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DECODING THE OIL PRICE CRISIS – 2014

DR. SUSHMITA
ASST. PROFESSOR

SHAHEED SUKHDEV COLLEGE OF BUSINESS STUDIES
UNIVERSITY OF DELHI
DELHI

MOHD RUMMAN
STUDENT

SHAHEED SUKHDEV COLLEGE OF BUSINESS STUDIES
DELHI

HARSHIT BAJAJ
STUDENT

SHAHEED SUKHDEV COLLEGE OF BUSINESS STUDIES
DELHI

ABSTRACT

Oil, the liquid gold which has caused many of the modern wars and caused economic turmoil is now facing its own crises. The prices of oil fell by more than 40% in the second half of the last year. The liquid gold is losing its sheen. The paper is aimed to analyse the major factors which determine the prices of the oil and find the main reasons for the recent downfall in the Oil prices both real and speculative.

KEYWORDS

Iraq Turmoil, oil prices, oil demand and supply, speculation, shale production.

INTRODUCTION

Crude oil is a complex mixture of various hydrocarbons found in the upper layers of the earth's crust. Crude oil is often attributed as the "Mother of all Commodities" because of its importance in the manufacturing of a wide variety of materials. Crude oil accounts for 35% of the world's primary energy consumption. Crude oil is used to produce fuel for cars, trucks, airplanes, boats and trains. It is also used for a wide variety of other products including asphalt for roads, lubricants for all kinds of machines; plastics for toys, bottles, food wraps, among others. Global proven oil reserves in 2011 was around 1652.6 thousand million barrels, of which the OPEC had 1196.3 thousand million barrels. Crude oil accounts for 33% of the world's primary energy consumption. Global oil demand was 88.3 million barrels per day (mmb/d) in 2011, an increase of around 0.7% from the previous year. In 2010, Russia, Saudi Arabia, the US and Iran were the top oil producing countries. Although the US is the world's third largest oil producing nation, it is the world's largest consumer and importer of oil followed by China, Japan and India. Oil accounts for 29% of India's total energy consumption and there seems to be no possibility of scaling down the dependence on these fuels. Crude oil production during the period April-March 2012 (provisional) was 38.19 million metric tonne (MMT), as compared with 37.71 MMT during the corresponding period last year. The total oil consumption of the world in 2010 was around 3.34 mmb/d, and India is currently the fourth largest consumer of oil and imports more than 70% of its crude oil requirement.

Oil has played a crucial role in development of human civilization and has driven economies in a big way by acting as the most important source of energy and is a key component for industries. Oil has provoked political as well as economic tug-of-war between the developed countries – the largest consumers, and the OPEC countries – the largest producers. This, conflicting situation between monopolistic and monopsonistic forces have been the key factors for determining the price of oil. In recent times, emergence of some Asian countries as major consumers of oil has changed the global oil-based economic and political scenario. It has been deduced here that in a bilateral monopoly market between OPEC and DCs, the side which has less elasticity, will have lesser surplus. But, in a cartel monopoly market, the situation gets worse as there is no force to pressurise the supply side.

LITERATURE REVIEW

The Economist published an article titled 'Why the oil price is falling' (December 8th 2014). The article focuses on the fact as to why the oil prices fell by 40% within 6 months from June 2014. It attributes it to 4 major factors which are Low Demand due to weak economic activities and introduction of better technology or replacements, non-impact of turmoil in Iraq and Libya on their oil production, America emerging as a leading oil producer and Saudis and Gulf nations not cutting down their production. It also identifies US shale industry, Russia and Iran as the most vulnerable parties in this oil price downfall.

Brad Plumer in his article 'Why oil prices keep falling – and throwing the world into turmoil' (April 18th 2015) (www.vox.com) talks about the major causes of what is believed to be major causes of the oil price crisis of 2014. He in the first half focuses on how the demand supply mismatch has caused this fall. He focuses on the increasing production in United States and Canada from Shale formations and at the same time disturbances in Libya and Iraq. He also discusses about the weak demand from Asia and Europe due to slowdown in China and Germany and subsidy cuts in countries like Indonesia and Iran. The second half focuses on the OPEC response of not cutting down production and explores the impact of it on Russia, Iran, Venezuela, Saudi Arabia and US and its Shale Industry.

