

Energy transition not a panacea for fuel importers

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Summary

- The energy crisis that has sent energy prices soaring in 2022 may act as a catalyst for accelerating of underlying trends in the energy mix towards cleaner energy provisioning. We expect oil and gas prices to continue declining over the coming decade, with price risks to the downside subject to the intensity of policies.
- The energy transition should offer relief to energy-importing economies. It reduces their dependence on fossil fuel imports in the medium term via significantly lower global energy prices and through greater energy self-sufficiency as imported fossil fuels are increasingly replaced by home-grown renewable energy supply.
- Our modelling confirms these benefits from declining fuel import bills, but the persistent current account deficits of energy-importing countries will not be completely eliminated and the debt problems they face will not be resolved.

The world is facing a global energy crisis of unprecedented depth and complexity. Extreme price volatility and supply insecurity, on top of increasingly dire climate change concerns, are ushering in a new era of policymaking – both public and private – to speed up the transition to renewable energy sources. The resulting downward pressure on oil and gas prices could help those emerging market economies that are dependent on energy imports to increase self-sufficiency and reduce their import bills. This should reduce country risk and even potentially offer investment and growth opportunities. But it will be a bumpy road. Broad economic structural reforms are equally as important to reduce deep-seated financial vulnerabilities and the decline of fossil fuels is likely to follow a volatile path.

In this research note, we present our outlook for the oil and gas markets over the coming ten years and what it means for country risk for energy-importing countries. We expect oil and gas prices to be significantly lower in 2032 compared to 2022, with downside risk based on the trajectory of government policies towards net zero goals. Taking the International Energy Agency's price forecasts

from their latest World Energy Outlook, we model what the impact would be on energy-importing countries. While it offers meaningful reductions to current account deficits, the energy transition alone will not be sufficient to resolve external imbalances or public finance woes.

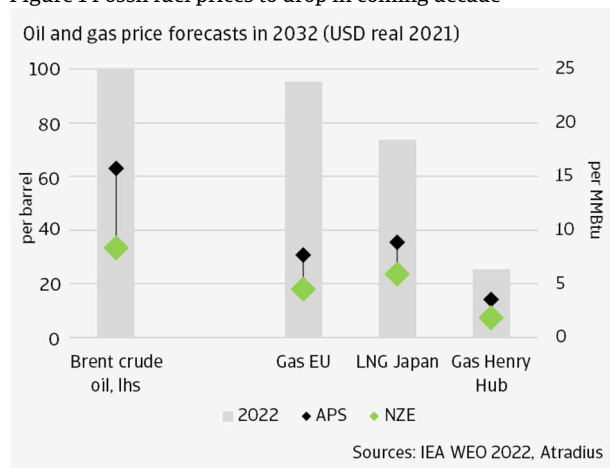
Oil and gas prices to continue declining over coming decade

Our baseline outlook is based on the International Energy Agency's 'Announced Pledges Scenario' (APS). This scenario models the impact of the already-implemented and announced climate policies on the global energy mix over the coming decades. It assumes that governments will meet all current climate policy commitments, however vague, in full and on time. Considering the increasing urgency of the energy transition and popular support, we think governments will meet their self-imposed goals. Moreover, the announced targets are still insufficient to meet climate goals so the chance of heavier-handed action may increase. Therefore we look to the Net Zero Emissions (NZE) scenario to understand the impacts of more

aggressive climate policies and the sharp fall in demand for fossil fuels that accompanies them.

As the energy mix increasingly favours renewables, the outlook for both oil and gas prices is downwards. Already seeing some relief from the extreme tightness observed in 2022, we expect prices for both commodities to continue gradually declining over the coming decade. In the oil market, we anticipate global oil demand will peak already next year as government policies, particularly in the US and Europe, prioritise reducing fossil-fuel demand. Lower demand translates to lower market prices, favouring lower-cost, conventional production. As such, OPEC's market share will continue to grow at the expense of US producers in particular. Under the APS, the price of oil will fall to USD 63 per barrel of Brent crude in 2032, from USD 100 in 2022 (figure 1). Under the NZE scenario, this drop will be even more pronounced due to significantly more aggressive energy transition policies. In this scenario, demand for oil never recovers to 2019 levels, dragging prices down more than twice as far to USD 26 per barrel Brent in 2032.

Figure 1 Fossil fuel prices to drop in coming decade



The gas market is still subject to high volatility in the near term. Gas prices rose sharply in 2022, mostly as a result of reduced Russian supplies to the European market and strong gas storage injections through higher LNG imports. The energy shortages experienced in Europe had a ripple effect particularly in the Asian market, which traditionally is highly dependent on LNG. In recent months, however, there has been some easing in market conditions as the mild winter and lower storage injections have lowered the European gas price.

