Federal Reserve Reaction Paper

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In the article *How to handle an Oil Shock* (Reinhart, 2017), the primary issue is the way in which countries that rely on oil can cope with the plummeting prices of oil and the increasing external debt. Such matters emanate from the fact that oil prices have dropped by about 60% for four years since 2012. In this regard, nations that rely on this commodity as the primary source of national income have had to grapple with perceived permanent drop in export and budget income. Saudi Arabia, Russia, Venezuela, and Iraq are some of those oil-exporting states that face problems in financing external as well as fiscal deficits in the ensuing oil shock.

The interesting part of this article is that the issue touches the economic performance of these countries. Most profoundly, the drop in prices of oil has a direct connection to the governments' income that directly affects its budget as well as external balances or deficits. Additionally, a continued fall in prices of oil means an increased foreign debt as governments increase outside obligations to cater for the national budget. Similarly, such nations face reserve losses and debt that is dominated by the U.S. dollar. In effect, they face a degrading credit rating and a likely default. Such information is important to learn as it comprises valuable knowledge about inflation and external debts in a country.

The article relies on primary data obtained from governments' financial records. While explaining the economic effects of the changes on oil trends, the article uses several states' external balance and budget for several oil-producing countries. On the other hand, to explain the downgrading of credit rating for these nations, this discourse cites Fitch as the source of such information. Also, the author uses financial institutions, such as the Bank of America Merrill Lynch, to support her claim about the sovereign issuance for Saudi Arabia, Kuwait, and Qatar.

The basis for this research is the continued volatility in the global oil market. In the past several years, the average annual world prices of oil in the world have dropped by alarming rates. Notably, the various countries that rely heavily on the export of oil, and therefore, the only source of national income. Additionally, the proceeds of this trade are used to settle external deficits. In this regard, the article bases its proposition on the fact that dropping oil prices are likely to continue. This way, the affected nations should find a means for responding to such shifts.

There exists a casual relationship between the basis of the research and issue of the study as well as the data provided. First, it is possible to note that most oil-producing countries rely on its revenue for national budgeting as well as the financing of external debt. Second, any changes in prices of oil in the world automatically affect the revenues of such countries as well as its ability to issue debts. On the other hand, fewer revenues culminate to increased deficits and credit rating downgrades. Such incidents are especially true when inflation affects the value of currency for those countries that depend on the U.S. dollar. As such, the events of the article are interconnected where an occasional change in one of them leads to a corresponding shift in the other.

The paper relates to several topics covered in the course. One of these cases is inflation where it mentions the loss of value for the U.S. dollar as a global medium of exchange. The article suggests that a continued slump in oil prices is a massive risk and cost for countries that receive debts whose exchange rate is pegged to the U.S. dollar since it could lose value. This concept helps to relate the idea of inflation, its causes, and the effect on the cost of debt. In this regard, this knowledge is applicable even in the international trade and economic performance of nations.

Another concept that stands out in the article is the demand and supply as they relate to a market scenario. The presence of a significant amount of oil in the market results in low prices as the need for the commodity decreases. The article explains that the demand for oil may increase in future due to diminishing stocks in Japan, and Europe as well as the increase in consumer purchases of guzzling vehicles in North America. However, some people believe the demand might remain low due to the declining authority of Saudi as the leading producer of oil. The two scenarios help explain how the concepts of demand and supply affect the market prices. As such, it is possible to ascertain the market conditions of a product by observing its current and future trend.

Finally, the article exposes the concept of economic performance as viewed using the gross domestic product, national budget, and foreign obligations. In the article, the prevailing prices of oil have a profound impact on the nominal GDP, government expenditure, and external borrowings. Notably, when the government has limited revenues, it is impossible to finance its national budget and foreign debts. As a result, it develops a weak GDP marked by a ballooning external deficit. Such observations have a positive contribution to the knowledge of a country's economic performance.

Based on the knowledge gained from this course, it suffices to note that the findings of the article are convincing. Such a stance emanates from the fact that it applies all the concepts of the financial performance of an economy to explain how states can handle an oil shock. Similarly, the discourse uses original and well-supported sources to support the information. Most of this data comes from government records as well as reputable financial institutions.

The strongest argument from the article is the fact that global oil market has remained volatile for several years now. Since some countries rely on this commodity for federal budgeting, there is a need to devise a mechanism for responding to such shifts. However, the remaining question is how countries could avoid additional risks and costs that surround currency depreciation. It is true that most of the affected countries obtain external debts using an exchange rate that is based on the U.S. dollar, hence the need for an alternative strategy.

On the other hand, an alternative elaboration of this work is that the current slump in oil prices is set to continue and that sovereign debt is likely to backfire. There is an expected increase in debt issuance among Gulf countries as they anticipate oil prices to stabilize. However, they ought to be cautious as the value of the dollar may depreciate leading to huge risks and cost. Besides, debt-issuing countries should not use this notion as a tool for formulating foreign policies and controlling economies.

References

Reinhart, C. (2017, Mar 30). *How to handle an oil shock*. Retrieved from Project Syndicate: https://www.project-syndicate.org/commentary/oil-producers-record-sovereign-debt-by-carmen-reinhart-2017-03