Talmiz Ahmad in his article 'Gulf stability and the oil supply scenario' (The Hindu) (November 17th 2014) discusses the Oil Price crisis of 2014. Apart from the economic explanation of the Demand Supply Mismatch he explores a political angle in it to. He delves into the possibility of a grand conspiracy involving Saudis deliberately keeping the prices low to hurt Russia, Iran and at the same time Shale Industry or otherwise another possibility being that even US is backing Saudi in its attempt to hurt Russia and Iran.

NEED AND IMPORTANCE OF STUDY

Keeping in mind the importance of crude oil as an energy source for fulfilling our daily energy requirements and acting as a base for driving future technological advancements it is important to study its production, demand and pricing. The issues related to oil prices acts as a relevant area for research studies and any major price fluctuations require critical analysis as it has both economic and political implications at the global level. With the recent slump in the oil price being observed it thus become a topic a research requiring a through analyses to explore the major causes behind this price crisis.

It is important to undertake this study to understand the implications of the crisis and take preventive actions. It would be impractical to predict future course of this turmoil without understanding its evolution.

GLOBAL DEMAND OF OIL

TABLE 1

Oil: Consumption							Change in 2013 over 2012	Share of Total (2013)
Thousand barrels daily	2008	2009	2010	2011	2012	2013		
Total World	86147	85111	87801	88934	89931	91331	1.4%	100%
of which: OECD	48085	46057	46509	46040	45545	45558	-0.4%	49.2%
Non-OECD	38062	39054	41292	42894	44386	45773	3.1%	50.8%
European Union	14710	13977	13827	13455	12946	12770	-1.9%	14.5%
Former Soviet Union	4040	3887	3984	4293	4434	4559	2.8%	5.1%

Source: www.bp.com

The balance between demand and supply of oil and gas industry has been falling since July of 2014, and many industry analysts have struggled to find a direction in the market. While, many anticipate the price of oil would rise again and seek any signs of their hopes-for increase; others can see no reason for a rise and explain that the low price of oil is now the new normal.

Months into the process of market rebalancing from the oil price collapse, one might be hoping for more clarity on supply and demand impacts. Yet, in some ways, the outlook is only getting murkier. That's in part because the backdrop against which the adjustment is playing out is constantly changing. Given deep changes in supply and demand in recent years, the way lower prices impact the market is also different from previous price corrections. That too is causing uncertainties, and not just about the response of unconventional North American supply to lower prices. The demand response has taken the market by surprise. Unexpected pockets of demand strength have emerged. Unexpected demand strength in crude and product markets has boosted refining margins in some of the very markets where demand had seemed to be the weakest.

Surging crude oil demand is being fuelled by strong economic growth, particularly in non-OECD nations. The U.S. Energy Information Administration projects that total world consumption of marketed energy is expected to increase by 44 percent from 2006 to 2030. Reduced spare oil production capacity leaves very little room to compensate for unanticipated supply disruptions or spikes in demand. The tenuous balance between supply and demand is even more of a concern when you consider that most of the world's oil is located in some of the more politically unstable parts of the world. As such, supply disruptions, whether real or perceived, can have dramatic effects on the price of crude oil.

