have also been successful as:

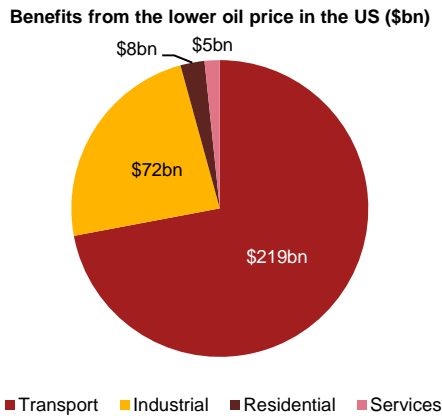
- Expensive ELA funding was replaced by cheaper collateralised interbank funding;
- Banks have been recapitalised by raising around €35 billion ahead of the ECB's comprehensive assessment; and
- The deposit base of the banking system had, in broad terms, remained relatively stable (at least until recently).

Unfortunately any lending growth momentum is likely to be disrupted by recent events. For example, two weeks ago two of the four systemic banks announced they applied for expensive ELA funding. If the ECB goes ahead and stops accepting bank-issued government guaranteed bonds by the end of February, then this could exert significant pressure on liquidity in the financial system.

The decisions taken by Greece and Europe in the next few weeks or months will therefore be of paramount importance for the country's future. Agreeing on a fair and realistic way forward could support long-term growth, support the gradual reduction of the debt burden and remove the uncertainties around Greece's place in the Eurozone.

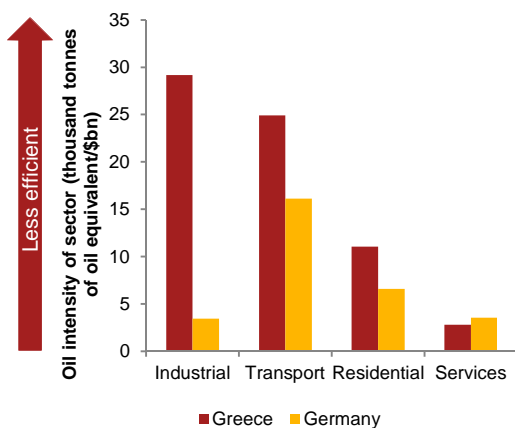
Cheap oil is good news for some countries, but which sectors will get the biggest boost?

Fig 4: The transport and industrial sectors are expected to benefit the most in the US from a low oil price



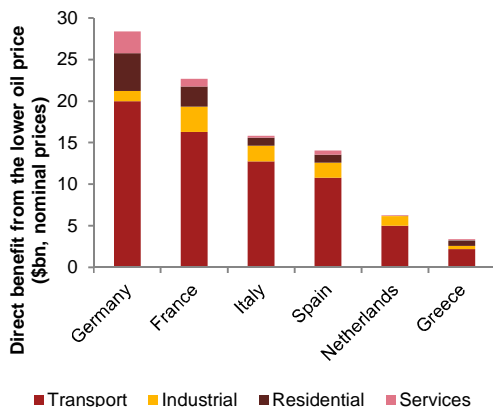
Sources: PwC analysis, EIA

Fig 5: The industrial sector in Greece will benefit relatively more than in Germany as it is less oil efficient



Sources: PwC analysis, Eurostat, Datastream

Fig 6: In the Eurozone, the transport sector is expected to benefit the most from the oil price fall



Sources: PwC analysis, Eurostat, Datastream

The biggest swing in the oil price since 2008

Oil prices are once again causing a global stir after the price of crude oil (the average of Brent and WTI) fell by more than 50% in 7 months. This was predominantly driven by strong supply; in the US, crude oil production increased by around one million barrels per day last year, helping to push prices down from \$108 per barrel in June 2014 to around \$48 in January 2015.

The oil price could average around \$55 per barrel during 2015

Oil price prospects remain highly uncertain, but our main scenario assumption is that oil will average around \$55 per barrel in 2015, similar to the average of other recent forecasts by the IMF, EIA and World Bank (see Figure 1). For net oil importing economies, this fall in energy costs should be good news, but the impact will be felt differently across sectors.

We have estimated the benefit of the oil price being \$55 per barrel in 2015, compared to \$103 in 2012.¹ We define this benefit as the expected savings in the cost of oil in 2015 compared to 2012. Our analysis covers the industrial, residential, services and transport sectors² in the US as well as in key Eurozone economies for which comparable data was available. These results give an estimate of the direct impact of the oil price fall, but do not take account of the knock-on effects that would flow through the wider economy over time.³

In which sectors will the lower oil price be felt the most?