We expect global gas demand to peak in the coming years. In the near term, gas prices are likely to remain elevated as the EU still needs to attract non-Russian gas. This has knock-on effects on prices in other importing regions, such as Asia. In the medium term, we expect that the gas price will trend down in all three major markets – the US, Europe and Asia – as the push for

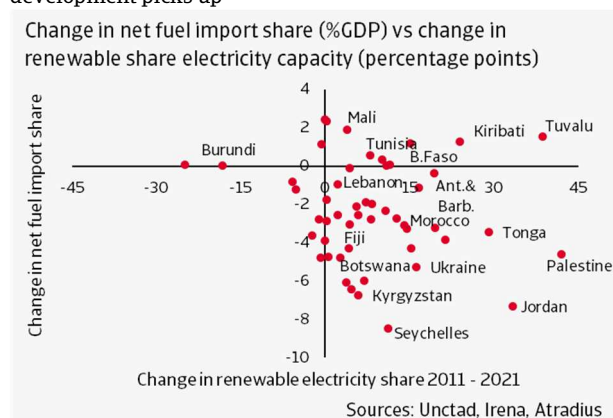
renewables is likely to lead to easing demand, while additional LNG facilities add to supply. Under the NZE scenario, the decline in gas consumption is stronger than under APS, leading to even lower medium-term equilibrium gas prices.

Energy importers become more self-sufficient

The energy transition clearly favours energy-importing economies, in comparison to hydrocarbon exporters. Significantly lower global energy prices envisaged in both the APS and NZE scenario offer relief to energy-importing economies by reducing their import bills. It will also make them less dependent on fossil fuel imports in the medium term, as imported fossil fuels are increasingly being replaced by home-grown renewable energy supply. The process of increasing energy self-sufficiency has already started. Based on a 6-year moving average of the 50 heaviest net fuel-importing emerging economies, the net fuel import bill has on average dropped from 8.4% of GDP in 2015 to 6.2% of GDP in 2021.

The scatterplot (figure 2) shows that a decline in the import share of fuel is generally accompanied by renewable energy development. The indicator used reflects the renewable electricity capacity that has been installed (not generated), which we see as the first and most important step in the energy transition¹. For the average energy-importing country, the share of renewables in the power mix has increased by about 10 percentage points over the past decade. The current share of 37% in terms of installed capacity is roughly equal to the global average. An acceleration of the development of renewable energy sources is expected in both the APS and NZE scenario. This will help to further improve the external position of importers and reduce their country risk.

Figure 2 Fuel import dependence declines as renewable energy development picks up



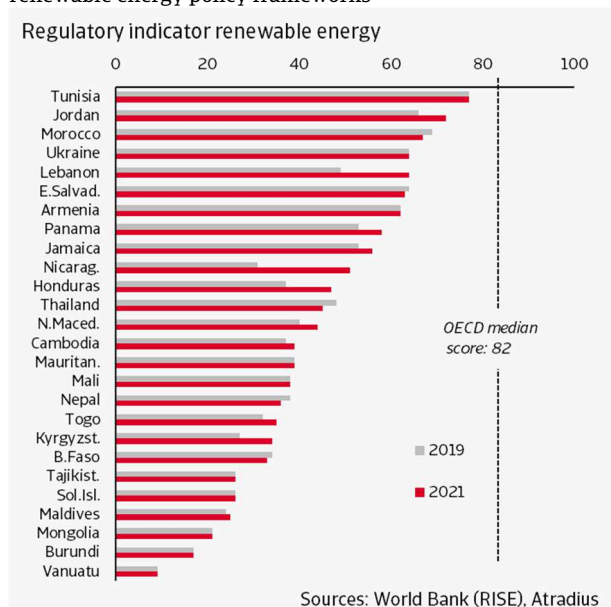
Countries that have ambitious renewable energy targets that are backed up by a comprehensive policy framework have the best chances for success. The World

¹ We realize this is not an all-encompassing indicator of energy self-sufficiency as fossil fuels are also used in industries other than the power sector. It also does not necessarily reflect capacity

actually used, as it is not uncommon for a country's power generation to lag behind and be considerably smaller.

Bank Regulatory Indicators for Sustainable Energy (RISE) is a useful tool in this regard. Their renewable energy composite indicator provides insight into the quality of the legal framework, planning, incentives and network connection, and various other elements that facilitate the development of renewable energy (figure 3). It shows improvements in the renewable energy policy framework in recent years, with some of the energy-importing countries – such as Morocco, Jordan and Tunisia – approaching the median score of advanced/ OECD countries. However, the lack of financial resources to invest in renewable energy development remains a major obstacle. Not all of the top performers in terms of policy have therefore yet made strong progress in installing renewable power capacity in practice. Tunisia and Lebanon, for instance, only managed to marginally increase their shares of renewable energy in the electrical capacity mix to 7% and 11% respectively by 2021, which is still far from their targets of 30% target for 2030. Jordan and Morocco stand out positively in that they combine a relatively strong renewable energy policy framework with impressive increases in the share of renewable energy in electricity capacity to 34% and 37% respectively.