TABLE 2

Oil: Proved Reserves	At End 1993	At End 2003	At End 2012	At End 2013	Share of Total	R/P Ratio
	Thousand Million Barrels					
Total World of which:	1041.4	1334.1	1687.3	1687.9	100%	53.3
OECD	140.8	247.5	249.6	248.8	15%	33.2
Non-OECD	900.6	1086.6	1437.7	1439.1	85%	59.5
OPEC	774.9	912.1	1213.8	1214.2	72%	90.3
Non-OPEC	206.3	325.2	342.6	341.9	20%	26
European Union	8.1	8	6.8	6.8	0%	13
Former Soviet Union	60.1	96.8	130.9	131.8	8%	26

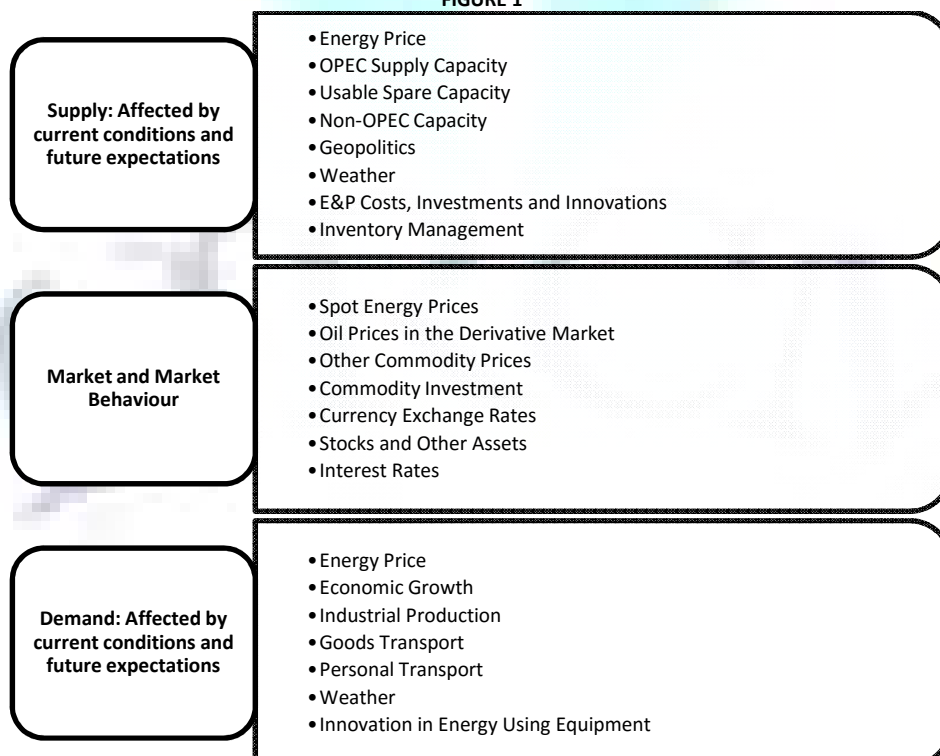
Source: www.bp.com

Global economic expansion is driving what the U.S. International Energy Agency (IEA) says is the biggest increase in oil demand in 24 years. In particular, energy consumption in the emerging economies of non-OECD countries is expected to increase by 73 percent between 2006 and 2030. All in all, that suggests the market rebalancing may still be in its early stage.

FACTORS DETERMINING THE PRICE OF OIL

The price of petroleum affects a variety of goods and services, because many economic activities use oil as an energy source. No one prefers to pay higher prices, but the global oil market is much more complicated than most people realize, and the price of oil is dependent upon many different factors.

FIGURE 1



❖ **OPEC (THE ORGANIZATION OF PETROLEUM EXPORTING COUNTRIES)**

OPEC, is a consortium of 13 countries: Algeria, Angola, Ecuador, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, the United Arab Emirates and Venezuela, is the single largest entity impacting the world's oil supplies. OPEC is responsible for 40% of the world's oil production, and sets policies among member countries to meet global consumption. OPEC can affect the price of crude oil, by increasing or reducing production among member countries. For example, the 2007 and 2008 increase in oil prices was due to reductions in OPEC production allocations in 2006.