The different characteristics of these sectors mean that the size of the impact and the time it will take to feed through could vary. Our analysis shows that:

- **The US should feel the biggest impact in the transport and industrial sectors (see Figure 4):** The industrial and transport sectors in the US consume the most oil per dollar relative to the size of the sector. The direct impacts on the transport and industrial sectors are estimated to be around \$220bn and \$70bn respectively. These benefits will be felt through a reduction in affected businesses' operating costs, which could lead to an increase in production levels. The resulting increase in the supply of goods to market would push prices down and stimulate consumption.
- **The transport sector should also be the big winner in the Eurozone, but the full effects could take time to feed through:** In the Eurozone the transport sector is expected to benefit the most from the low oil price. The combined benefit to the transport sectors in our sample is estimated to be around \$65bn. However, it could take some time for these effects to be felt as, for example, many airlines hedge against the cost of fuel.
- **Due to its lower energy efficiency, Greece could benefit relatively more than Germany:** Germany has the most oil-efficient industrial sector, which helps to explain its competitive edge in manufacturing. By contrast, oil intensity is above average in Greece in all four of the sectors we have looked at (see Figure 5). As a result, the impact of the lower oil price is expected to be relatively higher in Greece than in Germany in the industrial, transport and residential sectors.

However, a further depreciation of the euro against the dollar could erode some of the benefits. Our analysis shows that, for the six Eurozone economies in our sample, a 10% depreciation in the euro could reduce the direct economic benefit by a similar percentage.

Large corporations may use financial instruments to hedge against price volatility or may be bound by pre-existing long-term contracts within their supply chain, thereby restraining them from feeling the benefits in the short-term. Individual consumers, on the other hand, are less likely to enter such arrangements and are expected to feel the effects of a change in oil prices, through cheaper motor fuel costs sooner, though other benefits (e.g. via lower gas and electricity prices) may take longer to feed through.

Key assumptions:

- the energy consumption of each sector remains the same as in 2012, which is the last year for which detailed sectoral data is available; this may not be too unreasonable an assumption given that oil consumption does not tend to be too sensitive to prices, at least in the short-term.
- to estimate the size of each sector, sector gross value added (GVA) is used for the industrial and services sectors, household consumption is used for the residential sector, while transport benefits are expressed as a percentage of GDP.⁴

¹The saving is calculated in nominal terms, but calculated as a percentage of sector size in 2012 prices.

²This is not an exhaustive list of sectors so the totals do not sum to the total energy consumption of the economy.

³For the UK, we plan to look at these wider economic impacts in more detail in our next UK Economic Outlook report in March.

⁴According to Enerdata, the value added of the transport sector only captures the contribution of transport businesses, and this does not represent the total oil consumption of the sector.