Figure 3 Fuel importers have room for further improvement in renewable energy policy frameworks



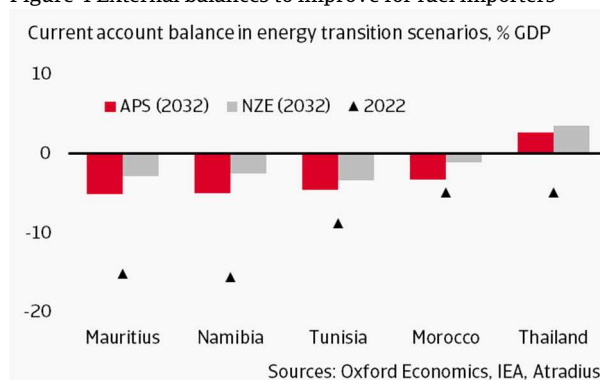
Renewables not a panacea

For energy-importing countries, renewable energy development is improving energy self-sufficiency, but it will not make them shockproof and will not solve their persistent current account deficits. The magnitude of energy price shocks can still be significant. Higher prices in 2022 caused a median deterioration in the current account deficit of about 2% of GDP, although higher food prices were of course also to blame. Moreover, due to various structural problems and weak policymaking, energy importers often run persistent twin (current account and budget) deficits, which persist even in times of low oil prices. This in turn has prevented them from building up financial buffers to protect them from oil

price related liquidity shocks. Of course, current account deficits cannot be entirely attributed to bad policies. Part is simply inherent in the fact that heavy energy importers are primarily emerging market economies that require relatively high imports of capital goods to invest in their economic potential to catch up with advanced economies.

To gauge better the impact of the energy transition on country risk, we conduct our own scenario analysis using the Global Economic Model of Oxford Economics. The oil and gas price paths envisaged in the APS and the NZE scenario are imposed on this model. First, we look at what happens to the current account balance, a main driver of macroeconomic imbalances and then at the external debt levels. Of the limited number of energy-importing countries available in the model, all show significant improvements in current account balances by 2032 – the end of the forecast horizon – in both energy transition scenarios (figure 4). The greatest changes are naturally achieved in the NZE scenario.

Figure 4 External balances to improve for fuel importers



Although current account deficits will narrow significantly during the energy transition, they will in most cases not be eliminated, at least not in the coming ten years. Positive exceptions are those fuel-importing countries such as Thailand that currently already have low current account deficits or even small surpluses, often due to mitigating factors like strong inflows of worker remittances or a strong export base. However, for most of them, the current account deficit is larger than the net fuel import share in terms of GDP. And as we do not expect that the net fuel import bill will be reduced to zero by 2032, part of the deficit is expected to remain. Ongoing import dependence for other commodities including food will also drive those deficits.

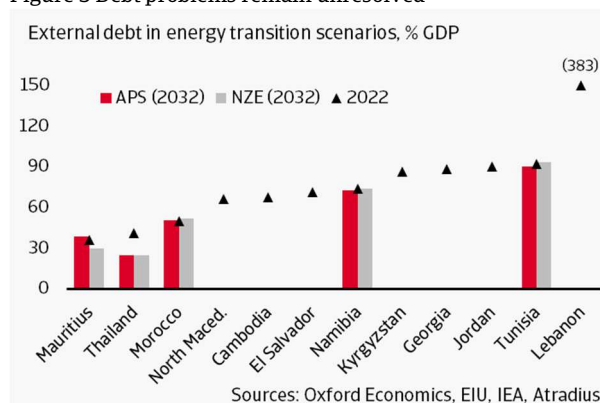
The expected boost in renewable energy development could initially contribute to current account deficits via higher import demand for capital goods associated with the energy transition, such as solar panels and wind turbines. This assumption of significantly higher investments in renewable energy capacity in line with the energy transition scenarios of the IEA has not been included in the model. However, additional improvements in energy self-sufficiency will eventually pay for themselves by further reducing future fuel imports.

Net zero is *not* zero country risk

The energy transition does not solve the existing debt problems of energy-importing countries either. While benefitting financially from lower oil and gas prices and greater energy self-sufficiency, current accounts remain largely in deficit and as such do not lead to external deleveraging. Moreover, since they lack financial buffers, investment in renewables will also have to be largely debt-financed.

While the model confirms that the energy transition will not propel energy-importing countries out of their existing debt problems, it also shows that the downtrend in oil and gas prices will at least help to stabilise external debt at current levels in terms of GDP.² Unfortunately, those levels are high for Namibia and Tunisia, above 70% of GDP, as well as for a number of other fuel-importing countries not included in the model output (figure 5). Thailand is one of the few energy-importing countries not hampered by a persistent twin deficit and will therefore be able to further reduce its already limited debt burden. Due to the often equally persistent budget deficits, public debt of many of these countries, including Morocco and Mauritius, will also remain high, and continue to exceed the IMF's critical threshold for emerging market economies of 70% of GDP.

Figure 5 Debt problems remain unresolved



So, the energy transition may offer some relief to emerging market economies that are dependent on hydrocarbon imports by reducing the costs of energy imports and, perhaps more importantly, substituting imported fossil fuels with home-grown renewable energy supplies. This will make energy importers less sensitive to global energy price shocks. However, their macroeconomic imbalances are typically deep-seated and will not easily disappear without broad economic structural reforms.

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² If current account deficits are low enough, financing them will generally not drive up the external debt ratio, as long as the

denominator (GDP) grows faster.

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