❖ **SUPPLY AND DEMAND**

Global oil inventories balance supply and demand. If production exceeds demand, excess supplies can be stored. When consumption exceeds demand, inventories can be tapped to meet the incremental demand, and the relationship between oil prices and oil inventories allows for corrections in either direction. Non-OPEC suppliers produce 60% of the world's oil, and although they are 50% larger than OPEC, they don't have sufficient reserves to be able to control price and can only respond to market fluctuations. OPEC, however can directly influence market pricing, especially when the supply of oil produced by non-OPEC nations decreases.

❖ **RESTRICTIVE LEGISLATION**

As the majority of the world's oil reserves and production are controlled by government-run companies, the global oil market is heavily politicized and its functioning is far from that of a competitive market. Energy policies and taxes in oil-rich countries also affect the price of oil. If a government bans oil exploration in a place with proven reserves, such as the Gulf of Mexico, then commodity markets mark this as a "loss" in crude oil supply and gas prices go up as a result.

In India, gas prices can vary from state to state because central and state taxes account for an average of 15% to 33% of the price you pay at the pump. Also, in the United States, gas prices can vary from state to state and city to city because state and local taxes account for an average of 11-12% of the price you pay at the pump. Other factors that affect the price of gasoline include local retail competition, proximity to gasoline suppliers, and environmental regulations.

❖ **POLITICAL UNREST**

If an oil-rich area becomes politically unstable, supplier markets react by bidding up the price of oil so that supplies are still available to the highest bidder. In this instance, only the perception of a shortage in supply can increase prices, even while production levels remains constant.

❖ **PRODUCTION**

The location of reserves, the amount and properties of oil found, the geological formation in which the oil is found, and the costs of extraction are all determined by physical factors. As oil is a non-renewable natural resource, physical factors significantly affect the cost of supplying oil from a particular reserve. In addition, substantial investment is required to continuously discover new reservoirs and to develop them.

❖ **FINANCIAL MARKETS**

Oil brokers match buyers and sellers of crude oil, and trade contracts for future delivery of oil, known as "futures". Clients purchase futures to hedge against oil price increases that could adversely affect their profitability. Oil producers sell oil futures contracts in order to lock in a price for a specific period of time and oil brokers purchase oil futures to promise future delivery of oil at a certain price. Conclusively, financial markets plays a vital role as a deciding factor for determining the oil prices.

❖ **WEATHER**

Like most commodities, seasonal changes in weather affect the demand for oil. In the winter, more heating oil is consumed, and in the summer, people drive more and use more gasoline. Even though markets know when to expect these increased demand periods, the price of oil rises and levels out with the season every year. Extreme weather conditions (hurricanes, tornadoes, thunderstorms) can physically affect production facilities and infrastructure disrupting the supply of oil and induce pricing spikes.

❖ **SPECULATIVE BUYING**

Speculative buying creates a varying cost for oil based products as speculators buy and sell futures contracts on the open market. Oil speculation also leads investors to purchase more contracts when negative tensions enter the oil market. In 2008, it was thought that speculators were bidding up oil prices and creating an unsustainable price level (up to \$140/barrel). By late 2009, prices fell to \$30/barrel because the demand was not present to support the inflated price level.