Projections: February 2015

	Share of 2013 world GDP		Real GDP growth				Inflation			
	PPP*	MER*	2014p	2015p	2016p	2017-2021p	2014p	2015p	2016p	2017-2021p
Global (Market Exchange Rates)		100%	2.8	2.9	3.3	3.2	2.6	2.5	2.4	2.5
Global (PPP rates)	100%		3.4	3.5	3.9	3.9				
United States	16.4%	22.4%	2.4	3.2	3.1	2.6	1.6	0.9	1.8	1.9
China	15.8%	12.7%	7.5	7.1	7.2	6.9	2.1	2.1	1.8	3.0
Japan	4.6%	6.6%	0.2	1.0	1.2	1.0	2.7	1.4	2.3	1.9
United Kingdom	2.3%	3.4%	2.6	2.5	2.3	2.3	1.5	0.6	1.8	2.0
Eurozone	12.3%	17.1%	0.8	1.1	1.7	1.6	0.5	0.8	1.2	1.4
France	2.5%	3.8%	0.5	0.8	1.4	1.7	0.6	0.6	1.0	1.2
Germany	3.4%	4.9%	1.4	1.1	1.9	1.4	0.8	1.2	1.7	1.7
Greece	0.3%	0.3%	0.6	1.9	3.0	3.5	-1.3	-0.1	1.0	1.4
Ireland	0.2%	0.3%	4.3	3.3	3.2	2.5	0.3	0.6	1.0	1.5
Italy	2.0%	2.8%	-0.4	0.3	1.1	1.1	0.2	0.5	1.1	1.4
Netherlands	0.8%	1.1%	0.8	1.4	1.6	1.8	1.0	1.2	1.1	1.3
Portugal	0.3%	0.3%	0.9	2.1	2.1	1.8	-0.2	0.5	0.9	1.5
Spain	1.5%	1.8%	1.3	2.0	2.1	2.1	-0.2	0.4	1.0	1.2
Poland	0.9%	0.7%	3.3	3.5	3.5	3.5	0.2	1.0	2.0	2.5
Russia	3.4%	2.8%	0.2	-5.0	-0.5	2.0	7.8	15.0	8.0	4.3
Turkey	1.4%	1.1%	2.8	3.5	3.8	4.0	8.9	6.9	6.5	6.2
Australia	1.0%	2.0%	2.6	2.6	3.1	3.1	2.6	2.5	2.6	2.5
India	6.6%	2.5%	5.3	7.0	6.9	6.5	4.4	4.2	5.2	6.0
Indonesia	2.3%	1.2%	6.3	5.9	6.3	6.3	6.3	6.5	6.7	5.1
South Korea	1.7%	1.7%	3.4	3.7	4.0	3.8	1.3	1.5	2.2	2.9
Argentina	0.9%	0.8%	-0.4	0.1	3.1	3.1	25.0	25.0	-	-
Brazil	3.0%	3.0%	0.3	1.0	2.9	3.0	6.3	5.5	4.5	4.8
Canada	1.5%	2.4%	2.4	2.5	2.3	2.0	1.9	1.3	1.9	2.1
Mexico	2.0%	1.7%	2.3	3.4	3.8	3.6	4.0	3.5	3.5	3.1
South Africa	0.7%	0.5%	1.4	2.0	2.5	3.5	6.1	5.3	5.4	5.3
Nigeria	1.0%	0.7%	6.0	4.2	4.9	7.0	8.1	11.7	9.9	7.3
Saudi Arabia	1.5%	1.0%	3.6	3.0	3.2	5.2	2.7	2.8	3.0	3.4

Sources: PwC analysis, National statistical authorities, Thomson Datastream and IMF. All inflation indicators relate to the Consumer Price Index (CPI), with the exception of the Indian indicator which refers to the Wholesale Price Index (WPI). Argentina's inflation projections use the IPCNu Index released by INDEC. We will provide a 2016 and 2017-2021 inflation projection once a longer time series of data is available. Also note that the tables above form our main scenario projections and are therefore subject to considerable uncertainties. We recommend that our clients look at a range of alternative scenarios.

Interest rate outlook of major economies

	Current rate (Last change)	Expectation	Next meeting
Federal Reserve	0-0.25% (December 2008)	Rate to start to rise during the middle of 2015	17-18 March
European Central Bank	0.05% (September 2014)	Rates on hold following decrease in September	5 March
Bank of England	0.5% (March 2009)	Rate to start rising gradually later in 2015	5 March



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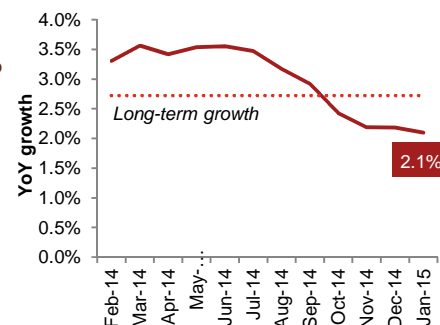
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PwC's Global Consumer Index

Growth in global consumer spending failed to start off with a bang in the new year.

Equity market performance weakened slightly in December, however overall industrial production improved owing to a better performance in Asia Pacific. However, news of weakening global growth continues to weigh on consumer and business confidence, which could have a negative effect on the GCI over the short-term.



The GCI is a monthly updated index providing an early steer on consumer spending and growth prospects in the world's 20 largest economies. For more information, please visit www.pwc.co.uk/globalconsumerindex

We help you understand how big economic, demographic, social, and environmental changes affect your organisation by setting out scenarios that identify growth opportunities and risks on a global, regional, national and local level. We help make strategic and tactical operational, pricing and investment decisions to support business value creation. We work together with you to achieve sustainable growth.

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