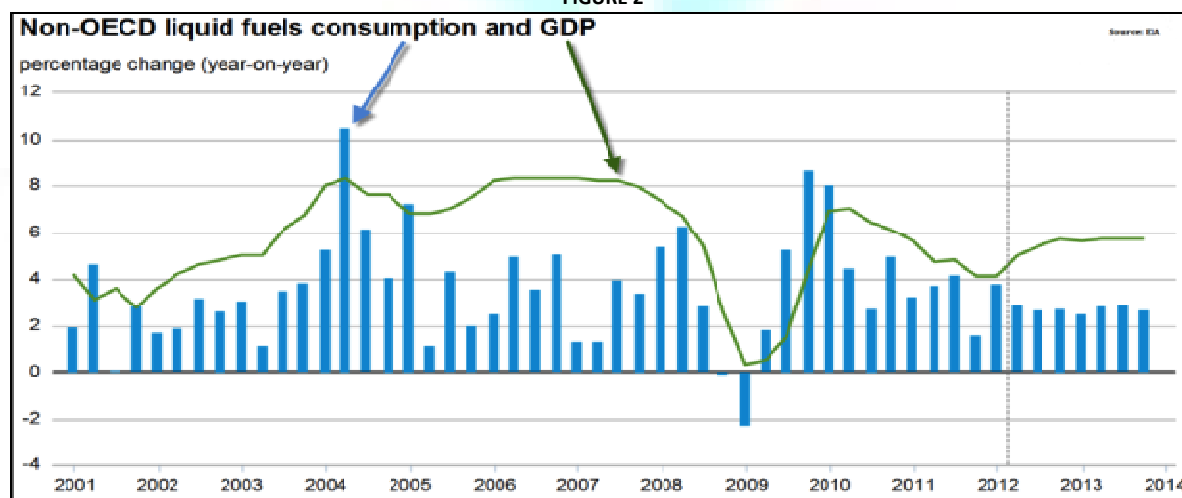
❖ **EXCHANGE VALUE OF THE DOLLAR**

Oil is traded and sold internationally in US dollars. Dollar depreciation generally tends to increase oil demand and raise the price of oil. Conversely the strengthening of the dollar reduces real income in consumer countries, decreasing the demand for oil and lowering prices.

❖ **NON-OECD DEMAND**

Oil consumption in developing countries that are not part of the Organization of Economic Cooperation and Development (OECD) has risen sharply in recent years. While oil consumption in the OECD countries declined between 2000 and 2010, non-OECD oil consumption has increased more than 40 percent. China, India, and Saudi Arabia have had the largest growth in oil consumption among non-OECD countries during this period.

FIGURE 2



Source: EIA

With oil's stature as a high-demand global commodity comes the possibility that major fluctuations in price can have a significant economic impact. The two primary factors that impact the price of oil are:

- ❖ supply and demand
- ❖ market sentiment

The concept of supply and demand is fairly straightforward. As demand increases (or supply decreases) the price should go up. As demand decreases (or supply increases) the price should go down.

But in case of oil, supply and demand are quite complicated, the price of oil as we know it is actually set in the oil futures market. An oil futures contract is a binding agreement that gives one the right to purchase oil by the barrel at a predefined price on a predefined date in the future. Under a futures contract, both the buyer and the seller are obligated to fulfil their side of the transaction on the specified date.

Oil peaked with the commodities index in both 1920 and 1980. It is important to note that supply, demand and sentiment take precedence over cycles because cycles are just guidelines, not rules.

Unlike most products, oil prices are not determined entirely by supply, demand and market sentiment toward the physical product.

Rather, supply, demand and sentiment toward oil futures contracts, which are traded heavily by speculators, play a dominant role in price determination. Cyclical trends in the commodities market may also play a role. Regardless of how the price is ultimately determined, based on its use in fuels and countless consumer goods, it appears that oil will continue to be in high demand for the foreseeable future.

REASONS FOR RECENT FALL IN OIL PRICE

In the recent times the prices of oil have fallen substantially. The prices were more than \$115 a barrel in June 2014 and it fell to below \$50 in December 2014, which translates to a fall of more than 40%. This has happened after stability for more than 3 years. Even at OPEC (Organisation of Petroleum Exporting Countries) meeting in Vienna on November 27th the Organisation, which controls nearly 40% of the world market, failed to reach agreement on production curbs, sending the price further tumbling. Also hard hit are oil-exporting countries such as Russia (where the rouble has hit record lows), Nigeria, Iran and Venezuela. The question arises why is the price of oil falling?

As we have seen above that the oil price is partly determined by actual supply and demand, and partly by expectation. Demand for energy is closely related to economic activity. Supply can be affected by weather (which prevents tankers loading) and by geopolitical upsets. As far as the expectation is there if producers think the price is staying high, they invest, which after a lag boosts supply. Similarly, low prices lead to an investment drought. OPEC's decisions shape expectations: if it curbs supply sharply, it can send prices spiking.

The reason for the current scenario can be categorized to two broad heads:

- ❖ Demand Supply Mismatch
- ❖ Grand Strategies

DEMAND SUPPLY MISMATCH

There has been a demand supply mismatch in the oil market in a sense that the demand for oil has been falling and the supply increasing that is a deficit in demand and a surplus in supply which resulted in the oil prices spiralling down.

REASONS FOR FALL IN DEMAND

❖ Negative European Growth Outlook

The EU economy has not yet recovered from the sovereign debt crisis and the growth forecasts not very strong; this has resulted in a weak demand from EU in the recent past. The EU economy is expected to enjoy a short-term boost from falling oil prices. According to the European Commission's economic winter forecast, the EU's GDP growth is expected to rise from 1.3% in 2014 to 1.7% this year, thanks in part to cheaper oil. But the economic impacts of the oil price fall are complex and as well as include some negative consequences like, by pushing consumer price levels down, the fall in oil prices could lead indirectly to lower wage growth and decreased investment in the oil sector.

❖ Economic Slowdown in Japan and China

Japan being the 3rd largest oil importing country in the world with imports of 4,394,000 bbl. /day was faced by an economic turmoil and slowdown which impacted directly on the global oil prices due to a lower demand. Abenomics, a strategy introduced by Japanese Prime Minister Shinzo Abe will play a vital role in deciding the path of global oil prices if it boosts the oil demand to the expected level. China's national growth projected at around seven per cent per year, thus an increase in oil demand is negligible.

❖ A subsidy cut in the Asian Countries

Prominent Asian countries reduced the subsidy on oil prices during the last 2-3 years, which resulted in the shift of burden on the consumers which conclusively reduced the total oil consumption in these regions. Hence, collectively lowering the global oil consumption.

❖ Domestic Production in USA

Post the global recession the demand has not seen major strides. Along with that the US oil demand in the international market has reduced to increase in domestic production especially with the increasing shale oil production.

Demand is low due to weak economic activity. The global economic slowdown is the principal culprit. Along with this increased efficiency and a growing switch away from oil to other fuels due to increased focus on sustainability, green development and environment.

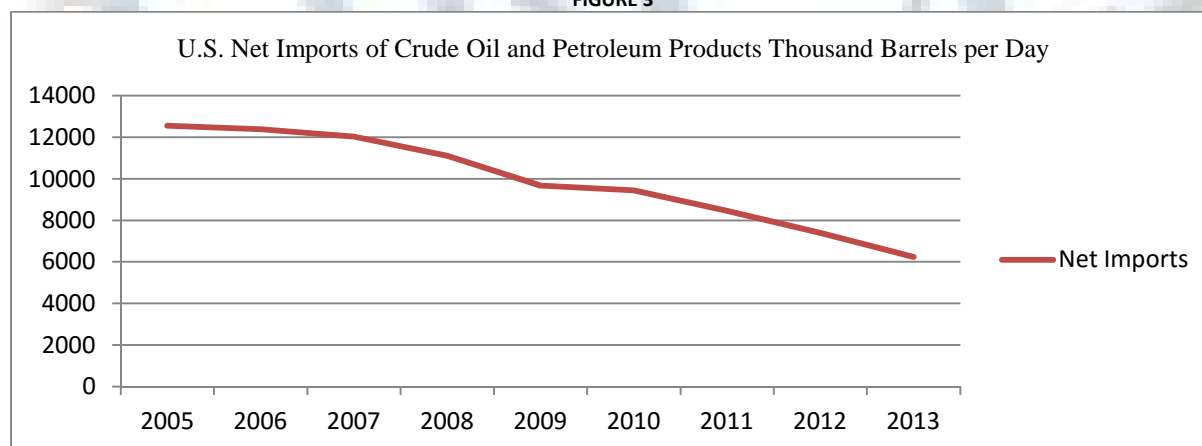
REASONS FOR RISE IN SUPPLY

❖ Shale Production in USA

The rise of US shale gas supply had the effect of displacing coal in favour of gas for US power generation in the last few years, despite the US having the world's largest reserves of coal.

Consequently, US coal has found its way into European markets, where its relative low price coupled with low carbon prices has made it more competitive in power generation than gas.

FIGURE 3



Source: EIA

Thereby, emerging as the biggest market changer is shale oil production in the United States: with additional production of 3.9 million barrels a day (MBD), the U.S. now produces more than all OPEC members except Saudi Arabia. Though it does not export crude oil, it now imports much less, creating a lot of spare supply.

❖ Increased Production Iraq and Libya

Iraq is now the second largest oil producer in OPEC, with Iraq & Libya's oil production averaging at 2.9 million bpd in the year 2014. This created a situation of oversupply, which ultimately resulted in disturbing the balance of demand and supply and affecting oil prices. Another reason for this to have a major was the expectations. With the political disturbances in the region it was expected that the supply from both the countries would fall but in reality the supply increased to counter the turmoil in Libya and IS increased the production from captured wells in Iraq to fund their rebellion.

❖ Saudi's Reluctance to cut production

Saudi Arabia has showed its reluctance to cut production in the OPEC meet citing the reason that it would lose its market share as it happened in the last oil crisis when they agreed to cut production.

Not only have the Organization of the Petroleum Exporting Countries (OPEC) members not effected cuts in their production, additional production has also come into the market from member-states experiencing domestic turmoil — Libya and Iraq — which have had record exports. With the central government and the Kurdish regional government in Erbil reaching the agreement towards the supply of Oil, it will increase production to raise more money to fight ISIS and US has also entered the oil supply market.

It seems low prices will continue next year due to low demand and high shale oil production and we now have "a new chapter in the history of oil markets." Even with the most optimistic of the predictions does not show prices to go beyond \$95 a barrel in the next 1-2 years.

GRAND STRATEGIES

Another scenario which seems to be coming up is that Saudis and their Gulf Allies and deliberately not taking any action to curb the oil production and letting the price fall continue. They do not want any impact on their own market shares. Saudi Arabia can tolerate lower oil prices quite easily. It had around \$900 billion in reserves when the oil prices started tumbling. Its own oil costs very little (around \$5-6 per barrel) to get out of the ground. But all the countries with a major dependence on oil revenues would be seriously affected by the low prices which include the countries detested by them: Russia and Iran. It seems that the U.S. and Saudi Arabia have arrayed against Russia and Iran. The west is of the belief that this economic pressure caused by the low prices may force them to act in a more accommodative way in their engagements with western interlocutors. It seems that a scenario of a global oil war emerging.

Russia's intrusion into the Ukraine in February 2014 and the ensuing annexation of the Crimea have been prompted by energy and geopolitical factors. The energy factors are that 50% of Russia's gas and oil supplies to the European Union (EU) are piped through the Ukraine. It is in Russia's energy interests to make sure that the gas and oil pipelines transiting the Ukraine are well defended not only against sabotage but also against the Ukraine making use of the gas without paying for it. Ensuring that there is a pro-Russian government in the Ukraine becomes a very important Russian national interest. There is, however, a geopolitical dimension. The Ukraine has become like a chess pawn in a grand chess game being played by the United States and the EU with Russia. At the heart of the Ukraine-Russia crisis is the EU's attempts incited and abetted by the United States to draw the Ukraine away from Russia into the EU and eventually into NATO, thus bringing NATO to the borders of Russia. Having failed to achieve their aim, the EU supported by the US instigated internal strife in the Ukraine which ended with the ousting of the legally-elected president and eventually the annexation of the Crimea. If the conflict between the West and Russia continues to escalate, an oil and gas embargo could be one of the sanctions that is considered against Russia. Even before the current tension with the West over the Ukraine, Russia was in the process of reorienting its energy posture to Asia in view of the growth in energy demand in that continent and the likely stagnation or decline of demand in Europe over the next few decades.

Russia's Gazprom and China's CNPC has finally signed a historic gas deal which will provide the world's fastest growing economy with the natural gas it needs to keep pace for the next 30 years. The total value of the contract is \$400 billion signed in May, 2014. One of the major factors impacting is Russia and China's progressing friendly relations. Despite of sanctions imposed by the west, this deal showcased that Russia could not be isolated.

However, whatever the neo-cold warriors in Washington may hope for, both Russia and Iran are known to be resilient and unlikely to compromise their established foreign policy positions only on account of falling oil prices. In fact, the adverse circumstances are likely to encourage domestic tenacity and greater camaraderie between the two beleaguered nations.

Optimistic thought is economic pain may make these countries more amenable to international pressure. Pessimistic one is that when cornered, they may lash out in desperation.

The other scenario sees a deliberate Saudi attempt to retard the further development of the shale oil industry in the U.S., to dent its production capacity which is crucially dependent on high oil prices of \$80-90 per barrel to sustain production. It is known that oil firms have committed investments of over a trillion dollars in projects based on oil prices at \$95 for them to be viable including include Western oil companies with high-cost projects involving drilling in deep water or in the Arctic, or dealing with maturing and increasingly expensive fields such as the North Sea.

However the above scenario seems unlikely as, while low prices may put medium-term U.S. production in jeopardy, this is hardly a deliberate Saudi ploy. The Kingdom is well aware that shale oil has in fact stabilised world markets at a time of acute turmoil in oil-producing countries. For this reason it has repeatedly welcomed new production sources, particularly since unconventional production boosts the demand for fossil fuels and reduces investments in renewables. Also going against a military giant like Russia without any backing or assurance from any super power including USA is an unlikely scenario.

Looking through another perspective to this situation, with the almost 20% drop in oil prices, we also have been wondering why Saudi Arabia suddenly has become so dovish — actually saying, in the face of recent price declines, that it has at least 3 million barrels a day in spare capacity it can dump on the market. Perhaps not coincidentally, that's about how many barrels Iran sells on the world market each day. As oil nears \$50 a barrel, the Saudis' comments make sense only if one supposes they want to punish Iran — where oil output has been dropping sharply, and which desperately needs hard currency from oil sales to buy weapons and nuclear know-how. While keeping in mind that Oil provides Iran nearly 90% of its budget and 40% of its GDP. To say it is the lifeblood of Iran's economy is an understatement. Without oil revenues, the government might collapse.

With the OPEC meeting in Vienna on November 27th the Organisation having failed to reach the conclusions/ consensus and the market being more optimistic about geopolitical risk the end is not in sight.

What happens in the long term and how the prices stabilize and which strategy works only time can tell?

CONCLUSION

Unlike most products, oil prices are not determined entirely by supply, demand and market sentiment toward the physical product. Rather, supply, demand and sentiment toward oil futures contracts, which are traded heavily by speculators, play a dominant role in price determination. Cyclical trends in the commodities market may also play a role. Regardless of how the price is ultimately determined, based on its use in fuels and countless consumer goods, it appears that oil will continue to be in high demand for the foreseeable future.

The recent fall in the oil prices has been caused by a mismatch in the demand and supply. A falling demand caused by slow economic growth especially in China & Europe; excessive supply from Iraq, no production curbs from OPEC and increasing domestic production of U.S.A.. Another reason is Saudi's deliberately letting prices fall, to hamper economy of Russia & Iran and destroy economic viability of Shale production.

Sanctions against Russia will therefore fail as they mostly failed against Iran whose economy is 18% of Russia's economy in size. It would be a huge technical and economic endeavour to find an alternative source for Russia's gas and oil supplies to the EU with Germany being most vulnerable to Russia's whims. And whilst some oil supplies could partially replace Russian oil supplies to the EU, it will impact on the global oil price since replacement could only come from the Arab Gulf suppliers whose production is virtually committed to the Asia-Pacific region.

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